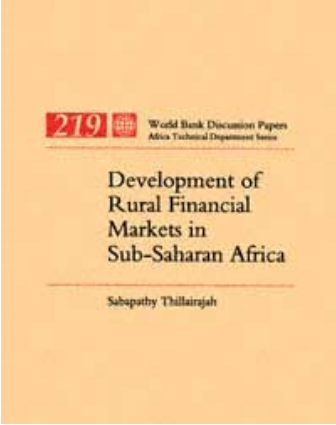

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Sabapathy Thillairajah

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Sabapathy Thillairajah has retired from the World Bank. At the time this paper was written, he was principal financial analyst in the Environmentally Sustainable Development Division of the Africa Technical Department of the World Bank.

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Contents

Foreword

This report synthesizes the experience with rural financial markets within and outside Africa. The objective is to help policymakers, project designers and others engaged in the development of these financial markets. The report's focus is on policies and programs that have worked rather than on those that have not been successful.

The World Bank's approach to the financial sector and rural credit recognizes that an increase in the supply of credit alone is not sufficient to ensure economic growth. More important is an appropriate macro−economic and agricultural policy environment. However, this report finds that the existence of efficient financial systems where the rural poor can save and borrow freely contributes to the development process. The sustainability of special financial market and development schemes and the financial viability of the institutions involved is key to ensure success. Success also depends on forging collaboration between formal financial institutions and the informal ones so as to increase access by rural people to a variety of financial instruments and services.

The report advocates mobilization of household savings as the prime source of rural credit. It reiterates the importance of ensuring the financial viability of lending institutions, and recommends caution in relation to directed/targeted credit. It supports the maintenance of flexibility in interest rates and lending margins so as to enable greater competition among savers, depositors, lenders and borrowers. State ownership and bureaucratic interventions should be minimized.

While the recommendations of this report might not find general acceptance, it is hoped that the further discussion and debate of its contents would contribute to the development of sustainable rural financial markets in Sub−Saharan Africa.

KEVIN CLEAVER
DIRECTOR
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Abstract

The World Bank report, *Sub−Saharan Africa, From Crisis to Sustainable Growth, A Long−Term Perspective Study, 1989* has targeted an annual growth rate of 4 percent for the countries of Sub−Saharan Africa. This ambitious target also relies on agriculture as the main foundation and engine of growth. A very strong rural financial system and self−sustaining institutions should be integral parts of the enabling environment needed for such economic growth.

Over the last two decades, the efforts of governments and donor agencies to provide agricultural credit, targeted and often subsidized, have at best produced only mixed results, in terms of outreach and impact at the borrower's level. But the performance of the participatory institutions, the parastatal lending institutions in particular, has been disappointing. Undue reliance on external sources of funds, and subsidies provided in various forms contributed to the weakening of these financial systems, making most of the sponsored special credit schemes

unsustainable.

The World Bank's approach to financial sector and rural credit has evolved over time. The more recent Bank−supported credit operations in Sub−Saharan countries have been in the context of a process of financial sector reform in which market distortions could be minimized, and where the emphasis has been on the operational autonomy and financial viability of the participating institutions; their self−sustainability in terms of resources for lending; their capacity to undertake effective loan portfolio management to ensure satisfactory loan repayment performance, and to offer cost−effective and competitive financial services.

This report attempts to synthesize the promising elements in rural finance operations reviewed in countries within and outside Sub−Saharan Africa, with the focus on savings mobilization, improving loan portfolio management, reducing transaction costs etc. The experiences reviewed point to the relatively successful performance of the informal sector, particularly financial cooperatives, group finance and trade finance, and the promise it holds through possible greater integration with the formal financial system for the development of viable rural financial markets in Sub−Saharan Africa.

Preface

This report is a Regional overview drawn from several country case studies intended to stimulate further research and discussion in the countries of Sub−Saharan Africa (SSA),* the donor community and the World Bank itself. The Study Team benefited immensely from the knowledge and views of researchers, professionals and practitioners familiar with rural finance issues and experiences within and outside SSA countries. While the report reflects the combined wisdom of the Study Team, it has not been possible to reach consensus on contentious issues which are likely to engage the attention of policymakers and professionals for some time to come.

The study draws on the experience and lessons from several countries, but does not attempt to summarize all the findings in the country studies. Rather, it is an attempt to synthesize the relevant experiences and aspects. It is the hope that these findings would help in understanding the special situation and prevailing circumstances contributing to instances of success. The lessons would enhance the ability of policy−makers, professionals and practitioners to decide on optimal strategies, and to prepare future operations most appropriate to their respective country circumstances and hopefully assist in defining desirable design features of successful programs that could be replicated elsewhere. Attempts to replicate successful experiences should, however, be made with great caution, after careful analysis of prevailing circumstances in the different situations.

Undertaken at a time of extensive search for new initiatives to stimulate economic growth in Africa, the study represents another attempt to develop systematic and analytical knowledge based on the prospects and problems of developing sustainable rural financial markets. The Study Team took care to review both cautionary experiences as well as the successful ones. Though the insights gained are considered valuable to governments and aid agencies alike, the primary audience would be the World Bank's Africa Regional Staff engaged in rural finance related lending operations. The successful experiences and the lessons to learn would hopefully also stimulate debate among donors and serve as practical guidelines for optimal policies, strategies and best practices that could be adopted. Although many of the problems of Africa are, to a large extent, not specific to the continent, generalizations, based on selected cases and isolated situations, are fraught with pitfalls.

The World Bank has improved its lending strategy, learning from its own experience, and from those of client countries and donors, as well as from regional studies, country sector work and other special studies such as *Sub−Saharan Africa: From Crisis to Sustainable Growth, A Long Term Perspective Study.* This Rural Financial Markets (RFM) study would thus be a logical follow−up to:

(a) The Bank's *World Development Report 1989;*

(b) The Bank's Policy on Financial Sector Operations, as approved by the Board on July 11, 1991.

* The acronym SSA, as used in the text, refers to Sub−Saharan Africa.

(c) The Bank's Operational Directive 8.30 on Financial Sector Operations;

(d) The implementation of the Long−Term Perspective Study; and

(e) The Bank's *Strategy to Develop Agriculture in Sub−Saharan Africa, 1992.*

Thus the primary objectives of this study are to:

(a) Provide a systematic and critical assessment of the development of rural financial markets in Sub−Saharan Africa;

(b) Synthesize the lessons learned from experiences, within and outside SSA, on design, implementation, impact and modification of rural finance policies and practices;

(c) Identify the policies, institutional set−up, instruments, procedures, systems, and practices which have proved successful;

(d) Identify special principles, features, circumstances and other factors which have contributed to the better performance of the successful cases; and

(e) Highlight the safeguards to be taken in attempting to replicate successful experiences and promising programs.

The study is not intended to be a comprehensive review of every SSA country or even the various rural credit and savings programs in the countries selected for case studies or as reference cases. In reviewing the experiences, lessons from positive rather than negative features are stressed, in the hope that they will assist in the further development of rural financial markets in SSA. The study's emphasis is on the need for the development of self−sustaining rural financial institutions.

Financial systems can play a major role in harnessing domestic resources to finance investments. Financial policies followed over the last two decades have left financial institutions insolvent in many countries. The financial systems in several of these countries are in the process of being restructured as part of their financial sector reforms. The past approach of pervasive government intervention in the financial system to promote economic growth is also being revisited and revised, with greater reliance being placed on the private sector and on market forces. This trend would in due course result in a more limited role for governments in the allocation of credit, determination of interest rates, and the day−to−day operation of financial intermediaries. The reform of the financial sector and the restructuring of the constituent institutions provides a unique opportunity to chart out a realistic program for the development of rural financial markets. The study reviews the lessons of experience and tries to identify the measures that could be made to work by mobilizing and allocating resources to the most profitable investments. Some of the lessons are cautionary emphasizing the DON'Ts − others are salutary pointing to the DOs.

Chapter 1 of the study explains the emphasis placed on rural financial markets development, on financial intermediation, on the financial viability of lending institutions and sustainability of the financial systems,

including the informal systems, serving rural households and enterprises. Chapters 2 and 3 present a summary description of the financial systems, and rural financial services with special reference to SSA countries. The importance of interest rates, transaction costs, and risk management are discussed in Chapter 4. The role of governments and aid agencies is the theme of Chapter 5. Lessons of experience, drawn from the country cases and special reviews as well as initiatives with potentially the greatest probability of success, and viable options for the sustainable development of rural financial markets are summarized in Chapter 6. The key issues identified in the course of study are recapped in Chapter 7 and findings and recommendations are summarized in Chapter 8.

The study is operations oriented and the concentration has therefore been on reviewing experiences. It does not attempt to engage in policy analysis or to discuss other important aspects such as the links to macro−economic issues or important financial sector issues such as capital market development which are dealt with in other financial sector studies and reform programs.

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This report has been prepared by Sabapathy Thillairajah (Principal Author) with contributions from a Study Team comprising of Sakwa J. Bunyasi, James H. Coates, Nwanze Okidegbe and Ousmane Sissoko. The Team was assisted by consultants financed by the Finnish, Japanese and Swedish Trust Funds. Professional guidance was provided on a continuing basis by members of a Steering Committee and a Technical Advisory Panel (List in Appendix 1).

The Study Team has been privileged to work on these rural finance issues with a diverse group of specialists, both within and outside the World Bank. Thanks are due to the members of the Study Steering Committee and the Technical Advisory Panel for all their guidance provided throughout the Study, as well as to the several colleagues and the external reviewers for their critical and constructive comments. The list of people to thank include the many with whom the Study Team have interacted during the entire process. They have been a great source of genuine support and encouragement each step of the way. The contribution from all these and several other specialists who have read, reviewed and commented on earlier drafts, providing constructive feedback, is acknowledged with deep gratitude. In preparing this report, the Study Team also utilized inputs from several multilateral and bilateral agencies, NGOs and research institutions (lists in Appendixes 2 and 3). The completion of the study is a result of the strong commitment and support given by Kevin Cleaver, Chaim Helman and Pierre Landell−Mills. Thanks are also due to Mmes. Gemma Abarcar, Yanick Brierre and Caroline Boyer de la Giroday who helped to type and desktop this report.

It should also be emphasized that this overview report is not intended to reflect a consensus of views on the issues covered. It would be too ambitious an endeavor to expect such consensus on some aspects which have been the subject of controversy for more than two decades. The responsibility for the findings, conclusions and recommendations in the report is entirely that of the Study Team and should not be attributed in any manner to the World Bank or any of the other institutions or individuals who provided assistance.

Acronyms

ACCOSCA	African Confederation of Cooperative Savings and Credit Associations
ADB	African Development Bank
AFRACA	African Regional Credit Association
CB	Commercial Bank
CCCE	Caisse Centrale de Cooperation Economique
DANIDA	Danish International Development Agency
DFI	Development Finance Institution
FAO	Food and Agricultural Organization of the United Nations
FINAFRICA	Center for Financial Assistance to African Countires
FINNIDA	Finnish Department of International Cooperation
GTZ	German Agency for Technical Cooperation
IBRD	International Bank for Reconstruction and Development
IDA	International Development Agency
IFAD	International Fund for Agricultural Development
IFPRI	International Food Policy Research Institute
ILO	International Labor Organization
LTPS	Long−Term Perspective Study
NABARD	National Bank for Agriculture and Rural Development
NBFI	Non−Bank Financial Institutions
NGO	Non−Governmental Organization
ODA	Overseas Development Administration (United Kingdom)
OSU	Ohio State University
POSB	Post Office Savings Bank

RFM	Rural Financial Markets
ROSCA	Rotating Savings and Credit Association
SACA	Smallholder Agricultural Credit Administration
SME	Small− and Medium− Scale Enterprises
SSA	Sub−Saharan Africa
UNDP	United Nations Development Program
USAID	United States Agency for International Development
WOCCU	World Council of Credit Unions

Executive Summary

Several financial sector studies have focused on the key problems, prospects and issues in rural finance in SSA countries (mainly Benin, Ghana, Kenya, Madagascar, Malawi, Niger, Nigeria and Tanzania) the failure of directed credit programs, weak deposit mobilization performance, and limited access to financial services by households and enterprises. Although it is relatively easy to document the symptoms and identify the causes of failures in rural finance, the material seems to be less abundant on successful and promising experiences. This Rural Financial Markets (RFM) Study therefore emphasizes drawing lessons from successful and promising experiences in SSA and elsewhere that might help develop rural financial markets in the SSA countries.

This study relies upon existing literature and draws heavily on the personal experiences of several researchers, practitioners, and professionals with whom the Study Team has been able to establish contact to identify cases, and to establish plausible causes of success among rural financial systems and mechanisms in SSA and elsewhere. The study uses a comparative approach to focus on the factors underlying the success of certain mechanisms in other regions that have failed in SSA, and the opposite. Why is it, for example, that credit unions show a remarkable performance in several SSA countries, while they have generally failed in Latin America and showed mixed results in Asia? Why is it that informal financial groups [such as Rotating Savings and Credit Associations (ROSCAs) and money−keepers appear to be much more prevalent in SSA than in Latin America and even in South Asia where informal finance is predominant in rural areas? Why does informal finance appear to be far more integrated with the formal sector in East Asia and Latin America, while market segmentation is marked in SSA countries?

In reviewing the experiences in specific country cases, the study examined the operation of credit schemes in the absence of conventional forms of collateral, collateral substitution or collateralization, the nature and avenues for savings, additional potential available for tapping, as well as past and present policies impacting on savings and credit availability. Experiences of administrative interventions through interest rates ceiling and resource allocation, as well as the many innovations and pilot programs aimed at disadvantaged sectors were similarly considered in all country case studies. The rural sector is comprised mostly of private sector constituents − farmers and other small−scale entrepreneurs − who are both providers and users of funds. Mutual self−help groups, including registered multi−purpose as well as financial cooperatives and clubs, comprise significant segments of the rural financial markets in SSA countries.

The World Bank's approach to the financial sector and rural credit has evolved over time. There has been growing

recognition that increasing the supply of credit alone is not sufficient to achieve economic growth, and that an increase in production/ productivity is not an adequate measure of the success or otherwise of policy−based lending. Ensuring the viability of the lending institutions is one way of improving the chances of success of credit schemes. Financially viable institutions provide better services over the long haul than non−viable and illiquid institutions uncertain of their future. The sustainability of special schemes and the financial viability of institutions involved are therefore essential to ensure continuity − unviable programs die, often carrying with them me lending institutions.

The World Bank has set a target annual agricultural growth rate of 4 percent for SSA. Agriculture accounts for up to 90 percent of national per capita income in some SSA countries, and the vast majority of Africa's poor is located in the rural areas. Agriculture also forms a large and vital part of the economy in SSA countries, accounting for a high proportion of their Gross Domestic Product (GDP), employment, and raw material input for their manufacturing sectors. Small−scale farmers are the backbone of the rural sector in these countries. However, smallholder farmers have for the most part been locked out of the formal financial systems, particularly for their credit needs, primarily due to the lack of bankable collateral, high administrative costs, and perceived high risks associated with agriculture and smallholders.

Agriculture in SSA is inherently a private sector endeavor, either directly as farming or indirectly as related processing, marketing and other off−farm activities. Support for private entrepreneurship and risk−taking in the agricultural sector and micro−enterprises should be supported actively through sustainable credit operations which should help financial intermediaries to reach a larger number of rural households including smallholders and women. Such operations should be undertaken in the context of financial sector reforms designed to improve the allocative efficiency of financial intermediation. Liberalization of interest rates, reduction of credit rationing by governments, strengthening of credit institutions, and improvement of collection rates are objectives that should figure prominently in this agenda.

Achieving these objectives is linked to building on the successful lessons learned from completed and ongoing operations and special programs. The study draws on some of the successful experiences in countries within and outside the SSA, in the hope that this would provide some guidance to operational task managers, policymakers, and practitioners. It is important to focus on country−specific sector work to design and develop strategies for the future, with emphasis on the type of programs that should be supported and on successful approaches that could be replicated. Greater efforts are needed to liaise closely with other donor agencies, to share experiences and strengthen through careful coordination, the effectiveness of development assistance to the rural sector.

Government has a legitimate role to play as a catalyst of economic growth and in developing the financial sector. However, specialized credit or policy−based lending has failed because of too much governmental presence and the lack of its commitment to enforce loan repayments. In SSA, agricultural credit operations dependent on parastatal banks and specialized government institutions have often been failures, due in part to politicization, resulting in low loan recovery, mounting non−performing portfolio, and heavy losses suffered by the participating financial intermediaries.

Many of the past agricultural credit programs relied on subsidies intended to enhance agricultural production, growth, adoption of improved technologies, and so on. It has, however, become evident from the experience over three decades that cheap credit has often failed to achieve the designed objectives. Because of subsidized interest rates, high transaction costs and increasing loan losses, financial intermediaries had to rely on state subventions to sustain operations, although only a few state−owned controlled institutions, and sponsored credit programs have succeeded in sustaining their operations. Generally, it has not been possible for financial institutions which have either been established or mandated to implement special credit programs to become sustainable financial institutions.

Programs have not always been successful in reaching the targeted population, the benefit of explicit and implicit subsidies having been often captured by affluent borrowers. Subsidies

would not be required if the prices of inputs and outputs are market determined−subsidies can, in fact, slow down development. Such state−sponsored programs are also becoming an unmanageable drain on the government budget, already resource−starved, for the most part. Furthermore, pervasive administrative intervention interferes with the natural development of financial markets. Thus, the support through subsidies cannot be expected to have a significant effect over long periods of time.

Profits revealed in conventional profit−and −loss statements are not necessarily indicative of the financial viability of lending institutions — particularly if they are state−owned or controlled (parastatal) because contributions to equity capital and long−term loans are generally not adequately serviced. Funds given for on−lending at below market rates, subvention payments towards administrative costs, and restitution of loan losses under state−funded guarantee schemes etc. would significantly distort the picture.

There is enough evidence to suggest that rural credit from the formal financial institutions is minimal — less than 10 percent — in most SSA countries, and it is the more affluent farmers who probably have greater access to formal credit sources. On the other hand, there is evidence of widespread participation in the informal financial markets. It is also apparent that formal and informal lenders are non−competing and that borrowers do not have equal access to all credit sources, particularly in the formal financial sector. Some do not borrow because they do not have access to credit sources on acceptable terms. Probably many more do not wish to be in debt and therefore do not want to borrow. Some do not have the need to borrow, because they have the funds adequate for their needs, and yet others have no felt need to borrow, nor have a worthwhile activity to be financed from borrowed funds.

A well−established and smoothly functioning informal group savings and credit system exists in almost every SSA country, playing a crucial role in its savings−investment processes. The essentially spontaneous emergence of these groups constitutes part of the reason for their sustainability. The success of these groups depends on their structural form: their self−selected and voluntary participation, autonomy and self−reliance; and their service delivery mechanisms: low transaction costs, convenience, flexibility and trust. An oral promise is frequently all that is needed as collateral or security. Confidence, trust and mutuality are the cornerstones on which the lending and borrowing relationships are established. A person's image or reputation is paramount in this voluntary, mutualist, self−help group relationship.

The group approach emphasizes the savings habit as a way to accumulate money for future production and consumption needs. Women often find this to be a great motivation for participation. The group savings approach appears more likely to succeed than those centered on individuals: group schemes make it possible to save without appearing selfish. Some of these features, at the root of ROSCAs, Tontines and Susus, would merit adaptation by formal financial institutions. Group−based savings and credit systems also tend to work more smoothly among the rural poor, and particularly among women. Some studies suggest that the informal sector grows and adapts itself to changing situations without losing its major characteristic of flexibility, thus remaining strong at all times.

There seems to be considerable promise in using group liability as a substitute for conventional collateral and to control and minimize administrative costs. Employing groups as a service delivery mechanism helps to lower transaction costs for depositors, borrowers and intermediary lenders. Groups also provide a relatively inexpensive source of funds for formal financial institutions and serve as a self — monitoring mechanism for loan repayments. In a

close−knit homogeneous group there would be a great deal of peer pressure on defaulting individuals — if one member of the group fails to pay, the rest of the group may be denied further credit. Joint liability undertaken by groups thus serves as an effective substitute for traditional forms of collateral.

While groups offer many advantages, some in−built limitations should also be recognized. Groups too small in number may not be practical or useful for joint liability, and larger groups might not be homogeneous enough to be cohesive. Larger groups would necessitate costly organizational and procedural control mechanisms to ensure probity and to function effectively and smoothly. There would also be significant costs involved in group formation and management. Self−selection of group members, so critical to the success of group functioning, dependent on trust, shared characteristics, ethnic background, common residential location, and collective responsibility, becomes difficult and problematic if the groups have to be very large. Not much data is available on linking informal finance with formal financial systems in the countries studied. Care would be needed in the process of linking groups with the formal institutions, since such integration in the formal sector could also result in formalization, leading to the loss of precisely those important characteristics such as informality and flexibility, which are responsible for the success of the groups and their operations.

Informal finance is much more extensive and diverse than formal finance. The informal sector accounts for most of the financial services provided to the rural sector in the SSA countries. The general view of informal finance, however, is of powerful moneylenders who exploit the poor through usurious interest and unfair seizure of collateral. Much of the traditional criticism of moneylenders has derived from the high interest charges and intimidating practices of loan sharks, and as lenders who often finance illegal activities. The higher rates that moneylenders charge, however, are in large part due to the higher costs and risks associated with informal loans. Because informal lenders and their customers are small and isolated groups, the risks of long−term lending are also greater. Improvements in the provision of financial services might be gained by upgrading informal arrangements and linking them to formal institutions. This implies building upon, not supplanting, the existing arrangements. In this regard, the linking of informal arrangements with cooperatives is becoming increasingly common in Africa.

Despite their success in providing financial services to small businesses that would otherwise lack them, informal financial arrangements do not meet all the needs of the rural sector. Such arrangements do not allow savings to be collected from more than a small group of individuals well known to one another, and they do not move funds over large distances. Informal arrangements generally do not provide term finance since there is hardly any termtransformation. These shortcomings may inhibit the long−term planning and investments that are necessary if rural productivity is to increase.

The limitations of informal financial arrangements do not, however, call for completely new formal institutions. Indeed, formal intermediaries have often failed where informal arrangements have prospered. Formal institutions could, however, benefit by studying and adopting informal financial arrangements. Transaction costs are kept to a minimum, and lenders are able to reduce the risk of default by using knowledge that they have already gathered from other social or business dealings. Sometimes, informal arrangements provide a reliable basis for establishing links with formal institutions so as to provide a fuller range of services.

Country studies indicate that there is great potential for increasing deposits/savings mobilization in the rural areas and that even the poor and people with small incomes do in fact

save, in both real and monetary forms. It is feasible to reduce transaction costs significantly to enable savings and credit schemes to be viable and competitive. The SSA country cases reviewed also confirm the prevalence of the following features.

(a) The inclination of governments and donor to support administered credit for priority sectors, and policy−based lending on the assumption credit is the limiting factor;

(b) State−owned, sectorally specialized banks always involved in administered credit and dependent on discounted credit lines, subsidies, and subvention payments etc. to compensate for high cost operations and chronic loan delinquencies;

(c) General denunciation of all forms of informal financial systems other than those registered as cooperatives and credit unions;

(d) Scant attention to savings mobilization from the rural population; and

(e) Funds mobilized in rural areas through Post Office Savings schemes, rural banks, insurance corporations etc, generally used by government.

The success or failure of a particular credit activity has usually overshadowed concern for the overall development of rural financial institutions, rural banking services, and savings mobilization. Past emphasis has thus been on the implementation of transitory projects and programs instead of the promotion and systematic development of self−sustaining institutions and services. A rural credit program should be evaluated on the basis of whether it increases the capacity of the financial intermediary to provide a continuing flow of financial services to the rural population rather than whether it succeeds in disbursing a certain quantinum of credit to a particular target group within a defined period.

To be financially viable, an intermediary should cover all its costs including loan losses, and service its equity capital and long−term loans. Profitability is vital for business growth, providing self−generated funds available for ploughing back, and to attract new capital seeking higher return, in the form of deposits, debentures and new equity, etc.. Continuing losses would result in cash flow and liquidity problems. Viability should be ensured by cost−effective operations, containing loan defaults through careful risk management, and by securing interest margins adequate to cover the cost of money, administrative and transaction costs, and all loan losses. The sustainability of lending schemes would, in addition, require the institution's ability to raise adequate resources to enable it to combine the operations without having to rely on external support on an extended basis. Demand−driven services seem to be more sustainable and have greater outreach than the traditional supply−driven approaches. It would make good sense therefore for financial intermediaries to design instruments and mechanisms that offer reliable long−term access to deposit and credit services. In developing financial markets the approach should be to support self−sustainable institutions that would be capable of offering financial services on a continuing basis.

In planning for the future it is important to have a clear and consistent objective for finance. The key objective of the financial system is the provision of financial services at prices that reflect their true costs. While the financial system can be used in moderation for other objectives, SSA country governments have, in the past, tried to do too much − using the financial

system to redistribute income, and to serve as a ready and easy tool in implementing their development strategies. Conflicting objectives have impaired the financial system in many of these countries.

A significant increase in formal credit would follow financial liberalization, and a major shift in the allocation of credit to the private sector. There is a strong relationship between credit availability and private investment − though the causal relationship between the two is not too evident. Governments tend to capture substantial portions of savings through formal institutions, using their authority over financial institutions, to meet financial fiscal deficits. Institutional savings such as those mobilized through post offices, savings banks, bond issues are

captured by the fiscal authorities. Fiscal crowding out thus inhibits private investments.

Financial sector policies must be seen as an adjunct to other policies. Deregulation of interest rates helps provide more alternatives to holding money or spending and can provide incentives for savings and investments. Directed credit at subsidized interest rates often involves the narrowing of intermediation margins for the participating financial institutions, and lowering of interest offered on deposits, resulting in reduced savings. The argument that increases in interest rates on deposits do not result in significant increase in savings mobilization is not tenable.

There is a general lack of appreciation of the importance of positive real interest rates and the need for convenient savings facilities. This would involve positive deposit and lending interest rates, appropriately designed savings instruments, and the avoidance of explicit or hidden subsidies. Attractive savings services would also help reduce information cost and lending risks, and enable financial intermediaries to reach levels of sustainability more quickly. The impact of any program would be shortlived if improved access to financial services lasts only during the life of that endeavor. To ensure the sustainability of financial institutions, the emphasis should be on providing cost−effective and convenient services, meeting demand−driven facilities.

Savings mobilization is crucial to achieving the sustainability of rural financial systems. Financial intermediaries should, therefore, attempt to combine credit schemes with savings mobilization efforts in their attempts to serve the rural dwellers and enterprises. Credit performance too would improve if coupled with the promotion of savings and deposit mobilization efforts. Compulsory savings schemes designed as part of credit programs, and voluntary savings schemes linked to group lending schemes would improve the strength of the individual customers and the financial intermediaries. Such combinations would also instil confidence in the savers as well as the borrowers that the schemes would be available on a continuing basis.

Past investments in human capital and capacity−building in Africa have been inadequate. Development operations must be viewed not merely as a discrete product but as part of a larger development process. Development of private sector capacity in agriculture, agro−industry, marketing, input supply and credit is increasingly being recognized as a viable productivity increasing strategy. The liberalization of the regulatory environment, financial sector reform and the privatization of parastatals are essential steps towards expanding private sector development. Next to an untenable macroeconomic environment, institutional and managerial weaknesses are recognized as the major causes of agricultural project failure in Africa. Governance and culture too are contributory factors. Action− oriented analysis and amelioration of the underlying problems and causative factors are therefore essential steps in developing rural financial systems.

It is important to recognize the cultural dimension in formulating financial sector development schemes. Culture, in all its ramifications, would need to be considered − traditions, spiritual and social beliefs, life styles, value systems, respect for government, and rule of law. So much depends on the social environment and cultural traits that determine the general behavior of the people and the bureaucrats they are obliged to deal with.

The importance of well−functioning financial institutions to serve the rural sector in developing countries has not been sufficiently appreciated. The existence of efficient financial systems where the rural poor can save and borrow freely as the need arises is essential in the development process. Since formal financial institutions do not reach this target group, separate funds have often been provided under special credit schemes to finance development activities of this group. Such ad hoc efforts might at best serve short−term goals, for example, introducing new technologies or increasing production. However, they often fail to identify the fundamental problems of rural finance and they do not remedy the lack of well−functioning savings and credit institutions.

Much can be learned from informal finance which seems to be the mainstay for the majority of the rural population in many countries. These forms of informal organizations cannot always be replicated or replaced by formal financial institutions. In pursuing a rural financial markets development strategy, a number of

experimental programs and pilot−scale operations should therefore be developed and supported. Ongoing and completed rural credit schemes and rural operations, particularly those with savings components should be critically examined focusing on the factors contributing to growth of financial institutions. To meet the growing demand for rural credit, the supply of money must be ensured through the mobilization of savings. While there has been a lot of talk about the importance of savings in providing credit facilities, the focus continues to be on delivering credit.

In attempting to develop rural finance in a sustainable manner the following issues must be addressed.

(a) What are the dos and don'ts?

(b) What comes first, savings or credit?

(c) How much government and how much people?

(d) Should everything be left to the informal sector?

(e) What should the World Bank do what it does not at present?

(f) What should it not do of the kind it has done in the past?

(g) What should other donors do which they and others have not done so far?

(h) Should the formal and financial sector gulf be bridged? Can it be? How? and

(i) How could the strategies on which there is some degree of consensus be operationalized?

While there has been some awakening, there is also cause for real concern. Many countries in SSA have undertaken significant financial sector reforms and there is widespread agreement on the importance of sustainability, a competitive market, and a well−defined role for governments. Sound policies, backed by an appropriate infrastructure, institutions and instruments can transform the RFM. The critical challenge therefore is to promote the sustainable development of RFM. In this regard, reducing and phasing out subsidies would help promote growth of the RFM and avoid the exit of existing weak but potentially viable financial intermediaries. While group schemes can be effective mechanisms in many cases for providing financial services, based on an understanding of what works and what does not, flexibility in approach between countries should be emphasized to account for the heterogeneity of RFMs.

If underlying problems causing rural poverty are addressed directly, a larger number of poor may benefit than by emphasizing credit, and creating debts for the poor. Overemphasis on credit may also lead to unrealistic expectations, neglecting the need for mobilizing savings, and paying inadequate attention to ownership capital. Savings mobilization improves resource allocation. The focus should therefore be on addressing the fundamental problems, and not tinkering with the symptoms, berating the banks for inadequate lending, and pressuring governments and aid agencies for subsidies.

Many rural financing schemes supported by governments and donors alike fail to achieve their main objective of providing financial services to a critical mass of rural population, particularly women, in a viable and sustainable manner. The few that succeed in this mission have some distinct characteristics. First, they attach equal weight and importance to savings mobilization as to the allocation of credit. The importance of enjoining household savings cannot be overemphasized in any rural finance scheme. Savings mobilization is the most dependable source of loanable funds for a rural financial intermediary to achieve financial viability and sustainability, without

having to rely on external support. Convenient and readily accessible deposit facilities would motivate rural households to save part of their income in financial assets. This would also be an important step towards monetizing the rural economy. Besides, savings facilities would be a means of helping the rural population to develop a banking history, thus increasing information on the creditworthiness of borrowers that financial intermediaries/institutions need in loan appraisal.

Second, sustainable intermediaries charge interest on loans adequate to cover their full cost of operation of funds, cost of lending, and anticipated losses. Experiences of sustainable financial institutions show that to accomplish this goal, they must be autonomous and operate on a commercial basis − they have complete freedom to set their interest rates for deposits and loans and to manage their operations. This is more likely to be accomplished where there is minimal government interference, a stable macroeconomic environment and a liberalized financial system.

Third, such intermediaries succeed in reducing their transaction costs and risks of lending to manageable levels. Some of them employ group lending techniques to lend to small− and medium−scale enterprises (SMEs) and smallholder farmers. Such a group scheme has distinct advantages, especially when coupled with the joint and several liability of members. In addition to reducing the risks of lending to SMEs and smallholder farmers, group arrangements would significantly reduce the transaction costs of providing small size loans to rural households. Since high transaction costs and high risks are the primary constraints to formal finance being made available to rural households, group lending offers a viable option for increasing financial services to rural households. However, group lending is not as effective for term lending and should not be employed until it has been perfected through pilot operations.

In addition to measures known to work in well−functioning rural financial institutions, there are other emerging approaches that show promise. One such approach is the collaboration between formal finance and informal finance on which most rural households have come to rely on for so long. Given its time−tested manner of operating in the rural areas, informal finance could, working closely with formal finance, promote rural development through increased access to a variety of financial instruments and services. Such collaboration could include formal financial institutions using informal agents such as traders, inputs suppliers, stockists, savings and credit associations, moneylenders, NGOs, etc. as channels for resource mobilization and onlending. This could also lead to the strengthening of the legal framework including prudential oversight, recovery enforcement and safety of financial assets. As already indicated, such an integration of the informal financial system with the formal institutions could result in formalization of the smooth functioning informal financial sector, and the loss of precisely those characteristics of informality, flexibility, convenience, timeliness, simplicity etc. which make informal sources so appealing to the rural population.

The lack of conventional forms of collateral has been one of the major constraints to lending to the rural sector. It increases the risks that financial institutions face since there is no recourse to readily realizable tangible assets in case of default. To overcome this constraint, there are a few collateral substitutes (collateralization) that financial institutions are experimenting with. One such mechanism is the self−financed Reserve Fund approach, under which the beneficiaries build up a Reserve Fund of say, 10 percent of the normal loan requirements. This fund could be built through personal or group savings, income from off−farm activities, etc. The financial institution could have recourse to the fund in cases of default and a group would be able to meet its debt service obligation even though individual members might delay repayment. This does not eliminate risk but helps to reduce the financial institutions' exposure. Other forms of guarantee or insurance schemes too could perform similar functions. However, further testing and refinements would be necessary before wider application of such schemes could be recommended.

More research would be needed in individual countries to identify the positive characteristics, prevalence, potential and possible impact of group savings, and similar lending schemes, how they could be made

self−sustaining, and the extent of experimentation needed before advocating group finance schemes for wider replication in SSA countries. The success of rural financial markets in contributing to the economic advancement of rural households would depend on the capacity of the constituent institutions to provide the required financial services on a continuing basis. Such options could include exploring ways to strengthen institutional capacity to manage risk, build the banking infrastructure and develop expertise as well as viable lending and savings mobilizing instruments. This would call for further research and experimentation with different options.

Successful schemes and promising models developed in a country in a particular situation and cultural setting are not always replicable in another country under different circumstances. The effectiveness of policy recommendations would depend on how the special circumstances of individual country cases are considered. Only then would attempts to replicate successful experiences and best practices realized elsewhere have a reasonable probability of success. Therefore, it is important to have a thorough understanding of what the experience was, and where and why it proved successful. Caution should be exercised before accepting relative improvements over past chronic situations as successful stories. From the general lessons of experience it should be possible to articulate policies and programs conducive to the sustainable development of rural financial markets.

It should also be recognized that future studies and operations will be driven primarily by country priorities. Implementation of policy objectives would be through individual country economic and sector studies. These findings would hopefully provide the region's operational staff and rural finance practitioners with improved guidance regarding the design, monitoring and evaluation of rural finance schemes. Policy reviews could include a broad range of issues of concern to World Bank staff and policy−makers, including the specificity of financial intermediation in rural areas, financial innovations designed to reduce transaction costs, interest rate considerations, etc.. A careful selection of best practices in areas such as institutional and operational matters related to management structure, resource mobilization strategies, project appraisal capacity, appropriate training and technical assistance would be of help when considering the possibilities of replicating successful schemes.

RFMs in SSA cannot be developed without altering the way these markets are used, and altering the many policies imposed on them. If attention is to be focused on developing RFMs it would also be necessary to address financial sector policies and systems at the national level. Therefore, policymakers must develop a consensus on the approach toward RFMs. World Bank and other donor support for rural finance operations is best provided in the context of financial sector reforms designed to improve the allocative efficiency of financial intermediation. The liberalization of interest rates, the removal of any remaining credit targeting, the strengthening of financial institutions, and the removal of obstacles to the functioning of informal financial systems should all figure in financial reform programs that could be supported by the Bank and other donors.

The review of several rural finance programs that were either quite successful or were disappointments point to some salutary Dos and Don'ts:

DO

- stress deposit mobilization;
- stress the viability of financial intermediaries, loan recoveries, and the need to reduce transaction costs to low levels;
- maintain positive real rates of interest on loans and deposits; and
- stress making credit programs sustainable

DO NOT

use the financial system as a fiscal agent or to allocate subsidies;

target loans to groups, enterprises, areas, or for earmarked activities;

use concessionary rediscount lines to fund rural credit; and

offer cheap loans, discouraging savings and deposit mobilization and undermining the viability of the financial system.

1. Introduction

Background

The governments of countries in Sub−Saharan Africa (SSA), and aid agencies including the World Bank, have long recognized the importance of financial sector reform and rural financial markets development in realizing the goals of real sector growth, food security and poverty alleviation. The Bank's *Sub−Saharan Africa: From Crisis to Sustainable Growth, Long Term Perspective Study* 1 /posits agriculture as the main source of growth in SSA — targeted to expand annually by 4 percent. To meet such an ambitious target, SSA−countries will have to dramatically raise domestic savings and investments. A sound financial sector, supported by appropriate macroeconomic policies, and institutional infrastructure are prerequisites in creating such an environment. A strong and vibrant rural financial market should be an integral part of this effort. Great emphasis is therefore being placed on developing rural financial markets, particularly on the mobilization of rural savings and the efficient allocation of resources to the most productive investments and activities in the rural areas.

The Bank's *World Development Report 1989,* 2 /recognizing the non−viability of the financial sector in most of the developing countries, and having reviewed the lessons of past experience, stressed the need for efficient financial systems. The Report emphasized the importance of governments having to lay the foundations of well−functioning financial systems, through financial liberalization, increasing competition, restructuring institutions, improving allocative efficiency, prudential oversight functions of central bank, and increasing resource mobilization to ensure sustainability. While recognizing that properly designed administrative interventions might be desirable in special circumstances, the Report cautions against (a) their possible adverse impact on the financial viability of the lending institutions, (b) inefficient resource use, (c) compounding distortions in the financial market, and (d) the retarding of the development of the financial sector itself. The Bank policy on financial sector operations 3 /reiterates the importance of such interventions their having to be designed and carried out in the context of a coherent strategy for sustained development.

Rural credit markets in SSA countries, as in other developing countries, have been subject to policy interventions during the last two decades and more. Until recent times, the main focus of African governments and aid agencies alike was on providing agricultural credit, largely with funds external to the rural financial systems. The targeting/directing and subsidization of credit, often delivered through state−owned specialized financial institutions, neglected the overall development of the rural financial market. Experiences of such heavy−handed approaches abound in SSA countries where the infusion of soft external funds to meet perceived credit gaps have at best produced only mixed results. Improvement in agricultural performance − whether in the form of investments, productivity increase, production, food security, poverty alleviation or social equity − has not been as spectacular as hoped for. There are instances of the economic environment, the financial systems, and the rural community as a whole having suffered from such a misdirected approach. Such financial system distress is, however, not unique to Africa. The results of many of the World Bank's traditional agricultural credit operations,

and the special credit schemes supported by other donors and governments too have been disappointing. Causes and consequences in a number of cases have also been researched and recorded. It is evident, as reported in these various studies, that subsidized and directed credit does not always reach the intended beneficiaries, while at the same time jeopardizing the financial viability of the lending institutions and discouraging domestic savings.

The World Bank experience to date in SSA has revealed the following common problems.

(a) Low recoveries, mounting non−performing loan portfolio, and loan losses;

(b) Heavy reliance on external sources of funds for lending, ignoring the great potential for and the importance of savings/deposit mobilization;

(c) Preponderance of state−owned specialized institutions formed to administer credit;

(d) Political patronage in the staffing, management and operations of state−owned lending institutions;

(e) Inadequate capitalization, high administrative overheads, and the bureaucratic culture of state−owned intermediaries;

(f) High transaction costs for depositors and borrowers alike;

(g)Inadequate appraisal and monitoring capability of credit staff;

(h) Growing tendency to lend short−term (seasonal for agricultural production, working capital for trade, etc.) and reluctance to lend for long gestation investments;

(i) Lending operations by government agencies and parastatals, and targeted credit often leading to misallocation of scarce resources; and

(j) Inadequate attention to institution−building, sustainability, and development of the rural financial system as a whole.

