Rural finance & agricultural credit: Past experiences, lessons learnt and practical examples Presentation at Intercooperation, Bern, August 11, 2003

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Outline of presentation

1. Renewed interest in rural and ag finance: Why?
2. Changing paradigms and policy objectives in development finance.
3. What is specific about rural and ag finance: environments, ag production, clientele.
4. Types (or models) of rural finance institutions.
5. Micro-finance best practices: Transfer possible?
6. Policy recommendations: Towards sustainable rural financial systems.

Renewed interest in rural and agric finance: Why?

1. Decline in formal rural and agric credit. First recommendation: *Learn from past failures*.
2. Role of rural finance for agric and economic growth, food security and poverty reduction.
3. Hope of doing better this time because of our enhanced knowledge on:
   - market and government failure
   - demand for financial services by clients?
   - best practices in (urban-based) micro-finance and financial systems building

Old versus new paradigm

Old paradigm of sector-directed, supply-led and subsidized agricultural credit:

- faulty assumptions about demand
- focus not on financial sustainability of institution no focus on institution-building, but on (depth) of outreach. Impact was assumed.
- Paid lip-service to equity/poverty outreach, but benefitted larger farmers (similar to EU policy)
- Fitted well into gov-led agric marketing/input supply system (SAP)

New paradigm:

- focus on institution and systems building
- liberalization of financial markets as necessary but not sufficient condition for deepening financial systems → need institutional and technological innovations to reduce transaction costs

Shortcomings of past rural finance policy following the old paradigm

Wrong premises...

- poor can‘t save, are not creditworthy, need to be helped, need to be told how to use the loan and then be supervised to ensure that they do what they are told (otherwise „they go drink beer“)
- input credit for (export) crop production and animal husbandry is sole credit product that is to be offered
- „Beneficiaries“ instead of demanders of financial services

...led to wrong sector policy and institutional approaches...

- subsidize loan interest rates, „Give and Forgive“
- not offer savings services (or insurance)
- direct credit to specific sectors (agriculture) and crops through special credit institutions (mostly export crops, in only few instances also food crops)
- emphasis on number of „beneficiaries“ /not clients
- no emphasis on building institutions, poverty outreach or impact (government/donor subsidizes forever)

...and had negligible impact.

- failed to reach the poor (traditional banking approach)
- inefficient, inequitable income transfer programs

(Bangladesh 50 → 20 % repayment, Pakistan's defaulters)

- could not demonstrate impact on poverty alleviation
- system collapsed with implementation of SAP's