Many SSA governments and aid agencies too have therefore come to recognize that in developing rural financial markets it is essential to shift emphasis from the delivery of credit to financial intermediation in rural areas and that the long−term development of the rural economy in these countries will have to rely more on domestic savings and cost−effective financial intermediation. It is also being recognized by many that reliance on external sources of funds makes most of the credit schemes neither sustainable nor replicable. The means by which efficient financial intermediation can be achieved are thus key concerns. The present environment, when many governments and donors alike are anxious to improve the situation, would seem to be an opportune moment for pursuing a systematic approach to developing rural financial markets in SSA. It is generally accepted, however, that the development of a coherent financial sector strategy for any country, and the restructuring of its weak and insolvent financial institutions are long−term processes. This Rural Financial Markets (RFM) study is thus an attempt to explore practical means of meeting the financial needs of the rural sector, particularly those of disadvantaged groups − smallholders, micro−enterprises, women − in the transitional period, but without endangering the viability of the financial intermediaries or exacerbating the distortions in the financial sector.

Some research studies indicate that there is great potential in SSA countries for increasing resource mobilization in rural areas to meet the increasing credit demand of farmers and micro−enterprises, and that it should be possible to reduce transaction costs significantly to enable rural savings and credit schemes to be operated viably. By careful risk assessment and

management, and by concentrating on savings mobilization and reduction in transaction costs it should be possible to develop rural finance markets on a sustainable basis. Studies also show that state−owned financial institutions seldom function on a competitive and viable basis, and have often needed substantial subsidies and subvention payments which many SSA governments can ill−afford. Without adequate research, market failure and segmentation are often cited as reasons and accepted as ready justification for many forms of administrative interventions in resource allocation. High administrative costs, loan delinquency, and non−performing portfolio are common symptoms in state−sponsored credit schemes. These problems are accentuated by the attitudes of politicians, public officials, management and employees of parastatal credit institutions, as well as the ultimate borrowers, which contribute to the failure of such credit schemes. State intervention thus exacerbates the distortions in rural financial markets.

Smallholders, landless farmers, women, and micro−enterprises might need special treatment to facilitate their access to credit. Where there is tangible evidence of such need and/or justification for intervention by means of targeted/directed or subsidized credit, there is a growing consensus now that such arrangements should be only transitional so that the financial viability of the intermediary institutions could be safeguarded. The effective cost of subsidies in such operations should also be ascertained, made explicit, and funded appropriately so as not to distort the financial market.

The informal financial sector seems to be the major source of rural savings and credit in SSA countries. While professional moneylenders in the informal sector charge interest rates substantially higher than the formal financial institutions, they continue to co−exist and thrive. It is the weaker sections of the rural community which seems to rely heavily on the informal systems for their credit needs. It is therefore important to explore factors which would influence a greater integration between formal and informal financial systems so as to optimize on the savings potential and deepen financial intermediation to serve a large number of rural households and enterprises.

In the efforts to achieve sustainability in financial intermediation and financial market development, consideration needs to be given to the sustainability of the lender, the intermediary institution, the depositor, the saver, the borrower and the sector. If borrowers become chronically indebted nothing else can be sustained; if savings cannot be mobilized on a consistent and continuing basis there will be no resources to lend; if the lenders do not recover all the money they lend, they will soon cease to exist. Also, if a financial intermediary cannot fully recover the cost of mobilizing resources (money costs − interest paid to depositors, plus administrative costs of intermediation) the institution will soon have to shut its doors. Sustainability is thus the crucial aspect in developing rural financial markets.

Study Objectives

Enhancing the performance of smallholder agriculture and rural micro−enterprises is vital in SSA countries. The deepening of rural financial intermediation and provision of financial services to support the rural communities in a cost−effective and sustainable manner, therefore, becomes paramount. Despite the many studies already carried out by governments, donors and the World Bank, information on the functioning of the rural financial markets, particularly of the informal financial institutions, has been limited. Perhaps more is known about what does not work than about what does in rural financial markets. This study is, therefore, an attempt to review operational experiences among African countries (and elsewhere) with a special focus on

Box 1.1: Importance of Sustainability

The World Bank's *Sub−Saharan Africa: From Crisis to Sustainable Growth, A LongTerm Perspective Study* recommends a minimum annual growth of 4 percent. This ambitious target also relies on agriculture as the main foundation

and engine of growth. Such a significant increase in agricultural production — food crops, cash crops and export crops − cannot be achieved without an appropriate enabling environment for all rural sector economic activities. A very strong rural financial market, and viable rural institutions to provide support services should be integral parts of such an environment. Almost all of the food crops and even cash crops production would come from small farmers who generally have not had access to established financial institutions, and are therefore obliged to rely on informal sources and mutualist associations for most of their financial services.

Over the last four decades, the efforts of governments and the donor community were aimed at providing credit to agricultural enterprises and small farmers, with funds external to rural markets. Such preoccupation with supplying credit was also often associated with the targeting (directing) and subsidization of credit, using state−owned specialized financial institutions or Development Finance Institutions (DFIs) as channels. Past experience in SSA countries, as in many other developing countries, shows that government intervention, and the infusion of external funds to meet perceived credit needs have not often yielded the expected improvement in agricultural and rural performance. In many cases, the economic environment, the financial system, and the rural community as a whole suffered from such an approach.

An enabling environment — macro−economic stabilization, financial liberalization, sector reform and restructuring, facilitative legal framework, prudential oversight — are essential for the sustainable development of rural financial markets. Increased competition could be induced by the entry of new banks, privatizing state−owned financial institutions, removing interest rate controls, and eliminating subsidized credit. Lessons from experience would help formulate practical approaches to developing sustainable rural financial systems, paying attention to linkages with non− financial/agricultural/rural institutions, and between formal and informal sectors.

what does and what could work in developing rural financial markets in Africa. The emphasis is on the lessons of experience, policy, institutional, implementation, impact, etc. to help decide on effective approaches and best practices that could be adopted while financial sector reforms and market liberalization policies are being pursued. Particular attention is given to the need for and the feasibility of adopting new/different instruments and mechanisms for mobilizing domestic savings and for providing credit, consistent with country realities and the World Bank's guidelines.4 /

Based essentially on country experiences, this study attempts to assess the status of the rural financial markets in selected SSA countries, the effectiveness of the different policies, approaches these countries have adopted in supporting rural financial markets, development of

institutions, financial instruments, etc. Lessons drawn from such experiences would hopefully enable the governments and donors to decide on the best approaches to adopt in:

(a) Improving access to credit, particularly to the needy and disadvantaged population, without jeopardizing the viability of financial intermediaries;

(b) Encouraging savings mobilization which should be emphasized not only for increasing local resources available for credit but also as a means of instilling a more disciplined credit and repayment culture; and

(c) Ensuring the sustainability of special credit schemes.

The primary objective of the study is to identify practical means of achieving competitive and cost−effective financial intermediation in SSA countries − the development of sustainable rural financial markets. The lessons drawn from experiences reviewed are intended to help replicate, with appropriate adaptation, proven successful approaches to optimizing savings mobilization, improving accessibility of credit to those hitherto inadequately served, and increasing competitiveness among providers and users of financial services in the rural areas. Thus, the thrust of the study has been along two main themes:

(a) Factors influencing the development and performance of rural financial markets, and mechanisms for deepening and diversifying financial intermediation in rural areas, and the

(b) Financial viability of rural financial intermediaries.

The SSA country case reviews (internal World Bank document) are aimed at testing the following hypotheses which would provide guidelines for the design and implementation of sustainable savings and credit programs.

(a) Economic stabilization, financial sector reforms, strong and stable central bank, and effective prudential regulations and oversight are necessary conditions for the successful development of rural financial markets;

(b) By concentrating on cost−effective savings mobilization and the delivery of financial services, rural financial markets could be developed on a sustainable basis;

(c) Elimination of direct state intervention in rural financial markets would minimize distortions, and improve competition;

(d) Explicit subsidies for financial sector operations, which are specifically funded and provided to lending institutions would not distort the rural financial system;

(e) Group savings/credit schemes would be an effective means of deepening financial intermediation, and fostering community investment in rural areas; and

(f) The growth of informal financial institutions would serve as a catalyst for the voluntary forging of formal/informal sector linkages.

Methodology

This study is a synthesis of the lessons of experience drawn from separate special case studies of eight selected countries within SSA (Benin, Ghana, Kenya, Madagascar, Malawi, Niger, Nigeria and Tanzania), three countries from East Asia (Japan, Korea and Taiwan), where directed credit programs are claimed to have been successful, and from a comparative study identifying cases and plausible causes of successful rural financial systems and mechanisms in South Asian (Bangladesh and India), Latin American (the Dominican Republic and Bolivia) and Sub−Saharan countries (documented as an internal World Bank review). Care was taken in the selection of SSA countries for detailed study to ensure that the experiences would be representative enough to draw meaningful conclusions and useful lessons. Ghana is a typical case where the government has resolved to follow a systematic approach to financial sector reform and restructuring, and to develop its rural financial market relying on its large network of rural banks. Kenya, as in the case of Nigeria, is one of the larger SSA countries with wide banking networks and where there is a substantial presence of the private and cooperative sectors in the rural financial market. Malawi and Tanzania are countries which can offer evidence from their innovative financial schemes, institutions and instruments as examples of viability. Benin, Cameroon, Madagascar and Niger would serve as

reference cases of how grassroot organizations could be encouraged to provide rural financial services, in the absence of effective formal financial institutions, to serve the rural population.

In addition to the research findings on successful formal rural financial institutions, already available in the World Bank,5 /special attention was given to informal sector rural financial systems, including mutualist self−help associations − cooperatives, savings and loans groups and credit unions. The country cases and special aspect studies (internal World Bank document) themselves are based on exhaustive literature search conducted by the respective researchers (Appendix 4).

Difficulty in Measuring of Performance

Governments, in their efforts to prime the countries' agricultural and rural development, have been preoccupied with providing credit liberally and making it affordable to rural borrowers. Outside interventions in the financial markets have generally been in the form of administered credit (often subsidized in different ways), nationalization of financial institutions, and establishment of other bodies specifically for the delivery of credit for agriculture and related activities. In assessing the performance of such credit schemes, understandably, the criteria generally applied have been the amount of credit disbursed, the number of participating beneficiaries, physical benefits (production increase, yield improvements, adoption of new technology, etc.). While these indicators might have been adequate for assessing the validity of specific interventions by governments and aid agencies, other measures are needed to assess whether strategies, policies, programs, etc. help or hinder the development of financial markets. In this process, the more important element of the financial market − savings mobilization − has been ignored in the equation, the financial viability of the intermediary institutions often disregarded, and the role of the informal financial sector − the more versatile and virulent part of rural financial markets − generally ignored or condemned.

The definition of success and sustainability as these relate to rural financial markets, financial intermediary institutions, and credit schemes is not without controversy. Often, only the performance of the formal financial sector is considered, and there too the emphasis has been on the credit aspect of financial intermediation, without questioning the source of funds needed

for lending. When the performance of financial intermediaries is being assessed, the focus again is on whether and to what extent they are able to meet the credit needs of chosen sectors, without considering cost implications, or whose funds are put at risk in lending to priority sectors, or to non−creditworthy and delinquent borrowers. When the success of special credit schemes is assessed, the emphasis often is on outreach6 /and economic benefits, and seldom on whether these schemes could be sustained with high administrative costs, subsidized interest, and with unacceptable repayment default rates. This school of thought has been classified as the Traditional Credit Project View.7 /Proponents view loans in rural credit projects as part of a package of inputs. The performance of these programs is usually measured by the number of loans made to target group members, inputs purchased with loans, outputs increased through borrowing, changes in levels of income or employment among borrowers etc. These measures concentrate on the borrower. Even when high costs, chronic overdues, non−performing loan portfolios, and high loan losses are recognized as problems these are not considered to be crucial in the measurement of a scheme's success. From a development point of view the true test of success should have been to assess the sustainability of the schemes over a longer period, the replicability of similar schemes in wider geographical areas, and in other sectors of the economy, the safety of depositors' funds (if that is the source), the health of the national budget which ultimately will have to carry the cost of failed schemes, and the financial viability of the intermediaries which have to thrive if such schemes are to continue.

In stark contrast is the Market Performance view which contends that more attention should be given to the supply−side of financial intermediation, to long−run issues, to deposit mobilization, to the behavior of intermediaries, to lowering transaction costs, to cost−reducing financial innovations, to building sustainable

financial services, and to how policies affect the performance of rural financial markets as a whole. The emphasis here is on disciplined loan recovery, controlling of transaction costs, and the optimization of deposit mobilization to provide funds to meet the growing demand from rural borrowers. What then are the conditions most conducive to the development of rural financial markets? As large a number of intermediaries as feasible should offer diversified financial services to as many as who can benefit in the rural sector, in the most cost−effective and competitive manner, and on a continuing basis. Ideally, such a situation could prevail in a free market − demand for and supply of services clearing at market prices − attracting deposits at a sufficiently high reward, and offering to lend at a high enough rate to compensate for risks and to cover costs and margins for the servicing of debt and equity. There would be freedom of choice for both providers and users of the financial services, and keen competition facilitated by easy entry and exit for both parties.

The reality, however, is that this ideal situation does not prevail − at any rate not in SSA country circumstances. Furthermore, concentration on priority sectors is required to ensure speedy economic growth − agriculture and other economic activities in the SSA rural sector unquestionably fall in this category. Growth with equity would be an important goal to be pursued in these countries. The SSA governments and supporting donors will therefore be in the business of special credit programs for some time to come. However, sustainability of special credit programs (policy−based lending), and viability of the financial intermediaries involved should be paramount considerations in the assessment of performance unless these are considered as one−shot operations or small−ticket schemes, as otherwise the related costs might be so high as to become unacceptable. In addition to the degree of success in achieving the desired economic and equity goals, therefore, the ability to fund the costs involved to the extent required and in an efficient way should be given equal consideration in assessing successful schemes. The performance of the institutions involved in implementing them and their viability should be evaluated similarly. The financial viability of the intermediary institutions would be crucial to

the long−term sustainability of the schemes as well as the overall development of the rural financial markets.

Measure of Success

The controversies over the criteria for measurement of the success of credit projects and sustainability of rural finance strategies are likely to continue. Traditional measures stress demand, number of borrowers, number of loans, percentage of targeted groups reached, increase in productivity/production of enterprises, etc. whereas the proponents of financial markets, however, rightly stress the sources of funds for credit, transaction cost reduction, viability of participating financial intermediaries, and sustainability of the credit schemes themselves. The major factors that contribute to success or failure are, however, generally acknowledged to be:

(a) Degree of emphasis on savings/deposit mobilization, and the incentives provided to savers/depositors;

(b) Criteria used in making loans, and the effectiveness of loan portfolio management;

(c) Transaction costs reduction, and efficacy of cost recovery;

(d) Management effectiveness of intermediaries;

(e) Level of government intervention and political interference; and

(f) Extent of loan targeting, and use of discounted refinance.

Many would take the view that market efficiency and social equity goals do not always go together and that policymakers are often faced with the conflict between efficiency and equity especially in the early stages of development; that policy intervention on grounds of equity would probably result in market distortion, in turn

causing inefficiency in resource allocation, particularly in the early stages of financial market development; that directed/subsidized loans aimed at the rural poor might even aggravate the situation, and that cheap loans might even harm the financial markets, but that at the same time, pervasive intervention by governments may have to be accepted and supported if equity is to be given priority. The proponents of this view maintain that the prominent feature of RFM development in East Asian countries has been the very strong commitment of the governments to providing targeted credit; that RFMs there have been supported through many forms of policy interventions and instruments; that RFMs in East Asia could not have been sustained without government support; that though the RFMs have been sustained with government subsidies, the countries, however, have had a good record of deposit mobilization and loan recovery, and that the financial markets have expanded with fairly high growth rates. They justify such intervention on the grounds that despite transaction costs in sponsored schemes having been higher, compared to commercial lending or to informal finance, most people had easy access to formal financial institutions. On this basis, the proponents consider these cases of RFM development as quite successful. But the criteria used in this line of argument ignore the importance of self−sustainability. It is also maintained that even if the financial institutions were subsidized, the interventions should be regarded as sustainable as long as there is a low loan−arrears ratio, and expansion of their business volume. The mere sustaining of the institutions with government support is regarded as a success. They therefore

maintain that performances of RFMs should be judged not only from the point of view of financial sustainability but also from that of the effectiveness of government policies.

This study, however, concentrates on the sustainability of financial systems. The financial intermediaries should be financially viable and able to continue in business and grow without external props − both in regard to resources and profitability. If savings cannot be mobilized by the financial institutions on a consistent and continuing basis, soon there will be no more resources for them to lend; if lenders do not recover from borrowers all the money they lend they will soon be out of resources to lend; and if the financial intermediaries cannot be competitive and recover all incurred costs from their customers and make a surplus to service capital there will be no growth. Self−sustainability is thus crucial in developing rural financial markets.

Success cases selected for emphasis and elaboration in the study, however, are those which show promise of replication. Instances abound where accidents of history, the confluence of favorable factors, etc. have contributed to success. Obviously, such success cases would be of limited practical value in attempts to develop rural financial markets because such special circumstances would be impossible to recreate. The scope of this study is the *development of rural financial markets,* learning from lessons of experience − in the hope that such development would be feasible through the *replication of successful* experiences. In this context some success identified somewhere would not be of great relevance if the contributory factors and conducive conditions identified were unique to that country or situation. Also while success could be defined as the achievement of a set goal or goals, it cannot be looked at in isolation − it has to be viewed in relation to the costs involved in securing that result. If therefore, a financial intermediary's performance is to be considered a success, in addition to achieving the set goals, it should be financially viable − at least in the long haul, able to cover all incurred costs, regularly service its debt obligations, earn an acceptable rate of financial return for owners' equity, and generate a surplus to help it grow and equip itself to meet future challenges, including competition. A savings scheme could be rated a success only if the savers are able to earn interest at competitive rates and the savings potential is fully captured by the financial institutions. If a credit scheme is to be accepted as successful, the most important criteria would be whether loans were repaid by the borrowers fully and promptly.

The rural financial markets have to be developed on a *sustainable* basis. If the constituent intermediaries and the schemes operated in the markets are to be subsidized on a continuing basis then they cannot be considered sustainable − the only element sustainable, under such circumstances, is the subsidy itself − and that kind of drain is difficult for most SSA countries to sustain in perpetuity. The business of a financial intermediary is circumscribed by the resources available for its lending operations. There is a limit to the amount and tenure of

external sources of funds, particularly concessionary funds. An intermediary's operations would therefore not be sustainable unless it can locally raise the bulk of the resources it requires through deposit mobilization on competitive terms. Operating on competitive terms would also mean operating at optimum cost efficiency by reducing transaction costs. For the limited purpose of the study, therefore, success is defined as the long−term financial viability of intermediary institutions, and the feasibility of expanding savings and credit operations without undue reliance on financial support from outside the market; and sustainability is taken as the ability of the market to operate and grow without reliance on continuing government subsidies.

Classification of Informal and Formal Financial Systems

Informal finance is heterogeneous and dynamic. The informal financial sector is understood to embrace a wide group of individuals and institutions whose financial transactions are generally not subject to direct control by the country's key monetary and financial policy instruments.Individual economic entities in the informal sector include moneylenders, moneykeepers, tradesmen, millers, landlords, employers, friends, neighbors, relatives, etc. Institutions outside the formal sector cover an array of intermediaries such as ROSCAS, Tontines, Susus, Chit Funds, Savings and Credit Unions, and other financial cooperatives and mutualist groups which are not subject to surveillance by Central Banks. It also includes the activities of even very large institutions such as finance companies and wholesale traders. Informality, the common characteristic of these institutions as of the other smaller constituents of the informal financial sector, is a matter of degree and is a relative concept. It is therefore more meaningful to consider the formal and informal systems as two sides of a financial continuum, and to classify the grey area in the middle segment of the continuum as semi−formal. 8 /

Credit unions and cooperatives are classified in some literature as semi−formal intermediaries. In this study, however, for convenience of classification these entities are all deemed to be part of the informal financial system. 9 /Institutions such as post offices, insurance companies, building societies and finance houses which accept deposits from the public, and operate savings and similar schemes are all treated as part of the formal financial system (although these institutions might not be subject to Central Bank oversight) along with commercial banks, savings banks, investments banks, merchant banks, cooperative banks and development banks, as well as non−banking financial institutions (NBFIs) such as development finance institutions (DFIs).

It would be misleading to talk of financial dualism as an aggregation of two discrete financial enclaves. The formal and informal financial sectors form, rather, a continuum, with many sub−markets within each sector, and many between the two. 10 /Non−regulation by the central bank is at times used as the defining characteristic of the informal financial sector, treating unregulated financial institutions and lenders, or those regulated by other agencies as informal. Some kinds (or degrees) of regulations may be compatible with informality and flexibility in operations. It should be recognized, however, that like regulation, informality itself is a relative concept.

Some writers prefer to adopt the institutional/non−institutional dichotomy as more appropriate in discussing rural credit − institutional referring to formal, and noninstitutional to informal credit. This study has opted for the formal and informal dichotomy to make the distinction and to avoid confusion, particularly because the informal finance sector includes large institutional lenders. Also, some constituents in the informal sector are legal entities, and have generally been deemed in the different countries to be institutions, and there are many one−man institutions in the field as well. The use of the term institutional credit has therefore been avoided in this study.

A word also about how the terms finance and credit are used interchangeably in the rural finance literature reviewed. More often than not, policymakers and practitioners cannot define finance except in terms of credit. So a discussion on rural finance and rural financial markets development tends to emphasize rural credit. The savings element tends not to feature prominently, even though savings facilities and deposit mobilization should be the starting point for the allocation of financial resources.

2. Financial Systems

Macroeconomic Factors

The importance of a sound macroeconomic framework in developing a country's financial sector has long been acknowledged by governments and donors alike. A number of policymakers have, however, ignored this fact from time to time, and undermined its development through the pursuit of short−term and elusive economic and equity goals. Inefficiencies in the financial sector, if not corrected in time, will seriously impede the development of the real sectors as well. An environment that supports the development of a strong and sustainable national financial system would also enhance the growth and strength of the rural financial system. The importance of sound macroeconomic policies in building efficient financial systems cannot, therefore, be overemphasized.

Progress has been made in expanding financial infrastructure in several SSA countries. The World Bank and other multilateral and bilateral aid agencies have played a major role in this development. The recent economic stress in SSA countries, however, has interrupted this process by making fewer people creditworthy, by lessening the ability of people to repay their loans, and by reducing the income available for deposits and savings. While economic stress explains part of the difficulties in SSA's rural financial markets, government policies and administered credit schemes have also contributed to these problems. Most governments attempt to use financial markets to promote targeted activities such as on−farm development and use of chemical fertilizer, and to provide preferential assistance to certain chosen groups (e.g. the rural poor). Recent research shows that subsidized credit programs have not been effective in helping the rural poor and that ambiguous relationships have developed between targeted or directed loans and borrower behavior. There is also a growing recognition that using rural financial markets extensively to handle targeted loans and subsidies undermines their ability to perform other vital functions.

The World Bank has for some time been focusing attention on financial markets in SSA, has carried out sector studies in some countries, and supported Adjustment Programs aimed at improving the financial sector's performance. There is a growing belief among other donors as well that a similar approach should be applied to rural financial markets. There is also evidence of increasing recognition that more attention should be given to deposit mobilization, to lowering transaction costs, to risk−reducing financial innovations, to the financial behavior of intermediaries, and consequently to building sustainable financial services.

Formal Financial Systems

The formal financial sector in most countries is comprised of the nation's Central Bank, the banking sector and non−bank financial institutions. The banking sector includes commercial banks, cooperative banks, development banks and savings banks. Community−based banks include institutions such as the rural banks in Ghana and Sierra Leone and the village banks being established in Mali and Burkina Faso (with GTZ support). Non−banking financial institutions include government departments and statutory agencies, finance companies, building/housing societies, hire−purchase and leasing companies, insurance companies, etc.

Governments and aid agencies have been active, since the 1950s, in establishing and supporting development banks. These development finance institutions (DFIs) specialized in investments and operations which could not meet the common business or "commercial

criteria of existing financial institutions. DFIs are, therefore, assumed to require special treatment − both in regard to what investments DFIs can fund, and where they can seek the financial resources necessary to conduct their special type of business. DFIs, largely stateowned, were thus created to meet the special financial needs of enterprises that conventional commercial banks, investment banks, merchant banks, cooperative banks, etc. could

not provide. The operations of DFIs have also been often heavily subsidized. Their efforts were usually limited, having to rely mainly on government and other external funds, and to contend with low loan repayment rates and low liquidity.

There are other types of financial institutions which fall outside the purview of the country's Central Bank but are subject to the regulatory and administrative control of government ministries and statutory agencies. These include Multi−Purpose Cooperative Societies (MPCS), as well as specialized societies such as Saving and Credit Associations and Credit Unions, Non−governmental Organizations (NGOs), and Private Voluntary Organizations (PVOs). These institutions are generally governed by their own charters and by−laws. Many of them, in addition, are obligated to be registered or licensed under designated statutes. These institutions are generally classified under the category of the Semi−Formal Financial Sector.

Commercial Banks

Almost all SSA countries have one or more commercial banks. In a few countries, however, the Central Bank, being the only bank in the country, also functions as a commercial bank. The major sources of commercial bank funds are the traditional ones: share capital and accumulated reserves, demand deposits, savings deposits, term deposits etc. Most of the deposits are small, and withdrawable on demand or at very short notice. Commercial banks balance the need for this liquidity with the pursuit of profitability by generally lending only short−term, and engaging to a limited extent in medium−and long−term lending through term−transformation. Some commercial banks have financed agricultural activities through non−financial intermediaries, using crop finance mechanism (as in Kenya). The role of commercial banks in financing agricultural and rural enterprises, particularly the small borrowers, has, however, been limited because of perceived risk and high transaction costs of administering new and small borrowers' loans. There has thus been a tendency for commercial banks to concentrate their activities on large customers in urban areas and avoid the risk−prone rural areas.

Recognizing the potential for mobilizing rural savings, many commercial banks set up rural branches for this limited purpose, and for lending mainly to some traders operating in the rural centers. In an effort to provide banking services in rural areas, many governments coerced their banks to expand their branch networks and increase their volume of lending in rural areas, as has been evident in Ghana, Nigeria, and Tanzania. Commercial banks in SSA, however, tend to cluster in urban locations and in certain rural centers, and concentrate on lending to commercial and industrial enterprises, and large−scale farms while most of the rural areas continue without banking facilities. Hence, in some countries, alternative institutions such as rural banks (Ghana) and cooperative banks (Nigeria) were set up specifically to serve small rural communities.

Credit to trade continues to be larger than the credit extended for agricultural production, agro−processing or other rural enterprises. In Ghana, for instance, the primary banks 11 /which mobilize nearly all the available savings in the country devote less than 13 percent of their total loans to agriculture, and nearly all of this is taken up by relatively large commercial farmers. Very little credit gets to small farmers and micro−enterprises. Similarly, the commercial bank

systems in most SSA countries devote a large share of their rural loan portfolio to large−scale agricultural undertakings. Agricultural lending by the two commercial banks in Malawi for instance, has gone mostly to large estates. In some countries, direct participation in agricultural credit by commercial banks is very limited. In Ethiopia, for example, lending by the Commercial Bank of Ethiopia to agriculture has been less than 5 percent and has stagnated, and all agricultural credit provided by the Agricultural and Industrial Development Bank has been from external funds. In some other countries, as in Nigeria and Zambia, the funds for agricultural lending which originate from commercial banks are for the most part channeled through other state−owned agricultural lending institutions.

There is a tendency for commercial banks in many SSA countries to concentrate on deposits mobilization in rural areas, but avoid what they see as more costly and higher risk operations of lending directly to the rural community, preferring to place their excess liquidity in Treasury Bills and other government securities. While many governments found the latter practice to be a convenient method of meeting their fiscal needs, the lack of credit availability to farmers was taken as the justification, as in Nigeria (and until 1986 in Ghana), for mandating a specified proportion of total lending to be allocated for agricultural purposes. Such direct intervention by governments has tended to reduce the viability of commercial banks and to restrain the development of the financial systems.

Specialized Development Banks

The commercial banks, even those that are financially strong and in a position to lend large amounts by borrowing retail from many small depositors and lending wholesale to few borrowers, would not generally engage in long−term lending because of the short−term nature of their liabilities and the limited potential for term−transformation. Agriculture and rural enterprises are perceived to have high risks and are therefore considered unattractive at given market interest rates. Governments bent on promoting development activities which cannot pay such as market rate of interest therefore feel justified in setting up special institutions Development Finance Companies (DFIs) in which private entrepreneurs are generally reluctant to participate. The DFIs, including Agricultural Development Banks in SSA countries, are therefore either wholly state−owned or indirectly controlled by governments. The resources for these DFIs are generally provided directly by the government, or indirectly out of funds provided by external donors, either on a grant basis or at concessional interest rates.

Cooperative Banks

In most countries, these banks are set up under special statutes or under the general legislation governing cooperative organizations. In theory, cooperatives are intended to be owned and democratically controlled by the members (i.e. policies to be decided by a board comprising representatives appointed by the members), managed by paid staff appointed by the board, with operations designed for the mutual benefit of all members. In practice, however, cooperative banks in many SSA countries receive substantial capital contributions and financial support from governments, their board composition is controlled by governments, and the senior executives themselves are drawn from the civil services or are political appointees. It is therefore, not surprising that their policies, procedures, motivation, management, staffing, discipline, accountability, and the absence of a banking culture are similar to those in nationalized and stateowned commercial banks, and that they are driven to financial distress for similar reasons.

In many SSA countries the banking systems have become heavily illiquid. Many individual banks, particularly state−owned banks, have become technically insolvent largely on account of:

(a) Credits to public sector enterprises which are poor performers;

(b) Inadequacies in the policy, regulatory and institutional framework;

(c) Profitability being undermined by restrictive margins set on credits, over−extended branch networks due to government/political pressure, and excess staffing;

(d) Administrative strictures − mandated interest rates on savings, deposits and loans thus stifling competition and not conducive to savings mobilization;

(e) Competition being further curtailed by quantitative prescriptions, sectoral allocations, and targeting select group of borrowers;

(f) Ineffective banking (prudential) control exercised by the Central Bank;

(g) Overly complex control instruments including statutory reserve and liquidity ratios, and operations not systematically monitored and enforced;

(h) Weak banking management, particularly in the state−owned/dominant banks; and

(i) Accumulation of non−performing loan and loan losses.

Post Office Savings Banks

Post office savings schemes available in almost all developed and developing countries provide easy savings facilities in SSA to people even far way from urban centers and those with small savings. Deposits collected by post offices are generally paid into the government treasury. Post offices do not engage in credit services. In effect, they function passively as cashiers and book−keepers to the governments. In some countries, as in Japan, the Post Office Savings Banks deposits are earmarked for specific rural developmental purposes, though the credit itself is administered through state−owned enterprises. In others, the collections are not reinvested in specific sectors or in the areas from where the savings were mobilized, but wholly subsumed in the national budget expenditures.

Informal Financial Systems

Informal finance may be defined as the totality of legal financial activities and transactions which are not, however, recorded and regulated and which fall outside the sphere of the official financial institutions. 12 /Many SSA countries have an active informal financial sector which provides financial services − savings, money−lending, money−keeping, etc. −to households, farms, and off−farm micro−enterprises − serving constituents that formal financial institutions find unattractive. Since the activities of savers/depositors, lenders and borrowers are

informal, unregulated and often unrecorded, they necessarily escape official statistical scrutiny. The informality of the unregulated financial market, and the ignorance, prejudice and even hostility on the part of some Central Banks, governments, bureaucrats and politicians account for the paucity of information regarding the significant role played by the private informal sector. Consequently, it is very difficult to accurately gauge the extent of its operations, although it is an important factor in rural life.

Several features make it possible, however, to characterize the informal sector: the predominance of cash transactions, the absence of record−keeping and regulation, the restricted scale of individual transactions, the ease of entry and exit, the convenient exchange of assets outside the legal framework, and a mode of operation which relies on personal relationships or interdependence within communities, of individuals (relatives, friends, neighbors, traders, moneykeepers, landlords etc.), and groups such as ROSCAs and Tontines. Arrangements that are reported, though not systematically recorded, indicate that the informal financial markets in SSA provide a significant share of the capital requirements of households and small−scale rural enterprises. Informal credit, however, is often scarce, available in small amounts, and for short periods. It is sometimes very expensive when offered by professional moneylenders but may carry no interest charge when transacted among family members, neighbors and friends. The terms may vary when the credit is given by traders, landlords etc. Transactions are governed by custom, are generally unrecorded and without collateral, and are based almost purely on promise and faith.

Informal finance operations fulfill economic needs, but are carried out in a social context. Although transactions may be formalized, personal knowledge of the borrower is generally what informal lenders rely on. Thus, applying for credit and repaying loans becomes a social obligation as well. While most institutions are small mutual assistance groups, others are quite complex and large, capable of mobilizing significant amounts of resources. Informal financial systems supply most of the rural credit need. Their importance to the rural economy is therefore significant. The surveys in Ghana, Malawi, Niger and Nigeria indicate that the volume of informal credit is far greater than that of formal institutions. The high rates of interest charged by informal moneylenders do not seem to discourage borrowers from using their services.

Informal Not Illegal

It is possible to distinguish between several thresholds of illegality of informal finance. There are countries where extending credit by unregistered entities is illegal. However, it is difficult to take action against illegality when such lending between friends and relatives is so ubiquitous. In some other countries, the extending of credit for interest is illegal (Islamic countries), while in many others lending at above a certain rate of interest defined by usury laws is illegal (India and Sri Lanka). There are also cases where while private lending itself may be legal, some or all of the credit instruments used (promissory notes and post−dated checks) and the obligations created may be legally unenforceable. In all these cases the lender has the legal right to his money and the borrower the freedom to use it for whatever purpose. In rare cases, however, the money lent may have been illegally obtained or the credit may finance totally illegal activities like smuggling, or trading in forbidden substances such as drugs. In these cases too it might be almost impossible to have legal recourse to enforce loan recovery. However, the lenders in these markets are often the ones able to use strong−arm tactics to ensure repayment of loans.

Box 2.1: Informal Finance

The informal financial sector is comprised of heterogeneous entities − individuals, institutions and groups − including moneylenders and moneykeepers, traders and stockists, landlords and estate owners, businesses and employers, grain millers and food processors, farmers and friends, relatives and neighbors, clubs and cooperatives as well as community funds. The rural households and enterprises lean more on the informal financial system, both as savers and as borrowers, for obvious reasons such as:

- ease of obtaining loans, simplicity of procedure, convenience and personal attention, confidentiality, dependability and timeliness;
- low transaction costs in terms of time and money, and low interest (often no interest) on loans except from professional moneylenders;
- facilities available closer to home, and flexible hours of accessibility;
- personal guarantee accepted as collateral, and flexibility of instruments and terms; and
- ease of exit and entry.

Almost all SSA countries have a long−established informal financial sector that provides services to households, small farmers and micro−enterprises. Rotating savings and credit associations (ROSCAs) are ubiquitous in the SSA countries. The informal sector has been able to serve customers who have no access to formal institutions which often find them too costly or risky to serve. Informal financial institutions have also proved to be able to serve the rural households, as well as agricultural and the micro−enterprise sector on a

sustainable basis. The scale of informal sector lending, however, is small, for short durations and at often usurious interest rates. The more successful formal financial systems utilize rather than suppress indigenous systems. But as economies grow, informal systems need to be augmented by the services that only formal financial institutions can supply.

By creating a macro−economic environment and a legal framework conducive to the continued growth of the informal financial sector and its co−existence with the formal financial sector, it should be possible to foster competition in the rural financial markets. As the financial system develops efficient intermediation mechanisms, the informal sector institutions will gradually graduate into formal and more modern systems as has been observed in Japan, Korea and Taiwan. Many ROSCAs have in course of time become part of the formal systems as banks, building societies, etc. as seen in Cameroon, India and the United Kingdom.

Rotating Savings and Credit Associations (ROSCAs)

ROSCAs prevail in most developing countries and are known under different names, such as Tontine in Togo, Susu in Ghana, Esusu in Nigeria, Ekub in Ethiopia, Niangi in Cameroon, and by other names elsewhere. 13 /A ROSCA consists of members who know each other on a personal basis, usually as a result of social, employment or locational bonds, and who agree to contribute a fixed sum periodically to a pool or hand that is assembled and distributed by lot at meetings on agreed dates. One member receives the hand at each meeting. When every member has received a hand, the cycle is completed and the ROSCA disbands or reorganizes. Members will be especially interested in the stature and reputation of the organizer. In return for this trust, the organizer has control over who is admitted, and may be expected to make good defaults arising from the failure of other members to make contributions in full and on time. ROSCAs create pools of funds which would usually be difficult for each member to assemble individually, and constitute an incentive to become a member. They permit accumulation because of the contractual nature of membership. ROSCA membership is generally taken very seriously − to default on a payment is a great stigma. Accordingly, accumulating funds to meet ROSCA obligations is recognized as important by the community. The associations are organized so that transaction costs are minimized — nobody except the organizer has to visit a number of people, and terms and conditions are relatively few, straightforward and applied consistently.

There are certain special features in the functioning of these groups which make them successful − the most important of which are social cohesiveness, mutuality, self−sufficiency, and informality. Great care would therefore be needed when trying to integrate these systems into overall financial sector development programs. While bringing in outside resources may pose a threat to the system itself, informal groups left to operate with whatever resources they can mobilize from within the group restricts the possibility for further development. Nonetheless, the question of linking informal and formal financial sector arrangements seems promising.

Informal/Formal Sector Linkage

Informal financial arrangements and institutions, mostly indigenous, have withstood the test of time. They have thrived for so long and continue to do so both when many formal financial institutions fail, and when the formal systems develop and expand. The informal financial sector, though often not included in official statistics and also outside the reach of government control, is larger than the formal financial sector in most SSA countries − both in regard to savings mobilization and credit provided in rural areas. This pre−eminence is likely to continue for some time into the future. The informal financial sector is also known to play a more prominent role in the lives of the lower income and disadvantaged groups. Contrary to the common belief that interest rates prevailing in the informal financial sector are usurious, they are often not so high in relation to the effective interest rates and costs

borne in formal sector lending. Significant portions of informal sector loans do not bear interest, since few of the traders, relatives friends, landlords, employers charge interest on loans they extend. Moneylenders (for example, Katapila in Malawi) who generally lend smaller amounts for shorter periods exact higher interest rates, perhaps to compensate for the greater risk factor and collection costs. Traders and millers generally use interest−free loans as a means of custom building; and landlords and employers use loans to ensure a reliable supply of labor for their operations from their own tenants and employees.

Commonly−quoted examples of informal arrangements in rural finance, such as savings clubs, rotating savings and credit associations, etc. may not be very relevant to the requirements

of agricultural production, particularly for investment needs. Most of the funds collected through those systems would be short−term, and mainly for consumption purposes. There are, however, exceptions such as the women's savings clubs in Zimbabwe, where the group savings are used for the bulk purchase of farm inputs. Informal credit is also provided by private traders who lend directly to individual farmers. Thus they are known to the farmers and are often the only source of credit. Some farmers often have to take inputs on credit. Attempts to increase the flow of credit through private traders have failed due to the lack of credit facilities available to these traders themselves.

Despite its ubiquitous nature and growth, the informal financial sector is generally known to be very localized, offering a small range of services, lending short−term and unable to meet all the demands for loans from the rural population. Such limitations of the informal financial sector could be overcome by making more funds available to those individuals and institutions (traders, landlords, etc.) equipped to perform the financial intermediation efficiently. While one approach would be to create conditions conducive to better links between the intermediaries in the formal and informal financial sectors, since the two sectors generally serve the interests of different types of clientele, such integration might not, after all, result in greater benefit to the weaker sections of the rural population.

Formal financial institutions concentrate their lending in urban areas while informal intermediaries operate in both urban and rural areas. The former could provide inducements to the informal financial sector constituents to deposit their surplus funds, offering to meet their requirements of extra resources when needed. The formal financial institutions could begin to adopt some of the techniques successfully employed by the informal financial sector parties, and also explore the possibility of using informal financial intermediaries as their agents. Many of the informal intermediaries, e.g. traders, moneylenders, landlords and the like are already clients of the banks. The formal sector institutions prefer to deal with such clients as wholesalers, because they have already established their credit−worthiness, and need to make a fewer number of loans with less collateral problems to contend with. While some believe that the future of the African rural financial system lies in integrating the informal and formal sectors, others contend that such efforts would simply be a distraction from the need to concentrate on a more thoroughgoing reform of the formal financial system.

Traders are an important link in rural finance — at times linking commercial banks with rural customers. Credit−in−kind is common in rural settings, extended as short−term loans for consumption goods, farm inputs, and raw material supplies to off−farm enterprise and as longer − term loans for capital investments. Credit to farmers, millers, etc. might be repaid in kind, as farm produce, processed goods, etc. for retailing by the trader−lender. Loan repayments are therefore made at the end of cropping season or processing cycle. The trader−credit mechanism has proved to be successful in delivering credit to small farmers and small−scale enterprises to whom commercial banks have been reluctant to lend. There is evidence, as in the Tanzania Cashew and Coconuts Project, that small farmers could be assisted far more effectively by providing credit to the input traders who are better credit risks, from the lending bank's point of view, and are in a better position to enforce loan repayment from the farmers. The traders thus also function as intermediaries between the lending bank and the ultimate borrowers.

Moneykeepers are persons generally acknowledged to be trustworthy in a locality, with whom individuals and groups feel comfortable in entrusting their spare cash for safekeeping. Some moneykeepers may charge a fee for the safekeeping service (as in Ghana and Nigeria). Others may render it as a free facility (as in Niger) or even pay some interest on the deposits,

because of their opportunity to make loans at higher interest rates (as mortgage brokers do in Sri Lanka), or to use the funds for personal investments. Moneykeepers cater to a large variety of rural households and are known to fulfill a strong demand for safekeeping and depository services. Unlike Tontines and ROSCAS, where there is female dominance, males dominate as moneykeepers. Moneykeepers are also recognized as lenders, able to lend short−term, undertaking some term−transformation at their own risk, but splitting the interest earned with the depositors. Some notaries and lawyers who prepare mortgage trust deeds and function as moneykeepers are generally able to extend long−term loans as well by arranging the mortgage of title to land and buildings (as in India). With lawyers, the safekeeping and lending activities are often very formalized; the depositors' funds are kept in separate Trust Accounts maintained with Banks, the mortgage deeds entered in the name of the depositor customer, with the lawyer collecting only a fee for services.

Professional moneylenders are individuals involved in financial transactions, as part of their occupation. They are far less important in SSA than for example in South Asian countries, and the total amount of their transactions is estimated to be considerably smaller than that of other actors in the informal financial sector. Some moneylenders have as their main occupation the granting of loans as funds for small and short−term emergency needs. These loans, like any other informal credit (except pawnbroking) are not secured by collateral, and rates of interest are reportedly high. Resort to moneylenders, except as a result of circumstances beyond one's control, carries a social stigma. Their appeal, however, is the very convenient and instantaneous credit. Moneylenders play a significant role in serving the credit needs of rural households which have limited access to formal finance. They have also been credited with financing start−up capital for micro−enterprises. Sources of funds for their lending vary from own savings to cheaper funds borrowed from other sources (sometimes more efficient moneylenders, and also from banks).

Loan terms and conditions include the pledging of physical assets, usufruct, third party guarantee, etc. The rates of interest charged also vary according to amounts and tenure of loans. Annualized interest rates are known to vary from 365 percent (1 percent per day), and more for very small loans for short durations, to 24 percent (2 percent per month) for larger amounts and longer durations. According to Chipeta's study, 14 /katapilas in Malawi were known to charge interest varying from 25 to 100 percent per month. Several factors limit the ability of moneylenders in SSA countries from being more active in offering credit services and in contributing much more efficiently to resource mobilization and allocation. The foremost constraint is the lack of legal or official approval and sanction; as a result they have had to operate very much in private (underground). The absence of such recognition also has the effect of preventing them from using the legal system to enforce loan recoveries. Inadequate financial resources too constrain their ability to extend more loans to those in need; and the lack of recognized legal status denies them the alternative opportunity of directly and openly accessing the formal institutions.

Landlords, who themselves borrow from banks, have also been providing credit, in particular to tenant households. In Malawi for example, at the end of 1989, there were about 14,670 estates primarily engaged in the production of cash and export crops (tobacco, tea and sugar), most of which were employing tenant labor to produce their crop, supplying them with inputs and provisions on credit. It is estimated that some 40 million kwacha [(US$1 = 4 kwacha (1992)] in credit was extended to more than 60,000 tenants by the estate owners during the 1988/89 season. The majority of the loans (51.5 percent) were made at interest rates as low as 5 percent per annum. Most landlords, however, demand some form of security from tenants,

although for a number of them the tenants' signature is all that is needed. For most of these lenders, interest earned was supplemental income, and there is no indication that estate owners provided credit to non−tenants or households outside the estates.

Cooperatives and Mutualist Groups

Group arrangements beyond family and friends have proved to be an effective instrument in providing savings and credit facilities in the rural sector. Groups play a major role in informal finance because the mutuality provides a framework for confidence as well as the mobilization of savings. Grassroots organizations such as credit cooperatives and self−help groups, who are customers of commercial banks, have proven successful in servicing rural areas. They are the product of local initiatives, their staff can identify and interact well with small rural producers and their services and products reflect the regional culture and ethos. Because of their proximity to clients and because of greater regulatory freedom, they are in a better position to innovate in ways that commercial banks with regimented and centralized organizations cannot, and also to effectively minimize transaction costs. Through peer monitoring, they are more effective in managing and controlling credit risks. The small size of their client group facilitates the process of gathering information on the members, all of whom reside in the same locality. Compared to commercial banks, however, such groups are limited in important ways. Unlike banks, they do not generally have access to secondary sources of finance, and are subject to the covariance of regional cash−flow patterns. They often lack professional financial expertise and depend excessively on the personal leadership of the promoters. Because of their small size and scope in the initial stages, they take time to reach a financially viable scale of business.

There are examples of cooperatives that take advantage of both a large resource base and a rural−based network. The European cooperative banks, such as the Rabo Bank in the Netherlands, combine size, professional management, modern information technology and a decentralized structure to provide an efficient transactions and credit mechanism for farmers. Although the European banks took long years to mature as farmer−oriented, financially viable institutions, the present banking technology, policy initiatives and available external support should make it possible to replicate the successful elements of the cooperative system in SSA countries, adopting decentralized systems operated through local small group institutions.

Financial intermediaries including registered cooperatives, credit unions, and other forms of savings and credit associations have been very effective in reaching small borrowers, particularly women, because they are based on traditional systems of savings and borrowing. Cooperatives are adaptable to a large variety of economic activities. Their potential to meet the needs of members in many different activity areas is reflected in the diversity of cooperative organizations in the SSA countries. The most prominent types of cooperatives in the region in terms of the number of societies, membership and business volume are the agricultural service cooperatives or multipurpose cooperatives, and the financial cooperatives or the savings and credit cooperatives (credit unions). Multipurpose as well as specialized financial cooperatives are actively involved in providing financial services to their members.

In discussing the role of cooperatives in providing financial services two aspects need to be considered. First is the availability and adequacy of finance for the cooperatives and their members. In most cases this has been seen as the major problem, and the need for additional funds has been identified as a priority. The second is the relevance of cooperatives in the rural financial system − an aspect which has received much less attention in the past. The hoped−for results have not been achieved through the allocation of additional financial resources because the

cooperative institutions have not been capable of handling the increased volume of loanable funds. Injection of outside funds also has in many cases destroyed some emerging cooperative financial systems.

Rural cooperatives have several attributes that make them well−suited to providing financial services to their members. Many characteristics are those commonly related to a cooperative type of association. Cooperatives operate at the grassroots level and are thus close to people, and in most cases members know each other well — one of the basic conditions for trust. More specifically in the area of financial services, the cooperatives are often the only financial institutions and perhaps the only legally recognized organizations in rural areas. It is therefore natural to try and organize financial services through such existing institutional structures instead of attempting to create new entities to supplement the traditional informal sources of credit.

Many types of cooperatives are involved in providing financial services to farmers and other people in rural areas. At the primary level, savings and credit cooperatives or credit unions are single−purpose institutions, dealing only with collecting savings and lending moneys so collected. Another category at the primary level comprises various other types of cooperatives also providing financial services linked with or in addition to their other operations. Both these groups might have operational contact with a secondary−level cooperative or they may link up directly with an organization at the next higher level which might be the state or national level. At state level, there can be a cooperative bank or another type of cooperative apex body, specifically established for handling financial services. Cooperatives providing financial services at the primary or secondary level can also have operational linkages at the national and regional levels with non−cooperative financial institutions such as commercial banks.

Savings and Credit Cooperatives and Credit Unions

Credit Unions (variously described in different countries as Thrift Societies, Savings and Loans Associations, Savings and Credit Cooperatives, etc.) are unique cooperative institutions. They share important features which distinguish them from other financial institutions, whether formal or informal. They are part of the financial sector and, at the same time, are typically the most developed and best−functioning component of the cooperative sector. The most important single factor seems to be that Credit Unions are self−contained financial institutions, capable of generating their own funds for lending through internal savings mobilization. Credit Unions do not generally depend on government grants or loans at concessionary terms to financially sustain themselves. This capability is further enhanced by the fact that they are locally oriented, self−selected member−owned institutions. Credit Unions complement and supplement, rather than compete directly with other financial institutions, whether formal or informal. They generally serve different clientele, offering different ranges of services, and can coexist in the same geographic area and market.

The early Credit Unions established in SSA countries were in urban centers and among salary/wage earners. They have now spread into the rural areas and include lending for agricultural and other rural activities in their operations. Small Credit Unions try to base their lending operations on their own funds. In this way they are able to maintain their independence to a much greater extent than many other rural financial institutions or multipurpose cooperatives which rely on external sources of funds. Because it is location−specific and its members engage in seasonal and similar activities it is subject to covariance constraints in more than one respect, e.g. when all the farmers need money at the same time. Within Credit Union movements, the

Box 2.2: Credit Unions

A Credit Union is a financial cooperative (specialized cooperative savings and loan association). Its purpose is to encourage savings, to use pooled funds to make loans, and to provide other related services to the members of the union. As a cooperative it is a voluntary, mutualist, and democratic non−profit organization. Surplus income earned is distributed as dividends on shares. It is owned and controlled by its members who own shares in the Credit Union. The basic requirement for starting a Credit Union is a group of people with a mutual financial interest. The group should, however, have a potential

membership large enough to ensure sustainability. Most Credit Unions form part of a large network worldwide, through regional, national and international linkages. Examples of such higher−level confederations includes: the Africa Cooperative Savings and Credit Association (ACOSCA), based in Nairobi, Kenya and The World Council of Credit Union (WOCCU) in Madison, Wisconsin in U.S.A. which serves as the international membership organization of Credit Unions. WOCCU assists its members to establish new unions and strengthen existing unions throughout the world by providing technical and financial support, facilitating communications exchange, external relations activities, etc.

solution to this problem has been attempted through the creation of a central finance facility which provides member Credit Unions with a secure place for liquid funds, investment of surplus funds, and credit when needed. There has been an enormous growth of urban Credit Unions, as in Kenya and Nigeria, which provide savings facilities to rural dwellers employed in urban areas, and are also an important source of financing for rural investments and production activities.

To overcome the problem of inadequate resources for lending, some donors have offered funds to be channelled through the Credit Union movements, with unfortunate results. The best results in these efforts have been achieved where the facility is operated by the Credit Union national association managed as a separate entity, at the apex level within the Credit Union system. In some cases, the government has directed Credit Unions to use existing cooperative banks and/or commercial banks, as in Benin, but attempts at such collaboration have not been satisfactory.

Multipurpose Cooperatives

Multipurpose cooperatives in SSA traditionally provided short−term cash advances to members against their anticipated crop proceeds. Unfortunately, such transactions were often not properly managed or recorded and controlled, resulting in substantial losses to many cooperatives. In some cases, as in Kenya, systematic efforts were made with external assistance to develop an effective lending system. The credit system was carefully designed, and lending operations were initiated on a limited scale with a small loan from the government. Savings mobilization was also incorporated into the operations at a very early stage and in a few years the savings mobilized exceeded the loans granted for members' short and medium−term needs. Kenya is a good example of where cooperatives have been successful in the initial stages in operating without major financial inputs from external sources. Subsequent excessive injections of external funds, though not originally planned, occurred because various donors wanted to take advantage of the success of the initial programs. In many other cases, however, distribution of credit is imposed on cooperative structures without adequate preparation.

In the case of multipurpose cooperatives, the question of mixing financial services with commercial activities, such as processing and marketing, has caused problems. It is justifiably argued that it is in the small farmers' interest to have all agricultural support services available at one contact point. But when substantial amounts are mobilized as savings, as in Kenya, there may be a temptation to make use of the savings mobilized to finance the operational expenses of other activities of the societies. In Kenya, action has been initiated to separate the financial services from the multipurpose cooperatives to form single−purpose or specialized savings and credit cooperatives, along the same lines as the Credit Unions.

State and National−Level Cooperative Financial Institutions

What has been said about the financial services within primary cooperatives not functioning properly holds even more true for state/national−level institutions. For any cooperative financial system to function well at the primary level, proper links are needed with overall financial systems at the national level. In Nigeria, for example, State

Cooperative Financing Agencies have been created to act as apex bodies at the state level, but with mixed results. A Cooperative Financing Agency at the state level (as in Nigeria) or a cooperative bank at the national level (as in Somalia), without a well−established cooperative network at the primary level and a properly−designed financial service system, is bound to face tremendous difficulties with the probability of complete failure. Due to the limited volume of business within the cooperative sector, some cooperative banks have tried to get additional business from outside their membership, as in Zambia, thus assuming the character of commercial banks, but without the benefit of prudential supervision by the Central Bank. In some cases, such banks had neglected their member cooperatives almost completely (as in Ghana and Uganda), and subsequent attempts to regain their trust have met with understandable resistance.

Looking to the Future

Cooperatives

Experience gained so far indicates that cooperatives could play a significant role in rural financial systems in SSA countries. It should be recognized, however, that cooperative−type institutions have to complement the other sectors of the rural financial systems. the most successful and rapidly growing type of cooperatives in rural financial services have been the single−purpose financial cooperatives, particularly the Credit Unions. These financial intermediaries could be made to play a greater role in the further development of rural financial markets in SSA in the future. Special caution would, however, be necessary where members' deposits are utilized by multipurpose cooperatives for commercial activities.

The cooperatives, including Credit Unions, may be able to carry out their activities satisfactorily within their limited local area and without contacts with the outside world for a while. In time, the needs of members will grow to such an extent that without having access to additional resources, particularly at certain times during the production cycle, their operations will slow down. It is of utmost importance therefore that linkages between cooperatives providing financial services at various levels be planned at an early stage and established.

As for all other cooperatives, the policy and legislative framework should provide a conducive environment for financial cooperatives to be democratically managed. Governments have to allow cooperatives to function as independent financial institutions and let them compete in the financial markets along with other institutions, without expecting to have special support

from the government. External support provided to develop cooperatives as part of the rural financial system needs to be handled with great care. Much more attention should be paid to the institution−building aspect, thus improving the capacity of the system, than to providing excessive funds for lending. In this way mobilization of local resources can also be more easily incorporated into the operations of the cooperative financial institutions.

Informal Finance

Bouman and Houtman summarize the appropriateness of the informal sector to rural societies thus: Informal lending has a number of favorable features. The most important one is that it belongs to and has been part of the rural economies for centuries. In keeping with the environment, they operate without costly buildings, staff, and paper work. Because of proximity, they have knowledge of the credit−worthiness of borrowers, which minimizes the cost of assembling information. They are accessible at all times and keep procedures simple to accommodate and reduce transaction costs of customers. They supply saving facilities if requested, offer and accept payment in cash and kind, and are flexible in rescheduling loans. Superior local intelligence and possibility of applying social pressure and exercising extralegal forms of sanctions enable them to collect debts in a timely manner. 15 / Compared with formal sector lenders, transaction costs and repayment performance of savings and lending−group lenders are remarkably better, through group pressure. The costs of processing and recovering loans are much

lower. Almost all group administrative work is done on a voluntary basis. The simplicity of procedures reduces transaction costs for the borrowers and lenders. Credit from these organizations is more accessible than formal credit; the terms and conditions are less stringent, more transparent and applied consistently, and in general, no collateral is required. Credit is available for both agricultural production and consumption (although consumption loans may be more significant) and for the non−farm enterprises of rural households. Because of the proximity to clients, these groups have been able to innovate in ways that formal financial institutions cannot. Since the lender and borrower usually know each other, no time is wasted in screening; there are no bureaucratic delays to increase the cost, and the lender and borrower are often from the same locality, thus minimizing transport costs.o

A well−established and smoothly−functioning informal group savings and credit system could play a crucial role in the savings−investment processes. The essentially spontaneous and voluntary emergence of these groups constitutes part of the reason for their success and sustainability. The success of these groups depends on their very nature: their self−selected and voluntary participation, autonomy and self−reliance; and their service delivery mechanisms: low transaction costs, convenience, flexibility and trust and confidence. An oral promise is frequently all that is needed as collateral or security. Confidence, trust and mutuality are the cornerstones on which the lending and borrowing relationships are established. A person's image or reputation is paramount in this voluntary, mutualist, self−help group relationship.

The group approach emphasizes the savings habit as a way to accumulate money for future production and consumption uses. Women often find this to be a great motivation for participation. Group−based savings and credit systems also tend to work more smoothly than individual−based ones among the rural poor, and particularly among women. The group savings approaches appear more likely to succeed than those centered on individuals: group schemes make it possible to save without appearing selfish. Some of these features of ROSCAs, Tontines and Susus, would be worth incorporating into institutional financial systems.

3. Rural Financial Services

Rural Credit

Credit is often considered to be a key element in the modernization of agricultural and other rural sector investments and operations. Not only is it expected to remove a financial constraint, but also to accelerate the adoption of new technologies. Many SSA countries have undertaken targeted credit programs to support rural activities on the premise that credit is an integral part of the process of commercialization of the rural economy 16 / and a vital instrument of economic development. The justifications for directed credit schemes have included support for weak economic groups, need to assist priority sectors or activities, infant industry, and avoid or recover from market failure, etc. The market failure argument is often used in favor of such intervention because of:

(a) Imperfect competition;

(b) Asymmetric information and absence of credit history;

(c) Adverse selection;

(d) Inadequate enforcement of contracts and property rights;

(e) Higher transaction costs involved in lending to smallholders and rural microenterprises;

(f) Risk associated with small enterprises; and

(g) Lack of acceptable/adequate collateral, due to:

(i) poverty,

(ii) low value of machinery and equipment, and

(iii) inadequate property rights.

Agricultural Credit

The main reasons for advocating government intervention, through targeted and subsidized credit, in support of agriculture are that:

(a) Agricultural financing is the most risky venture, shunned by profit−oriented private banks;

(b) Agriculture is at the mercy of the vagaries of the weather, and hazards like pests and natural disasters;

(c) There are no organized marketing outlets for farm produce;

(d) Farmer incomes drop heavily in years of abundant yields and uneconomical producer prices at harvest time;

(e) Small−scale operators cannot generally offer collateral or guarantees;

(f) It supports the pursuit of government policies like self−sufficiency in food, producing industrial raw material, and export crop cultivation; and

(g) Accelerated development of agricultural sector would serve as the motive force in economic development;

Targeted credit, often also subsidized, is frequently advocated as a panacea for poverty alleviation and for minimizing the vulnerability of the poorest of the poor. The use of selective instruments to deal with a generalized problem has often led to the failure of many financial intermediaries without remedying the problem itself. Increases in non−performing loan portfolios are often condoned by state−owned financial intermediaries, governments, donors and NGOs. On the premise that no viable alternate sources of credit are available, governments and donors have been reluctant to disengage or suspend dealings with money−losing and financially ailing lending institutions. In a number of initiatives intended to provide credit at the grassroots level, many defaulters are often precisely the people at whom the program or scheme is aimed. The loan losses for the financial intermediaries thus become a subsidy to be met by the government out of its constrained budgetary resources. Even the managers of government institutions may be relatively insensitive to loan losses. Their status as officials of a government department, development institution, a state−owned bank or lending agency shields them from personal financial, career or professional risk related to the performance of the loans for which they have direct or indirect responsibility. 17 /

Existing banks are perceived as being overly cautious, risk−averse and unimaginative, preferring to lend to friends in large businesses, and larger borrowers in industry and commerce. This perception provides the justification for targeted loans to chosen sectors declared as priority, the imposing of interest ceilings, charging discriminatory lower interest rates to specified groups, the offering of lower central bank discount rates, requiring or encouraging banks to cross−subsidize, providing direct subsidies by governments and expecting or requiring banks to write−off debts or to indefinitely postpone loan repayments. Other devices used by governments to provide subsidies include: offering equity capital to state−owned banks without an expectation of dividend payments, providing interest−free loans, or charging interest below market interest rates, and allowing such loans to be

effectively perpetual debts without any stipulation or expectation of loan servicing.

Impact of Subsidized Credit

Financial markets may transfer subsidies in two ways, through concessionary interest rates, including cross−subsidization and subvention payments made by governments toward the operational costs of the intermediaries, and through loan defaults which too might in the end be reimbursed or condoned by governments. Subsidy has the effect of crowding other sectors (deemed non−priority) out of the market. Once credit programs are begun, they create a constituency of beneficiaries who do not want them stopped and it becomes extremely difficult for any government to reduce its support for such programs, regardless of changed circumstances, high cost, inefficiency, abuse etc. Many directed credits have resulted in mounting non−performing loan portfolios and the eventual demise of the lending institutions.

Box 3.1: Directed Credit

Because of the high visibility of the formal sector the constituent financial institutions are easy targets for interventions by governments. The form of intervention most commonly resorted to is the targeting of loans or directing of credit, frequently at below market interest rates, for priority economic sectors or channelling funds to preferred sections of society. Directed lending is resorted to at times by the Central Bank in the country by imposing lending quotas on the commercial banks or requiring them to place a specified percentage of loanable funds either with the Central Bank or other specialized lending institutions at below market interest rates.

Lending institutions, even though owned and/or controlled by governments, generally try to avoid high−risk loans and consequent losses in order not to jeopardize their financial viability and the possibility of institutional expansion and continuity. Financial intermediaries cover such losses and operational losses occasioned by high transaction costs by cross−subsidizing by charging their other customers more than what they would otherwise have to, or through subsidies from the government. The situation is often compounded by financial institutions, particularly parastatals, postponing the day of reckoning by carrying bad loans on their books without making adequate provisions for doubtful debts and not writing off the bad loans.

The assumption behind targeted credit is that without it very little of what is expected to be achieved would happen − yield improvement, production increase, adoption of new technology, irrigation, new varieties of seed, increased fertilizer use, etc. There is, however, evidence from many SSA countries, as also in Asia, that significant improvement in production takes place even without formal credit specially targeted. The increased purchase and use of fertilizer by small farmers for cash in Zimbabwe through savings clubs, and in Tanzania under a pilot project component in the Tree Crops Project are just two cases in point. Factors such as timely availability and competitive prices are more important than credit. It is unfortunate that in certain inputs supply and other special programs, the farmer is obliged to accept credit in order to benefit from the program. Credit alone is not sufficient for economic development because there are other factors more crucial − input and output prices and markets, infrastructure, etc.

Cheap interest rates encourage less productive investment. Those who borrowed for low−return projects often cannot or do not repay their loans; in other cases, borrowers default considering themselves protected. Erosion of financial discipline has left intermediaries unprofitable, and in many cases insolvent. Refinance schemes at discount rates have reduced the motivation and the need for lending institutions to mobilize resources of their own, leading to a lower level of financial intermediation. Social and equity goals could be achieved cheaper and more effectively through appropriately−funded direct subsidies or budget allocations, than through credit. Subsidization of interest rates in favor of targeted groups has often been found to be highly inefficient and ineffective for the purpose.

The traditional view is characterized by credit being perceived as an input into agricultural production, similar to seeds and fertilizer, and contends that extending subsidized

credit for production purposes will result in additional supply and help to usher the rural poor into the modern economy. It is also generally assumed that the rural poor do not save and need cheap credit to take advantage of improved agricultural technology and investment potential. Therefore, certain governments and donors consider formal credit programs − through directed credit and specially formed institutions − as a convenient vehicle to resolve the problem of rural development. The creation and support of specialized credit institutions was advocated in support of the need to provide a substitute for the usurious money lenders in the informal credit systems. Informal credit systems were believed to be exploitative of the rural poor, and incapable of expanding to meet the financial requirements for increased agricultural investments and production. Difficulty in measuring the production impact of credit, suspicion that financing for crops was being diverted to consumption or alternative productive purposes, high rates of default on repayments, and concentration of official credit in the hands of a limited number of recipients prompted legitimate concerns over the validity of this approach (i.e. providing subsidy through the financial institutions).

Since money is fungible, financial substitution by the borrower should be expected, and it would be impossible also to counter the motivation for or monitor the actions of the borrower switching funds to a different purpose. Neither the availability of borrowed funds nor the concessionary terms of the loan secured will make a material difference in the economic benefit derived from the investment concerned. The input/output ratio, relative prices of input and outputs, marketability of crops are the more significant factors that would influence the decisions of farmers and rural entrepreneurs regarding investment and production options. Cheaper credit would by no means substitute for the availability of profitable investment opportunities nor would it induce an entrepreneur to embark on any venture of doubtful profitability.

Funds provided through directed credit projects have often displaced funds that would otherwise have been forthcoming from other sources, thus resulting in limited additionality. Subsidized credit targeted at small farmers would substitute resources already available, and the benefits were not infrequently snatched by non−targeted, affluent borrowers. Credit used in conjunction with subsidized inputs themselves are rationed out, because of the subsidy burden, and thus often leads to the diversion of benefits from intended beneficiaries. Subsidized credit has diminished the ability of banks to pay attractive interest rates on deposits, thus discouraging savings, and increasing the reliance on government and donor funds.

Impact of Directed Credit

The experience in most countries indicates that directed credit programs too have, by and large failed to match their initial promise. Thirty years of experience with these programs have highlighted me following difficulties :

(a) Many programs have come to a halt and or are continued only because they are implemented by state−owned financial institutions, utilizing government funds;

(b) Even though many of these programs had proliferated since the 1960s, some supported by international development agencies including the World Bank, there is no demonstrable evidence that they have increased investments and/or led to the expansion of outputs in the targeted activities. On the contrary, the institutions that were entrusted with this type of lending have had serious financial difficulties;

Box 3.2: Subsidized Credit

Subsidies are transferred in the financial markets through administered interest rates below market interest rates allowed to depositors, concessionary refinance facilities offered by central banks, below market rate of interest stipulated for loans to targeted sectors or clientele, high transaction costs absorbed through subvention payments, and loan losses reimbursed from the national budgets. Attempts to provide special help to the needy and the poor through subsidized credit programs are known to have been subject to abuse and mismanagement in many SSA countries and not having yielded the expected benefits. Apart from benefiting rent seekers, the financial intermediaries themselves have been weakened, in many cases beyond redemption. Subsidies, once introduced, tend to balloon and are generally difficult to phase out quickly, if at all possible.

Credit is not the most appropriate instrument for subsidizing any economic investment or operation even if priority sector needs warrant such special support. The extent of subsidies involved in policy−based credit schemes is not always explicit or evident − it generally takes the form of unserviced equity and loans provided by the state, subvention payments, etc. (Yaron 1992). Subsidies when deemed essential should preferably be made as direct explicit assistance and not through the credit instrument. Explicit and implicit subsidies involved in any credit scheme or in the operation of financial institutions should be computed at the planning stage, monitored on an ongoing basis, and appropriately funded to avoid cross−subsidization and gradual weakening of the institutions involved.

Care is required to ensure that the subsidies do not compound the distortions in the financial market which prompted their introduction in the first place. Subsidies offered to end−beneficiaries should not impinge on the operational and financial autonomy of the financial intermediaries. To minimize further distortion of the financial markets, end−users should be charged interest on loans in keeping with market rates, and any subsidies, where considered essential, should be passed on to the financial intermediaries so as to ensure their viability.

(c) They have not recommended themselves as the most appropriate mechanism to address market distortions. Real sector policies, public investments in infrastructure, budget−related grants, improvements in the legal and administrative environments etc. are probably more effective ways to support priority sectors;

(d) Under these programs, the financial markets have themselves been distorted through imposed low interest rates, while financial institutions have not had sufficient incentive to mobilize savings since funds were readily available through the Central Bank discount windows and concessionary lines of credit. They have functioned as mere conduits for financial transfers rather than as financial intermediaries.

Experience also shows that directed credit programs carry with them high costs in terms of inefficiency, non−achievement of equity goals and prejudicing financial sector development.

Over time, farmers would no doubt respond to new opportunities, but attractive prospects for the use of funds do not justify special credit programs. Substantial improvements in productivity and yields are often achievable even without the injection of funds through changes in cultivation or management practices, appropriate sowing periods, plant spacing, soil preparing etc. requiring no purchased inputs. Even farm operations that require special inputs for improvements, as for example, fencing and earthworks could be carried out with materials available on the farm and using family labor. For example, the Kerala Pepper Rehabilitation Program (in India) had a poor demand for credit because farmers used pepper vine cuttings and supports from their existing plantings and family labor; and farmers used their own savings to buy milk cows in the Indian Anand Dairy Scheme, as did many Kenyan cattle farmers who used their own funds to buy improved stock.

There is no scientific and reliable means of identifying or quantifying rural credit demand. The best proxy for credit demand is the sum of credit applications backed by bankable propositions. Mistakenly, unmet credit demand is considered to be the difference between approved applications and the total number of loan applications received. 18 / Attempts to hasten credit expansion in selected sectors, to segments of the population, or geographical regions (which has happened virtually in all developing countries including SSA countries) are based on this premise. Supply−led finance is advocated on the premise that it stimulates growth by creating financial institutions in advance of the demand for their services. A special problem besets state−owned lending institutions established to promote investments not considered bankable by existing private financial institutions — they find it difficult to be objective in rejecting unbankable proposals because of the government's expectations and consequent pressures to lend.

Tackling the Fundamental Problems

Directed/subsidized credit tends to treat the symptoms rather than the root causes of the problem. Barriers to development cannot be removed by providing loans since other fundamental problems intrude: deficient production technologies; low commodity prices; high transport costs; poor marketing infrastructure; price controls; inefficient bureaucracies etc. There are other non−financial factors as well which cannot be put right with cheap credit. Although a degree of intervention may have been useful during the early stages of rural finance development, many countries have come to recognize that this policy has had an adverse effect on financial development, and that directed credit programs have been an inefficient way of redistributing income and of dealing with imperfections in the market. Directed credit programs have also often been used not to correct the inadequacies of financial markets but to channel funds to priority sectors regardless of whether these were the most productive investments. In some countries, it is likely that the programs have had little impact, because they supported lending which would have happened anyway, or because they offered only weak incentives. It might be more defensible to provide directed credits for certain activities (for example exports or research and development), or for specific sorts of financing such as long−term loans rather than to target specific subsectors.

Once directed or subsidized programs begin, they create a constituency of beneficiaries who do not want them stopped. This makes it extremely difficult for governments to reduce their support for such programs — regardless of how costly or inefficient the governments perceive them to be. Whatever other conclusions may be drawn concerning the impact of directed credit programs on growth and the distribution of income, it is clear that they have tended to damage existing financial systems. Many directed credits have substantial nonperforming loans. Borrowers do not hesitate to default because they believe creditors will not take legal action

against those in the government's priority sectors. It should also be recognized that the imposition of more debts on individuals does not overcome their lack of financial discipline, lack of managerial skills, dearth of high−return investments or of the multitude of other factors that impede economic development. 19 / The sooner it is recognized that poverty cannot be overcome by merely supplying credit, the sooner it would be possible to identify more appropriate instruments for dealing with poverty, and economic development.

Resource Mobilization

Emphasizing credit wilfully ignores the fact that such credit is not sustainable, that it ignores savings mobilization and the essence of financial intermediation between depositors/savers and borrowers, and does not explore alternative ways of stimulating and financing investments, thus contributing to inefficiency and greater inequity. Savings mobilization improves resource allocation by drawing funds away from less productive purposes and allocating the resources to more productive uses. Lending rates kept deliberately below market level under government programs tends to discourage savings. Artificially low rates also discourage lenders from improving the mobilization of savings, because they cannot lend these funds at remunerative rates, as they have to pay market rates to attract savings. Offering attractive interest rates for savings, and lending to cover lenders' costs and profit margins supports the development of rural financial markets.

Savings mobilization is essential for financial market development. The record of failures of financial development programs, particularly in the rural financial sector, demonstrates that savings mobilization has invariably been neglected or has played a minor role. Savings will benefit a larger proportion of rural poor than credit programs. Innovative savings instruments and institutions that pay greater attention to deposit and savings mobilization are therefore essential ingredients of rural financial market development. Integration of savings schemes greatly contributes to the sustainability of rural finance programs.

An offer of higher interest on savings deposits will influence the individual's decision on the allocation of funds between current consumption and savings. This may also induce a higher transformation of non−financial savings into financial assets, and this substitution effect would result in additional savings. Financial institutions also mobilize local resources by providing safekeeping facilities and by serving as a dependable source of ready financial liquidity in times of need.

Until recently, it was widely believed that providing loans at low interest rates was the main function of financial institutions in the rural areas of developing countries. Virtually all governments and donors who finance projects in SSA have stressed lending, and virtually ignored savings and deposit mobilization. Many of the intermediaries handling donor funds do not offer deposit facilities, finding it cheaper and easier to lend captive low−cost funds from government or donors rather than mobilize the needed resources. Some intermediaries aggressively discourage small deposits by levying charges on them. Interest rate regulation, plus the availability of relatively cheap outside funds act as disincentives for financial intermediaries to mobilize deposits. High statutory reserve requirements in many countries are also an effective tax on deposits, forcing intermediaries to pay low rates of interest on savings, and diluting any enthusiasm in deposit mobilization. This preoccupation with providing agricultural credit represents a damaging bias against savings in which deposit mobilization has almost become the forgotten half of rural finance.[20 /]

It is also common in SSA for those agencies accepting deposits in rural areas to make few agricultural loans—some rural Credit Unions and the rural banks in Ghana being the main exceptions. Rural people must often deal with two agencies if they want to both borrow and hold deposits and the splitting of functions makes it much more difficult to realize any economies of scope in financial intermediation. The separation of deposit mobilization and loan granting functions has also led to situation where rural savings are channelled to urban areas (e.g. Botswana, Cameroon, Kenya, Lesotho, and Zaire), while governments and donors provide funds from rural credit schemes through other agencies.

Deposits mobilized by commercial banks through their rural branches and mobile units flow to urban areas to finance urban industries and traders. While use of resources to fund activities with the greatest economic potential might be beneficial from the country's point of view, the rural sector would be neglected due to the flight of even the limited available resources. Rural areas are also similarly deprived of their resources when rural deposits mobilized by banks are captured through very high statutory reserves and liquidity ratios specified by central

banks, and when government savings banks collect deposits which are absorbed in government expenditures. The most practical way to arrest the flow of funds away from the rural areas would be to encourage the formation and growth of local savings and loan groups and community banks.

The *World Development Report 1989*, notes: Certainly in the next decade, and perhaps the next two, the net flow of foreign capital to most developing countries is likely to be relatively small, regardless of how the present debt crisis is resolved. This indicates that developing countries must find funds from domestic resources. In most SSA countries significant amounts of public savings are generated by the taxation of export crops. These public savings often represent a form of forced savings on behalf of farmers to be held in the public sector and rechannelled to farmers through directed credit and/or other subsidized rural development programs. The government approach of forced savings is based on the premise that farmers are incapable of saving. The analysis of the average savings and investment for eighty developing countries revealed that households as a group financed all of their investments from their savings. The household sector includes individuals as well as small, mainly unregulated firms. Rural sectors, in many SSA countries, almost exclusively comprising of households (including small and medium−sized farms and firms), provide considerable, if not the main net flow of resources to other sectors.

A policy designed to meet the financial needs of households and the rural sector should therefore:

(a) Provide safe and easily accessible facilities for placing financial savings;

(b) Facilitate the flow within the rural sector from net savers to net borrowers; and

(c) Facilitate the flow of surpluses of the rural sector to other sectors.

In other words, the rural sector as a net saver would not need externally provided funds if efficient rural financial markets facilitated the flow of finance from surplus to deficit units within the sector; and economic growth in any country depends on the efficient flow of resources from small savers, especially in rural areas, to high−yield activities in the corporate sector.

Government ownership or control of formal financial institutions and the availability of low−cost donor funds offered in the past provided little incentive for resource mobilization, and the emphasis on targeted credit stifled financial market development. Most donor−supported rural finance operations have focused on credit, unwittingly diluting the importance of savings/deposits mobilization which is essential not only for expanding credit for agricultural and rural development but also for ensuring the sustainability of rural financial institutions. The Banco Agricola in the Dominican Republic illustrates, in contrast to the public development banks/parastatal syndrome in SSA, that a strong deposit mobilization strategy coupled with organizational reform can succeed in a liberalizing environment when donor policies are supportive and government intrusion is kept to a minimum.

For any financial institution to maintain its growth and financial viability on a long−term basis, it would need to seek ways by which it will no longer be reliant on external sources of soft term finance and/or government subsidies to meet its operational/administrative expenses. The institution should be able to mobilize its own resources on market terms—whether it be from rural savings, offering sufficiently attractive interest on deposits, or by borrowing from the financial markets at the prevailing rates of interest.

Potential for Savings

Rural households have a high propensity to save, prompted particularly by the insecure economic conditions that generally prevail in rural settings. There is ample evidence that rural holders in SSA countries, do in fact, save — in real and money forms. Surveys conducted in Ghana and Malawi show that households, as groups, save more

than they can invest. The rural poor, more than anyone else, must have a liquid reserve to meet emergencies. Credit, usually from informal sources, can sometimes supplement this liquid reserve, but credit is available only to those who have actual or potential savings. Even the moneylender will not lend to someone with no accumulated or potential surplus, and friends and relatives, as well as savings and credit societies, usually require the ability to reciprocate.

In addition to keeping the money in their homes, rural people in SSA save mainly with informal intermediaries. The most important informal intermediary in many SSA countries, especially in Western Africa, is known generally as the Rotating Savings and Credit Association (ROSCA). The significance of savings mobilized by informal intermediaries varies considerably from country to country, depending on many factors, for example, the degree of monetarization of the country's economy, services offered by formal intermediaries, and sociological factors (such as the degree of prevalence of common bonds). Rarely are estimations of amounts attempted.

The Case for Savings Mobilization

The most important service that financial institutions can provide for rural savers is the opportunity to hold liquid deposits paying reasonable interest rates. Without this, the rural poor hold a variety of inflation hedges, many of which earn very low rates of return, and pay an inflation tax on any cash and deposits held for current obligations. The rural non−poor, on the other hand, can often avoid these unfortunate alternatives by investing in trade, industry, or land, possibly in urban areas. Even without the perverse concentration of credit to a few borrowers, resulting from low interest rates, the essential function (the pooling of resources) of financial intermediaries is to bring together comparatively small amounts from many savers so that a few,

Box 3.3: Savings Mobilization

A better concept of credit is to view it as mobilization and transfer of savings. Credit is best seen in the context of savings − both voluntary and compulsory. For any individual, savings should be the best step to qualify for credit, and the first step toward a possible future investment. Monetary savings placed with established institutions − whether formal or informal − would also be the best means to establish a financial history and build a financial relationship with a financial intermediary. Savings−First type schemes would therefore be an ideal means of creating clients in rural areas instead of making them feel the beneficiaries of sponsored and subsidized credit operations. Therefore, any help provided for the rural poor in saving would be the best inducement for developing rural financial markets. A good way to begin would be to make it possible for the rural households to join cohesive groups in which savings is an integral part of the scheme − be it Savings−First, Savings−Plus, Savings and Loans, or Savings and Investment type.