Understanding role of rural finance for agric and food/livelihood security

Pathway 1: Ag credit → Improved income

capital constraint → old paradigm: borrow, borrow more and then more …

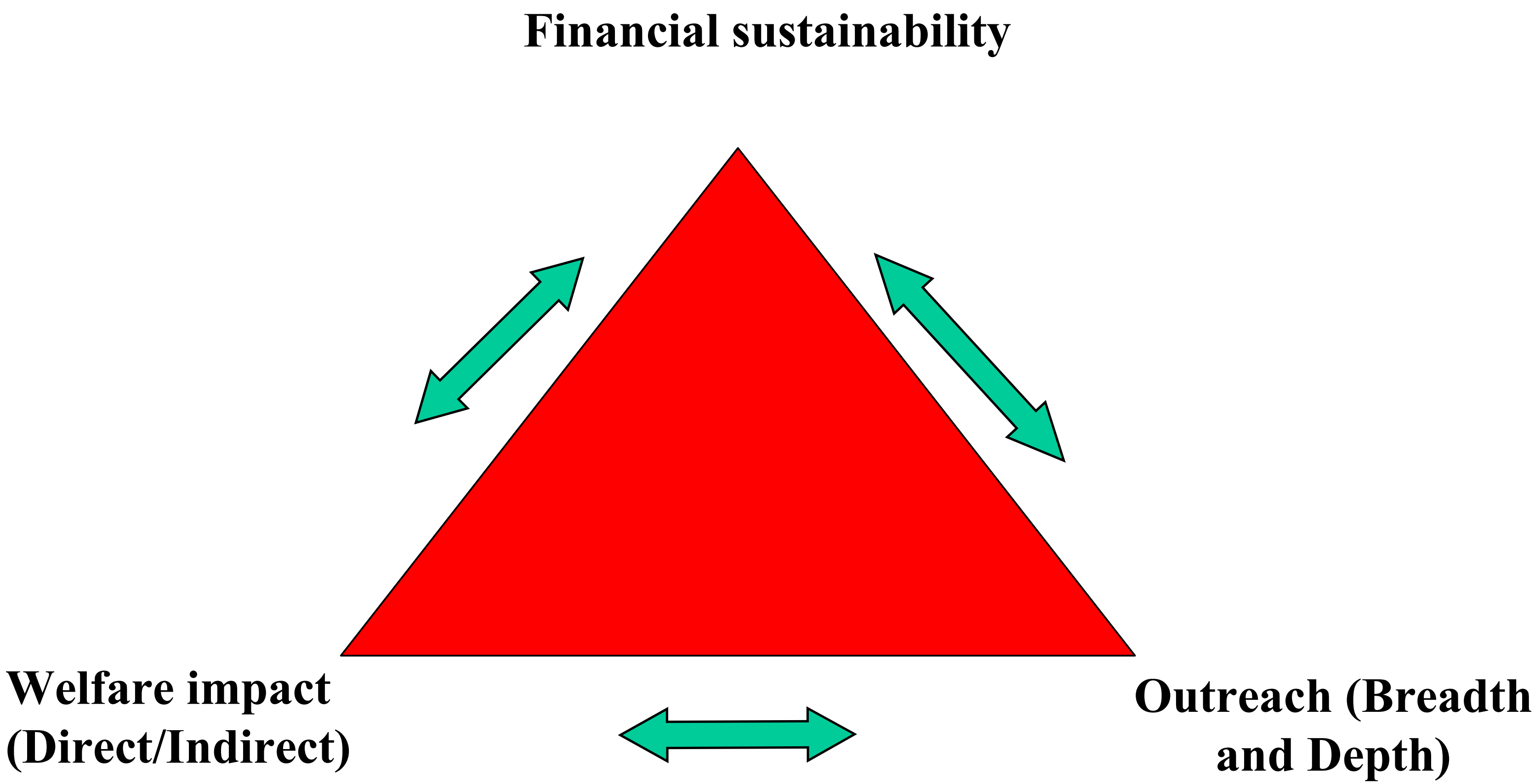
Pathway 2: Stabilize future consumption (ex-ante, before the risk/shock occurs)

More efficient asset and liability portfolio → *save, insure and borrow*

Pathway 3: Stabilize current consumption (ex-post, after the risk is realized) → save more, insure more, and borrow less

3 > 2 > 1: The poorer the household and the higher the risk → many borrow, more save, and all insure

The triangle of finance: Synergies and trade-offs



Source: Zeller, M., and Meyer, R.L. 2002. The triangle of microfinance: Financial sustainability, outreach, and impact. Book published by IPPRI/John Hopkins Univ, Dec. 2002.

The Urban-Rural Dichotomy

- higher transaction costs for FIs and their clients (irrespective of the institutional model)
- higher systemic risks, more volatile cash flows, and complex, heterogeneous legal frameworks
- lower risk bearing ability and higher vulnerability of rural households
- lower policy commitment to rural areas

→**Rural finance is more difficult**

Specific characteristics of agriculture

1. Location-specificity (ag is production in space).
2. Unfavorable terms of trade for agriculture.
3. Production depends on natural conditions (covariant risks!), and can require a lot of time.
4. Seasonality (production, food and factor prices).
5. Significant role of women in ag, especially food crops.
6. High incidence and depth of poverty among population dependent on agriculture.
7. High volatility of prices in ag commodities.