In reality, savings are the only legitimate source of sound credit. Credit and savings are different sides of the same coin. One more significant misconception about financing or credit to the poor, is that funds will always come from somewhere else − governments, donors etc. This is what makes most present−day approaches to the problem unsustainable. The way to resolve the problem is intermediation proper: financial intermediation. This holds true at all levels of society, including the poorest of the poor. Under normal circumstances, in any society, savers will outnumber borrowers. The conclusion would therefore be that it is not as much a problem of credit as one of ignoring savings mobilization. The economic misreading that the poor do

not save, and ignoring the importance of such savings, has led to faulty conclusions. In many known cases, savings have even exceeded the market or demand for loans. The challenge therefore is how to transform credit institutions into effective savings institutions.

* Fernando Romero. 1992. The Performance of Commercial Banks. Paper presented at the Workshop on Issues in Financing Small Enterprises in Developing Countries. Washington, D.C.: World Bank.

relatively large projects can be undertaken. Hence, by their nature, financial intermediaries serve more savers than borrowers. Policies that focus on improving services for savers, not for borrowers, are thus crucial to helping the rural poor.

The positive effect of savings mobilization on financial institutions is another argument in favor of savings mobilization. Financial institutions which neglect savings mobilization are incomplete institutions. They not only fail to provide adequate services for rural savers, but also make themselves less viable, as can be seen from the high rates of delinquency and default that plague most agricultural development banks. When financial institutions deal with clients only as borrowers, they forego useful information about the savings behavior of these clients that could help to refine estimations of their creditworthiness. Furthermore, borrowers are more likely to repay promptly and lenders to take responsibility for loan recovery when they know that resources come from neighbors rather than from some distant government agency or donors.

Financial institutions that mobilize savings effectively from a variety of sub−sectors (e.g. cash crops, food crops, rural trading) are also likely to have a continual flow of resources available for lending. Those that neglect savings mobilization on the other hand are inevitably subject to the feast−or−famine cycle of government and donor projects. Belief in the future availability of loan on a timely basis can be a strong incentive for borrowers to repay promptly.

Savings mobilization provides appropriate incentives and discipline not only for rural financial markets and institutions but also for governments and donors. Financial institutions are likely to have little interest in savings mobilization or loan recovery when cheap funds are available through loans from government or donors, or central bank rediscounts. The fact that the volume of resources that can be obtained through effective programs of savings mobilization and loan recovery is potentially far greater than the most optimistic estimates of the amount of subsidized loans and grants available from governments and donors is largely ignored. It has sometimes been alleged that government officials use subsidized lending as a means to distribute patronage. If true, this provides another reason for imposing the discipline of savings mobilization.

Saving determines the rate at which productive capacity, and hence income, can grow. On average, the more rapidly growing developing countries have had higher saving rates than the slower−growing ones. It is useful here to distinguish between the flow of savings and the stock of savings. Many factors affect the saving rate of a household, including the rate of income growth, and attitudes toward thrift. Liquidity and ease of access may make financial instruments a more attractive form of savings. Although interest rates have an uncertain effect on the amount people save, their effect on the form in which people save is clear. High interest rates favor financial over non−financial forms of saving. Higher real interest rates are likely to lead to financial deepening as savers switch some of their saving from real to financial assets. Coversely, the negative real interest rates discouraged the holding of financial assets. While there is evidence to suggest that the rural poor would be willing to deposit their savings, and convert real savings into financial assets, without paying great attention to interest rates, there is no doubt that real interest rate has a positive impact on the quantum of savings that could be mobilized by financial institutions. High inflation rates dampen the desire to hold savings in financial assets. It is important therefore to aim at offering positive real interest rates to savers. Interest rates paid for savings deposits have a marked impact on an individual's decision to switch from real−form to financial savings. Financial savings by the

rural poor are sometimes secured by burying money, putting it in lockable metal boxes, or containers such as earthen piggy banks. Often, money savings are converted into real−form or physical assets, whereas for the development of financial markets, real−form savings should be transformed into monetary savings, and the money so saved placed with trustworthy intermediaries who might be in a position to offer a monetary reward in the form of interest, by on−lending the funds to creditworthy borrowers.e

The successful development of rural financial markets cannot be achieved without the long−term financial viability of the intermediary institutions, and the financial services (including savings and deposit facilities as well as credit) being made accessible to wider sections of the rural population, i.e. increasing market share. To satisfy the needs of their clients on a sustainable basis, financial intermediaries should concentrate on the mobilization of savings, by providing convenient access, attractive financial rewards, and easy withdrawal facilities. Because of me risk and lack of convenient access to formal financial institutions, large amounts of cash are held in the country−side. High transaction costs in terms of money and time, and cumbersome procedures of formal financial institutions put off small savers.

Households as a group are known to finance all or most of their investments from their own savings. An advantage of such self−finance is that, in combining the acts of saving and investing, it internalizes all the information, transaction, monitoring and enforcement costs that would be involved if the resources were lent to someone else — no complex contracts, collateral, or other devices are required to reduce the risks inherent in lending. The shortcoming of self−finance is that an individual's investment opportunities may not match his or her resources or may be inefficiently limited by them. Even though the financial system intermediates only part of the total investable resources, it plays a vital role in allocating saving. In the early stages of development, relatives, friends, and moneylenders may be the only sources of external finance. As the financial system grows, local banks, then national financial institutions, and finally securities markets and foreign banks become sources of funds for investors.

Self−finance is predominant in the case of small farmers and micro−enterprises. Many investments and operations are financed from the farmers' or other small entrepreneurs' own savings. Savings mobilization could be the most cost−effective way of raising local resources, and attracting new clients for financial institutions. From the borrower's point of view, the availability of convenient and dependable deposit facilities would demonstrate a sense of performance and enhance the credibility of the intermediary. Savings may help rural areas to supply not only most of their local capital investment needs but also to become net suppliers of capital. Savings facilities would also contribute to the institutional development and sustainability of the financial intermediary. Savings is a service critical to the poorer sections of the rural societies as a means of capital accumulation, and also serve as a form of loan guarantee. Group savings (and lending) schemes are familiar mechanisms for low−income segments of the population, especially women, particularly for developing financial discipline, improving their capacity to finance their own future investments and enhancing debt capacity for borrowing.

Rural financial markets channel excess household savings to borrowers with productive investment potential. The financial institutions intermediate between a large number of small savers and depositors and a small number of large borrowers. Such term transformation helps small savers with surplus resources in liquid form and provides large borrowers with resources for long−term investments. Savings mobilization also improves relationships between clients and financial intermediaries. The prospect of being able to borrow from the institution, based on a savings/deposit relationship is a powerful incentive to depositors. Institutions competing for savings also have a positive incentive to be efficient and to become financially attractive. Voluntary deposit mobilization improves an intermediary's financial strength and provides an increased flow of funds for additional lending. The sustainability of the institution's lending activities cannot be achieved without cost−effective savings/deposit mobilization schemes. A combination of carefully−designed and effectively−managed savings and credit−schemes is essential for the financial viability and sustainable development of financial systems.

The household sector is a significant potential surplus unit for generating financial savings. Low−income economies in SSA are not an exception. Country studies suggest that it that gross domestic savings have been by no means negligible, amounting to a considerable portion of income (studies suggest that it might even be as high as 50 percent in some SSA countries). The savings capacity and potential growth are higher in the rural areas than in the urban areas. Rural households tend to have higher average and marginal propensities to save. 21 /However, savings, particularly in rural areas, are mostly held in various non−financial real assets such as stored produce (e.g. bags of maize), live animals, building materials, cleared land; thus, financial savings account for an insignificant share of total savings.

A survey of informal savings in Colobane in Senegal identified the following two forms of savings.

(a) Informal *individual* savings being:

(i) in−kind savings (rice reserves, poultry, cattle); and

(ii) cash savings (hidden at home, given to a friend, relative, shopkeeper or even to the nuns of a Catholic Mission).

(b) Informal *group* savings, including:

(i) women's group savings, derived from group work activities, the earnings being consumed collectively;

(ii) joint group savings by women and men, with mutual help connotations; and

(iii) young people's group savings, used for cultural events, and/or to purchase group social equipment.

A study in Zaire found that, as in many other developing countries, informal financial groups play an important role in the supply of financial services such as deposits and credits to rural households. While enthusiastic about such groups serving as a channel for formal institutions to inject credit into rural areas, at lower risk and lower cost, the study cautioned that this mechanism must be carefully articulated so as not to have a destructive effect on the informal financial market. Prior to any such intervention, it is necessary to fully understand the linkage and cohesive factors of these groups, e.g. the gender of members, the geographical proximity of members and the occupational homogeneity within the group.

Most of the financial savings of the household sector (estimated at 8095 percent of total savings in some countries) have been mobilized through informal financial agents or institutions. Country studies also suggest that savings mobilized and credit extended by the informal financial sector appear to exceed by a large multiple those of formal institutions. Undoubtedly, the combination of high risks (arising from the lack of marketable collateral and default risk) and high transaction costs associated with small short−term loans and deposits have engendered fragmentation in savings mobilization through the informal sector.

The increasing financial dualism between the formal and informal sectors and the limited progress in financial widening by the formal sector can be attributed to prevalent bottlenecks. On the one hand, the lack of access to credit facilities has hindered the majority of the population in using the savings facilities of formal institutions. On the other hand, due largely to the excess liquidity syndrome, commercial banks, the most dominant financial institutions in these countries, do not have the incentives to change their orientation and to make efforts at savings mobilization.

The commercial banks consistently hold liquidity well above the required statutory level. They also concentrate their loan portfolios on the short−end of the market. They hold their surplus assets in very liquid form, in cash

with no return, or in treasury bills or government stocks with nominal returns. Among the factors contributing to the poor intermediation of

savings for investment are (a) the excessive risk−aversion of some of the formal institutions; (b) the limited linkages between the formal and informal sectors as well as within the sectors; (c) the weak risk assessment and management capacity at the institutional and macroeconomic levels. This weakness is highlighted by the coexistence of excess liquidity among some banking institutions with apparent capital shortages elsewhere in the system.

Deposit Insurance

Although some developing countries have established deposit insurance schemes, 22 / most SSA countries have not established such schemes. Deposit insurance guarantees the nominal value and liquidity of deposits up to a certain amount. The insurer is an institution, generally government−owned, established for that purpose, and funded with premiums paid by the institutions whose deposits are insured. In countries where the banking habit is not widespread, deposit insurance can help to establish confidence in the safety of saving with banks and other institutions. The principal targets of deposit insurance are small, unsophisticated depositors who are least able to assess the soundness of a particular depository. Thus, while advocating the importance of savings and deposits mobilization, it is important to recognize the need to ensure the safety of depositors' funds. Prudential regulations and oversight arrangements should be effective to ensure safety, and accountability commensurate with the autonomy of the financial intermediaries. By assuring depositors that their money is safe even if the depository is not, deposit insurance supplements the Central Bank's lender−of−last−resort role in forestalling bank runs.

Like all insurance, deposit insurance too suffers from the risk of moral hazard, because insured depositors no longer need to be concerned about the quality of their depository's assets. An inescapable fact of deposit insurance is that it places greater responsibility on government or an outside authority to see to it that insured institutions behave prudently and in accordance with strict prescribed rules. With or without insurance, depositors would be fully protected if banks were closed and liquidated the moment their capital fell to zero. This is not practical since the condition of a bank cannot be known to inspectors and supervisors on a day−to− day basis. However, up−to−date and effective information and frequent inspections would help in this regard. Effective monitoring would help to identify problems in bank management and in banks' portfolios well before insolvency occurs and to take corrective action in time.

4. Interest, Costs And Risks

Interest Rates

Many policymakers, technicians, and writers on development often do not think of interest rates as prices, and they fail to recognize the impact of these prices on the behavior of participants in financial markets. The importance of interest rates as prices is also often clouded by religious dogmas and stereotypes about lenders, savers, and borrowers. It is too often overlooked that in most moderately advanced economies, interest rates are the second−most important price after the foreign−exchange rate. 23 / Interest rates offer present measures of future values and also influence the level of savings and volume of investments.

Much of the popular debate on interest rates fails to distinguish between nominal and real rates. The nominal rate of interest is the rate specified in a loan contract; the real rate is the nominal rate and other non−interest costs adjusted for inflation over the period of the loan. Many countries have had persistent inflation that has typically exceeded the nominal rates of interest paid on formal loans as well as on deposits. As a result, real rates of interest are often close to zero and, in many cases, negative. Policymakers are, however, becoming increasingly aware

that the influence of real rates of interest on financial market performance is more important than that of nominal rates. They have also come to recognize the importance of interest rates in influencing not only the behavior of borrowers, but also that of all other participants in the financial markets. Until recently there was relatively little appreciation of how interest rates affect the behavior of financial intermediaries, savers, and politicians as they interact with or through financial markets. It is also increasingly realized that cheap credit provided through below market interest rates cannot be justified on efficiency grounds. It is unlikely to serve as an incentive for farmers to use more inputs to produce a good at an artificially low price, particularly because interest is a small input in agriculture relative to labor cost. It is becoming more evident that availability, simplicity, dependability, convenience of programs, and the continuity of financial institutions are, in general, more important that the rate of interest itself.

Interest subsidies for credit may be required and could be justified to cope with externalities. But governments also want to keep interest rates low so that interest payments on their loans do not cut too much into their stringent budgets. Repressed interest rates fail to fully compensate lenders for their costs, and are inconsistent with the importance of deposit mobilization. Low interest rates discourage savers, influencing them to keep their savings in cash and/or to invest them in physical assets, thus depriving the financial intermediaries of deposits of loanable funds from the rural community.

Transaction Costs

Transaction costs include money costs, incurred administration costs, and opportunity costs in terms of time and lost opportunities suffered by depositors, savers, intermediaries, borrowers, etc. These include money and time spent in information−gathering, formalizing collateral arrangements, document processing, approvals, disbursements, collections, and establishing relationships. Depositors of savings, and institutions that mobilize savings incur transaction costs, including the opportunity cost of time of travel and waiting time to deposit savings. Similar costs are incurred related to the withdrawal of funds, inconvenient banking hours and the bureaucratic procedures often adopted by formal institutions. For the financial intermediary itself there are generally money costs involved in deposit mobilization, maintaining

branches, operating mobile units, etc. to facilitate the mobilization and withdrawal of savings, customer account administration, control procedures, and so on.

There is ample evidence that lending to small farmers carries unusually high risks and is far too expensive for commercial banks which rely on mobilized public deposits for their business. The high cost of screening large numbers of small borrowers of doubtful creditworthiness, and the evaluation and control of numerous small loans, dispersed over distant areas, makes them shy away from lending to smallholder farmers. The transaction costs for rural dwellers dealing with formal financial institutions could easily exceed the interest payable on loans taken or eat into the interest receivable on savings deposits. Transaction costs on loans tend to be relatively higher where the loan interest is below the comparable market rates because of induced high demand for capital. For risk averse lenders, the most effective means of discouraging applicants who are risky propositions is to impose high transaction costs, reflected in complex and time−consuming documentation, delaying tactics, rationing, restricting service, exacting bribes etc. Transaction costs for depositors also tend to be high when there is no effective competition and also if the financial institutions have cheaper external sources of funds, therefore not having to depend on depositors' funds for increasing their lending business. Transaction costs would be minimized when lenders and deposit−takers face competition and are obliged to offer convenient and cost−effective services in order to thrive.

Although transactions costs are incurred both by lenders and borrowers, only the lender's transactions costs are relevant from the point of view of interest rate formation. Lender transactions costs consist of the costs of appraising, administering, monitoring and enforcing loans. Appraisal costs could often be zero if the lender

already possessed adequate information on the borrower through previous credit transactions, transactions in other markets, or through community and neighborhood ties. The costs of loan monitoring and enforcement could also be avoided or minimized by the same factors of interlinkage, local ties or collateral. Transactions costs are not fixed, since collateral and documentation requirements may increase with loan size. Financial intermediation catering to the rural sector can be very costly for centralized formal financial institutions because the values of the transactions are relatively small, customers are located in scattered geographical areas, loans generally carry higher risks for a variety of reasons and because of the poor rural infrastructure. The challenge in developing the rural financial markets, therefore, is to increase the competition for depositors, borrowers and intermediaries through innovative instruments, thereby also reducing transaction costs and increasing returns to all participants.

A critical issue related to savings mobilization and lending to the poor households is the high transaction costs. Transaction costs determine the cost−effectiveness of credit schemes as well as of input delivery systems. For instance, in 1985, the transaction costs incurred by the lender to a fertilizer credit project in an African country were reported to be about 62 percent, as against an interest rate of 10 percent charged to farmers (Mittendorf 1987). Obviously, such high transaction costs in credit schemes make fertilizer very costly in economic terms. The costs of financial transactions have to be borne both by providers and users of financial services. Institutional transaction costs are reflected as financial costs of the institutions, and they are normally closely reviewed and attempts made to reduce them. However, less attention, until quite recently, has been paid to the transaction and intermediation cost of users of formal rural financial institutions despite the fact that in many parts of SSA they appear to be quite significant, both in terms of money and time spent. These costs include travel costs, queuing costs, the costs of completing documentation required by banks for depositors and for loan applicants, the costs of forming and maintaining groups where these are preferred channels for lending, costs of

entertainment of bank and extension personnel on farm visits made in conjunction with loan application and supervision, bank fees and charges, and the costs of handling cash. Although no serious research appears to have been conducted on the transaction costs of formal rural financial services, these costs are known to be material, particularly for small borrowers and savers.

The major transaction cost for rural savers and borrowers in gaining access to the formal market is the cost of establishing financial relationships. Savers have to satisfy themselves that institutions willing to accept deposits merit their confidence. When they open an account, they may have to provide a photograph or documentation concerning their identity and residence; personal identity documents, routinely available in many countries, may be difficult and costly to obtain in others. A prior account relationship may also be required. In addition, many financial institutions may not have offices in rural centers and their office hours may be inconvenient. Prospective depositors from these places have to spend time, and possibly money, walking, cycling or using public transport to reach the banking offices. These trips often have their own challenges, such as the temptations to spend, security worries, and possibly long queues for public transport and for service at the banking office.

Would−be borrowers have to obtain information about the sources of funds that may be available, and about the terms and conditions attached to each; would−be lenders have to gather information about prospective clients. A loan application is subject to delays in processing, and in certain situations, has to be accompanied by a gift from the applicant. As with depositors, transport and queuing may consume loan applicants' time, effort and expenses. Apart from monetary costs, the time spent in these activities has an opportunity cost, consisting of lost opportunities to produce income or enjoy leisure. These costs decrease the attractiveness of borrowing and make it more difficult to obtain much benefit from savings deposits with institutions.

Risk

Lending is risky and risk arises from uncertainty. Financial contracts involve, among others, credit risk, price risk, liquidity risk and systemic risk. Credit risk is the danger that the borrower will default. Price risk is the risk of loss

caused by unexpected changes in prices −in interest or exchange rates, for example. Liquidity risk is the risk of being unable to sell financial assets quickly, except at a steep discount. The risk that the default of one or more large borrowers will endanger the whole financial system is called systemic risk. Credit markets differ from commodity markets in various ways. Important transactions in credit markets involve a relationship over a period of time between a lender and a borrower. Hence, uncertainty resulting from imperfect foresight is an essential element of credit markets.

Also, information is imperfect and asymmetric. Information asymmetries are one source of credit risk. Lenders can reduce credit risk either by developing their own expertise in the selection of borrowers or by relying on information from institutions such as credit clearing houses or rating agencies. Measures that increase the information available to lenders, such as the strengthening of accounting and auditing requirements, information systems, etc. improve lenders' ability to identify the borrowers with the best investment opportunities. To cover credit risk, lenders raise the interest rate they charge on loans, to include a risk premium. But this may be partially self−defeating, because the more creditworthy borrowers may choose not to borrow, and mat would leave the lender with less creditworthy clients, a problem referred to as adverse selection. Furthermore, only clients who take on riskier projects would normally resort to the higher cost of borrowing. Because of their limited ability to identify risks and

monitor behavior, lenders tend to require collateral and to ration credit to the most creditworthy borrowers rather than to charge higher interest rates on riskier loans. Borrowers with little collateral are therefore likely to be the most affected by credit rationing.

The rural sector is subject to a greater probability of covariance risks. For example, due to weather fluctuations, commodity price variations affect whole groups of farmers, making it difficult for members of the group to repay the loans at the same time, particularly when the lending is highly correlated through area concentration or loans related to a particular commodity. This situation arises when the characteristic of borrowers are unknown to lenders. Lenders tend to be very cautious in credit policies if not cognizant of borrowers' circumstances, activities, characteristics and the ability to repay. The adverse selection problem is characterized as individuals having different perceptions of the riskiness of their projects. If the interest rate were to be raised to counter the possibility of loan defaults, it is precisely those borrowers with lower risks who will cease to borrow first. Individuals most likely to repay their loans are put off by the higher interest rates. Those who would be inclined not to repay their loans would not care too much about the high interest rate stipulated. Moral hazard is the possibility that borrowers will relax the efforts that they put into making the project successful or the type of project that they undertake, thereby increasing the risk. Riskier projects are those that would seek financing at higher rates of interest and they are less likely to lead to loan repayment. A higher rate of interest may therefore have a self−defeating effect on loan recoveries as well as on profits.

Lenders, however, try to manage credit risks by advance assessment, continuous monitoring, and providing for such a situation in different ways. Financial risk can be reduced to a certain degree through avoidance, portfolio diversification, transference, sharing and through guarantees of different types, including credit repayment reserve funds. In addition, lenders could improve the availability and quality of information about borrowers, improve the design and enforcement of loan contracts, and enlarge the range of instruments so as to permit greater diversification of portfolios. Inherent risks cannot usually be eliminated altogether, but the irreducible risk can often be transferred to those more willing to bear it. Loan maturities, the choice of adjustable or fixed interest rates, equity participation, and collateral or cosigner requirements are all examples of different risk assignments.

Lending Margins

In most credit systems, the gross margins — the difference between the lending rates received on the one side and the cost of money to the lender — though positive, are very low. The banking institutions cannot survive and

grow without adequate margins. It is also clear that the administrative and other non−interest costs are quite high per unit of operation, even without taking into account the cost of risks, overdues and bad debts. The small scale of operation makes the overhead costs per unit of operation excessively high. Thus, in addition to the increase of gross margins, the banking system will have to make a serious effort to enlarge the net margins which finally generate bank profitability and enhance resources for the further expansion of the banking system. Little has been done in most countries in terms of cost reduction, as the focus has not been on the improvement of quality and efficiency but on the expansion of volume. Cost reductions can be achieved through improving productivity per worker through better recruitment and training, more active field work both for the canvassing of deposits and better lending by bringing in worthwhile investment−oriented borrowers into the banking system, enhanced loan recoveries and risk reduction, computerization and the consequent efficiency improvement, and so on. To the extent these things happen, efficiency improves on the one hand and volume of

business on the other; and to the extent business volume increases, the costs per unit of operation will come down and net margins will be enhanced.

The opportunity cost of lending is the return on the next most profitable alternative opportunity available to a lender. While in a theoretically perfect market, risk−adjusted marginal returns should be the same over all activities, at a level that is equal to the cost of borrowing, in practice the opportunity cost of funds will vary among lenders, depending on the opportunities they face. The opportunity cost is likely to be higher in technologically stagnant agriculture where returns to further investment in traditional inputs have been driven down to the going interest rate.

Lending to the Poor

One of the important issues is as to what should be a legitimate/desirable charge to be made on loans to the poor, or what should be the criteria for charging the poor for loans? From the lender's point of view there should be no argument − all costs must be recovered to ensure sustainability, that is, the cost of raising resources (interest paid and expenses of resources mobilization; administrative costs of lending; and risk premium). In addition, there should be an adequate element as profit to enable growth. From the borrower's point of view, the question would be how much the poor can afford to pay in interest. The charge should not be higher than alternate sources available. When one deals with rural households and small enterprises which have very limited access to formal sources, the competition is really with informal lenders who are known to charge interest at rates varying from 30 percent to 3000 percent per annum. Furthermore, rural borrowers do not reckon the cost or burden of borrowing by reference to nominal or effective rates of interest payable to the lender. Focusing on the number and amount of debt service installments in absolute terms is more meaningful from we point of view of the rural dweller than the rate of interest applied to the loans. The instalment burden is what would often weigh in one's mind, as cost when deciding whether or not to borrow.

Guarantees as Collateral Substitutes

Various forms of credit guarantee schemes are resorted to in an effort to induce lenders to extend credit to rural borrowers who cannot offer acceptable collateral and are considered to be high−risk propositions. The most common method adopted seems to be for governments to guarantee all loans provided under special state sponsored credit schemes as for example, by the state governments in India and Nigeria. In some schemes, the pay−out or restitution against loans losses is 100 percent. In other cases, it might be a proportion of the loan default, allowing the lending institution to absorb part of the losses, on the assumption mat sharing of the loan losses by the guarantor and the lender would make the lender exercise greater care in loan portfolio management. There are other instances where a guarantee fund is operated by third parties such as the Central Bank or a local insurance company, with the lending institutions contributing to the build−up of the fund.

Sometimes, such a guarantee/reserve fund is operated by the lending institution itself, by setting aside a portion of the interest charged to borrowers, and at times also requiring the borrowers themselves to contribute to The fund. Whether the contributions to the fund are shared between the lender and borrower or not, the borrowers at large have to ultimately bear the cost because the lender would be obliged to recover all costs from the borrowing customers in order to continue in business. The more satisfactory arrangement would, however, be for the borrower groups themselves to build a credit reserve or contingency fund on their own, to equip themselves

to meet loan repayment obligations, as provided in the Grameen Bank scheme, or as envisaged in the Rural Financial Services Project in Malawi.

A more systematic and formalized arrangement between the borrower groups and the lending institutions whereby the group operates a Credit Reserve Fund for meeting the loan repayment installments of borrowers in distress would help reduce loan risks and improve credit access and outreach. Such reserve fund schemes could be operated by the lending banks on behalf of the farmer clubs or other cohesive groups. The borrowers could be required to contribute a fixed percentage − say 10 percent of their total borrowing from the lending bank to be held in an interest earning account maintained at that bank for the group. The lending bank could then have recourse to such funds in the event of the group being unable to meet its debt service commitments in full. Thus, if the balance in a group's reserve fund account at the bank could be maintained at 10 percent of total loans extended to the group as a whole, a 100 percent repayment requirement could be satisfied by the bank transferring the necessary amount from the group's reserve fund account to meet the loan repayment shortfall even if the repayment by members was only 90 percent. At the end of every season, a group could, if it wanted, withdraw from its reserve fund account the amount in excess of the 10 percent back−up necessary for the following season's borrowing. Such a reserve build−up could be achieved in one of many convenient ways:

(a) Every member of the group could be compelled to contribute a small amount on a regular basis − weekly or monthly, and any interest earned on the balance with the bank as well as likely savings surpluses, unlikely to be required in the future, could be utilized for a common venture benefiting the whole group;

(b) Every borrowing member of the group could be required to pay in 10 percent of the sum borrowed at any particular time, and such a sum could be left in deposit with the lending bank as reserve;

(c) The lending bank could withhold and credit 10 percent of the loan granted to a borrower member of the group into the group's reserve fund account; and

(d) Groups having savings schemes as part of their normal activity could deposit such savings with the lending bank which in turn would offer loans to group members up to say ten times the amount of such savings left in the reserve fund account.

Such arrangements would help instill financial discipline in individual members as well as the group as an entity. The lending banks would be more forthcoming in providing loans to such disciplined groups, even without the adequate conventional forms of collateral. The group members would be assured of continuity in obtaining credit, even if one or more members were unable to meet their immediate debt service commitment, since the group as a whole would not be in default on repayments. These arrangements would, however, require some additional record−keeping on the part of the lending institution. But the benefits of operating such selffinancing reserve funds, the cost of which is borne entirely by the borrowing beneficiaries, would be very significant in terms of access, outreach, minimization of loan losses, improvement of selfdiscipline on the part of the borrower, peer monitoring, and loan portfolio performance. The operation of reserve funds with contributions from individual members could also become the forerunner of self−sustaining financial intermediation.

5. Role of Governments and the World Bank

Role of Government

Governments intervene in the provision of financial services for very many good reasons; in particular to influence the level of economic activity, and to ensure that financial intermediaries behave prudently. Most SSA countries use direct controls to regulate the overall expansion of credit and to influence the sectoral allocation of financial resources. Several countries impose interest ceilings on deposits and loans. Governments must certainly play their legitimate part in creating a financial system which mobilizes resources efficiently, minimizes allocative mistakes, curbs fraud, and minimizes instability. SSA governments have, however, intervened in the financial sector too often to channel cheap credit towards the sectors that have high social or political priorities.

Following independence, almost every SSA country nationalized privately−held banks and other financial institutions. The increasing involvement of governments in ownership, control and management was also justified on the basis of ridding themselves of foreign dominance and minimizing the influence and hold of non−indigenous entrepreneurs, for example, Asian, European, over their national economies. The governments themselves have borrowed heavily from the domestic banks to reduce budget deficits, and required formal financial institutions to finance parastatals, thereby also relieving the burden on their national budgets. The interventionist approach in most cases has hindered financial development. The banks made loans to state−enterprises and priority sectors at below market interest rates, with interest spreads often too small to cover the banks costs. Many countries have, however, begun to reconsider and revise their approach and rely more on the private sector and on market forces, leaving a smaller role for government in the allocation of resources and determination of interest rates.

A recent review of agricultural credit operations financed by the World Bank/International Development Agency (IDA) during the 1980s revealed a near 100 percent failure rate of stateowned participating financial institutions. In recent years, the World Bank and the donor community have urged governments to improve the financial sector policy environment so as to make it more conducive to greater participation by private entrepreneurs. The Bank has thus been increasingly supporting financial sector reforms − exchange rate and trade liberalization, interest rate reforms, financial restructuring, effective prudential supervision, privatization of parastatal banks, and establishment of private banks − in an effort to create a competitive financial sector which would respond to market signals.

Government Intervention

Interventions have taken the form of imposed lending requirements; refinance schemes; loans at preferential rates; credit guarantees met by the state; and lending by DFIs. State−owned DFIs have perhaps been the most common means of directing credit, supported by bilateral and multilateral aid agencies. DFIs are established on the assumption that there is market failure due to asymmetric information, and unjustified risk aversion, and that they would serve as a catalyst in growth and development, and mitigate policies that discriminate against priority sectors.

Box 5.1: Government Intervention

Post−independence, many governments decided to remodel their financial systems, ostensibly to ensure that (domestic) resources were allocated in accordance with their development strategies. They nationalized existing financial institutions, created new parastatals in an attempt to provide funding at low interest rates to chosen (priority) sectors or they directed existing institutions to comply with their instructions. To do so, banks were directed to

open rural branches to provide credit to widely dispersed smallholders. Interest spreads imposed on financial intermediaries were generally inadequate to cover higher transaction costs. Often, directed loans were not repaid. The inability, unwillingness and disinclination of borrowers to repay their loans has become a serious problem. Financial institutions in many SSA countries have suffered heavy losses making them insolvent.

Governments can take a number of actions to encourage the private sector to take a greater role and participate in providing rural financial services. The most important of these is a clear statement of government policy with respect to informal financial systems, and the possibility of entry by private sector investors in the formal financial sector. The state also can assist by facilitating the exit of weak and inefficient financial intermediaries. The first step therefore must be to develop clear policy objectives with regard to the development of the rural financial market in the country. The next step would be one of problem identification to ease the constraints to financial market development.

Such an interventionist approach has contributed to several problems.

(a) Nationalization of existing banks and the creation of new financial institutions owned and/or controlled by the governments crowding out the private sector;

(b) Establishment of specialized development banks without a mandate for accepting savings deposits but concentrating on lending;

(c) Formal financial institutions, most of which are parastatals, relying on funds provided by governments and donors;

(d) Inadequate attention paid to mobilizing rural savings; and

(e) Interest rate ceilings on savings and credit set far below market rates.

Consequences of Government Interventions

Despite their good intentions, directed/targeted credit schemes have not produced the positive effects they were designed to have on productivity or investment and economic growth. Instead, there is ample evidence of a dampening effect on domestic savings and financial market development. Lending without being able to recover the full cost of intermediation (money cost and transaction cost) weakens financial intermediaries. Subsidizing lending institutions tends to dilute their resolve to improve the quality of the loan portfolios, resulting in poor loan recoveries

and higher loan losses. This in turn reduces financial viability and the ability of the intermediary to offer attractive interest rates to depositors, thus reducing the amount of savings that could be mobilized.

History is replete with instances of the failures of financial intermediaries and the undermining of the financial sector through well−intentioned schemes of governments, supported by international aid agencies. One result of these state interventions has been the accumulation of bad loans and non−performing loan portfolios reflected in the poor financial condition of the lending institutions, mostly state−owned, designated to lend to target groups that would not otherwise obtain credit from these lenders. The primary justification for this approach has been to increase the economic productivity and income of households and enterprises without access to the formal financial system. Government officials and those who advocate this approach often have very little experience

with credit markets, and lack familiarity with financial institutions that are subject to credit risk and have to be guided by commercial considerations. As officials of a government department, development agency, or government−owned bank or lending institution, they are shielded them from personal, financial, career, or professional risk related to the performance of the loans for which they have direct or indirect responsibility often. Often, they do not even recognize their potential to do considerable damage to the financial institutions.

Government intervention has had some degree of success in Indonesia, Japan, Korea, Taiwan and Thailand, whereas others report mixed results in terms of coverage and efficiency as well as disastrous consequences in terms of sustainability. Sometimes, this intervention has been through the the establishment of new state−owned special financial institutions. In other instances, commercial banks − both private and public sector commercial banks − were mandated to lend heavily to the rural sector, either directly or indirectly, by depositing a stipulated proportion of available funds with the specially established agricultural banks. Governments also encouraged farmers to form groups, and to set up credit cooperatives which were provided with funds from external sources. Typically, the default rates in such situations were high and the institutions soon ran out of funds for further lending.

Some governments also control interest rates on deposits and loans, which makes it difficult for banks to cover their costs on these activities. The effect of these controls is like a tax on banks because it obliges them to take on high−cost business at a narrow margin or even at a loss. This diminishes the intermediary's earnings, with important secondary effects that are not always readily apparent. Financial intermediaries respond to such higher risks and lower returns by trying to increase income and reducing risks in other areas. They identify the least profitable businesses and most risky clients, and decline to take on more business of this type, or cut back on existing clients. Thus, more credit directed to small farmers in response to controls may mean less total lending to small business or to consumers, and high−risk and low−return business for many intermediaries. Lenders may also offset reduced income by lowering interest rates on deposits, which affects savers adversely.

Where credit is subsidized, it is virtually impossible to reach large numbers of people, because external funds are limited, government budgets are always under pressure, and the funds available for subsidy are limited. Direct subsidy also tends to invite political influence in loan allocation, either directing credit to people outside the targeted group or resulting in losses that limit the effective life of the lending program, and weakening the institutions. In spite of billions of development dollars poured into cheap agricultural credit, there is evidence that fewer than 20 percent of rural households receive formal loans in most developing countries. 24 /

Box 5.2: Credit as a Limiting Factor

Credit need is generally assumed do be the total amount of funds needed by a farmer or entrepreneur, for investment and operational needs. No allowance is made for own funds or self−generated cash flows. Credit need so defined minus the credit extended by formal financial institutions is taken as credit demand gap or unmet demand. Another misconception is the deeming of desire to borrow as true demand representing bankable loan propositions.* To be realistic, demand should be related to price. Credit will be available at some price. But if that price is imposed at below market rate there will be credit demand far in excess of supply available at the lower price. Similarly, credit demand will far exceed supply if the interest charge is fixed at negative real interest rates.

The governments and donors have not always contested or tried to verify the general contention that there is an unmet credit demand based on such assumptions. With the mistaken perception that there is a substantial extent of

unmet credit demand in the rural areas, credit to farmers is often claimed to be an important limiting factor in agricultural development. The pervasive credit need is usually assumed and advocated in canvassing external assistance. Although no serious research has been undertaken to confirm the hypothesis of unmet credit demand, circumstantial evidence and intuitive conclusions suggest that the role of credit in agricultural production is overstated, while the potential of savings in rural areas is underestimated. Farmers have to and do, in fact save, though not necessarily through formal institutions and not always in monetized form. Also, not recognizing the important role played by informal financial markets, the case for branch expansion of financial institutions into villages has been overstated. Availability of credit will not in itself bring about development activities as long as producers perceive them as not being profitable. The assumption that there is appropriate technology available, that it is widely disseminated and has resulted in the farmers deciding to undertake the production, but that credit is the limiting factor, is also open to serious question.

* J.D. Von Pischke. 1991. *Finance at the Frontier: The Role of Credit in Development of the Private Economy*. Washington, D.C.: Economic Development Institute, World Bank.

Impact of Interventions

The rural landscape in the developing world is strewn with examples of rural credit systems that failed. Over the past three decades, governments and aid agencies working separately and together have supported several different types of rural credit schemes. Most of these experiments have been failures − with large loan defaults − and these efforts were not sustainable once the large subsidies involved were removed. 25 / The lessons of the Indonesian experience with rural banking and Bank Rakyat Indonesia's (BRI) reforms have been part of a more general effort to convert its financial system from one governed by bureaucratic procedures and central commands to a market−oriented system of competitive commercial banks. BRI being state−owned — not a private enterprise — is also a test case which could prove that state−owned enterprises too can be made responsive to market forces.

In SSA, support for the maintenance of a considerable government presence in credit, following the period of independence, is also derived from a profound distrust of the private sector. Much of the private sector was in the hands of foreigners, such as the Indian, Lebanese and European immigrants, occasionally supplemented by a dominant African ethnic group. A common view was that governments could substitute for the unwanted foreign dominance or ethnic monopoly, and serve the entire nation. The smaller private sector, more difficult to control or plan for, was not seen as a viable partner by any African government or donor. This was particularly true in the area of credit, where the idea of private or cooperative banking serving rural areas was viewed as unrealistic.

The results of the government−dominated effort to manage and promote agricultural credit have been mixed. Virtually all the analyses available today indicate that the parastatal financial institutions are nearly universally expensive and inefficient. This has resulted largely from political interference in their activities, with management and staff often appointed for political reasons rather than for reasons of competence or necessity.

A World Bank review undertaken in the late 1980s of credit projects in Sub−Saharan Africa found that, despite years of donor and government efforts, there was not a single viable public sector agricultural credit organization to be found — the failure rate was 100 percent. The World Bank response both to the failures of the government−dominated approach to credit, and to the successes of the private sector, has been to switch its support to the private and cooperative sectors. The new focus, developed in the second half of the 1980s, has been

to help African countries improve the policy environment for the private sector and cooperatives. The World Bank has supported financial market reform, permitting the free entry of private and cooperative banks into the credit market, a liberal interest rate policy, careful and professional supervision of banks to help them avoid or mitigate both corruption and unwanted government interference. The privatization of parastatal credit institutions has been an important objective.

The 1991 Annual Review by the Bank's Operations Evaluation Department of twenty−two Development Finance Companies (DFCs) operations revealed that two were regional institutions, two were quasi−public, and the rest were state institutions, i.e. not one was privately−owned. The review found that a common problem was government interference in the investment decision making process, which often brought large losses to the concerned banks. As in the industrial projects, management deficiencies were also a factor. DFCs often look to their governments for local currency funding, preferably on soft terms. Even in a conducive environment, it is hard for financial institutions to achieve maturity in the medium term. Without strong government support, it is difficult to transform large state institutions into efficient DFC type organizations.

DFC operations include funds for on−lending to small−and medium−scale enterprises and therefore also serve rural sector activities. Failures among DFC projects are also linked to poor macroeconomic performance e.g. high inflation, interest rate ceilings and changes, devaluation, etc. which also result in high levels of portfolio arrears and default. More specifically, the projects suffered from design and preparation shortcomings, the negative impact of sectoral policies and other exogenous factors. In the Côte d'Ivoire Small and Medium−Scale Enterprises Project, for example, a subsidized interest rate structure caused distortions in relative factor prices, reduced economic benefits, and ultimately led to the insolvency of the intermediary. Implementation of the East African Development Bank loan nearly ground to a halt due to uncertainty about the institution's future after the disintegration of the East African Community, declining regional economic conditions, the Tanzania−Uganda war, and the breakdown of law and

order in Uganda (where the bank was located). Two DFC projects in Senegal were likewise implemented against a deteriorating economic background: a shrinking of the country's regional markets, crippling droughts, a limited resource base, low labor productivity, and institutional weaknesses in policy and planning, which failed to provide adequate incentives and efficient interventions in agriculture and industry.

Box 5.3: Repressing the Financial System

The system of production − particularly agriculture, trade and industry − is the motor of the economy, finance is its fuel. Unless there is a functioning fuel injection system which supplies that fuel, the motor will not run. The faster the motor is to run, the more fuel it needs. It is the financial system which has to pump the money into the economy: it has to mobilize savings, provide credit and assure the adequate growth of money supply. An undersupply of money will stall the engine, thus halting the economy; an oversupply will lead to inflation, thus choking the engine.*

Several decades of experimentation with development have taught a powerful lesson: rigid regulation of the economy, in combination with an all−encompassing role of government in all spheres of the economy, leads to underdevelopment. This has stifled the growth of money, production, income and employment. Tight regulation has repressed the growth of the financial system. The main instruments of financial repression were interest rate controls, credit targeting and interest rate subsidies. Low or negative real returns on deposits discouraged savers. Ceilings on interest rates prevented

banks from covering their transaction costs; this made banking unprofitable. Subsidized credit channeled on behalf of the government led to inappropriate and unintended borrower selection and insufficient borrower scrutiny. Credit targeting induced borrowers to divert loans to other purposes. Generous credit guarantees led to moral hazard among both lenders and borrowers. Low recovery rates and program decapitalization as well as market distortions were some of the immediate results. While agriculture was usually the beneficiary at least of some subsidized targeted credit, the informal sector of production and service activities in both urban and rural areas was the most neglected: its savings went uncollected, its credit needs unfulfilled.

* H.D. Siebel. 1992. From Cheap Credit to Easy Money: How to Undermine Rural Finance and Development. Paper presented at the Seminar on Financial Landscapes Reconstructed. The Netherlands.

The general conclusions drawn from these projects include the following:

(a) DFCs often look to their governments for local currency funding, generally on soft terms. Adequate domestic resource mobilization which should be fundamental for financial intermediation was neglected.

(b) Assumption of the exchange risk remains a heavy and uncertain burden for intermediaries, particularly in countries which lack realistic exchange rate policies.

(c) Even in a conducive environment, it is hard for such financial institutions to achieve viability in the medium term, because an institution's capacity to achieve its assigned objectives is heavily influenced by exogenous factors. Without strong government commitment, it is difficult to transform large state institutions into efficient DFC−type organizations.

(d) Another common problem is government interference in the investment decision−making process. Management deficiencies, as in other government and parastatal institutions, also contribute to the malaise.

(e) Extensive involvement by governments in ownership, management and control is incompatible with sustainability.

(f) Donor support is more appropriate in capacity−building, human resource and systems development. However, support is often directed to government and parastatal institutions which lack independence in their operations.

In summary, the history of state interventions in the rural financial markets of SSA countries is generally not a happy one. With little success, a great deal of money and manpower has been spent to strengthen parastatal banks through credit components in agricultural development projects. Low interest rates and margins seem to have been a fixation of governments, although rural people tend to have a better understanding of the importance of savings and of managing the risks in investments they undertake. Most credit schemes in the past were supply−driven and lacked in prudence. The provision of credit itself could do little if other crucial factors remained unchanged. As the countries turn their attention to macroeconomic adjustment measures, the inadequacies of their financial sectors become more evident. The financial sector also generally mirrors the problems of the productive sectors. In the process of structural adjustment, the financial system can often prove to be a bottleneck. Many of the issues affecting the financial sector are at the level of banks and other financial institutions, but some relate to sector policies.

Subsidized capital tends to encourage the uneconomic use of capital and also reduces incentives to invest personal savings. Interest rate ceilings and credit controls meant to help small farmers actually end up limiting their access to credit by limiting resource mobilization and making lending to them unprofitable. Since it is access to rather than the cost of formal credit that is the main problem facing rural borrowers, credit schemes should be based on market interest rates which would also help minimize distortions in financial markets. In addition to explicit interest subsidies arising from government intervention, hidden (indirect) subsidies arise from mismanagement, frauds, non−performing portfolios, etc. when losses are eventually covered by government subventions. Explicit subsidies are invariably counterproductive, inhibiting the gradual development of financial markets. Hidden subsidies on the other hand promote lethargy in ailing institutions and greater delinquency among borrowers who often perceive loaned funds

Box 5.4: State of Rural Financial Services in SSA

Financial services, such as deposits and savings mobilization an credit facilities, offered by both formal and informal agents, are essential for agricultural and rural development. Financial intermediaries must work in liaison with several non−financial institutions or agents engaged in providing related rural services—research, extension, input supply, produce marketing, etc. Governments play the most important role of having to provide an appropriate macroeconomic, policy and legal environment in which all agents have the opportunity to develop. Such an environment should foster the easy entry and exit of financial intermediaries, the competitive behavior of suppliers and recipients of rural financial services, and the continued growth of rural financial markets on a sustainable basis.

The past rural finance activities of governments, the World Bank, other multilateral aid agencies, bilateral donors and Non−Governmental Organizations (NGOs) have for the most part been confined to credit. The experience in many countries has been very mixed. Concepts, causes and consequences are now common knowledge and there is general consensus on the new directions to be followed if the problems of the 1970s and 1980s are not to be revisited, that is, a systematic approach, strengthening the national *financial sector,* building *rural financial markets,* improving *all financial services* required by rural communities, and emphasizing the *mobilization of local resources* so as not to rely excessively on external funds and government interventions.

as government money. Slack credit discipline among borrowers from such state−sponsored financial institutions in turn tends to corrupt borrowers from other institutions as well, spoiling the

financial market environment. Experience also shows that administrative interventions are seldom temporary. It would be difficult enough to phase out subsidies, but the liquidation of specialized public institutions, established by government and staffed by a growing number of civil servants, would be politically extremely difficult—parastatals are seldom allowed to exit. Caution must, therefore, be used when dealing with governments' penchant for intervention, which is often claimed to be temporary.

The World Bank's Role

The promotion of efficient financial systems continues to be a major objective of the World Bank. For many years the Bank has supported several free−standing credit projects, and many others with major credit components. Its policies, procedures and practices over the years are delineated in a policy paper 26 / endorsed by the Bank's

Executive Directors in July 1991, and in the Operational Directive 27 / on Financial Sector Operations issued in February 1992. It has financed many credit projects described as Export Promotion, Crop Diversification, Private Sector Development, Tree Crops, Irrigation, Livestock, and Enterprise Development Projects. In almost all these projects, the implementing agencies as well as the participating financial intermediaries were parastatals. As already pointed out, the performance of these state−dominated financial institutions have often been unsatisfactory due to political patronage, bureaucratic culture, mismanagement, overstaffing, inefficiency, etc.

The Bank's involvement in agricultural credit in the past was for the most part aimed at small scale farmers viewed by the Bank too as a group with distinct disadvantages in access to institutional credit. The Bank and other donor−supported projects were thus intended to improve the availability of credit in general and its accessibility to small−scale farmers in particular, usually at interest significantly below market clearing rates, and, in particular, below the prevailing interest in the informal financial market. Such targeted projects and programs often did not, however, achieve their objectives, mainly because they did not address the root causes of the problems. In many countries, the regulatory framework and extremely low and frequently negative interest rates resulted in the misallocation of resources and undermined the viability of credit institutions. Politically and socially motivated interventions were pursued to the total neglect of the issue of sustainability. The negative real interest rates provide no incentives for mobilizing savings, which in turn led to a heavy reliance on donor funds. Governments lacked the resolve and the lending institutions the ability to improve loan recoveries.

The World Bank and donors also generally worked on the assumption that there is an unmet demand for credit and that policy−based lending (directed credit and subsidies) is essential to promote improved technology, agricultural growth and rural development. The assumption that the provision of additional formal credit by itself would remove a major impediment to development continues to be untested. The results of all these assumptions have in many cases been a failure in project objectives, of credit not reaching targeted beneficiaries, and credit not serving as catalyst for specified investments as intended, but making it difficult to develop viable rural financial institutions and to let the market operate on an efficient and sustainable basis. Projects did not, by and large, turn out to be the appropriate vehicles for upgrading institutions. Credit institutions to which Bank funds were lent were not broadly strengthened as intended. Thus, these interventions do not appear to have resulted in increasing medium− and long−term credit facilities. Substitution of World Bank and donor funds, lack of additionality and the neglect of concrete steps needed to develop rural financial markets are also not uncommon.

The Bank's strategic objective in recent years has been to support the creation of an enabling environment for the development of the client country's financial sector, including the formal and informal sectors in rural areas. Considerable progress has been made in carrying out financial sector reforms in SSA countries, including restructuring of the banking sector in several countries. Much more work is, however, still required to develop new financial instruments and viable institutions necessary to deepen financial intermediation, particularly those serving the rural areas. The World Bank and the donor community have for some time been urging SSA governments to improve the financial sector policy environment so as to make it more conducive to greater participation by private entrepreneurs. The Bank has been increasingly supporting financial sector reforms in SSA countries − exchange rate adjustments, interest rate liberalization, restructuring of weak financial intermediaries, effective prudential supervision, privatization of parastatal banks, and establishment of private banks − in an effort to create a competitive financial systems which would respond to market signals.

World Bank funds channelled generally through free−standing credit projects, or as credit components in agricultural, agro−industrial, marketing, private sector development−type projects are provided in the form of:

(a) Reimbursement of eligible disbursement by participating banks and credit agencies;

(b) Direct funding for procurement of:

−foreign exchange for imports, and

−local purchases by borrowers;

(c) Incremental operating costs incurred by credit agencies; and

(d) Institution−building elements e.g. technical assistance, training, systems development, etc.

Funds provided for credit, in the 1960s and 1970s, have predominantly been for medium and long−term loans for investment purposes, including permanent incremental working capital requirements. In recent years, however, support has also been provided for seasonal production credit given out as short−term loans. Bank financing has thus included:

(a) Capital investments;

(b) Clearly−defined input packages appraised by the local banks and credit agencies;

(c) Sub−projects prepared/appraised by the participating banks/credit agencies;

(d) General support to banks and credit agencies for ongoing/new lending schemes; and

(e) Technical assistance for capacity−building.

Problems commonly observed in such programs include:

(a) Total reliance on external sources of funds, ignoring the importance of and the potential for mobilizing local resources;

(b) Inability of financial institutions to actively mobilize savings and deposits;

(c) Inadequate capitalization of participating financial institutions which are generally owned and/or controlled by governments;

(d) High transaction costs for depositors and borrowers;

(e) Poor financial performance of financial institutions, caused by high administrative overheads and overstaffing, particularly at lower levels;

(f) Inefficient operations due to weak top management, lack of enthusiasm and motivation at lower levels, and bureaucratic culture in the government−supported credit institutions;

(g) Inadequate appraisal and monitoring capability of staff in lending institutions;

(h) Difficulties in providing inputs in a timely manner, even though funds are made available by lending institutions, poor produce marketing arrangements, and inappropriate pricing policies;

(i) Lack of demand for credit either because of poor extension/promotion efforts, or because credit was in fact not the limiting factor;

(j) Credit institutions being required to lend to inefficient parastatals;

(k) Political penetration in the management and activities of lending institutions; and

(l) Poor loan recovery performance, resulting in mounting overdues and large non−performing portfolios.

Agricultural Credit Schemes in Sub−Saharan Africa

The initiation of World Bank−sponsored agricultural credit activities in Africa lagged behind similar initiatives in other regions, the first credit project beginning in Kenya in 1967. Since then, only a dozen additional Bank−sponsored projects in Africa have been labeled as being exclusively for agricultural credit, but more than 150 other rural or agricultural development projects have components providing loans to farmers. The total value (1992) of the agricultural credit components of 167 projects was nearly US$400 million or 15 percent of the Bank's total commitments (US$2.65 billion)* on these projects. Apart from several relatively large projects in Kenya and Uganda, along with sizeable single projects in several other countries (Cameroon, Ghana, Liberia, Malawi, Nigeria, Tanzania, Zaire, and Zambia), World Bank funding for agricultural credit in these projects has been in relatively small amounts.

While not documented in this study, it should be noted that other donors and aid agencies have supported many, usually small, agricultural credit and savings activities in SSA countries. It is common to find dozens of such donor−sponsored projects scattered around countries such as Niger and Cameroon, many of them attached to area development programs. European donors have focused on developing financial services in rural cooperatives, the International Fund for Agricultural Development (IFAD) has stressed credit projects for the rural poor, and the United States Agency for International Development (USAID) has a variety of rural credit projects in the region.

Financing has included both the reimbursement of intermediaries' credit disbursements, and direct and indirect foreign exchange funding of machinery, equipment and inputs distributed on credit to farmers. In addition to finance for farmers, funds have been provided for forestry and fisheries development and for the processing and marketing of agricultural products. Institution−building elements have also been funded in support of credit program implementation. These include support for infrastructure (buildings, vehicles and equipment); capacity−building (technical assistance, training, feasibility studies etc.), and the incremental operating costs of financial intermediaries.

* 1 billion equals 1,000 million

Not surprisingly, the assumption that underlay agricultural credit activities in SSA countries are similar to those associated with credit programs in other regions. While several of these assumptions have changed, some through time, others continue to be accepted. One common assumption had been that farmers, particularly smallholders, have very limited access to formal credit, preventing them from access to modern farm inputs, and applying improved technology. A corollary to this assumption is that many farmers have farm investment alternatives and opportunities with high expected returns, an assumption not substantiated by farm−level research. Policy−makers in and for Africa have also assumed that existing rural financial markets were unable to support farm investments because they did not offer medium and long−term loans. Projects with credit components also involve assumptions about loans being essential parts of a package of inputs needed to allow farmers to improve productivity and production.

The World Bank's current policy regarding financial sector operations emphasizes the support needed in the context of an appropriate macroeconomic framework and coherent country financial sector development strategies − a framework that would lead to the efficient working of a market−based competitive financial system, and to the integration of lending to agriculture and rural enterprises with the rest of the financial sector. A sound financial sector, supported by such macroeconomic and financial policies and a strong institutional environment, is considered to be a prerequisite for the functioning of sound rural financial markets. The Bank's policy over the

years has evolved and come to stress the need to (a) minimize directed credit, specialized institutions for the agricultural sector, and subsidized interest rates, and (b) combine financial resource mobilization with the allocation of financial resources.

The World Bank continues to urge governments to set positive real rates of interest on loans. Inflation in SSA countries has forced many countries to adjust their nominal interest rates upward, but these adjustments have often been less than the increases in inflation. The resulting negative real rates of interest on deposits effectively tax individuals who hold part of their savings in deposits. These disincentives result in intermediaries having to rely more and more on donor or government funds at interest rates much lower than market rates. While less true in recent years, many of the World Bank's early credit projects had accepted the argument that concessionary interest was an important instrument for altering both lender and borrower behavior. Low interest rate lines of credit were thought to induce financial intermediaries to provide incremental lending for targeted purposes, and low rates on farmer loans were thought to stimulate borrowers to undertake targeted activities. Fungibility and financial substitution elements were ignored in making these assumptions. Intermediaries were expected to provide the additional loans on narrow margins. Realistic loan loss risk and capital erosion due to inflation were seldom considered in setting interest rate margins, and the vitality and viability of the financial intermediaries handling the credit were given inadequate attention. Many of the problems in Africa's RFMs are due to the low and often unstable rates of return that farmers receive for their produce. RFMs will never be robust until farming and rural enterprises become more profitable. Likewise, inflation erodes the vitality of financial markets, often forcing them to contract, and driving transactions into informal markets or to barter arrangements.

Few evaluations of credit projects in SSA countries provide detailed information on the transaction costs of the intermediaries in providing loans. The projects that do provide this information often reveal that these costs exceed the interest rate margins allowed on the loans. It also appears that lenders' transaction costs of making loans, per unit of money lent, have increased over the past few years as the volume of loans declined. Many intermediaries have been slow to shrink costs by reducing staff. Likewise, there is little information available on

transaction costs incurred by customers to get access to financial services. For small borrowers, these transaction costs may be much larger than interest payments.

The World Bank's Current Involvement in Sub−Saharan Africa

As of December 31, 1992, there were more than fifty ongoing agricultural projects in SSA countries (about 30 percent of all operations) financed by the World Bank, which have credit components, although only five of these carry Finance or Credit as part of the project titles (see Appendix 5). The sustainability of the credit schemes and the financial viability of the participating institutions are about the most important issues confronting all these cases. Poor loan recoveries, mounting overdues, non−performing portfolios, high loan losses, poor capital base, neglect of savings mobilization, high transactions costs; heavy reliance on government subsidies and subvention payments are common features, adversely impacting on institutional viability and sustainability of the schemes themselves.

The major area of the World Bank's pro−active assistance to private sector farming, marketing, and processing has been through rural credit. Most agriculture credit projects in SSA countries have failed (as reported by the Bank's Operations Evaluation Department in their expost project audits). Parastatal agricultural credit institutions have been failures in SSA for reasons detailed earlier. 28 /

The most recent World Bank−financed agriculture credit projects have been undertaken where there is an ongoing process of financial market reform in which financial market distortions are being minimized. This process offers some hope for the development of viable rural credit mechanisms. However, many of the ongoing World Bank financed agricultural credit projects or credit components of projects still use public sector lending agencies,

though only with the requisite management autonomy, positive real interest rates, and effective loan recovery policy. 29 / Whether these public sector credit agencies will prove viable or not when supported in a context of financial market reform, remains a major issue. For one thing, they must also focus on savings mobilization in the countryside, providing facilities for rural people to safely deposit money. They must also find ways of reducing transaction costs through, for example, group lending, linkage to cooperatives and farmers groups, to traders and agro−businesses which can function as intermediaries for lending and mobilization of deposits. Ways must be found to manage the risk of defaults caused by climatic and commercial crisis. 30 / This might be done through guarantee schemes. Instruments for lending to farmers who lack collateral must be developed, by using, for example, group schemes, joint liability, etc. The strategy must also encourage private and cooperative saving and loan institutions in rural areas. To be sustainable, these institutions too, like public institutions, mobilize rural savings, reduce transactions costs, and deal with extraordinary lending risks. A study is under way to look more closely at these issues. 31 /

Several recent donor−supported credit projects now under way assisting farmer−owned cooperative credit institutions and minimizing government involvement are a good example. The project in Benin supports cooperative credit institutions owned and managed by subscribers from the country's rural areas, and are autonomous from government. Lending is based on savings mobilized by these cooperatives rather than on donor credit lines. Donors provide technical assistance and financing of physical structures, as well as organizational or institutional support. Interest rates are set by the institutions themselves, and are now at high levels to cover costs and risks. Similar programs are under preparation in Guinea and Madagascar. Other good examples are Rwanda's banques populaires, Burundi's cooperative credit banks, Cameroon's Camcul and

Ghana's rural banks. Ghana's rural banks involve some equity participation by the Central Bank as a way of accelerating development. All of these experiments with or without government involvement in rural banking are good models which are applicable elsewhere in Africa.

Private commercial banks may also be assisted to develop rural lending capabilities. In situations of capital scarcity for private investment, lines of credit through apex arrangements for on−lending through qualified commercial banks and in turn on−lending for agriculturally related investments including micro− and small−scale enterprises will be desirable. This may be a good way to handle trade finance. Agro−business and traders receiving commercial loans can on−lend to farmers. Donor financing of seed capital for loan guarantee funds may be appropriate, initially, to cushion the risk of lending by private banks entering into the agricultural sector. When combined with financial market reform, technical assistance to private banks to develop agricultural lending, and other pro−active private sector agricultural development efforts; with proper safeguards lines of credit would contribute greatly to private agricultural sector development in countries which have a good economic policy framework. Although there are as yet no examples of such World Bank projects in Africa, several are under preparation, such as in Malawi, Guinea, Uganda, Cameroon and Madagascar, and USAID has developed several projects of a similar nature which merit monitoring.

In several countries, projects are being prepared with the objective of developing private sector agro−industrial, agricultural marketing or export crop investment. (Zambia,Burundi, Senegal, Guinea, Kenya, Cameroon, Madagascar, and Nigeria). Lines of credit through commercial banks will finance such investments at competitive interest rates. Although the focus is on private sector investment in agriculturally−related activities rather than on developing credit institutions, satisfactory financial sector policy or a satisfactory financial sector reform program is a condition for moving ahead. The major issue is the validity of targeting credit to specific sub−sectors. Targeting to agriculture seems to have worked well in China, Japan and Korea. A consensus is emerging that such targeting in the context of a reforming financial sector, using private banks and cooperative institutions (and in some cases banks involving government participation), at unsubsidized interest rates, is necessary to stimulate agriculture and rural enterprises in Africa.

Choices will have to be made in each country, based on careful analysis of policy constraints, on the appropriate vehicle for supporting the various policy reforms necessary, and on the capacity in the country to manage the reforms proposed. In some cases changes and reforms may have to be gradual due to limited management capacity, or to political and social constraints. Generally, agricultural policy reforms which liberate private sector capacity such as in areas like prices, taxes, exchange rates, marketing, and improved public expenditure programs could be undertaken quickly. Reforms which use scarce SSA management capacity such as those involving the privatization of agricultural parastatals, financial market reform, policy reform dealing with natural resource management, and land tenure will take longer.

The performance of RFMs in SSA cannot be substantially improved without altering the way these markets are used, and changing the many policies imposed on them. If attention is to be focused directly on developing RFMs, it would also be necessary to address financial sector policies at the national level. World Bank and donor support for rural financial services should preferably be provided in the context of financial sector reforms designed to improve the allocative efficiency of financial intermediation. The liberalization of interest rates, the removal of any remaining credit targeting, the strengthening of financial institutions, and the removal of

obstacles to the functioning of informal financial markets should all figure in financial reform programs supported by the Bank and other donors.

All SSA countries should have medium− and long−term agricultural development programs in which reforms are specified in a time−bound manner. It is important that these programs belong to the people and governments of the country concerned, rather than being imposed by donors. Strategies should be country strategies and not donor−designed strategies. Without country commitment, policy backsliding will take place and the intended reforms will not last. This need for local ownership will also affect the pace of reform. Reform should also be linked to investment programs — hence the importance of the medium− and long−term framework for agricultural development.

6. Instructive Experiences

General

In this chapter, some valuable experiences are highlighted which could help designers to better understand the strengths and weaknesses associated with some rural financial systems and schemes in selected countries. The goal is to identify the elements of programs and situations which have been successful in addressing the financial needs of rural clients, avoiding the pitfalls. Such recapitulation would help to consider how best to create a conducive environment in which successful elements and programs could be replicated.

Informal Finance

The scope and magnitude of informal finance in Africa is significant. Despite the expansion in formal credit, the role of informal credit is still very significant and a substantial proportion of farmers in these countries still borrow informally. No more than 2 to 10 percent of rural households and enterprises receive formal loans in any one year 32 / and a larger percentage of the population receives all its financial services from informal sources. There is widespread participation in both borrowing and lending in the informal credit market. These loan transactions appear to be extremely informal. They generally occur in private, with no witnesses and no written record. They are almost always made and repaid in cash (or kind). The simplest and most direct penalty for a loan default is the exclusion of the defaulter from future (dealings) opportunities to borrow from the lender. Informal sector loans occur between individuals who share a long history of personal association, exchanging gifts or of

previous credit transactions.

Although data on informal credit market are usually limited, recent studies show that their share of the total farm credit is still around 30 percent. Some studies contend that the informal financial sector in many African countries may be larger than the formal one. 33 / The studies of Cameroon, Ghana, Malawi, Zimbabwe, Benin, Senegal, Tanzania and other countries highlight the participation of rural people in informal groups and the dominant role that informal finance plays in monetary circulation in these countries. Informal savings and lending groups have been reported in a little less than half of the countries of Africa and a large proportion of the rural population makes use of them. Almost everybody in Cameroon belongs to at least one financial self−help group. Research in Cameroon 34 / suggested that informal groups account for more than one−half of total financial savings and the volume of deposits moving through ROSCAs may be larger than the amounts held in banks. In Benin, almost all men and women over eighteen years of age have been reported as being members of a Tontine. It is estimated that the credit granted by groups, associations and organizations in Senegal represents three−fourths of commercial bank credit to agriculture, and that the total annual deposits in Senegalese Tontines represent about one−half of the total currency in circulation. Most of these informal arrangements and institutions are autonomous and indigenous and they continue to thrive in contrast to many formal institutions which have failed. In Ghana, market women make weekly contributions to their association, which assists members in business matters or with personal financial setbacks. A sample in Nigeria showed that 67 percent of funds used by farmers came from informal sources. 35 / Similarly, other single−country surveys in Africa indicate that non−kin informal sources of funds represent from 85 percent − 90 percent of funds mobilized in the rural sector. 36 /

The experience of SSA countries has also shown that it is difficult, in general, for small farmers and micro−enterprises to obtain credit, and even more difficult for small−scale farmers to access formal sources of credit. Thus, they often borrow from informal sources for both production and consumption purposes. Informal savings and lending groups are popular because they provide significant advantages over services available in the formal financial sector. They provide services in regions and for segments of population not covered by formal financial institutions. A survey of five countries (Senegal, Côte d'Ivoire, Cameroon, Gabon, and Congo) showed that 28 percent of the population participate in Tontines, while only 13 percent have a bank account.

Box 6.1: Informal Moneylending

Loans from moneylenders are typically short−term and are extended to clients of long standing; they are rarely tied to collateral. Most moneylenders use their own funds for lending. Their interest rates are high, but other forms of informal credit too may entail hidden costs. Lending between friends and relatives often carries low interest or no explicit interest charge. In societies with strong traditions of mutual assistance and reciprocity, individuals who need funds can call on friends and relatives for help. Acceptance of such help, however, obligates the borrower to reciprocate by providing nonfinancial services or by supplying funds in turn when the lender needs to borrow. The traditional obligations of mutual support can be a problem for those who wish to accumulate capital. The desire to protect personal savings from family and friends creates a strong demand for less accessible savings instruments when these become available.

Market vendors and other small businesses often turn to moneylenders for their short−term credit needs. The so−called five−six arrangement in the Philippines under which the borrower receives $5 in the morning and repays $6 to the lender in the evening is common. The interest rate of 20 percent a day seems extremely usurious. Similar practices in Sri Lanka, for instance, the Rs. 10

borrowed in the morning and Rs. 11 repaid in the evening in urban areas, and Rs. 100 given at the beginning of the month and Rs. 110 taken at the end of the month in the rural areas are not uncommon. But the moneylenders do not perform such transactions every day or every month of the year, and the annualization of such interest payments is not meaningful. In the Sudan, for example, a merchant might provide a farmer with two sacks of millet in return for three sacks at harvest time two months later. The apparent monthly interest rate is 25 percent. But the true rate is much lower because the price of millet is typically higher between harvests than at harvest time.

Borrowers who own marketable assets may turn to pawnbrokers for short−term credit. Pawnbrokers take possession of assets for a fixed term and lend against them at an agreed rate of interest. During the term of the loan the borrower is free to repay and thereby to redeem the asset. Once the term expires, the pawnbroker can sell the asset and keep the proceeds. Because the loan has collateral, the pawnbroker needs no further information about risk. Pawnbroking is an example of how collateral is used even in some informal arrangements to reduce risk and fill the gaps in information that characterize informal sectors.

Group Finance

The most common form of informal institutions are groups of individuals pooling their savings, and lending exclusively or primarily to each other, and/or borrowing from outside institutions on joint and several liability principles. These informal associations are made up of individuals who regularly or otherwise deposit funds with a chosen group leader. The group may be established around a geographic unit such as a village, in a place of business, or within some small social grouping or organization. The main financial problem the groups endeavor to resolve is the pooling of deposits, and it is not uncommon for mobilized funds to be deposited in formal financial institutions. But many groups generally also make loans to their members and, sometimes, even to non−members. Often, members are charged a lower interest rate on their loans from the association's funds than are non−members. In some cases, the funds collected by the association are used to invest in some money−making group ventures. In virtually all cases, members of the groups build reciprocal credit possibilities through their deposits. Various forms of these associations can be found in most developing countries.

Box 6.2: Peer Monitoring and Mutual Guarantees

Members of a group known to one another do not hesitate to stand guarantee for loans taken by any of the fellow members. The group as a whole therefore undertakes joint liability for each member's loan. Every borrower is expected to pay back the principal and interest on the due date. If any member is unable to meet this commitment for whatever reason the other members put up the required funds so that the group itself is able to maintain a 100 percent repayment record. Some groups operate a contingency fund, collecting compulsory contributions periodically to build up a reserve which serves as a guarantee fund. In other cases, members contribute equal shares to help out the member unable to meet the repayment commitment. Reimbursement into the group fund, or personal obligations are settled by mutual agreement. In this way, it is possible for the lending institution to realize 100 percent loan recovery from the groups, and for the borrowers to be able to access credit without interruptions.

Peer monitoring systems have proved very effective, for example, in the group loan schemes operated by the Bank of Agriculture and Agricultural Cooperatives (BAAC) in Thailand, in the Grameen Bank schemes in Bangladesh, and in the Smallholder Agricultural Credit Administration (SACA) program in Malawi. The success of the farmer club schemes operated by SACA has been achieved through strict adherence to the collective responsibility of clubs for full repayment of loans made to their respective club members. When the principle of joint and several liability for SACA loans was not strictly enforced in certain years there was a noticeable decline in the repayment performance and many clubs shut down.

In Cameroon, for instance, people who do not participate in any informal savings and lending association in Cameroon are assumed to have a bad reputation in the community. Almost 80 percent of all adult family members in rural households participate in at least one financial group, the most common form being the djanggis. About one−half of active household members belong to several groups. A study carried out in 1988 found that most groups provided

both savings and credit services to their members. However, a few groups functioned only as depository organizations, while a few others acted as investment groups i.e. lending outside the group at commercial rates of interest, or investing in physical assets that provide a return to the group members, e.g., corn mills. These investment groups can be regarded as precursors of the financiera type of unregulated intermediary described previously and which are so common in Latin America.

The Cameroon case offers an important example of how the incipient integration observed between informal groups and credit unions is in turn well connected with the banking system. Several djanggis participate as member depositors in credit unions affiliated to Camcul, and a few benefit from group loans granted by credit unions. A guarantee fund provided by a foreign donor secures credit union loans in one case, while in the other, Camcul itself serves as a guarantor for an informal group accessing loans from a public housing finance institution.

Mutual/group membership enhances their standing in the eyes of formal lenders, improves information about potential borrowers − both of the individual members and of the group itself, facilitates the offering of joint guarantees, mutual guarantees and group guarantees. It also facilitates mobilization of savings in small installments, at greater frequency, at minimal transaction cost, decentralization, monetization of real savings because of ready accessibility of funds in emergencies. Social impact on non−financial sectors is also significant. There is also a greater possibility of savings being invested in the locality.

Other Group Schemes

Many SSA countries have tried group schemes of one form or the other, with mixed results. The group loan schemes of the Agricultural Development Bank and the Ghana Commercial Bank, as well as the Global 2000 loan schemes tried in Ghana have performed poorly. Similarly, in Malawi, the World Bank−financed Lilongwe Land Development Project (LLDP) started in 1973 incurred high administrative costs and once the external assistance was removed the project could not perform well. The Malawi Mudzi Fund, started in 1990, has not performed as well as hoped for, due to high administration costs and poor loan recoveries. The experience of group lending schemes in Kenya has been similar. Most of these sponsored groups, organized by governments and NGOs have demonstrated poor loan repayments capabilities and many have become defunct very quickly. The major reason for the failure of these loan groups was that these schemes were created specifically for the purpose of obtaining credit.

Despite their success, grassroots organizations are not equipped to meet all the demand for credit and other financial services. Funds mobilized by the groups are often insufficient for the growing financial needs of farmers and micro−entrepreneurs. In localized groups, there is also a covariance of credit demand and risk. Most group members need the credit at the same time for similar activities, and credit demand in rural areas is seasonal, peaking at pre−harvest times. These organizations are generally not financially equipped to accommodate such high seasonal credit demand, and members might be obliged to curtail economic pursuits when group funds reach the bottom. Grassroot organizations are also unstructured in their interpersonal relations and, as a result, are only able to finance the production and marketing of a relatively few goods and a limited range of activities concentrated in small geographic areas.

Box 6.3: Non−Governmental Organizations (NGOs)

Group organization is an effective mechanism to achieve financial discipline, particularly with regard to repayments through peer pressure, monitoring and cohesiveness. Group pressure, if coupled with joint liability would be a very powerful incentive for borrowers to honor their debt service obligations, and to develop the savings habit which would provide a financial history and help build a long−term financial relationship. NGOs in several countries have had some success in organizing rural savings and credit schemes; thus filling some of the gap in the services available from formal financial institutions. NGOs are often better equipped than bureaucratic formal institutions in understanding the needs and capabilities of the rural poor and are able to organize and communicate with the largest groups more effectively and gain their trust and confidence. While NGOs appear well−suited to play an important role in the future development of rural financial markets, their scale of operations in individual countries hitherto has been small. Regional NGO networks such as the African Regional Credit Association (AFRACA) and the African Confederation of Cooperative Savings and Credit Associations (ACCOSCA) could play a greater role in expanding group savings and credit activities.

The group lending method helps to achieve a high rate of loan repayment. The lender refuses future loans to a group until the old debt is paid, and the group in turn will not permit loans to a delinquent member until the payment of his/her debt obligations to the group and/or members who had earlier helped to settle repayment due from the borrower to the lender. Small groups whose members are jointly and severally liable for the debts of individual members have inbuilt safeguards. The group accepts the burden of selection and monitoring of borrowers and the enforcement of repayment obligations. The effectiveness of such groups in dealing with loans to its members has prompted many governments and donors to encourage and even to directly involve themselves in the formation of such groups. Despite notable successes when governments have been instrumental in organizing such groups (Huppi and Fedder 1990), there are many instances of high loan defaults and consequent quick disintegration of groups formed at the insistence of governments.

Financial Cooperatives (Credit Unions)

The First Rural Savings and Loan Rehabilitation Project in Benin, already under implementation, supports the financial cooperatives [CLCAMs and Caisses Régionales de Crédit Agricole Mutuel (CRCAMs)] in the country. The progress of this operation is very promising, as are other initiatives in the cooperative sectors in Burundi, Cameroon and Rwanda. There are many instances, however, where there is pervasive government intervention in the financial operations of cooperative institutions. Many cooperative banks, though nominally owned by primary and higher level cooperatives, are effectively managed as parastatals with all the attendant shortcomings. Cooperative banks in Ghana and Nigeria, for example, which for all intents and purposes are managed as parastatals, have a poor performance record. A number of useful lessons in credit−union development derive from

the relative success of Credit Unions in Cameroon and Togo, and the difficulties this type of organization has faced elsewhere. The most important lessons are summarized here.

Savings First

The single most important source of funds in the credit union is members' savings. No loan funds are obtained from government or donors. The major benefits of this funding policy are autonomy and independence from outside influence, and repayment discipline among the member borrowers. Borrowers are inclined to repay their loans not only because they feel an obligation towards the other members providing the funds, but also because they know that future credit availability depends on the repayment of current loans, in addition to regular savings. The undesirable effects of relying upon external funding for Credit Union lending are well documented. Discouraging savings mobilization and reducing repayment incentives are two of the damaging consequences of dependence on external funds, with immediate effects on Credit Union performance and viability. The tribulations of most Latin American credit unions illustrate this syndrome.

Cautious External Assistance

External support focused on capacity building, including infrastructure, technical advice and training can accelerate and strengthen Credit Union development. Financial assistance, not in the form of loanable funds, for promotion, training and institutional development will help members mobilize and manage their own resources. Furthermore, donor leverage on local governments may expedite legal and regulatory reforms essential for credit union functioning and growth. Perhaps the best example of external financial support and technical assistance contributing to Credit Union success is represented by the evolution of the Togo movement. In this case, the key NGOs involved have been the World Council of Credit Unions (WOCCU), and the African Confederation of Cooperative Savings and Credit Associations (ACCOSCA), with financial and technical support provided by USAID, the African Development Foundation (ADF), the Centre International du Crédit Mutuel (CICM, France), and BFDW (Germany).

In 1983, after a decade of slow but steady growth, a pilot assistance project brought the number of credit unions in Togo to 111 organizations with 9,000 members, culminating in the creation of the national federation (FUCEC−Togo). The new federation adopted a five−year plan focused on the improvement of personnel management, accounting standards and procedures, computerization of financial data, and most importantly, the creation of a Central Finance Facility. During this period, WOCCU provided management and training assistance, the CICM helped develop an inspection system, and the ADF funded a pilot viability promotion activity involving the improvement of physical facilities, the hiring of qualified managers, and the adoption of advanced management and credit policies.

The non−governmental organizations (NGOs) by virtue of their relatively small size are able to operate more effectively at the grassroots, rural community level. For practical purposes, therefore, they are less constrained to maintain a formal relationship with government authorities. This factor gives NGOs greater credibility with the local groups they have set out to assist. NGOs are also in a better position to influence a change in mentality and social expectations. Commercial banks might be more inclined to lend to small farmers and micro−enterprises if for a time−during the initial stages of a scheme − the technically specialized persons in government agencies, or preferably NGOs, offer to assist in loan application preparation, appraisal and loan use supervision.

Trade Finance

Informal financial intermediaries play a central role in rural financial markets as in Zaire where rotating and non−rotating savings and credit associations (informal groups), moneykeepers/moneylenders, and traders are of

crucial importance in funds mobilization and in the provision of credit and depository services to rural households. Credit appears to be an important component of marketing transactions between traders and farmers in Zaire (Cuevas 1989). One−fourth of the rural households interviewed in two regions reported credit activities carried out by traders in the area. The value of credit advanced by traders to farmers against future crop purchases fluctuated between 20 and 50 percent of the value of purchases. Traders were also active in providing credit not related to their business. More important, unlike informal groups, traders in Zaire appeared well connected with both formal and informal intermediaries. Access by traders to deposit services, primarily current accounts, with formal intermediaries, was also significant. Such integration of traders/intermediaries with the banking system was also found in Niger. About one−half of the wholesale traders interviewed had loans from banks, 36 percent from other merchants and suppliers, while retail merchants relied primarily upon informal sources of finance, other merchants and suppliers providing almost 80 percent of their loans.

The evidence of trade credit and of market integration through trade−credit activity reported here stems only from two field studies. However, the widespread incidence of supplier credit and customer advances among small−scale enterprises in suburban areas recently uncovered in The Gambia would seem to disprove the notion that this type of informal intermediation and market integration is absent or scarce in Sub−Saharan Africa. The ongoing study by the Regional Program on Enterprise Development in Africa at the World Bank is likely to shed additional light on this issue.

Trade Credit Links

One of the more important mechanisms the informal sector has for reducing transactions costs and risk premia is the interlinking of credit with commodity transactions both in urban and rural credit markets, and that interlinkage has the potential both of increasing the quantity and reducing the cost of credit to borrowers. Where commodity input and output markets are competitive, it is reasonable to expect that input and output dealers will use improved access to formal credit to on−lend to increase market share rather than attempt to make extra profits on the credit operations themselves. Where lenders have investment opportunities open to them other than on−lending as part of their marketing transactions, a possible diversion of funds to those other activities may have to be controlled by restricting refinancing to amounts actually on−lent. With this safeguard, however, promoting linkages with input suppliers (fertilizer dealers, yarn traders) and millers and processors (rice millers, tobacco curers) is an approach that deserves to be widely experimented with. Some formal lending already takes place at the higher level of commodity traders, and it may be easier for the banks to expand linkages at these higher levels if credit percolates down the marketing chain fairly smoothly. Here again, the appropriate point of entry will depend on competitiveness in the various tiers of the marketing chain.

Tied (or interlinked) credit describes credit transactions that take place between borrowers and lenders and that are connected in an essential way with simultaneous transactions in other markets: the lender may also be the landlord of the borrower in the land−lease market, or his employer in the labor market; it may be a supplier (farm inputs dealer, raw materials supplier, yarn trader, storekeeper, itinerant peddler) or buyer (produce trader, grain miller, cotton ginner,

sugarcane processor, etc.) in a product market. In these cases, the relationship in the other market serves as a substitute for collateral in the credit transaction and is one of the most important mechanisms by which informal credit reduces transaction costs and risk premia. The predominant form of interlinkage of credit in rural areas is also with product markets, in the marketing and processing of agricultural products and in the supply of inputs.

Landlords are an important source of production and consumption loans to their tenants and sharecroppers. Though less important now in most countries, there is often a need to distinguish this source of credit from the usually more important but untied source of the farmer−lender, lending to other farmers (who are not tenants, but are often neighbors, friends or relatives). The loans are made possible by pre−existing lease and sharecropping

contracts which eliminate transactions costs and greatly reduce the risk premium since the loans are recoverable as part of the crop share, or as an add−on to the cash rent.

There is another class of transactions involving the transfer of rights to a standing crop or to land for varying lengths of time which should be distinguished from transactions in which land is leased out. These are particularly important in Islamic countries because of the prohibition against interest. These transactions involve the borrower transferring the asset (a standing crop or land) to the lender, who leases it. The transfer of a standing crop in return for a consideration is really a forward sale of produce. The transfer of land from the borrower to the lender is known as a usufructuary mortgage, or the pawning of land. While usufructuary mortgages often have an adverse equity impact, they may be one of the few sources of long−and medium−term credit for persons not having access to formal credit ducts or lacking other forms of acceptable collateral.

Leasing contracts are not confined to land but extend to other productive assets such as milch cattle. The cow or buffalo is reared by the lessee, his crop share being his share of the enhanced asset value of the animal when it is sold. A variant would be a flock of sheep loaned in kind, the loan being repaid through an equal number of progeny with interest taking the form of a share of the sale proceeds of wool and meat until the loan is repaid. In both these cases the asset (like land) is transferred to the lessee and is either returned (after rearing) or replaced by progeny (to be lent out again). The existence of a wide variety of leasing transactions in the rural areas is partly a reflection of the dearth of credit.

One of the most ubiquitous forms of credit in rural areas is trade credit which takes advantage of the existing informational links between buyers and sellers that have developed over time through commodity transactions. Traders supply raw materials, other inputs or finished goods on credit and make advances to producers or suppliers to assist them in financing the production or procurement of a commodity. The success of the mechanism lies in the fact that the transactors are both actors in the same subsector, are well−connected through the business and know each other well. One has a product to sell, the other has a need to buy it. The deferred payment mechanism allows for continuous sales in a market situation where information costs are low and risks are minimal. With numerous traders, there is an element of competition which stabilizes interest rates at reasonable levels. 37 /

Trade credit finances the marketing and distribution of retail goods as well as inputs of all kinds and appears to be the most important source of working capital for small rural enterprises. Trade credit often links a series of marketing intermediaries, or factories/processing units so that recipients of trade credit are often simultaneously providers of trade credit. Even retail stores at the end of the marketing chains extend credit to their customers.

One of the popular forms of informal credit in the rural areas is the trade−credit link. Trade credit thrives on existing informational links between buyers and sellers that develops through the purchase and sales of inputs, outputs, etc. taking advantage of the links between buyers and sellers, as with raw material suppliers and processors or manufacturers. Such credit could be for productive or consumption purposes, and extended in cash or kind. Supplier credit is extended in kind and repaid in cash or kind. Buyer credit is extended by traders and processors and is extended in cash, in the form of advances, and repaid or settled in kind by the supply of harvest crop or raw materials. Traders provide farm inputs (and consumption goods) on credit during the cultivation period for repayment in kind or cash after harvest. Millers and manufacturers offer cash advances to farmers for production in return for the supply of raw materials after the harvest.

The lenders and the borrowers in the trade−credit link are obliged to interact on a continuing basis which makes information and transaction costs low and minimizes credit risks. In supplier credit, the prices of goods sold on deferred terms are likely to be higher than for cash sales. Commodity traders and agro−processors who make advances to be repaid with a future supply of produce and raw materials are likely to pay lower prices than free market sales for cash. The key to the relative success of the trade−credit arrangements is that the transactors

always operate in the same sub−sector, they are closely connected through continuing business, and are well−acquainted with each other.

The purchase order and stop−order systems of credit delivery and loan collection which are vogue in smallholder and outgrower schemes in Indonesia, Kenya, Malaysia, Sri Lanka, and Uganda (used in tea, rubber, oil palm, cotton, and sugar crops) could be adopted to make non−financial intermediaries (e.g. processing and marketing companies) to serve the small producer who cannot directly access the commercial banks.

Supplier credit is extended in kind and often repaid in kind. Credit extended by buyers, on the other hand, is usually extended in cash and repaid in kind. If the quantity of goods to be delivered by the borrower in repayment is fixed in advance, the transaction is not strictly a credit transaction but a forward sale, although it may be occasioned by the need for credit. If, on the other hand, the advance is to be repaid by a quantity of goods to be determined with reference to the prevailing price of the good at the time of repayment, the transaction is more correctly regarded as credit. The price at which the repayment good is valued will usually be lower than the prevailing market price, the difference representing the implicit rate of interest. Conversely, in supplier credit, the price of the commodity supplied on deferred payment is usually higher than the price at which it would be sold for cash. Where both credit and repayment take the form of kind, as in buy−back arrangements, the relationships of the two prices to prevailing prices for cash transactions jointly determine the rate of interest.

Sometimes, the farmers give credit to traders procuring the harvest. It is not unusual for farmers (large and small) to extend credit to buyers/millers when they sell their crop on deferred payment terms. The Anand Dairy Cooperative scheme (in Gujarat, India) became popular through trying to minimize this feature by paying cash for milk within twenty−four hours of delivery at the member's cooperative society. Smallholder tea planters, rubber planters, sugar farmers (Indonesia, Kenya, Sri Lanka) get paid for their delivered crop after varying time−lags. Similarly, cotton farmers in many countries delivering seed cotton to cooperatives do not get paid for a time. In a sense, farmers are providing the credit to the buyer, right from the time of planting or seeding in the case of a forward sale contract or tied sale. This arrangement

helps the farmers to secure an assured price, avoid storage charges and spoilage, dryage losses, etc.

Banco Agricola in the Dominican Republic

Contrasting against the public development banks/parastatal stereotype is the experience of the Banco Agricola which illustrates that, despite a certain element of political intrusions, a strong deposit mobilization strategy coupled with organizational reform can succeed in a liberalizing environment when donor policies are supportive and government control is kept to a minimum. The most significant implications stemming from the experience of Banco Agricola are:

(a) Deposit mobilization strategies can be a vehicle for public sector development banks to transform themselves into more self−sustaining financial institutions. They are necessary but probably not sufficient conditions for public sector banks to become solvent institutions.

(b) The demand for deposit services is strong in rural areas. For public sector banks with a branch network in rural areas, deposit mobilization strategies can succeed even with below−market deposit rates of interest due to the revealed demand for safekeeping services.

(c) Incentives in the form of staff bonuses can play a vital role in expanding deposits. This can become an important vehicle to continue deposit growth into new constituencies once the bank has exhausted its initial growth based on its traditionally loyal farmer−borrower clientele. In addition, some system of transfer pricing must be implemented for surplus transfers between branches to maintain incentives for branch level deposit

mobilization once local loan opportunities have been exhausted.

(d) Second−generation tensions emerge in marketing loans based on funds generated through local deposits. Past habits of lax loan evaluation, quick disbursement and perfunctory loan recovery efforts associated with donor−funded loan schemes are no longer acceptable practices for loans based on local residents' savings. Thus, the first−stage liability management reforms emphasizing local savings mobilization is soon followed by a second−generation portfolio management challenge to instill a more disciplined loan administration to better protect depositor−saver interests.

(e) The portfolio management reforms associated with deposit mobilization strategies emphasize shorter term loans, less loans to agricultural producers, agrarian reform units, and parastatal entities and more loans to commerce and trading activity; at the same time, greater effort is expended in collecting on outstanding delinquent loans.

Three exogenous factors contributed to Banco Agricola's positive response to the growing liberalization of financial markets in the country. First, the donors were largely supportive and, more important, not introducing any counterproductive actions (such as cheap money sources of funding) that would compromise this reform effort. Second, of even greater importance, the government was too financially strapped to presume to introduce any significant small farmer or agrarian reform clientele schemes that would have seriously compromised the bank's effort to clean up its portfolio and rely on domestic deposit sources of funding. Third, the country was

spared a major calamity (such as a hurricane) which would probably have resulted in a government loan forgiveness−bail out program.

BancoSol in Bolivia

Banco Solidario S.A. (BancoSol) 38 / like any other commercial bank, accepts deposits and makes loans at market rates. What sets it apart are its clients. BancoSol is designed to lend money to the poor. BancoSol does not rely on grants, concessional credits, government guarantees, or other subsidies that keep many similar schemes providing loans to the poor alive. It relies on market pricing and profit generation for its sustainability. Fernando Romero, the President of BancoSol believes that Bolivia's poor need more than credit; they need independent financial institutions. (They) cannot continue with the traditional pattern of dependency (and) must build institutions that maintain themselves and help the community grow.

BancoSol, officially opened only on February 15, 1992 is based on the accomplishments of Bolivia's Micro Enterprise Promotion and Development Foundation (PRODEM), a successful five year old, non−profit finance company. BancoSol started with PRODEM's 27,500 clients. BancoSol's seed capital came from Romero and some other Bolivians, as well as from external aid agencies. PRODEM's 1991 loan portfolio of US$5.9 million is expected to be increased by BancoSol to US$7.55 by 1993. Despite their poverty, PRODEM's clients taken over by BancoSol are good credit risks, with loan repayment rate as high as 99 percent despite it charging an effective interest rate of 45 percent a year, and making all loans on the basis of personal guarantees to desperately poor street vendors and tradespeople.

By transforming itself into a chartered bank, BancoSol will be able to take deposits and, thus, raise funds more cheaply than PRODEM could. However, it will still maintain the PRODEM tradition of making loans to those who do not have assets to put up as collateral. Thus, there will be a free−market, profit−oriented alternative to the old−boy banking network that had excluded first−time venture loans. And as BancoSol's deposits grow, so will its profits. To get a loan, clients must be part of a five−to−seven−member solidarity group made up of fellow vendors or neighbors. To be eligible for credit themselves, group members must make sure, sometimes out of their own pockets, that the debts of all other members are paid in full and on time (joint liability and 100 percent

repayment). BancoSol expects to make a loss until 1994 when it expects to make profit of about 15 percent return on equity. Mr. Romero insists dividends will be paid and hopes profits would attract not only new investors but competitors, too.

So far BancoSol's biggest problem is political. Its high interest rates, more than double those charged by commercial banks, have brought criticism from rival credit programs, many of which believe loans to the poor should be subsidized. Francis Otero, BancoSol's Managing Director, a former social worker who has been working on similar programs for nearly a decade, shrugs off the criticisms: Our rates are high because that is the cost of doing business. The big banks that charge supposedly low rates won't even touch our clients. In my experience, loans at artificially low rates of interest don't get paid back.

Box 6.4: High Interest and Timely Repayment − A Bolivian Example

BancoSol is an example of a private sector venture that has evolved through experimentation and institutional innovation. It lends small amounts of money to self−employed individuals at commercial interest rates and accepts deposits from the same client base. The average size of the loan is US$250. BancoSol has an excellent repayment record that has a lot to do with careful screening of borrowers, small−group joint liability, quality service, perception of institutional continuity, and the use of the profit criteria for lending. BancoSol's interest rates are about 20 percent higher than those of the downtown commercial banks. However, comparison with them is not correct because in Bolivia, banks belong to large financial groups and lend only to individuals personally known to the bankers. BancoSol clients do not have access to these banks. Thus, the proper comparison should be with alternative sources of funds, that is, the moneylender who charges effective annual interest rates from 88 percent to 3,600 percent. BancoSol's effective rates average only 54 percent per annum and are, therefore, very competitive. The demand for BancoSol's services is large. Its products − loans and deposit facilities − and its financial technology are simple. BancoSol services a particular, if large, segment of the market in which its technology overcomes many of the problems that apply to small borrowers.

Grameen Bank in Bangladesh

The Grameen Bank, was started as a small gesture to prove that the poor are responsible and are able to develop themselves if given the financial help, and to test the hypothesis that if financial resources were made available to the poor on reasonable terms and conditions, they can generate productive self−employment without any external assistance. The significant features of Grameen Bank operations are:

(a) *Personal and individual attention.* Attention to personal attitudes and norms of behavior among its leaders, staff and members; commitment to people and to the eradication of poverty; belief in hard work, honesty, integrity and accountability; learning from mistakes; supervision and discipline; and creativity.

(b) *Targeting the landless and very poor.* Only members of a family owning less than half an acre of cultivable land, and total family assets not exceeding the market value of one acre of cultivable land are eligible to take loans, and that too only for an income−generating activity.

(c) *Using a group to encourage mutual responsibility.* To take a loan, a person must join a group. This measure ensures mutual accountability and the sharing of experiences through the period of observation.

(d) *Bringing the bank to the poor.* Instead of members going to the bank, the Grameen Bank goes to the people. Bank staff conduct

most of the banking transactions in the center's weekly village meetings.

(e) *Training in bank rules.* The group members and leaders are given informal training by bank staff to familiarize them with banking rules and group discipline. Female staff train female group leaders concerning social development through workshops organized and held locally.

(f) *Dedicated and localized bank workers.* The major strength of the Grameen Bank is its workers. Banking transactions are conducted at the village level such as street corners, homes, or other convenient places. All field staff are required to reside in the villages that they are assigned.

(g) *Bank workers double−up as social workers.* Apart from banking knowledge, the workers are also trained in health education, nutrition and child−care through the trainers' training program.

Loan recovery is high due to a number of factors. The Grameen Bank's services are confined to the very needy, who have few alternative sources of funds. Borrowing from moneylenders is many times more expensive than Grameen terms. Loan repayment instalments are small but at frequent regular intervals, and adjusted to borrowers' financial capabilities. The group's joint liability, and the requirement that future loans would be conditional upon the repayment by all group members, keep defaults low. The bank is highly decentralized, and able to respond readily to customer needs and to monitor group lending activities effectively. Bank staff are well trained and highly motivated, and they perform an important social and economic leadership function in their communities, in addition to representing a financial institution. Loans are provided only for productive activities.

In order to expand as rapidly as it has, the bank incurs substantial administrative costs, about 18 percent of the value of the portfolio in 1986. Newly−formed branches have administrative costs of 15 to 25 percent of the portfolio. In branches with over three years operation, administration costs are reported to have dropped to 6 percent of loans outstanding. The Grameen Bank is funded by large, low−cost loans from IFAD, other donors, and the Bangladesh Bank. The Grameen Bank plays a much greater role than as a rural financial intermediary; its staff take an active part in forming and sustaining the small groups through which credit is channeled, in helping to set up kitchen gardens, in child education, etc. Bank workers interact with the credit groups once a week, at a fixed time and place, where the weekly payment is made and where other aspects of the program are also discussed.

A commercially−oriented financial institution obliged to borrow and lend at market rates cannot recover the costs associated with increasing lending to the very poor as the Grameen Bank has done. The extension of financial services to the rural poor would involve significant additional costs which cannot be borne by rural financial institutions which have to operate within the limits of their long−term financial viability. Special mechanisms will be necessary to permit an expansion of the system to those without access at present. Much of the effort and expenditure needed to expand coverage of the financial system into the interior rural areas is in the nature of an investment cost. Once the systems are well established and expanded, they can carry their own costs of operation and compete with the commercial banks. Such an institution

would need assistance in terms of funds and other capacity−building support till business builds up to make sustainability feasible.

Bank Rakyat Indonesia's Unit Desa Program

In many countries, financial institutions serving the rural sector have performed very poorly, and some rural banks have been shortlived. The Badan Kredit Kecamatan (BKK) and the Bank Rakyat Indonesia (BRI) in Indonesia, however, have not only made millions of loans to rural entrepreneurs, but also offered a safe and convenient place for rural population to hold their savings. These two banks have been profitable and have had no

problems increasing their lending business and charging market rates of interest, and have therefore been able to operate on a sustainable basis.

The relative success of BRI's Unit Desa program provides one of the rare examples of a state−owned financial institution having been able to operate in a sustainable manner. Bank Rakyat Indonesia is the oldest and largest state−owned commercial bank in Indonesia. It is one of Indonesia's five state−owned banks. It lends to small enterprises under the Unit Desa program. The program began in 1984 with the 4,000 sub−branch locations known as the Unit network. Loans are neither targeted nor subsidized and are based upon the appraisal of the enterprise rather than on the value of the collateral.

The Unit Desa system is the single most important nationwide banking network in the country. Operated as an autonomous financial entity within BRI, the Unit Desa system mobilizes resources and provides nonsubsidized loans (Kupedes) to creditworthy small borrowers. One of the few successful rural finance programs in the developing world, its success has been chronicled in numerous World Bank reports and publications, including the *World Development Report 1989* and the *Poverty Reduction Handbook, 1992.* Being state−owned, it is a test case for whether state−owned enterprises can be made responsive to market forces.

Promising institutions can be undermined by uninformed government intervention. Financial systems burdened by bureaucratic procedures and central commands should be transformed into market−oriented systems to operate on a competitive banks. In analyzing the factors contributing to BRI's success, one element identified was the strong support of the government, little or no political interference, political stability, steady economic growth and moderate inflation. However, there is more to the issue than just reducing the role of the government intervention. One must also transform the incentive systems within the institution.

Under the Unit Desa program, interest rates on loans are set to cover costs and net a profit. There is a strong emphasis on continuity, prompt approval and the availability of the follow−on loans based on good repayment. Attractive positive real interest rates are paid on deposits and unlimited withdrawals are permitted. Incentives are provided in the form of profit−sharing for employees, interest rebates to customers for prompt repayment, and lotteries and prizes for savers. Close supervision and effective loan portfolio management are key to program success.

Box 6.5: Grameen Bank in Bangladesh

The Grameen (Village) Bank in Bangladesh originated as a research project started by Professor Muhammad Yunus, its present Chief Executive, at the Chittagong University. Started in 1976 as an experiment to help poor farmers without adequate land to offer as collateral to conventional lenders, activities were expanded into five districts by 1981. It was formally incorporated as a bank in 1983. The Grameen Bank's activities are based on groups of five poor villagers and linked credit and savings. Its lending activities are managed effectively though peer monitoring and joint liability.

Group cohesiveness is ensured by keeping the group small and self−selected. The members of a group are given intensive orientation by specially trained field workers from the bank prior to the commencement of any financial activity. Contact between the group members as well as the bank worker is ensured through weekly center meetings at which five such groups would assemble. The community spirit is enhanced by the honorary (unpaid) services offered by the chairpersons and secretaries of the groups and centers, and the profile maintained by the bank workers trained to relate to and respect the group members.

Two of the five members selected by the group receive the initial loans, for productive activities selected by the prospective borrowers and endorsed by the other members of the group and approved by the bank worker. These two members would commence their weekly repayment of their loans (generally 50 weekly equal instalments) at the center meetings. After a short period of satisfactory repayments by the initial two borrowers, the next two members of the group become entitled to receive loans, following the same rigorous procedure and disciple. Satisfactory repayments by all four borrowers permits the fiftth member to receive a loan. Further loans would of course be made after full repayment of the initial loans.

A special feature of the Grameen scheme is the compulsion to participate in mandatory savings − a requirement to have each member contribute Tk 1* weekly and 5 percent of loans received into a group fund at the outset, and 4 percent of loans received after full repayment of the loan to the emergency fund operated by the center. Another feature is that loans to group members carry interest at the same rate as that charged by commercial banks for administered agriculture credit − loans are no cheaper than what would be available from other formal financial institutions. The effective cost to the borrower would, however, be higher at 25 percent which does not take into account the additional and significant transaction costs involved in the members having to attend the weekly meetings, and the time spent in peer monitoring fellow members' activities and obligations, as well as having to contribute to meet the joint liability of defaulting members.

* US $1 = 39 taka (1992).

Box 6.6: BRI's Unit Desas in Indonesia

The Unit Desas (village units) of the Bank Rakyat Indonesia (BRI) were established in the early 1970s to provide credit for agricultural inputs as part of an extension program, BIMAS, encouraging the use of fertilizer−intensive rice cultivation. They were not intended to be financial intermediaries. The country had to increase rice production quickly and authorities thought that the required sudden increase in cash inputs could only be met by credit to the farmers and that the government was the only possible source of such credit. The agricultural extension program succeeded. The rural credit network, however, was marked by increasing arrears and operating deficits, which were covered by BIMAS subsidies.

The BRI Unit Desas were in effect reborn in 19831984, when it was clear that BIMAS credit and operating subsidies were going to be stopped. The human infrastructure for a huge financial institution had been developed. The Unit Desas were providing the only formal banking services in more than 75 percent of all the locations in the country that had any such services. The ending of BIMAS could have meant abandoning this banking infrastructure. Instead, the decision was taken to turn the more than 2,000 Unit Desas into full banking units that would be financially viable without further subsidy from government.

In revamping the Unit Desa network, planners decided that savings would be the major source of loanable funds and would carry a positive real interest rate. Interest rates on loans were set at levels high enough to cover all costs, including expected loan losses, and to earn a net profit. The goal was to build a stable and financially viable institution that would earn the trust of the people

as a place to borrow and to keep savings. The credit operations of the Unit Desas have grown at an impressive rate since 1983, with more than 1.8 million loans on the books in mid−1990. Loan losses are well controlled, and the unit desas are now consistently profitable. The savings response has been even more impressive. In mid−1990 there were more than 7 million savings accounts in the unit desas. The value of savings exceeds credit outstanding, so there is no need for injections of outside funds. The Unit Desas now provide a steady flow of the financial services needed by the people in rural areas.*

* Richard H. Patten and Jay K. Rosengard. 1991. *Progress with Profit: The Development of Rural Banking in Indonesia.* San Francisco: ICS Press.

In his study on an experimental savings and credit scheme developed for farmers in West Java in Indonesia, Moll analyzed its performance and identified the organizational, financial and operational factors, and the external and internal conditions essential for the functioning of financial institutions in developing countries. 39 / This savings and credit scheme, formulated in consultation with the participating farmers and staff of the local village cooperatives (Koperasi Unit Desa − KUDs), were organized at three levels − the project in charge of overall coordination and monitoring, the KUDs representing several groups of farmers, and the groups themselves with a membership of about fifty farmers each. Moll's review and analysis, carried out after seven years of operation, showed that all costs of the scheme were in fact covered by interest

receipts and that the savings of the group members resulted in a considerable build−up of the group's own capital. The noteworthy features of the scheme included:

(a) Interest of farmers in a permanent financial relationship;

(b) Farmers exhibiting this interest by maintaining an admirable loan repayment discipline;

(c) Achievements largely the result of the localized group organizational structure which results in easy access, members' preparedness to save, and costs kept low through the use of management capacity available in the community.

From his review and analysis of this experimental scheme, Moll identifies seven essential factors which would help develop financial services to farmers worth reiteration:

(a) The government must refrain from interfering in interest rates and operational aspects such as lending policy.

(b) Farm households must have a capacity to save, to enable them to comply voluntarily with the terms and conditions of a relationship with financial institutions.

(c) The existing formal and informal financial relations in rural financial markets form elements of competition that limit the freedom of an institution to set interest rates and further terms and conditions of its services.

(d) Operational costs must be covered by interest receipts, and the operational costs must be sufficiently low so that credit can be offered at an attractive rate to borrowers, and capital can be attracted at a rate that satisfies lenders.

(e) The services provided must be adjusted to the farmers' requirements.

(f) The physical distance between the institution and farmers must be limited, so as to keep the costs of access low.

(g) Services must be provided in the knowledge that permanent relationships with farmers are essential, because these services are useful to farmers over the long term.

This comprehensive framework could serve as a useful basis for analysing the performance of financial institutions in rural financial markets.

Thus, rural banks offering credit to the poor, and especially the poorest sections in the rural areas have taken hold in several countries although in many others rural banks have been shortlived. The Grameen Bank in Bangladesh, the BancoSol in Bolivia, the Badan Kredit Kecamatan and the Bank Rakyat Indonesia in Indonesia have, however, not only made millions

of loans, but also offered a safe and convenient place to hold their savings. All except the Grameen Bank have been profitable and unsubsidized, and therefore self−sustainable. 40 /

Loan Guarantee Funds

Many potential borrowers cannot satisfy the lending institutions that they are creditworthy, or can offer adequate collateral. The lenders may also consider many loan propositions in the rural areas too small, too risky and the investment proposal unbankable. Such justifiable reluctance on the part of the lenders could be remedied at least in part by the operation of credit guarantee funds, thereby reducing their risks through risk−sharing arrangements. Systematic savings and setting aside funds to meet future contingencies is evident in group behavior, particularly in rural areas. Such savings help to enhance creditworthiness, where the borrowers are not in a position to offer conventional forms of collateral acceptable to lenders.

Some form of loan guarantee programs is implemented in many countries. In an effort to reduce lender risks in providing credit to borrowers with insufficient collateral, governments in some countries have given blanket guarantees to institutions lending to targeted sectors and clientele. Even private organizations, like the African Business Women's Association and Women's World Banking in Malawi have offered to provide seed capital for operating loan guarantee funds to back up credit given to their members.

The farmer clubs which obtain credit from the Smallholder Agricultural Credit Administration (SACA) in Malawi undertake joint liability for the individual member's loan repayments. If any member is unable to meet the repayment for whatever reason the other members put up the required funds so that the group itself is able to maintain a 100 percent repayment record which is a mandatory obligation under the SACA credit scheme. Some groups operate a fund, collecting compulsory contributions periodically to build up a contingency which in effect serves as a guarantee or reserve fund. Such arrangements feature also in the Bangladesh Grameen Bank scheme, where each member of a group is compelled to deposit one taka per week into a Group Fund as savings, and every borrower pays in 5 percent of any loan taken. In addition to contributing to the group fund, 25 percent of the interest paid by members on loans (now 4 percent) is deposited in an Emergency Fund operated by the Center. This fund would be available to help repay the loans of group members who are unable to meet loan servicing commitments due to unforeseen circumstances.

Loan guarantee funds financed by governments and external agencies usually cover an agreed percentage of the loan losses. Such a partial guarantee may also be related to the number or quantum of loans made to a specified category of borrowers. The global or floating guarantees operation of guarantee funds managed by outside agencies (often the Central Bank in the country) involves rigid and detailed criteria for recourse to the fund, and time−consuming procedures for securing reimbursement against loan losses. Such complex formalities inhibit many lenders from changing their lending policies in any significant manner. Credit assistance provided by governments to small farmers and disadvantaged borrowers may take the form of either a direct loan or a guarantee to a financial institution required to participate in a special credit scheme. Often, such directed lending

or guarantee programs have to be small both in absolute terms and as a percentage of the total amount of credit needs.

Support to Women

In general, the integration of women farmers into credit schemes is especially lacking. In view of the woman's essential role for expanded food output, particularly her dominating role in food crop production decisions and labor allocation to food crop production in much of Africa, this poses an equity and efficiency problem at the same time. There is evidence that incremental real income controlled by women leads to higher incremental nutritional improvement (at same income levels) than does incremental income controlled by men, due to intrahousehold decision−making and preferences. For instance, two recently completed studies in Kenya and the Gambia by the International Food Policy Research Institute (IFPRI) substantiate this point (Kennedy and Cogill 1987; von Braun, Puetz, and Webb 1989). Thus, to serve the objective of fast nutritional improvement calls for a focus on expanded, or at least maintained, income control by women in the process of transformation of subsistence agriculture. Credit specifically catering to women is an essential instrument for this purpose.

Recognizing that the rural poor, especially poor women, have limited access to financial services, governments and donors have provided large sums of money to improve the situation, often given out as subsidized credit. Experience has shown that such schemes have largely failed. The dismal experiences with directed subsidized credit programs in many SSA countries have been researched and documented. Direct gender targeting, advocated at times, is not necessarily the most effective way to guarantee access for women to financial services. While local economic, legal and cultural circumstances are crucial factors, program designers should be aware of various options that could be used to improve the provision of financial services to women clients. In more recent programs, however, instead of focusing on cheap credit, other barriers to accessing financial services, high transaction costs, unsurmountable collateral requirements, low levels of literacy and numeracy among the poor 41 / are being addressed.

Traditional savings and credit mechanisms which have thrived in the local, social and cultural setting may hold the key to the challenge of structuring mechanisms to deliver meaningful financial services to women clients in the rural areas. Since women have become increasingly important as farmers and rural entrepreneurs, their needs require greater attention in the design of rural finance and credit programs. A World Bank study reviewing project experience involving financial services components targeted at women entrepreneurs noted that it is becoming clear that women are economically rational actors who make judicious use of financial services when they are accessible and designed to match their income streams and productive opportunities . (This is) shown in the high repayment rates of projects and programs which address the needs of women, regardless of the country or sector involved. Field experiences indicate that women respond more rapidly to innovative approaches such as solidarity groups and joint liability, and display a previously unrecognized demand for deposit facilities which offer liquidity and security. Demand−driven services seem to be more sustainable and reach scale more than do traditionally supply−driven approaches. The choice of delivery mechanisms is also crucial to the client acceptance of services. Approaches that show considerable promise include group liability and the use of female extensionists and bank officers. It would therefore make considerable sense for financial intermediaries to design mechanisms that offer dependable longterm access to financial services for women clients.

Preliminary findings suggest that in many parts of Africa, small voluntary women's groups at village level, frequently organized as savings clubs, can serve as a point of entry to more formal institutions (such as Credit Unions) that serve as savings facilities and lend

production and consumption credit to the rural poor (Seibel 1989). In eight out of ten villages in The Gambia, for example, a recent IFPRI survey found at least one active women's savings society. Several societies give credit for

basic food security purposes in the hungry season when pooled resources permit. In Zimbabwe, savings clubs number more than 5,000 and are mainly run by rural women. Studies available indicate that most of the successful schemes have employed groups as a substitute for physical collateral and to control operating costs. Due to geographic realities, women in rural areas may stand to gain the most from using groups as a delivery mechanism. There is a marked preference by donors for targeted enterprise development services for women, often combined with general targeting for credit components.

In Benin, women have traditionally used the savings and loans cooperatives to gain access to credit and were adversely affected by the collapse of these institutions due to mismanagement, adverse financial sector policies and a lack of attention to savings mobilization. They did not have access to the banking facilities or access to Central Bank rediscounting facilities. This resulted in high operating costs, inadequate interest rate spreads, poorly−supervised credit operations and reduced income due to poor financial management. Even though the system has suffered from operational and policy problems, these Credit Unions, the Caisse Locale de Crédit Agricole Mutuel (CLCAM) remain the main saving institutions in Benin's rural sector. The Benin experience demonstrates that cooperative approaches can offer financial services in a cost−effective way to large numbers of rural clients, including women.

Increasing attention paid to women in development has led to a rapid increase in the number of Bank − supported projects to reach women. The strategy adopted in the majority of such projects was direct gender − targeted approaches, marketing funds specifically for women participants. Other projects used an indirect approach offering services for activities or segments in which women predominate. In designing new programs, it would be necessary to be gendersensitive and proactive in order that women may have improved access to financial services. The World Bank study referred to in an earlier paragraph found it difficult, however, to conclude that direct gender targeting or indirect mechanisms are the most effective ways for guaranteeing access to significant resources. While it noted that NGOs appear to offer an advantage in terms of targeting low income women it also recognized the institutional problems related to loan collection, administrative costs control and scale of operations in following the NGO route.

Possibilities with Promise

Group Schemes

Group arrangements in the form of ROSCAS have been in existence in SSA countries, as in other developing countries, for a long time and, as discussed earlier, can be major instruments of savings and credit in the informal sector. The system can be adjusted according to people's special circumstances. For example, in Ghana, the sequence of loans in rotating Susu groups can easily be changed if one of the members suddenly has an opportunity to buy items necessary for his/her work. Similarly, in The Gambia, some ROSCAs among farmers suspend their operations during the rainy season, when cash for contributions becomes scarce, and restart in the trade season. 42 / The availability of money when needed was reported to be a major reason for the rural people in Ghana preferring rotating groups to formal banking institutions. Convenience and regularity are other important factors. For example, money collectors in Ghana visit markets daily to accept deposits, no matter how small. In rural areas, collectors make their rounds early in the morning before farmers go to their fields and in the evening after they return home. These examples are a clear indication that convenience overrides the importance of the

interest rate, and that the customers are willing to forgo higher financial rewards from savings, or lower costs in borrowing, in exchange for such services.

Since these grassroot organizations are the product of local initiatives, they enjoy full autonomy and their staff can identify themselves with and easily relate to the group members. The people themselves decide how they are going to be organized and elect one another to the group — this means that all the members of the group can be

trusted. The members are entirely responsible for the management of the funds mobilized and for borrower selection. The creditworthiness of members and non−members and their individual debt servicing capacity are well known, which in turn helps to minimize the loan processing and recovery costs.

A distinction should, however, be made between the groups organized voluntarily by the rural dwellers themselves such as ROSCAs or Susus and the groups organized at the instance of governments, NGOs, or formal banks. Although most of the latter type of groups have several features similar to ROSCAs, such as short−term credit and periodic contributions, they differ in important ways from the informal groups voluntarily formed. First, these sponsored groups, unlike ROSCAs, are organized by external agencies and are generally obliged to follow the rules and procedures established by the sponsors. These groups are created for some specific purpose, designed by the sponsors, that is, credit. The evidence suggests that sponsored groups are difficult to establish and even more difficult to sustain; they need continuing financial and managerial support from the sponsors. Several studies have shown that group formation is a rather complex process, and outsiders (e.g. extension agents, credit officers, technical assistance) involved in group formation tend to underestimate the complexity because of their insufficient appreciation of the local conditions.

Formal and Informal Financial Systems Linkage

Both the formal and informal financial systems have their roles to play and should be encouraged to develop in tandem, with a view to better integration. Promoting linkages, or a two−way flow of funds between the formal and informal financial sectors, is a very practical way of increasing the flow of formal sector funds to informal lenders to supplement their own funds and deposits. 43 / The formal sector has proved more successful in mobilizing small savings than in making small loans. The basic advantage of promoting the linkages approach is that it combines the strengths of both sectors to supplement the resources of the informal sector. 44 / It is important to avoid the pitfall of discouraging informal savings by substituting cheaper formal funds for informal deposits. Attempts to channel subsidized funds through informal lenders, except in exceptional circumstances, would be neither feasible nor desirable − not feasible because the on−lenders are likely to divert funds to other purposes if the funds are provided at below opportunity costs, and not desirable because the on−lenders will have less incentive to mobilize savings themselves.

Contractual linkages between the rural credit market and other markets is prevalent in many forms − the pledging of standing crops as collateral, committing all or part of a crop or crops at harvest time, the forward sale of future crops, etc. Even the formal financial systems have adopted more cost−effective systems for dealing with rural credit, through peer monitoring systems prevalent in the ROSCAS−type informal sector arrangements. Formal credit programs could be equipped to compete effectively with the informal sector by adopting the innovations and instruments used by the latter.

Informal and formal credit agencies are known to interact through financial intermediation. The informal lenders keep the unlent or surplus funds with a commercial bank which in turn would be willing to lend to the moneylender in times of need. This relationship provides the potential for the larger formal financial institutions to employ rural moneylenders as their agents for improving financial intermediaries in the rural areas. One important measure to overcome the limitation of funds available to informal groups is to forge links between the informal and formal financial institutions. This would provide a basis for bridging covariance and seasonal variations in credit demand. This linkage can be in two forms: where formal banks could make use of existing groups or adopt features of ROSCAs or Susus; and where ROSCAs or Susus could establish links with formal banks by depositing their excess liquidity with them and subsequently borrowing from them. Each financial system could be associated with the activities of the other and adopt appropriate techniques from the other. Informal financial intermediaries could deposit surplus funds with formal financial institutions and meet their requirements for extra resources through borrowing from the formal market. Working with ROSCAs may be particularly desirable as they incorporate savings and credit, and appear to be effective in reaching women. It is

also important for the formal institutions to work through existing informal institutions without disturbing the autonomy of these organizations.

Some countries already have models linking formal and informal finance. For example in 1986, the Asian and Pacific Regional Agricultural Credit Association (APRACA) adopted a program of access to formal financial institutions for the poorer sections by focusing on: a financial intermediation system built around self−help groups as grassroots intermediaries between banks and rural microentrepreneurs. 45 / Subsequently, several APRACA member institutions held discussions and carried out research on self−help groups and their importance for the development of rural finance. The first country to test this linkage model was Indonesia, thus minimizing transaction costs for both bankers and final borrowers and overcoming the shortcomings of informal lending. The program has two principal linkage dimensions: institutional linkages between self−help groups and banks (direct or indirect), and financial linkages between savings and credit. Interest rates on savings and credit are market rates and an adequate interest margin provides the basis for the institutional viability of each intermediary: the bank, the private voluntary organization/NGO and the grassroots organizations. The program also seeks to preserve the autonomy of the existing groups and institutions.

Another example of this linkage is the Praja Naya Niyamaks (PNN) scheme inaugurated in 1988 in Sri Lanka. 46 / The basic features of the scheme are that the two state banks lend funds to persons of proven creditworthiness, often on the basis of collateral, at 18 percent per annum and expect PNNs to lend at an interest rate not exceeding 30 percent per annum. The banks give the PNNs guidelines on how to lend but do not require them to provide documentation and other proof of their lending. This will solve the problem of the liquidity of informal sources and at the same time provide the flexibility and convenience in lending, which the banks as formal institutions could never provide. However, one weakness of the scheme is that PNNs do not mobilize savings and are entirely dependent on the two state banks for their resources.

Linking Banks with Self−Help Groups

In Indonesia, financial liberalization since 1983, disenchantment with traditional subsidized credit programs and an openness to innovative approaches and financial liberalization since 1983 have led to Central Bank interest and support for a pilot project in which thirteen participating banks, with the assistance of twelve NGOs lend to about 420 self−help groups (SHGs) in the first phase, which would then on−lend to members (Seibel and Parhusip 1989).

Some of the principles underlying the project and the guidelines that have been issued to theimplementing groups are listed here.

(a) The SHGs are to use part of their funds for lending to their members, and another part for depositing in a bank to serve as the basis for refinancing from the bank.

(b) Savings are to come first: no credit will be granted by the SHG without savings by the individual members of the group. These savings are to serve as partial collateral for their loans.

(c) The joint and several liability of the members is to serve as a substitute for physical collateral for the portions of loans to members in excess of their savings deposits.

(d) Credit decisions for on−lending to members are to be taken by the group collectively.

(e) Central Bank refinance is to be at an interest rate equal to the cost of mobilizing savings.

(f) All the intermediaries (the Central Bank, banks, NGOs and SHGs) will charge an interest margin to cover their costs.

(g) Interest rates on savings and credit for members are to be market rates to be determined locally by the participating institutions.

(h) Instead of penalties for arrears, the banks may impose an extra incentive charge to be refunded in the case of timely repayment performance.

(i) SHGs may levy an extra charge on the interest rate for internal fund generation (which would be self−imposed forced savings).

Within the first ten months of the implementation period, in this case, by March 1990, seven private banks and eleven branches of government banks had made 229 group loans to SHGs, which had retailed them to about 3,500 members. Interest rates to end−users have been between 3044 percent after the NGOs and SHGs had added their margins to cover costs and build funds to cover joint and several liability. Only one of the participating banks had sought a guarantee under the scheme from Bank Indonesia.

In Africa too, some formal institutions have adopted some features of the ROSCAs and Susus. The State Insurance Corporation (SIC) in Ghana has started a Susu−type program, called Money Back to attract clients and bringing people who previously did not use their services. In 1987, SIC put the scheme into operation a under which a contributor gets his/her money back after saving for one year. Any participant who contributes over 200 cedis [(US$1=300 cedis (1992)] a day qualifies for a loan after six months, and finally, contributors get back their total contribution at the end of the calendar year. The Money Back scheme also serves as a life insurance cover for the contributors. Like Susu, the scheme is based on daily contributions and most of the contributors are women who have used the Susu system. Similarly in Nigeria, the

government has introduced the People's Bank scheme, an innovative program, to overcome the problems faced by small−scale enterprises in obtaining loans from the formal institutions.

In Senegal, proceeds from market collectors, Tontines and village savings are occasionally put into banks. 47 / These are small amounts which the banks have little interest in attracting. But the banks offer the informal sector savers safekeeping facilities, since security is very important to these savers. Similar links exist between Susu collectors in Ghana who deposit mobilized savings daily with commercial banks. This was extensively observed in some studies. 48 / Many Susu operators deposit the total savings mobilized from the markets in one of the banks near the market. Operators of the largest ROSCAs in Cameroon and other SSA countries continue to deposit their pooled monies in commercial banks until the time of disbursements to their clients. A significant amount of private sector savings held by indigenous banks are those mobilized in the first place by the Susu collectors. In Cameroon, a monthly savings and credit group with a monthly pool of over 420,000 francs [(US$1=300 CFAF Cameroon Francs (1992)] went formal in 1975, forming Cameroon's sixth bank. In Zimbabwe, the savings clubs are considering establishing their own bank to administer their assets in line with the needs and priorities of the savings movement. However, the immediate emphasis should be on consolidating and systematizing these initiatives. 49 / To encourage Susu collectors, incentives such as preferential deposit rates, special tellers to deal with the collectors, and waiver of all charges and fees on demand deposits, could be offered. 50 /

It is important is to focus on the techniques to achieve this linkage and there is much more to learn about the nature and feasibility of such links. It is necessary, however, to recognize the ability of these grassroot organizations to set their own objectives, rules and regulations and to choose their own leaders. This flexibility permits the groups to adjust quickly to new situations. These groups may lose their identity and indigenous nature

by linking with formal institutions. Forcing them to formalize operations may well impair or even destroy them. For these reasons, some argue that the best way to help ROSCAs might be to leave them alone.51 /

Operation of Credit Reserve Funds

Smallholder farmers and rural entrepreneurs operating micro and small enterprises often have no access to credit facilities because they are generally not in a position to offer conventional collateral acceptable to the lending institution. The formation of mutualist groups (e.g. farmer clubs in Malawi participating in the Smallholder Agricultural Project, obtaining credit from SACA) certainly improves accessibility. However, even such group arrangements will have only a marginal impact on accessibility, partly because the groups function in an informal manner − no legal backing to their formation, existence or operations. Joint liability obligation that farmers clubs are able to offer SACA thus provides substance to the creditworthiness of the clubs. In many farmer clubs, if a member was unable to meet the loan servicing commitment for whatever reason, the other members put up the required funds so that the club itself is able to maintain the 100 percent repayment record insisted on by SACA. There are other groups, however, which operate special funds to serve as a contingency or guarantee fund. The group collects small but compulsory contributions periodically to build up a reserve which could serve as a loan guarantee fund which could be used to help out a member in difficulty and unable to meet the required commitment. Reimbursement into this fund, and other obligations of the member in distress are settled by mutual agreement. Even under such arrangements, some farmer clubs have been unable to meet their debt service commitments to SACA, and hence have been denied further credit.

A more systematic and formalized arrangement between the borrower groups and the lending banks whereby the groups could operate a reserve fund to meet the loan repayment instalments of borrowers in distress would help reduce credit risks and improve credit access and outreach. Such a reserve fund scheme could be operated by the lending banks on behalf of the farmer clubs or other cohesive groups.

Hypothecation and Trust Loans

A modified form of trade−credit linkage in which the borrower sells the farm output/s to the lender has also been a very effective enforcement mechanism prevalent in the rural sector. Such an arrangement closes the borrower's option to seek additional credit from other lenders. This in a sense also reduces the lender's risk in securing repayment by preventing the borrower from entering into more financial commitments, thereby increasing total indebtedness. The ability of a trader−moneylender to enforce claims is thus enhanced. Hypothecation of a title, or the deposit of title deeds to land and saleable and fixed assets, though of no practical significance, is an effective method of preventing the borrower from accessing another lender and from selling the subject property to a third party.

Usufruct Loans

These are loans extended to borrowers unable to offer conventional forms of collateral — physical assets, land included, capable of being realized quickly and without too much loss — in the event of loan default. This might be in the form of the lenders' right to use or have control over the borrower's property. The lender may be given the right to occupy or use the borrower's land or other assets until the loan is repaid following the principle possession is nine−tenths of the law. Loans are sometimes guaranteed by the lender being allowed to harvest the borrower's crop for the whole or part of a season in satisfaction of the principal and interest owed. Such arrangements are common with tree crops.

Minimalist Credit

This approach is a scaled−down version of the Credit−Plus approach. The minimalist credit schemes confine their support to essentially providing credit to clients, minimizing their need to manage other support services, though such services would enhance the prospects of borrowers' achieving better results from the investments and activities for which the loan was taken. The advantage claimed by institutions adopting this approach is that it minimizes the burden of organization and costs which are likely to get out of control. The merits claimed for the Credit Plus approach is the probability of lower loan delinquency rates and loan losses. Therefore, the advantages of minimizing organizational costs in providing additional support services should be carefully weighed against reduction in transaction costs on loan recoveries and higher incidence of bad loans in opting for one or other of the two approaches or in the timing of any shift in emphasis from one approach to the other.

The Kenya Experience

The principal suppliers of inputs and machinery to the agricultural sector in Kenya are financed from the commercial financial system. Machinery purchases are funded mostly by the NBFIs on a lease−purchase basis. The large fertilizer distributors, MEA, Kenya Grain Growers Cooperative Union (KGGCU) and others also operate with funding from the commercial system. The other important source of supplier's credit for agricultural inputs is the cooperative system,

which has been described previously. KGGCU, an apex institution in the cooperative system, is the largest supplier of agricultural inputs in the country, and as the key supplier for the commercial agricultural sector has been getting increasingly involved in seasonal crop financing since the government funded the Guaranteed Minimum Return (GMR) program and the New Seasonal Credit System went bankrupt. Their clientele are, however, large and commercial farmers, with the average loan at about K.sh. 100,000. Much of the wheat crop is financed by KGGCU, which also takes delivery of the grain from the farmer for the National Cereals and Produce Board, thereby controlling repayment. Interest charged is 2 percent above the commercial rate, or 17 percent for the most recent season. Repayment is reasonably good, with recovery rates of about 80 percent. The credit review, approval and monitoring facilities are only sufficient to deal with the few large clients the KGGCU has at present and it is unwilling to expand the credit facility too much more. Its funding is obtained from the commercial banks through an overdraft facility, supplementing its own resources.

The foreign−owned Standard Chartered Bank is one of the four biggest banks in the country, and the one with the highest proportion of its portfolio in agricultural loans in 1987. This was due to an innovative and successful approach which combined high−quality technical assistance and financing for agricultural ventures with high−unit value of output. Some 25 percent of a total loan portfolio of K.sh. 4.3 billion (US$ 260 million) at end−1987 was invested in directly productive agricultural activities via a subsidiary agricultural development company: Standard Chartered Estates Limited. In addition there was substantial agricultural lending to customers of its broad−based branch network.

Until recently, a large part of the development assistance available to rural small and micro−enterprise in Kenya has emanated from NGOs. Public sector programs such as the Kenya Industrial Estates (KIE) have largely focused on the more substantial small− and medium−scale firms, but are now beginning to explore options for assisting the informal sector. Commercial banks, particularly the Kenya Commercial Bank (KCB), are also experimenting in the informal arena, less as bankers than as project implementation units for public sector programs. USAID has taken a leading role supporting NGO activities in Kenya with the creation of its Kenya Rural Enterprise Program (KREP) − an umbrella organization created in the mid−1980s designed to channel money and technical assistance to NGOs working in small enterprise development. KREP has successfully worked with forty Kenyan NGOs in developing small private enterprise. Some twenty projects, each with a separate NGO, are under way. Under a project, KREP capitalizes a loan fund (managed through a commercial

bank) and provides technical assistance to the NGO in enterprise development and management. The NGOs then work with clients, providing training and supervising credit use. Repayment rates are fairly high, in the order of 90 percent for the best NGOs, although only 30 to 40 percent of the projects can be labeled successful. Administration costs are also high (averaging 23 percent of loaned funds), and the NGOs are not commercial enough to ensure that their client enterprises are indeed managing successful business ventures. It should be noted that none of the assistance programs is capable of sustaining itself once external sources of funding are cut off. Nevertheless, through a trial−and−error approach, the program has supported a series of NGOs such as Partnership for Productivity (PfP) and the Promotion of Rural Initiative and Development Enterprises (PRIDE), Kenya which have developed useful and innovative approaches to supporting enterprise development and providing rural finance.

PRIDE is an NGO−sponsored extension banking program operating in the Baringo District of Kenya since 1989. It has had some success offering financial services to rural entrepreneurs unable to obtain formal credit. Of 1,200 clients in 1991, 71 percent were landless and only 8

percent owned more than ten acres. The average net profits of assisted businesses were less than K.sh. 2,000 per month and average assets less than K.sh. 15,000. In August 1991, PRIDE launched branches in Nyahuru and Machakos and by June 1992 had increased its portfolio to a total of 2,700 loans valued at US$570,000. The PRIDE model in Kenya uses three levels of non−traditional collateral for loans and peer−pressure enforced repayment. Clients are selected by the community. The network relies on a Loan Insurance Fund and a portfolio monitoring system based in Nairobi. The core of the credit model is the Market Enterprise Committee which consists of fifty members. This committee receives a loan from PRIDE, which it on−lends to individuals, members of the group. Members of this committee are selected by the community. Each committee is made up often Enterprise Groups, each of which has five people.

Until a credit record is established, individual loans are insured by the other four members of an Enterprise Group. If one person defaults the group suffers. Loans are disbursed in stages, as experience with loan administration increases. Members' credit history is fed into a credit reference bureau maintained in Nairobi. As members develop good credit histories, they become eligible for larger loans. Loans start at K.sh. 5,000 and go up to K.sh. 30,000. Interest rates are usually 5 to 10 percentage points higher than those charged by commercial banks. Studies indicate that: (a) recovery rates are over 90 percent; (b) female clients with less education and capital than men have a higher return on investment; (c) wage employment in PRIDE client businesses rose by 10 percent over a one−year period; and (d) there is a positive correlation between loan graduation (i.e. moving up to a larger loan size), growth of business assets and growth in monthly net profits.

Initiatives in Madagascar

Although the overall performance of the National Rural Development Bank (BTM) in Madagascar has been poor, there are two aspects in its credit schemes which could be considered worthy of development elsewhere too. Under the paddy bank schemes, farmers who offered to deposit their paddy crop in the cereal depot controlled by BTM could secure a loan up to a prescribed proportion of the crop value until it was sold. The paddy harvest served, in effect, as an acceptable collateral for the loan. Another noteworthy aspect in BTM's credit operations is the relatively better loan repayment performance by groups. The cohesiveness of these village groups is regarded as the cornerstone for developing the saving−first cooperative scheme under a World Bank−financed technical assistance project.

Pilot Credit Scheme in Tanzania

Under the ongoing Tree Crops Project in Tanzania, a pilot credit scheme is being implemented where the primary cooperative societies and other input traders obtain credit from the Cooperative and Rural Development Bank

(CRDB) for the purchase and sale of fertilizer. Although it is too soon to conclude that the scheme is a success, indications are that farmers, many of whom buy their fertilizer needs on a cash basis, get their fertilizer in a timely manner, and that there has been a phenomenal increase in fertilizer application. Loan repayments to CRDB under the scheme are satisfactory.

AERP in Tanzania

Long−term finance, particularly in the form of foreign exchange from international sources, can be provided to producers, processors and traders against export crop revenue. The IDA financed Agricultural Exports Crops Rehabilitation Project (AERP) in Tanzania is a

noteworthy example. CRDB, whose financial position and lending operations have otherwise been very problematic, has been very successful in implementing AERP on an enclave basis − providing foreign exchange loans for importing estate rehabilitation machinery, and ensuring loan recoveries from the captive export revenue generated by the rehabilitated estates.

Simplification of Lending Procedures, India

The Punjab and Haryana Cooperative Banks in India have succeeded in reducing their loan transaction costs by installing a passbook system for their credit customers. A careful assessment is made of the financial status − including farming and other economic activities − of every potential borrower. The credit status is ascertained ahead of time and the loan limit established and revised periodically. The customer can thereafter withdraw funds as and when needed, and can also deposit surplus funds into that account. In this way, the customer need not make special credit applications whenever a new loan is needed and no loan appraisals are called for. Such a passbook/loan limit scheme which is not dissimilar to the Ready Reserve, Line of Credit or Overdraft facility offered by banks in developed countries would also encourage customers to deposit funds into their accounts, knowing that they will have ready access up to the approved limit. The passbook scheme also facilitates decentralization loan disbursements, to be carried out by branches without having to seek headquarter's approval.

NCDC Credit Scheme, India

The National Cooperative Development Corporation (NCDC) in India has been operating a successful credit scheme under which primary cooperatives societies were extended loans for the construction of storage−cum−office buildings. Such infrastructure served partly as storage for farm inputs and partly as crop storage for society members. The physical facility enabled the society to stock fertilizer, made available in a timely manner, and sold to farmers for cash. Storage of harvested crop not only helped famers to sell their produce when the time and price were right but also to secure loans from their societies, pledging the crop as collateral.

Sustainability

Demand−driven services seem to be more sustainable and have greater outreach than the traditional supply−driven approaches. It seems to make good sense for financial intermediaries to design instruments and mechanisms that offer reliable long−term access to deposit and credit services. In developing financial markets, the approach should be to support self−sustainable institutions. Attractive savings services would also help reduce information costs and lending risks, and enable financial intermediaries to reach levels of sustainability sooner. The impact of any program will be short−lived if improved access to financial services lasts only till the life of that endeavor. To ensure the sustainability of financial institutions, the emphasis should be on providing cost−effective and convenient services, offering demand−driven facilities, paying more attention to deposit mobilization, to the performance of financial intermediaries, to the lowering of transaction costs, to cost−reducing

financial innovations, to building sustainable financial services, and to how policies affect the performance of the rural financial markets. 52 /

The following are thus important aspects to be considered in the development of rural financial markets so as to ensure sustainability.

(a) Modalities for increasing linkage between financial (formal and informal) and non−financial institutions;

(b) Risk management in the absence of acceptable conventional forms of collateral, and cost recovery;

(c) Provision of targeted/subsidized credit in appropriate circumstances, its phasing out, and funding during the transition period without jeopardizing the viability of the lending institutions;

(d) Finance for long−term investments;

(e) Cost−effectiveness and competitiveness of financial intermediaries in a private sector environment;

(f) Capacity−building to improve the efficiency of financial services, outreach, and participation by women; and

(g) Consensus and coordination among governments and donors on appropriate strategies, and measures to increase rural financial services.

7. Key Issues

Neglect of Sustainability

Governments, the World Bank and other aid agencies have pursued a credit−first or supply−led approach to finance, with or without support for institution−building. Such an approach which ignored savings mobilization and increased the dependency on external sources of funds also weakened financial intermediaries which were denied the options to effect full cost recovery. Most SSA countries also have relied almost totally on the state sector for formal financial intermediation, shutting out the private sector, and allowing only limited participation by cooperatives and trading networks.

In seeking to achieve sustainability in financial intermediation and financial market development, consideration has to be given to the sustainability of the lender, the intermediary institution, the depositor, the saver, the borrower and the sector as a whole. Their continuity and the ability to continue to play their respective roles should be sustainable. If borrowers become chronically indebted, nothing else can be sustained. If savings cannot be mobilized on a consistent and continuing basis there will not be resources to lend. If the lenders do not recover all the money they lend they will soon cease to exist. If a financial intermediary cannot fully recover the cost of mobilizing resources (money costs −interest paid to depositors, plus administrative costs of intermediation), the institution will soon have to shut its doors. Sustainability is thus critical to the developing of rural financial markets.

A successful financial institution should therefore:

(a) Be self−sustaining;

(b) Cover all costs incurred;

(c) Provide services valued by its customers;

(d) Seek to extend its outreach;

(e) Be dynamic in providing new services;

(f) Minimize transaction costs for itself and its customers; and

(g) Operate with the intention of becoming self−reliant and reliable.

Overemphasizing Credit

Research, analysis and discussions on rural financial market development have for the most part centered on credit and credit markets. The issues identified are invariably related to credit availability, accessibility, outreach, costs, short−term and long−term credit needs, and formal lenders, etc. Only passing reference is made to savings, and that too more in terms of the lack of rural savings to meet vital credit needs than from the point of view of the importance of savings. Although references are made to finance and financial institutions, these terms are used and often understood to be synonymous with credit and lending institutions. Thus, in the discussion of financial services, most of the attention is directed to

credit issues. Too much emphasis has been placed on providing a relatively small number of rural borrowers with credit facilities, and too little on the large number of rural dwellers seeking savings and deposit facilities.

Box 7.1: Targeted Credit

Targeted credit schemes may be justified if designed as a transitory measure taken in conjunction with economic policies, and financial sector reforms and restructuring programs, or when it follows sudden changes in the economic environment with an adverse impact on the rural sector. The World Bank's policy on financial sector operations makes allowance for such situations. The burden of proof, however is on the policymakers and project designers to establish that in the absence of the proposed intervention, the supply response or the adoption of new technologies would not be possible.

In these circumstances, rural credit projects serving as a catalyst to growth should be accompanied by the removal of distortions that inhibit demand for investments in the rural sector. The potential viability of credit institutions in a reformed competitive environment should, however, be a condition of their participation in such operations. In many instances, a significant institution−building component may be warranted, involving an overhaul of the institution's structure, management, and operations to achieve efficiency aimed at reducing transaction costs and improving loan recovery performance. Reliance on savings mobilization, instead on external funding and rediscounting facilities, should be emphasized to ensure sustainability.

Credit is perhaps not the most appropriate instrument for subsidizing any economic investment or operation even if priority sector needs warrants such special support. Subsidies when deemed essential, should preferably be given out as direct explicit assistance and not through the credit instrument. The extent of subsidies involved in policy−based credit schemes is not always explicit or evident, generally taking the form of unserviced equity and loans provided by the state, subvention payments, etc. Subsidies, once introduced, tend to balloon and are

generally difficult to phase out quickly, if at all. Care would be required to ensure that they do not compound the distortions in the financial market which prompted their introduction in the first place. To minimize further distortion of the financial markets, end−users should be charged interest on loans in keeping with market rates, and any subsidies, where considered essential, should be passed on to the financial intermediaries so as to ensure their financial viability.

Subsidies, when offered to end−beneficiaries, also tend to impinge on the operational and financial autonomy of the financial intermediaries. The lending institutions are obliged to carry the burden of carrying unremunerative and non−performing loan portfolios. To ensure that its important financial intermediation activities are not thwarted by having to administer directed/subsidized lending such programs should be kept separate from other operations of financial institutions. Finally, no directed credit program should be carried out on a permanent basis — it should at best be a temporary device, used only in the event of there being no immediate and viable alternative, to be phased out in a preplanned manner. When proposing a directed credit program, it should be possible to demonstrate that the scheme proposed is a viable solution to the problem of market segmentation or distortion, and that other means to support the activity are not available. The burden of proof must be on those advocating the directed or

subsidized credit programs. Any subsidy involved must be financed directly from the government's budget, made transparent, and reviewed on a continuing basis with the intention of being phased out.

Formal vs. Informal Systems

Commercial banks, often state−owned, were required to act as credit delivery channels, and specialized banks and institutions were created specifically for this purpose. Low interest rates were considered to be the most important instrument to bring credit within the reach of the poor. In practice, however, many such programs failed to meet the above objectives. The reasons include the following.

(a) The banks do not reach the target group (small farmers, the landless, women) sufficiently, and this group mostly remains dependent on the informal sector. Lending is too costly, and this is compounded by the low rates of interest charged, often combined with low repayment rates. The banks prefer lending to financially strong groups.

(b) The costs of lending prove too high in relation to the interest margin, partly as a result of low interest rates, which makes a self−sustaining credit operation almost impossible.

(c) Loan repayment performance is often moderate or poor, leading to the erosion of capital.

(d) Because the credit institutions, or the revolving funds in projects operate at a loss, there is a continuous need for new external financing.

(e) The formal credit institutions are not readily accessible to the target group. There are either too many (psychological) barriers, or it is impossible for clients to fulfill the institutions' credit terms, such as the provision of collateral security. In addition their services are often insufficiently oriented to the target group's specific savings and credit needs. In this respect, the target group from a future operational point of view should be regarded as that which is presently not served by formal financial institutions, but would want to be served by formal sources to meet (i) existing demand, and (ii) potential demand.

(f) No satisfactory solution has yet been found to the problem of the high inflation rates existing in many developing countries.

(g) There are very few initiatives to mobilize rural savings.

(h) Formal financial institutions are riddled with problems, particularly through poor loan recoveries; and

(i) The poor who borrow from credit institutions are already invariably mired in debt.

Confronted by this situation, it is necessary to re−evaluate the role and the functioning of the informal sector, which often succeeds where the formal sector does not in reaching the target group, offering it a services package which meets specific needs, and achieving a reasonable repayment rate. This prompts the question as to whether the formal institutions might not adopt certain characteristics or procedures of the informal sector. Or could certain participants in the informal sector, particularly the informal savings and credit groups or the professional moneylenders, be integrated in the money market in such a way as to play a more meaningful role in the lives of the rural population? Could credit funds to the target group be channeled through them? Could they deposit savings with formal lending institutions?

The important questions are:

(a) Do these informal types of organization have sufficient capacity to manage large amounts of money or to grow into larger regional, or even national organizations effectively serving large numbers of people?

(b) Would integration in the formal sector not result in formalization, leading to the loss of precisely those characteristics of informal organizations which might be responsible for their success?

Government Involvement

There is no consensus among researchers as to whether the two sectors are substitutes for each other or complementary, i.e. whether the growth of one sector is at the expense of the other. To the extent that the two sectors operate in their respective areas of comparative advantage, serving different groups and purposes, they can be said to be complementary. In the continuum of financial sub−markets arranged in a declining order of requirements met by the formal sector, one end of the continuum consists of sub−markets catered to entirely by the formal sector, while those at the other end are served entirely by the informal sector. In the middle segment, where neither sector has a clear comparative advantage, the two sectors tend to compete with each other.

Where the two sectors usually compete more than complement each other in meeting the credit needs of the borrowers, the availability and terms of the two types of loans determine the choice of sectoral source. In this substitutable relationship, as formal loans become more easily available, they are likely to displace informal credit. This indeed is what has probably happened in the large number of SSA countries where subsidized agricultural credit has expanded in the last two decades, perhaps marginally reducing the share of informal credit. Where informal lenders are not earning monopoly rents, and the markets are reasonably competitive, promoting linkages with the informal sector (rather than offering competition) would be a more appropriate approach. When funds flow from one sector to the other through such linkages, the two sectors become complementary again. Somewhat analogously, on the savings and deposits side, the two sectors tend to concentrate in their respective spheres of comparative advantage but would compete for deposits in the middle segment, through price and non−price terms.

A financial intermediary's role is to provide credit, savings facilities and other financial services. By helping to transform the size and maturity of financial assets, it provides a medium of exchange between financial clients. It collects savings from many small depositors, and makes the funds available to the borrowers who need larger long−term loans to finance their investments (*World Development Report 1989*). Formal financial intermediaries

such as traditional commercial banks and DFIs have not been very successful at reaching small−scale borrowers or savers. A combination of interest rate ceilings, high transaction costs associated with lending small amounts of money to many people with no formal credit history, and limited collateral has provided these lenders with few incentives to reach low−income clients. On the savings side, the mobilization of small deposits from the rural clients is considered administratively costly and is rarely attempted. For both supply and demand reasons, the result has been that few of these institutions have successfully served the weaker sections of the rural population. Innovative systems and institutions should therefore be developed to improve access by the weaker rural sections to financial services, since traditional approaches through formal sector institutions have not been effective. These financial intermediaries could be any or all of a wide variety of forms such as innovative decentralized banks and DFIs, non−bank financial intermediaries, and specialized units within these institutions (Credit Unions which have reached traditionally marginalized groups), informal financial schemes such as ROSCAs and Grameen Bank−type institutions.

Governments could help to increase the willingness of lenders to provide long−term finance and equity capital by providing a conducive economic environment, modernizing legal systems and making contracts more easily enforceable, clarifying property rights and improving title transfer and loan security, improving bank regulation and supervision, training accountants and auditors, ensuring the adequate disclosure of information and improving infrastructure. Institution−building takes time, but many governments wanted faster results. Moreover, many wanted to use the financial system for such purposes as allocating resources to projects with high social returns, and redistributing income and intervened to channel resources to activities mat they felt were inadequately served by existing financial institutions. Hence, they nationalized existing commercial banks, and created development finance institutions which were specifically mandated to provide long−term finance to specified sectors. Governments also imposed interest rate and credit allocation targets on both public and private institutions alike, and compelled banks to expand branch networks in rural areas. Bilateral and multilateral aid agencies too contributed to this process with targeted credit programs.

Governments sought to ensure that resources were allocated according to their development strategies. Quite often, deposits mobilized by such institutions were borrowed by the governments themselves to finance budget deficits. Such an interventionist approach was not successful, as hoped for, in most countries in promoting financial sector development. Banks were made to lend at below market interest rates and with a spread inadequate to meet their costs. Many of the directed loans were not repaid. Interest rate controls discouraged savers from holding financial assets and discouraged banks from lending long−term or to riskier borrowers. Financial institutions in many SSA countries have suffered large losses, making them insolvent, and some have failed. On occasion, the government may have a role to play as a promoter of financial institutions and markets in order to create a diversified and competitive financial system. This has been the justification for establishing several government−owned development finance institutions (DFIs). However, the performance of agricultural DFIs has been poor since they have suffered from many of the same problems as industrial DFIs: too much government intervention, over−reliance on governments and external agencies for funding and inappropriate

Box 7.2: Autonomy of Banking Institutions

The banking systems have come under great pressure from governments both in terms of interference with financially sound decision−making and the supersession of elected boards of management on the one hand and being overloaded with (mandatory) lending to serve populist objectives on the other. All this amounts to a serious abridgement of the autonomy of financial institutions and this has nearly brought these institutions to the brink of disaster. There has been a massive expansion in the loan business of the commercial banks since their nationalization since independence. The expansion has not, however, been without the concomitant systemic stresses

and strains. Among these, the most disconcerting has been the progressive decline in the quality of. their loans and advances portfolio. The mounting overdues of agricultural loans and untenable advances locked up in sick units in the industrial sector are witness to the inevitable strain to which the system has been subjected. One of the reasons for this phenomenon is the increasing involvement of the banking system in providing mandatory credit entailing very rigid target setting pursuant to policy directives by government. Extension in the coverage of mandatory credit programs and overstretching the target setting in such a way that it goes far beyond what the banking system could contend with or its overall profitability can tolerate, is another contributory reason.

lending criteria. Governments have often been unwilling to foreclose on small farmers, which has seriously eroded financial discipline, or allowed weak and insolvent financial institutions to exit.

Ownership is a significant determinant of enterprise performance. The good performance of state−operated enterprises (SOEs) has been difficult to bring about and even harder to sustain. Governments facing a financial crisis take precipitate actions, but when the crisis dissipates, so does the political resolve, and political interference, a deadly disease of SOEs, tends to re−emerge. While privatization, properly structured and implemented, can counter this trend and yield substantial and enduring benefits, it is sometimes less important then the emergence of new private business. The issue then is not one of whether the rural financial institutions should be parastatal (public sector) or privately owned (private and cooperative sectors), or whether the financial service needs of the rural sector should be left in the hands of the very conservative formal sector institutions or left to the vibrant and resilient informal financial sector. The noble aspirations of the government and the high expectations of the people are often dampened by the decay in political and other institutions (the civil service, judicial system, research institutions, etc.) the narrow self−interest of the politically privileged elite and the affluent minorities.

Creating too many institutions too quickly could cause expensive overlapping and a conflict of assigned roles. Government intervention (which often becomes political interference) in staff appointments and operational matters is also a major cause of the poor performance of parastatals. The top management of parastatals appear to do too little themselves to enhance their competence and standing, thus becoming easy prey to unscrupulous and determined politicians, or to prevent smothering by the excessive attention of well−meaning government/Central Bank officials. The World Bank's credit projects too had for the most part utilized specialized credit

institutions as lending channels. Although these projects almost always had institution−building components, the financial performance of the lending institutions had not shown the significant improvements hoped for. The transformation of specialized credit institutions and weak state−owned commercial banks into autonomous and viable financial intermediaries will be a long−term process. Why create an unnecessary parastatal system − with a high probability of failure and impossible to redeem − which is difficult to liquidate or privatize, preventing the entry of private sector through fair competition?

Loan Overdues

It is clear that variations apart, the percentage of loan overdues has in many cases been alarmingly large. On the one hand, these overdues impair the eligibility of the borrowers for fresh loans and their access to resources for raising the next crop and, on the other, place a serious constraint on the lending capacity, liquidity, profitability and, in the ultimate analysis, the solvency of the concerned institutions. The famous banking theorem that deposits create advances and advances create deposits is true only when the amounts advanced are also recovered. The overdues mount owing to factors internal as well as extraneous to the lending institutions. Overdues also

mount owing to deliberate acts by the borrowers, as for example, wilful defaults based on cynicism, defiance, etc. and those external to and beyond the control of the borrowers, e.g. droughts and poor crop seasons, the absence of backward and forward linkages in the farm economies such as input availabilities, extension services, marketing arrangements, transport systems, storage facilities, insurance covers, etc. The overdues could also emerge for any of the other numerous reasons such as insufficiency of the loan amount and scale of finance for a given purpose, too early a date fixed for repayment, absence of a cash credit system and the insistence by the institutions on the complete repayment of the loan before the next loan can be considered. The overdues situation could and does worsen because of insufficient staff for monitoring and recovering the loans, inadequate penal provisions, non−execution of the rule of law in dealing with wilful defaulters, and several other factors.

Systemic Weaknesses

Almost every review of the financial sector in SSA countries undertaken by the World Bank has revealed serious problems of one kind or another, with some systems barely performing any intermediation function. Studies already carried out also reveal that the problems extend beyond state−owned DFIs. The financial institutions in many SSA countries may therefore require major restructuring − organizationally, operationally and financially. Government and donor support to financial intermediaries should concentrate on institution−building and developing them into viable institutions. Targeted credit without adequate institution−building support would almost always result in prolonged dependence on external funds and bail−outs. If it is considered socially desirable to intervene in the financial market and to use scarce resources for achieving specific objectives, institution−building too should be a must so as to ensure that the financial intermediary will in course of time become autonomous and efficient. The lack of adequate emphasis on institution−building in rural financial market development is a common failing in supply−led credit schemes. Too few resources are devoted to appropriate and adequate training, efficient and meaningful managerial information systems, staff incentive systems, the promotion of savings mobilization and the like, all of which are crucial to the financial viability of intermediaries and the self−sustainability of financial intermediation.

Piecemeal reviews and restructuring of single−purpose institutions (e.g. Development Finance Companies, Agricultural Development Banks, etc.) would be of limited value. Though

their problems can be arrested in the short run, they will need repeated attention. A system−wide review would provide more options and offer a better likelihood of the sustainable development of the financial system. The starting point for banking system reform should, however, be a thorough diagnostic audit of the loan portfolio and of the management of individual banks. The portfolio audit should include a detailed review of all delinquent loans. These audits would reveal the true state of a bank which would be indicative of the extent of restructuring required.

Given the changing and increasingly liberalized environments in SSA countries, and the fact that financial reform also leads to the easier entry and exit of financial institutions and in increased competition, the case for specialized banks (DFIs), especially in small African economies, cannot be justified. On the other hand, recent efforts to draw commercial banks into term−lending in the productive sectors show that the banks perceive this as far too risky and expensive an operation. Meanwhile, potentially profitable investments ought not to be foregone because of the lack of reasonable access to credit.

Limits to Replicability

The Grameen Bank scheme in Bangladesh is often quoted as a successful example of providing credit to the core poor, achieving excellent loan recovery performance without jeopardizing the financial strength of the lending institution, and yet reaching out to very poor people in Bangladesh. The success of the bank is at least partly due to its ability to adapt certain positive features and methods from the informal financial systems. One of the

important strengths of the bank is the autonomy it enjoys. This has given it flexibility and adaptability which are very important features of informal systems. Working through the small groups and centers is one of the major innovations of the Grameen Bank. However, though successful in reaching the poor, it has two main weaknesses: its operating costs are very high and it lacks its own resources. It is therefore heavily reliant on external sources (IFAD) for its lending resources. The success of its operations is also attributed to the charisma and personality of its chief architect (Professor Yunus) and a few dedicated individuals associated with him, and such traits are not sufficiently abundant in the countries which may wish to replicate the Grameen Bank model. Grameen Bank−type schemes are being attempted in some SSA countries (e.g. Malawi, Kenya, Togo), but not all of its positive elements can be easily replicated.

Models developed in one country are not necessarily transferable to another country and it cannot be assumed that a model which has proved successful in one country will produce the same results or have the same impact in another at another time. Even within a country, certain types of organizations would be more appropriate for one area than another. In each case, the local conditions should therefore be carefully assessed before adopting a system which had shown promise elsewhere.

Gender Issues

In many SSA countries the informal financial sector has been the popular option for financial services, particularly for women because they have very limited access to formal financial sources. In addition, the vast proportion of women's productive activities are also in the so−called informal sector of the economy. Although many rural households and microenterprises in the rural areas face problems in having access to financial services, women face special constraints which men are not subjected to because of the following:

(a) Limited access to land and other productive assets;

(b) Inability to offer collateral due to inadequate ownership and biased inheritance rights in female−headed households;

(c) Low level of business and technical skills, and limited experience of rural women;

(d) Social and domestic roles that compel women to concentrate on traditional activities with low rates of returns and high risks;

(e) Social and cultural barriers faced by women entrepreneurs;

(f) Lending institutions insisting on husbands' guarantees for loans to women for their independent economic activities; and

(g) The ultra−conservative attitudes of lenders towards women.

Poor women especially desire financial security and stability which translates into a high propensity to save and good loan repayment behavior. African women are engaged in diverse economic and productive activities and they, like other rural dwellers, need liquid savings and flexible credit services. The formal financial institutions have generally neglected poor rural dwellers, especially women, who are not only generally deprived of financial services because they do not meet financial criteria but are also denied of other support services — technical advisory, input supply etc. — because in many externally−aided schemes, these are available only to recipients of credit. Those who would normally prefer to pay cash for services, are thus denied participation.

There is an increasing number of female−headed households and the need for income to maintain their families are forcing women to look for income−generating activities to supplement the family resources. In Malawi, for example, available evidence suggests that less than 20 percent of women entrepreneurs manage to secure credit for their business, and some 72 percent of the business women had to rely on their own funds, or money provided by their husbands to start their businesses. The number of women clients of some major financial institutions account for a mere 2 percent. It should be recognized that rural women in SSA countries, as in Malawi, have the need, motivation and resolve to save. There is also evidence to confirm that rural women exhibit greater financial discipline with regard to loan usage and meeting repayment obligations. In addition, they undertake greater responsibility in group activities.

Support to women for income−generating activities would help to capitalize on the positive features of women's behavior with regard to finance — emphasis on savings, greater discipline in loan repayment and respect for group obligations. Women could therefore be encouraged to place their savings with financial institutions which would help them to build a banking relationship and financial history that would be useful when they may later have to borrow from the same financial institutions. Those with very small savings could be encouraged to join savings groups. The strength in numbers principle could be adopted in helping women to participate in group loans and joint liability schemes to improve their access to lending institutions.

A project's impact may be limited and shortlived if it offers improved access for women to financial, informational and technological resources only for the life of the project. The failure to establish a sustainable financial institution that can continue to serve women's needs may be

due to several factors: poorly−run financial services, a lack of concern with financial and operating costs, or the provision of enterprise development services that are not relevant or are not offered in a logical relationship with technical assistance and financial resources (when required). Access must be sustainable to have long−lasting effects for the enterprise and the household.

It should be emphasized that project designs which reflect an awareness of complex local gender−related issues and are proactive toward women clients' participation are only as effective as basic institutional, financial and other systems and characteristics permit. Gender sensitivity can be reflected in the recruitment of female staff, the active search for women clients, or in the design of services that match women's special needs. However, this orientation cannot substitute for demand−driven services, positive on−lending interest rates, appropriately designed savings instruments that offer liquidity, a reasonable return and a high degree of security, an awareness of transaction costs, moral hazard issues, effective and culturally acceptable delivery mechanisms, cost consciousness, and the gradual elimination of any explicit or hidden subsidies.

Social intermediation 53 / is an approach which is increasingly being used in attempts to establish financial systems which could reach poor women by strengthening socially and economically marginal clients through assistance in organizing themselves into voluntary mutualist self−help groups. Through the use of joint liability mechanisms, self−selection, peer pressure, etc. such cohesive groups would be able to improve their access to financial services from formal institutions.

Project designers face a challenging task, even under the best conditions, as they attempt to understand the economic, cultural and infrastructural barriers and opportunities in complex local settings. It is difficult to conclude if direct gender−targeting or indirect mechanisms are the most effective for guaranteeing access for women to significant resources. While the approach depends largely on local economic, legal and cultural barriers, project managers should be aware of the wide range of options used by Bank−supported projects. NGOs appear to offer an advantage in terms of targeting low−income women, but this may be tempered by institutional problems related to loan collection, administrative cost control and the scale of operations.

8. Conclusions And Recommedations

General

The macroeconomic environment which exercises the major influence on a country's economic performance also has a significant impact on its financial systems. There is ample evidence of the macroeconomic policies and development strategies adopted by many SSA countries having had a debilitating impact not only on their general economic performance but also on the agricultural and financial sector development. Many of the policies pursued by the SSA countries to support agricultural growth have involved the provision of targeted credit, often also subsidized, administered through existing and also specially set−up state financial institutions. The World Bank's past preoccupation, as of governments and other aid agencies, has for long been with credit delivery, to the almost total neglect of financial intermediation. Recent efforts have sought to reverse this trend. In improving the performance of rural financial intermediaries, increasing emphasis is now being placed on financial sector reform and strengthening loan portfolio management, particularly loan collection performance. However, even now, only limited attention is being paid to improve savings/deposit mobilization by financial institutions.

Interventions

Financial institutions find it hard to operate in the unfavorable economic environment that exist in many SSA countries. Experience shows that distorted financial markets, inappropriate design of projects programs or schemes, weak institutional capacity, and the unrealistic, overambitious and complex scope of projects adversely affect performance. The targeting of credit to selected sectors and subsidization of loans cannot address fundamental problems. It is therefore important to address the basic problems in a fundamental way, and not dissipate resources in attempts to tackle the symptoms. The high level of government ownership, control and management and limited operational autonomy of financial institutions are also major factors contributing to the weaknesses and deficiencies in the financial sector. Such government ownership/control is not confined to the different specialized institutions specifically created for delivering rural credit, e.g. Agricultural Development Banks. Many of the commercial banks, previously privately owned, have since been nationalized, and even new ones are set up as exclusively parastatal bodies. Government−sponsored credit schemes, including several projects supported by the World Bank, have suffered from many of the problems documented. While the credit components in the projects had to a degree facilitated increased investments, input use, production, etc. their effects have been transitory. Since deposit mobilization too has been totally ignored, most credit projects in SSA countries have not helped improve the performance of rural financial markets.

Credit has always been assumed to be a limiting factor, and below market interest rates deemed to be essential to increase production, improve productivity, and for introducing new technology. Supply−led finance thus became the vehicle through which governments and donors provided support pumping in funds from external sources. This approach has undermined the viability of financial intermediaries, many of which continue in operation only through subsidization and/or donor aid. Participating financial institutions driven by the bureaucracy tended to operate inefficiently with high transaction costs, and often barely surviving, considering the narrow interest margins allowed under policy−based lending schemes. Administered interest regimes, with external funds made available at low interest rates, also discouraged savings mobilization. With high−cost operations, unacceptably low levels of loan

recovery, and dependence on low−cost funds and weakened intermediaries, not many of the schemes could be assured of continuity. The development of rural financial markets, with financially viable intermediaries and a sustainable supply of funds, can be assured only through locally mobilized deposits and savings. Several SSA countries have already embarked on economic liberalization, freeing markets and removing barriers to entry, privatizing state−owned economic enterprises, and also facilitating the exit of unviable financial institutions. Such

reforms, however, take time to have a meaningful impact on a country's economy and its undeveloped rural financial markets although the positive trend gives room for optimism.

Agricultural productivity levels are low for most crops in many SSA countries, and technology appropriate to local conditions is not highly developed for the main crops. The marketing infrastructure too is not very well−developed. The poor physical infrastructure contributes to high production costs. Profit margins are meager, and crop failures are not uncommon. All these add up to unacceptably high risks which lenders understandably shy away from, particularly when it comes to credit requests from tenant farmers, smallholders and other entrepreneurs who cannot offer collateral acceptable to risk−conscious financial intermediaries dealing with depositors' funds. These are some of the considerations, apart from those of social equity and political pressures, that led to state intervention in its many forms. In doing so, policy−makers have often not thought through the consequences of such interventions on the financial viability of the intermediary institutions which are obliged to accept high loan losses, the added misery of the poor, driven to suffer insurmountable debt burdens, and the unsustainability of the administered credit schemes themselves.

The formal lending institutions, particularly those owned or controlled by the state, record very high transaction costs. They are subject to the higher reporting and portfolio management costs involved in donor−supported lines of targeted or directed credit. Borrowers also have to contend with high transaction costs monetary and otherwise because of the bureaucratic procedures related to the arbitrary, though necessary, rationing of credit, special loan appraisal, approval and disbursement processes, etc. If properly computed, borrowers might find it more timely and convenient to secure their credit needs from informal lenders, even if it meant having to pay significantly higher interest on the loans.

High transaction costs are an obstacle to developing financial markets. Monetary and other forms of costs tend to

limit the services that financial intermediaries are able and willing to offer. Prohibitive costs in terms of time and inconvenience make prospective clients shy away from using the financial institutions for loans or deposit services. It is important therefore for the intermediary institutions to reduce transaction costs by improving their techniques, methodology, scale and scope of operations, staff attitudes, and general disposition towards customers. Governments and donors too could contribute by minimizing the regulatory and reporting work related to administered credit programs. Borrowers as well as lenders incur noninterest transactions costs in trying to secure or supply financial services. Frequently, these can be more burdensome than interest rates, especially to small borrowers trying to secure a loan.

Incidence of Subsidies

Credit is not the most appropriate instrument for subsidizing any investment or operation, even if priority sector needs warrant such special support. More direct forms of subsidies, given by way of subsidized inputs and services, guaranteed commodity prices, incentive payments for the adoption of new technology or the production of export crops, etc. are perhaps better

instruments not only to achieve the designed objectives but also to minimize any consequential harm to the other sectors and the potential weakening of the supporting institutions.

The incremental costs of administering such special credit programs which would involve intensive monitoring and the likely losses that would be caused to the participating financial intermediaries through loan delinquencies and defaults are seldom estimated or budgeted for in advance. The extent of subsidy involved in policy−based credit schemes is not always explicit or evident, generally taking the form of unserviced equity and the loans provided by the state, subvention payments, etc. It is almost impossible therefore to assess ex−post the extent to which the scheme was successful, how effective the participating intermediaries were in executing the programs

as envisaged, or even the extent to which such policy−based credit schemes were responsible for the financial collapse of these institutions. Subsidies needed in any scheme or the operation of financial institutions should therefore be made transparent and computed at the planning stage, monitored on an ongoing basis, and appropriately funded to avoid crosssubsidization and weakening of the institutions involved.

Impact of Low Interest Rates

Realistic interest rates are now widely recognized as being necessary to cover the costs and risks of lending. Subsidized interest rates could lead to the financial insolvency of the participating institutions and invariably skew the distribution of income even more through being captured almost exclusively by those clever enough to secure a loan. Low interest on deposits rates tends to discourage rural savers from making the efforts to save in formal financial institutions. Recognizing that the bulk of the investment needs of the rural entrepreneurs comes from self−generated funds, cheap credit also restricts savings itself.

Information Systems

The lack of respect for state property and slack discipline in handling transactions with governments are also factors to contend with. These factors have a bearing on the not−so−uncommon reports of alleged corruption, mismanagement and misappropriation in parastatal institutions, resulting in the high cost of credit schemes operated through formal financial institutions. While any number of regulations and bureaucratic procedures have been instituted for regulating these activities, very little effort has gone into devising effective internal controls and management information systems to help improve efficiency, probity or loan portfolio management, etc. From available documentation, it is surprisingly difficult to get a clear picture of the loan recovery performance of many formal lending institutions. In several cases, loan repayment data is not reported, and when reported, is often unreliable. Financial intermediaries should be assisted in the collection, analysis and use of information necessary for the efficient management of financial intermediaries to make their operations viable, for example, deposits mobilized, loan distribution (sizewise and sub−sectorwise), transaction costs, loans recovery and customer classification. The prompt reporting of loan recoveries, preparation of overdue statements, ageing of loan arrears, adequate provisioning for doubtful debts, etc. are not given the serious attention they deserve in institution−building efforts.

Importance of Informal Finance

Formal financial institutions have not always been very successful in serving rural clientele. Evidence available suggests that less than 10 percent of the rural households and enterprises in SSA countries have access to formal institutions for their credit needs. A much higher proportion of the rural population appears to have deposit services freely available, particularly in countries where non−credit institutions like Savings Banks and Post Offices offer such facilities in remote rural areas. Large segments of the rural population therefore rely on cooperatives and credit unions, informal groupings such as ROSCAS, and a variety of other informal sources for meeting their financial service needs. While ROSCAs and similar mutualist self−help groups have shown a more promising performance record, in terms of growth, success and sustainability, it should be recognized, however, that the number and size of such groups cannot be increased to the extent that they have a meaningful impact on rural financial market development. It is also not conceivable that the services provided by the informal financial sector lenders can be fully replaced by formal sector institutions in any of the SSA countries. The formal and informal rural financial systems will therefore continue to co−exist. With voluntary or natural integration, both systems could be mutually supportive and grow together the informal intermediaries expanding their geographical coverage, and the formal institutions adopting techniques employed by their informal counterparts who could be used as agents for deposit mobilization, lending, loan recoveries, etc. These and other risk−reducing mechanisms should be explored further in designing long−term strategies for developing the rural financial markets in SSA.

The informal sector grows and adapts itself to changing situations without losing its major characteristic of flexibility. Thus, the sector remains strong at all times. One characteristic that differentiates these groups from other types of financial arrangements is the relative homogeneity of the participants and the small size of the groups. To choose to participate, to accept the financial and social obligations of membership, and to accept group liability for loans requires that the members know each other very well. This intimate knowledge is secured by restricting group membership to one village, to persons in the same occupation or workplace, and those with the same social and ethnic background. Another strength of these group schemes is the simplicity of operation. Analysis of these group schemes also shows that the local−level groups most likely to succeed in mobilizing or managing finances are those that have been in existence for some time, engaged in other activities such as farm−work groups, youth activity groups, etc. The groups engaged in more than one function often have effective ways to exert pressure on each other when needed—they are usually bonded in membership, for example, by residence in a single village.

More research would be needed on the nature, prevalence and functioning of group lending schemes to determine how they can be used more extensively and effectively in individual SSA countries. Such studies would help to understand better the strengths and weaknesses of these schemes in the specific circumstances prevailing in a particular country. Since not much data is available on efforts to link informal finance with formal financial systems, great care would be needed in attempting to link such groups with the formal institutions, particularly because integration into the formal sector could also result in formalization, leading, as mentioned before, to the loss of precisely those important characteristics such as informality and flexibility, which are responsible for the success of the groups and their operations.

Need for Long−Term Finance

It has been difficult enough to extend credit facilities to rural borrowers to meet their short−term needs for seasonal production and working capital. The provision of long−term credit for capital investments and improvements is much more complex. The informal sector by its very nature cannot cater to long−term credit needs. Most of the funds which commercial banks rely on for their lending resources are public deposits in the form of demand/current/call accounts. Even their term deposits seldom have maturity periods of more than a year. Therefore, even if me banks were able to accept lending risks on short−term loans, they would understandably not be willing to accept the risks of overstretched term−transformation and a mismatch of term−structure.

Self−financing is the predominant means of funding rural investments and operations. Rural households save from farm as well as non−farm sources of income and informal credit is the major source for micro−enterprises associated with rural households that require credit. Surveys reveal that in many SSA countries most of the funds for long−gestation investments too are met out of the entrepreneurs' own savings, and contributions from family members. However, recognizing that there are limits to capital investments that could be financed out selfgenerated funds, many SSA countries, where capital markets are not yet very well developed, might find it necessary to continue relying on external sources of funds.

Non−Financial Intermediaries

Multipurpose cooperatives in many countries have generally not been successful in providing savings and credit services, partly due to their lack of specialization in financial services, and mostly because governments have been accustomed to using these cooperatives as agents for handling other activities − the handling of rationed consumer goods, stocking and distribution of farm inputs, collecting harvested crops for state marketing agencies, etc. Cooperatives in many countries have in fact been created by governments for specific purposes, and even micro−managed by staff from the government's cooperative departments. While linking trade transactions with credit could have been used to advantage by the cooperatives − similar to the private trader−credit link − they have often failed because of the lack of commercial orientation, poor cost consciousness, and staff lacking

necessary financial management skills and training. Financial cooperatives − Savings and Credit Associations (Credit Unions) − have on the other hand generally been successful although inefficiency, mismanagement, corruption and embezzlement are not uncommon in these institutions as well.

Formal and Informal Links

There is evidence that these informal intermediaries have business links with the formal financial institutions, both for depositing funds and for obtaining credit. Though not documented in many countries, there is evidence that informal lenders − traders, moneylenders − do in fact borrow money from formal institutions for their lending activities. It is not uncommon for some individual savers and borrowers as well as enterprises in rural areas to utilize both formal and informal financial systems for their deposit and credit needs. Constituents of the informal sector institutions are therefore also clients of the formal institutions in more ways than one. Strengthening the trader/moneylender link with commercial banks and the formal sector institutions would be an effective means of providing loans to the small farmers, microenterprises, and others considered by the formal lenders to be too small or risky to handle − the trader/moneylender serving as the retailer of loans, and the banks as wholesalers. Such natural

linkages should be preferred to legally mandated integration mechanisms suggested by some policymakers.

Support to Women

Studies reveal that women in Africa play a more active role in rural economic activities than in many other parts of the world. In addition to carrying the burden of running the house, including financial responsibilities, the majority of the women in Africa manage their own farms and other economic enterprises. There is evidence that women often play an active part in informal groupings such as ROSCAs, Tontines and Susus − sometimes by forming all−women groups, and sometimes by playing an active role in the membership and management of mixed groups. The same is, however, not true when it comes more formalized associations such as registered cooperative societies and Credit Unions which are generally male−dominated. In the case of female−headed households, and sometimes even in male−headed families, women have great problems in accessing credit from formal financial institutions. Often, the women are unable to offer tangible collateral for loans. Even when personal guarantees are acceptable, the requirement that husband and wife should co−sign for loans creates problems for separated couples or where the husbands are far away from home for employment or other reasons.

Changes Needed

It is now generally accepted that the following policy actions are needed to improve the functioning and efficiency of a country's financial system as a whole.

(a) The freeing of interest rates;

(b) Elimination of direct credit allocations;

(c) Removal of barriers to entry into the market of new financial institutions, or to the exit of existing financial institutions;

(d) Elimination of restrictions on related activities into which any given financial institution may enter;

(e) The assurances of a supportive legal, regulatory and administrative framework, including an adequate bankruptcy law, and the effective and efficient enforcement of debt contracts and a proper supervision and oversight mechanism; and

(f) The establishment of proper accounting standards, disclosure arrangements, property rights and similar mechanisms to facilitate ownership transfers and the associated development of capital markets for investment.

Next Steps

While a generalization of the problems and remedies recommended for the rural financial sectors of all SSA countries is not appropriate and the pervasive problems are not unique to the region or to any of its constituent countries, fundamental problems and the assessment of their seriousness should not be postponed. Also, the general approach to correct the situation and to build financial sectors to effectively ensure future economic development need not be different. In devising schemes for strengthening rural financial services in any country, however, the first

essential step is to understand the economic, legal, political and social environment in which the various actors function.

As concluded in the World Bank's *World Development Report 1989*, the experience of the 1980s has led many countries, including those in SSA, to reconsider their approach to development. Though countries differ on the extent to which their economies are centrally controlled and on the scale of government intervention in the financial sector, more countries are leaning towards allowing market signals guide the allocation of scarce resources. Several countries with nationalized banking systems are, therefore, reconsidering their policies and reforming systems hitherto used as extended arms of governments and as politicized instruments for disbursing government and donor funds at subsidized interest rates to parastatals and selected private sector groups.

The Bank's and donors' knowledge and experience in dealing with the financial sectors and rural areas of SSA countries, however, are already significant and should be reflected more effectively in the design of adjustment and operational programs. The circumstances and conditions in individual countries may be unique and might, therefore, require a planned and comprehensive assessment of the present state of the country's financial markets in general, and the rural financial markets in particular. The roles of the various participants in the country should therefore be ascertained, particularly that of the national and local governments, the central banks, commercial banks, cooperatives, credit unions and, above all, the participants in the informal sector constituency. In some countries, the only bank in operation in the country is the central bank, and the World Bank and donors have had no operation directly impacting on the rural financial sector, and no study has ever been made of the country's financial sector, either by the governments themselves, or by any of the external aid agencies. At the other end of the spectrum, there are also countries with several banks (parastatal, commercial and development banks, with wide rural branch networks) competing with totally private banks, where the donors' numerous operations directly or indirectly involve rural financial markets, and where comprehensive up−to−date studies of the financial and the rural sectors are available.

In strengthening the rural financial system, a country's financial sector should be reviewed as a whole for necessary reform/adjustment programs (Indicative Terms of Reference given in Appendix 6) Before direct operational support by governments or donors is offered to any particular financial institution, all major institutions in the financial sector should be examined to identify systemic problems. Institutions in the formal financial sector and the constituents of the informal financial sector should be considered in providing support to the rural financial sector in a systematic way, as is being done, for example, in Ghana. The reform programs in Ghana aim at developing a strong, efficient, and responsive financial sector, with an effective banking system at its core to provide the needed support for the ongoing structural adjustment effort. The liberalization of interest rates and the removal of sectoral ceilings are expected to enhance the efficiency of financial intermediation by channelling savings to higher yielding investments. The restructuring of financially distressed banks, training programs for their employees, and improvements in supervision by the Bank of Ghana should ensure the soundness of future banking activities and increase confidence in the banking system. Ghana's reform programs

could serve as a basic model for other countries to approach the strengthening of their overall financial and rural financial sectors.

Sequencing of Rural Finance Market Development

Financial reforms should preferably follow macroeconomic reforms if not undertaken as an integral part of the overall reform. By restoring economic stability, by restructuring financially distressed enterprises, and by providing a legal and accounting framework, solid foundations for growing and sustainable finance sector could be laid. In restructuring distressed financial institutions too, it would be inadvisable to deal with one or more selected institutions in a piecemeal manner arrangements should be made for dealing with the entire financial system. If the fundamental problems are not tackled system−wide, the whole system may relapse into inefficiency.

Many of the SSA countries are too small to individually develop capacity to undertake detailed surveys and analyses or the training necessary to develop sustainable rural financial markets. The World Bank and other aid agencies should therefore work in close coordination with and reinforce the endeavors of regional groups such as the Centre for Financial Assistance to African Countries (FINAFRICA), AFRACA and ACCOSCA which focus on rural financial services. Over the long term, however, donors should support measures to enhance the capacity of the local people and institutions in the individual countries to diagnose the problems and develop suitable institutions and instruments to improve rural financial services.

As a first step, a detailed assessment of rural financial services, including those provided by the informal systems, should be undertaken as part of the country's financial sector review and reform, as has been carried out in Ghana with World Bank support. A better understanding of the strengths of the informal financial systems in a country would also provide valuable insights into how best to develop more sustainable formal financial services in the rural areas.

Lessons for Consideration

Studies indicate that:

(a) Rural financial markets cannot be developed on a sustainable basis unless the country's macroeconomic and financial sector policies as well as legal framework are conducive for such development.

(b) The targeting and subsidization of credit cannot fully resolve the fundamental problems that hinder agricultural production and rural development, and cause rural poverty. Instead, they increase financial sector distortions and weaken financial institutions.

(c) Below market rates set by governments compound the problems of small borrowers and reduces the financial viability of the lending institutions.

(d) Informal financial systems are pervasive in SSA. A large proportion of smallholders, rural households, and rural enterprises rely on the informal financial systems for their needs because the formal systems are not adequately equipped to serve the rural sector.

(e) Savings mobilization and effective loan recovery are vital for the long−term viability and self−sustainability of financial intermediaries, and for the continuity of service to customers.

(f) SSA countries lack the funds and facilities to provide long−term credit, and the performance of Development Finance Institutions have not been successful in meeting the challenge.

(g) Cooperatives and self−help groups which have been relatively successful in providing financial services to the rural people should be helped to grow both in numbers and in the variety of financial services they can offer.

(h) NGOs could become a useful link between the rural population and the formal financial sector and in promoting group savings and credit schemes.

The rural financial systems have to be developed systematically if larger numbers of the rural population are to be provided with cost−effective and quality facilities for savings, deposits and credit. The informal financial sector performs in a noteworthy fashion and should be encouraged to grow, diversify and integrate with formal sector institutions. The longer−term strategy for rural financial sector development should, however, be to improve and expand the formal financial systems, concentrating on savings mobilization without having to rely on external sources for long−term lending resources, and adopting a savings/deposit−led strategy as opposed to the past supply−led approach.

In promoting formal financial systems and in implementing administered credit schemes there is much that can be learned from what is happening in the informal financial sector. It has been successful in providing cost−effective and convenient savings/deposit facilities to the rural population, and proved to be a dependable and ready source of loans to those without realizable collateral. Many of the services offered and some of the instruments used by the informal systems could be adopted, with modifications, if need be, by the formal financial institutions. Emulation instead of elimination of the informal financial systems, and complementing instead of competing with them should be the strategy for policymakers and practitioners to follow in their efforts to develop the formal financial sector. 54 /

Rural financial markets are not likely to develop and grow if they are required to perform functions they are not capable of or were intended for. Countries which do not attempt to target credit or deliver subsidies through their rural financial markets are likely to have more active and competitive financial systems. Most of the strong and durable rural financial systems emphasize deposit mobilization: the Dominican Republic, Indonesia, Taiwan and Korea. Deposits and savings not only increase local resources available for credit and enhance prospects of sustainability, but also help the depositors to establish their creditworthiness, and instil a more disciplined lending and repayment culture.

Past research has confirmed that:

(a) Lending on too easy terms can easily lead to permanent indebtedness. Accumulation of reserves, to prevent indebtedness, is often much more important, especially for the poor.

(b) The ability to save provides the lender with information on the financial capabilities of the borrower. In addition, savings may serve as loan security.

(c) Credit organizations have so far been largely dependent on external financing for their credit funds. There is a large, untapped resource for the financing of credit funds in the mobilization of savings.

(d) Informal channels are the oldest and most obvious channels for saving and lending in rural areas and they still play a more important part than formal channels in this process;

(e) Formal institutions can learn a lot from the way the informal institutions are organized; the latter succeed in reaching the target group, which cannot often be said of formal institutions.

(f) Formal and informal institutions can complement each other.

Any research agenda for rural financial markets in any SSA country should analyze the fundamental causes for the widespread failures of the formal financial institutions with emphasis on identifying needed policy changes, including the ownership, control and management of intermediary institutions. Further investigations should be devoted to identifying practical innovations and related instruments which could help remove existing constraints and foster the development of financial systems capable of being tested and the results thereof evaluated quickly (see Appendix 7). The concentration of research efforts should, however, be on increasing the mobilization of local resources; improving the performance of intermediary institutions−capacitybuilding, controlling and containing transaction costs; the greater integration of formal and informal financial systems; and improving competition among providers and users of financial services.

The viability of credit programs cannot be assessed in isolation. Mechanisms to assure the viability of credit projects require due consideration of the investment alternatives open to the poor, including access to technology and potential income−generating activities. Credit schemes for food production and income generation frequently fail because loans are provided to those who cannot use them effectively, thus leading to low recovery rates and non−sustainability of schemes. Moreover, administrative costs for rural lending are frequently a critical issue, especially where the rural institutions are weak. Managerial capability at the credit institution and at the loan recipient levels is a critical variable in determining viability and absorptive capacity and, therefore, the size of programs. Appropriate criteria must be developed to assess effective and potential demand for credit by the poor. Such criteria, to be effective, should be flexible under varying circumstances, and subject to change over time. The research should address these problems of managerial capabilities conceptually and empirically.

Box 8.1: Some Necessary Emphases

In securing the commitment of client countries for a more pragmatic approach towards RFMs, dialogue with policymakers and project designers should focus on some salutary lessons learned from the more than two decades of experience with sponsored credit programs.

DON'T use the financial system or credit schemes as fiscal agents or as a means of allocating subsidies.

DON'T target loans to special groups, enterprise geographical areas, or for earmarked activities.

DON'T use concessionary rediscount lines to fund rural credit schemes.

DON't offer cheap loans which discourage savings and deposit mobilization, and undermine the viability of the financial system.

DON'T evaluate the performance of credit projects purely on the basis of the credit impact at the borrower level, ignoring the impact on the financial intermediaries and rural financial market development.

DO stress making rural financial programs sustainable.

DO stress savings and deposit mobilization.

DO stress the viability of financial intermediaries and loan recoveries, and the need to reduce transaction costs to economic levels.

DO stress the need to maintain flexible interest rates to permit margins adequate to cover costs and to be positive in real terms.

DO stress the need to evaluate credit projects on the basis of how they influence the performance of the participating financial institutions.

In the past, most initiatives emphasized credit and, more specifically, agricultural credit. This credit was targeted for a specific clientele with subsidized interest rates and often channeled through specialized institutions (generally Agricultural Development Banks). All efforts were directed to facilitate the quick and easy delivery of credit to borrowers, with little attention given to the probability of loan recovery, creditworthiness, and the debt−repaying capacity of the borrower. These special credit programs and specialized credit institutions are not sustainable resource−wise, and they are in many cases not financially viable due to high overhead costs (i.e. high non−interest operational costs to carry out the loan appraisals, targeted supervisions, and cumbersome reporting requirements) and lax loan recovery efforts. The costs of administering these institutions are also greatly underestimated.

In contrast to these more traditional institutional efforts are those that emphasize institutional viability and the sustainability of special programs. There is a growing recognition of the need to offer a complete range of financial services (i.e. savings mobilization, deposits and safekeeping facilities, and credit services. Thus, emphasis is being increasingly placed on finance and intermediation, moving away from the preoccupation with credit and specialized lending institutions. Borrower domination should give way to a more neutral concern that also accepts the fiduciary responsibility of protecting savers' and depositors' interests (i.e. making creditworthy loans). The importance of loan recovery stands out in evaluating institutional viability, along with realistic interest rates to reward savers, and to cover the administrative and other costs of lending and recovering loans.

Recommendations

SSA governments, the World Bank and other aid agencies have a challenging task ahead. They have to assist governments in carrying out the much−needed macroeconomic and financial sector reforms to ensure long−term economic growth. At the same time they must respond to short−term problems − poverty alleviation, and financing priority sectors which slow economic growth, without jeopardizing the long−term development of the rural financial markets. The following are some promising approaches which merit serious consideration in meeting this challenge.

(a) Linkage of formal and informal financial systems, as well as of financial and non−financial institutions;

(b) Risk management and collateral substitution measures;

(c) Funding of long−term finance;

(d) Improving contract enforceability;

(e) Adopting a minimalist−credit only approach to agriculture, and a savings−first approach to credit;

(f) Human resource development, through appropriate training of local personnel;

(g) Capacity−building to improve performance and facilitate the privatization of parastatal financial institutions.

While exploring and experimenting with such approaches, further research should aim at developing instruments of credit for the rural poor to effectively cope with hunger, malnutrition, and poverty in Africa. Research efforts should seek to identify ways of facilitating credit and savings mobilization assistance to the poor. The poor have little or no collateral to offer, and credit amounts and repayment instalments have necessarily to be small, which would result in high overhead costs for the lender. Also, credit needs for production and credit for consumption

cannot be clearly distinguished in poor households (for instance, borrowing for food consumption in hungry seasons to maintain the ability to work is both for consumption and production). A review of experience with credit projects indicates, however, that in order to develop a sustainable rural financial system in SSA, information is needed about consumption credit, which the poor until now obtain almost exclusively from the informal systems.

Research on credit for the poor should be approached not only in the context of specific programs and projects, but also in the context of rural financial markets, including the informal systems, in the country concerned. Learning from, and building on, existing informal systems currently being used by the poor, or even formed by them for multipurpose credit (for productive and consumption purposes) is essential to achieve viable innovative credit programs targeted to the poor. A hypothesis to be tested is that the improved understanding of existing indigenous institutions at the community level will provide the key to the innovative design of sustainable and viable credit (component) projects built from the bottom, which, when expanded to a critical mass, can link up with the formal credit/savings systems of rural banking.

There is a growing recognition that there should be much less targeting of credit and that it should be resorted to only in exceptional circumstances. Indeed, some would argue for no targeting whatsoever—targeting cannot be effectively carried out, and involves high transactions costs. Savings mobilization should be encouraged as an important element in developing financial markets. This mobilization would create a new constituency within financial institutions concerned with creditworthy borrowers, and financial institutions would thus become less borrower dominated. Financial intermediation (between savers and borrowers) should be the goal of financial programs, moving away from the creation of financial institutions to serve as mere conduits for credit.

There is a need for more autonomy for financial institutions and decentralization in the supply of financial services. Autonomy implies that the lender institution would have the right to say no to risky loan requests, to any borrower whose debt repaying capacity is low. Nonagricultural loans — loans to small−and micro−enterprises for any viable income−earning activity — should be incorporated into the loan portfolio, thus diversifying risk and facilitating rural development.

NGO support to groups can help in reducing risks and high transaction costs in the supply of financial services to a rural clientele. Savings and credit associations (financial cooperatives) have proven successful as non−bank financial intermediaries servicing marginal rural clientele in Africa. Group−oriented initiatives, emulating the Grameen Bank model, have been launched with some apparent promise in some SSA countries. These informal finance schemes draw upon collateral substitutes such as joint liability, close personal relationship and trust, and peer pressures which help to promote cooperative behavior in honoring debt service obligations. These positive experiences highlight the important role of informal finance in rural areas, and merit closer examination and careful assessment.

Additional studies should focus on determining the nature of the collateral substitutes operating in the informal financial sector, possible collateralization including joint liability and loan repayment guarantee schemes that are successful in generating disciplined loan repayments behavior, and preventing free−rider problems.

The emphasis should be on the development of rural financial markets, moving away from the past concentration on agricultural credit delivered through specialized institutional channels. The focus should therefore be on intermediation and savings mobilization. Financial viability of constituent institutions and sustainability of the operations should be prime considerations. A coherent country assistance strategy should be responsive to client needs, taking into account the prevailing socio−economic situation and the country's development priorities. To ensure the viability of financial intermediaries, the margin or interest spread should

cover: money cost; operational costs; loan loss provisions; surplus to cover servicing of equity; and reserves toward business growth.

Traditional savings and credit instruments suited to local cultures could be adopted in designing new schemes. While local circumstances and the stage of rural financial market development in a country would feature in the choice of institutions, instruments, mechanisms, and phasing in the designing of programs, models such as the Grameen Bank in Bangladesh, BRI/Kupedes in Indonesia, BancoSol in Bolivia, Rural Banks in Ghana, and PRIDE in Kenya offer good possibilities for adaptation.

The focus should be on improving the financial market structure by removing regulatory impediments where they exist, such as usury laws (which only increase fragmentation through the secrecy requirements they impose), or non−enforceability of the contracts of private lenders which increases the risk premium. Licensing and registration requirements tend to restrict entry to the informal sector and drive it underground, serving to raise risk premia. Licensing and regulations, if needed, should be confined to the protection of depositors and to enhancing the lender's capacity to enforce contracts. The informal financial sector could be developed by facilitating the increased flow of formal sector funds to informal lenders. The formal financial institutions could take advantage of the lower transaction costs of the informal lenders by planned refinancing. Availability of such refinance is likely to encourage new entrants and promote competition among informal lenders. An enabling policy entails a judicious combination of facilitating linkages, promoting competition and complementarity, and optimal protective regulation, primarily in pursuance of prudential objectives aimed at the depositor and the lenders.

Larger economic enterprises and wholesalers are possibly net borrowers from the formal financial system (i.e. they borrow more from commercial banks than they put back in deposits). However, through the consignment of goods or sales on credit, they transfer down through their network of small and micro−enterprises, retailers and rural households, the liquidity that they were able to secure initially from banks. This linkage between formal and informal finance plays a valuable role in extending short−term working capital down to the smaller economic units that the banks could not hope to reach directly. Trader and enterprise finance (linked credit) should be explored more thoroughly in the SSA countries. Further country studies should examine the terms and conditions of such contractual arrangements between wholesalers and retailers and between retailers and their final customers. Once this is accomplished, it would be possible to assess the degree of existing segmentation and the feasibility of integration between the formal and informal financial systems and between financial and non−financial institutions. This assessment could be done through a comparison of interest rates, extent of term transformation, collateral, transactions costs, etc. that prevail in the formal and informal systems. To the extent that fragmentation prevails, policy initiatives could be considered to reduce the existing barriers to the greater integration of financial markets. Country−based studies should also be directed to assessing the importance of deposit services to rural households and economic enterprises and institutions in the rural areas. These units are invariably net borrowers (or debtors) from the informal systems, and net creditors to the formal system (i.e. they have more deposits in banks that the loans they receive from banks). Therefore, the expansion of rural branches, deposit agencies, mobile units, etc. would enable the more marginal groups in rural society to have improved access to finance.

Linkages between the two sectors through which the flow of funds takes place already exist to some degree in most countries. However, many of these flows are incidental, since formal sector policy is usually to lend directly to the end−users of credit, in an attempt to keep

transaction costs low and to ensure its designated use. A complementary approach would be to increase the flow of formal sector funds to informal lenders to supplement their own funds and deposits. The formal sector could take advantage of the lower transactions costs of informal lenders by refinancing them at an interest rate that reflects the opportunity cost of funds. This might raise the interest rate for the limited number of borrowers at present receiving subsidized credit, but would likely decrease the interest rate and increase the availability of

credit to a much larger number of borrowers presently rationed out of formal credit. Refinancing informal lenders will, however, not solve the problem of information entirely, since some poor borrowers may not be in a position to develop informational links with alternative lenders even if the number of such lenders increases.

The formal financial institutions could also be permitted to relax the requirement that the borrowers should confine the use of the loan to designated purposes which, for reasons of fungibility, is both unnecessary and infeasible, and merely serves to further increase paperwork and loan supervision costs. Greater decentralization and delegation of authority to local bank branches should also be explored. The formation of new mutualist self−help institutions, with the assistance of NGOs, would help to combine the advantages of both approaches, adopting some of the features of informal finance while availing of refinance to supplement local deposit mobilization. A policy of benign neglect of the informal sector might be a practical approach to adopt, along with a judicious combination of promoting linkages and promoting competition and optimal regulation. Such policies should greatly enhance the contribution of informal finance to development objectives.

Caution is necessary in recommending a stereotype reform of the financial sector or the standardized adoption of some type of innovation or financial instrument because it had reportedly worked in some situation in a particular country. Care is also required against an excessive preoccupation with symptoms and short−term problems, because this mind−set will create longterm problems in addition to exacerbating existing fundamental problems.

Appendix 1:
Development of Rural Finance Markets in SSA

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Appendix 2:
Development of Rural Financial Markets in SSA

Supportive Donors and Agencies

The Study Team liaised closely with and received assistance from the following institutions in various ways.

ACCOSA	KFW
AFRACA	NABARD
AFRICAN DEVELOPMENT BANK	ODA
CCCE	OECD
CIDA	OHIO STATE UNIVERSITY
DANIDA	OXFORD UNIVERSITY (IDC)
EIB	PLUNKETT FOUNDATION
FAO	RABO BAN
FINAFRICA	SDID
FINNIDA	SIDA
GTZ	UN SECRETARIAT
ICA	USAID
IFDA	WAGENINGEN AGR. UNIVERSITY
ILO	WOCCU

Studies of Direct Relevance

The execution of the RFM Study provided to the Study Team the opportunity to work closely with other agencies involved in research on the development of rural financial markets, and with those engaged in the undernoted

studies of direct relevance.

Outside the World Bank

FAO	Rural Financial Markets in Benin and Zambia
OECD	Informal Financial Sector − A Worldwide Study
Oxford Univ. (IDC)	Domestic Resource Mobilization for African Development and Diversification
USAID/OSU	Financial Markets and Agribusiness Development in Sub−Saharan Africa
WOCCU	Credit Unions in Twelve SSA Countries

Within the World Bank

AFTAG* (Agriculture Division, Africa Technical Department) Regional Study of Cooperatives and Rural Organizations

AFTEF** (Economics and Finance Division, Africa Technical Department) Financial Systems in Sub−Saharan Africa − A Comparative Study

AFTIE ** (Industry and Energy Division, Africa Technical Department) Regional R&D Program on Enterprise Development

PHRWD*** (Women in Development Division, Population and Human Resources Department) World Bank's Experience in Africa with Rural Finance and Women

OED (Operations Evaluation Department) Review of Experience with Rural Financial Institutions

* Now part of the Environmentally Sustainable Development Division, Africa Technical Department.

** Now part of the Private Sector Development and Economics Division, Africa Technical Department.

*** Now part of the Education and Social Policy Department.

Appendix 3:
Country Case Studies

The following documents have been issued under the regional study on Development of Rural Financial Markets in Sub−Saharan Africa. The African case studies have been used as drafts for discussion in the concerned countries. Some drafts are available on request, in the Africa Technical Department, Environmentally Sustainable Development Division, World Bank.

Case Studies	*Primary Researchers*
Ghana	Sakwa Bunyasi
Kenya	James Coates
Madagascar	Ousmane Sissoko
Malawi	Nwanze Okidegbe
Tanzania	Nwanze Okidegbe
Asian Experience	Fumio Egaitsu and Yoichi Isumida
Latin America and SSA Comparison	Carlos Cuevas
Cooperative and groups in Rural Finance	Pekka Hussi
Survey of Group Savings and Lending	Meena Munshi
Role of Credit Unions	Dale Magers
Other studies, and Overall Coordination	Sabapathy Thillairajah

Appendix 4:
Africa − Ongoing Rural Finance and Credit Operations

	Country	*Operation*	*LN/CR No.*
AF1AG			
	BENIN		
		Zou Province Rural Development	CR−1314
		Borgou Rural Development II	CR−1877
		Rural Savings and Loan Rehabilitation	CR−2086
	CAMEROON		
		FSAR II	LN−2567
		Livestock Sector Development	LN−3014
	GUINEA		

	Agricultural Development	CN−1635
	Livestock Sector Rehabilitation	CR−1725
COTE D'IVOIRE		
	Rubber IV	LN−2323
	Palm Oil Development V	LN−2627
	Rubber V	LN2874
	Dabakatla/Katiola RDP	LN−IFAD187
TOGO		
	Rural Development Project II	CR−1302
	Coffee III	CR−1745
	Notse RDP	LN−IFAD122
	Small Ruminants	LN−IFAD213
CONGO		
	Kindamba	IFAD187

AF2AG

ETHIOPIA		
	Coffee Processing II	CR−1429
	PADEP I	CR−1965
	Small Scale Irrigation	CR−1765
	Livestock IV	CR−1782
KENYA		
	Coffee Improvement II	CR−2062
	Cotton Processing & Marketing	CR−1237
	Rural Services	CR−1974
Country	*Operation*	*LN/CR No.*
SUDAN		
	S. Kordofan Agriculture	CR−1867
	W. Savana	CR−1840

	UGANDA		
		Agricultural Development	CR−1539
	TANZANIA		
		Agricultural Rehabilitation	CR−1891
		Tree Crops	CR−2050
AF3AG			
	BURUNDI		
		Coffee Sector	CR−2123
	MADAGASCAR		
		Agricultural Credit	CR−1804
	RWANDA		
		Bugesera II	CR−1283
	ZAIRE		
		Maize II/LULUA Agricultural Development	CR−1540
		So. SHABA Agricultural Development	CR−1790
AF4AG			
	GHANA		
		Oil Palm II	CR−1498
		Rural Finance	CR−2040
		Agricultural Diversification	CR−2180
	NIGERIA		
		Livestock II	LN−2737
		Tree Crops	LN−3126
	Country	*Operation*	*LN/CR No.*
AF5AG			
	BURKINA FASO		
		Fertilizer Credit	CR−1550

GAMBIA		
	Agricultural Development II	CR−1476
MAURITANIA		
	Small Scale Irrigation	CR−1571
SENEGAL		
	Irrigation IV	CR−1855
AF6AG		
BOTSWANA		
	Land Management & Livestock	LN−2566
MALAWI		
	NRDP IV	CR−1343
	Agricultural Credit	CR−1851
	Agricultural Marketing & Est Development	CR−1966
	Fisheries	CR−2225
MOZAMBIQUE		
	Agricultural Rehabilitation & Development	CR−2175
ZAMBIA		
	Fisheries	CR−1529
ZIMBABWE		
	Agricultural Credit & Exp. Promotion	LN−3063

Appendix 5:
Rural Finance − Sample Terms of Reference for Rural Finance

The study should pay particular attention to:

(a) Government policies and strategies relating to agricultural and other rural activities, and related financial services.

(b) The role of the Central Banks in rural finance and rural economic activities, and its ability to fulfill its defined role.

(c) Performance of the specialized financial and related institutions − Agricultural Development Banks, Development Finance Companies, Cooperative Banks etc.

(d) Performance of commercial banks, cooperatives, and other rural institutions.

(e) The constraints to savings mobilization, and enforcement of loan contracts.

(f) The particular needs of small farmers and micro−enterprises.

(g) Availability of resources for long−term and short−term loans for production and investments.

(h) Adequacy of the interest rate structure and margins available for financial intermediation.

(i) Risk management options − Credit Guarantee and Deposit Insurance Schemes.

(j) Institutions and instruments available for savings and deposit mobilization in rural areas.

(k) Technical support available for implementing rural sector programs.

(l) Agricultural pricing policies, input supply, storage and marketing facilities.

Appendix 6:
Summary of Promising Approaches

The following are some of the initiatives and operations which appear to have shown promise and would help policymakers and project designers in identifying elements likely to contribute to the successful development of rural financial systems in SSA.

Group savings and loan schemes prevalent in many countries.

Financial cooperatives and credit unions which emphasize savings mobilization.

Trade/credit links which take different forms.

Strong deposit mobilization strategy adopted by Banco Agricola in the Dominican Republic.

Banco Sol in Bolivia lending to the poor without relying on grants or concessional credits.

Grameen Bank in Bangladesh lending to the poor without collateral.

BRI in Indonesia operating its Unit Desa Program on a sustainable basis despite it being a state−owned financial institution.

Effectiveness of peer monitoring, joint liability of groups, and operation of sustainable Credit Reserve Fund systems in Malawi.

Role of NGOs in providing promotional and technical assistance support to rural entrepreneurs in Kenya.

Savings first operations in Madagascar

Enclave operations for credit during a transactional period of financial sector reform in Tanzania

Infrastructural support to facilitate credit and innovative methods to reduce transaction costs in India.

Agenda for Further Research and Experimentation

Savings First (Savings Associations)

Cooperatives and Group Schemes

Trade−Credit Links (Input−Output Marketing)

Formal−Informal Sector Links

Guarantee Funds (Self−Financing Loan Guarantees)

Safety Net − Serving the Core Poor

Support to Women's Group (Gender Issues)

Privatization of Parastatal Banks

Entry/Exit of Financial Intermediaries

Enclave Arrangements for Targeted Credit

Rural Banks (Excess Liquidity and Ploughing Back)

Coordination − Donors/NGOs/PVOs/Governments

Controlling Transaction Costs

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