→ **Serving ag clients is more difficult.**

Role of state in techn/inst. innovations in finance

1. Institutional and technological innovations in rural and microfinance are rarely the PURE product of market forces seeking to maximize profit. (IPC microbanks will not spread like wildfire in poor rural areas serving smallholders, but even IPC's methodology is the outcome of subsidized state action)
2. Successful innovations were ALWAYS done conform with market principles. Yet, they were fostered by public investments (example BRI) or by private altruistic action (1. coop movement in Germany started by Raiffeisen and Schultze von Delitzsch, 2. Grameen Bank: Yunus 3. Many others).
3. State HAS A ROLE to invest in innovations – Much of investment (and learning) can and needs to be done together with others (private firms, NGOs, clients).

Models of rural finance institutions: Overview

- Credit projects (part of integrated rural dev programs) and revolving credit funds → These are NOT models for various reasons
- Member-based: Credit unions, Village banks
- Micro-banks (owned by individuals/entities)
- Lending technologies: Individual and solidarity group lending, and linkage model (with pre-existing self-help groups).
- Other: (1) State-owned ag/rural dev banks (2) downgrading commercial banks (3) contract farming (4) leasing , warehouse credit, others (see also FAO)

Lending Technologies

1. Comparative advantage of solidarity credit group (SG) is its potential depth of outreach. Despite high transaction costs (TCs) for forming groups, SG enables partial transfer of recurrent TCs to clients. SG can have benefits for social mobilization, and built-up of social capital.
2. There are also many valid concerns with SGs.
3. Individual lending (IL) is preferred by clients if and when client TCs (incl. risk) and price of service are lower compared to SG.
4. IL can create high recurrent TCs in areas with low infrastructure (for client and/or MFI).

→ SGs and IL are complementary technologies.

State-owned rural/ag dev banks

→Need to be transformed (based on business principles), or, if not possible, liquidated.

Successful transformation is possible even if STATE OWNERSHIP is retained (BRI, BAAC) → depends on political will, suitable macro-economic and ag sectoral framework, and on mgt that is independent and has incentives to perform

A number of donors are involved in reform of state-owned banks (IFAD/GTZ/IDB, USAID): No reason to write them off.

Liquidation (even if possible) is often not the best option.

Micro-finance best practices

Best practices in mainly urban-based microfinance are relevant and applicable in rural areas.

→Agricultural lending: See FAO publications

→Savings: CGAP working papers.

→Insurance: Innovations by SEWA and others, see ILO and other publications: MFIs can serve as retailers, or set up reinsurance contracts.

Adaptation to rural and farm households is needed. *But this is nothing new: Best practice means to design specific products for certain target clientele groups. However, current best practice will not solve ag credit issues, especially for investment term loans in agric.*

Conclusions

1. *Learn from past failures of rural/ag finance*. It is too costly to repeat them.
2. *Promote institutional diversity*. Each of the institutional models has their place because of comparative advantages.
3. *Promote rural finance institutions within a LONG-TERM financial systems perspective*. Stand-alone retail rural financial institutions are doomed to vanish once public support is phasing out.

Conclusions

4. *Do the relatively easy things first, while gradually experimenting with the more difficult ones.* Rural and ag finance is more difficult than urban finance, and many environments are too hostile without preceding improvements in other sectors (law, infrastructure).

5. *Be patient.* Building of rural financial institutions and systems is a labor-, knowledge-, and time-consuming process. It is technical, not financial assistance that matters. More of capital in this process can do more harm than good.

Policy implications: What are good practices for building rural MFIs?

1. Change attitudes of those involved in „helping“:

- The poor are creditworthy, they pay market interest, they are able to save, and they prefer to help themselves instead of being helped as „beneficiaries“.
- The poor are entrepreneurs, they are creative, they are receptive to advice and training, but they are likely to blame their „helpers“ for failures if told what to do.
- Recognize that credit or savings used for consumption are an integral part of the poor‘s economic strategy for maintaining and enhancing their most important production factor. Denial of this demand will lead to MF failure. Thus: Do not supervise loan use, just advise, provide options through training.

- Microfinance is and should not be meant as welfare assistance, but it can potentially achieve many of its objectives at lower public costs.
- As such, MF has a limited role to play for the ULTRA-Poor (i.e. those for whom their labour even has limited or no earning potential).
- Institutional innovations are required that reduce transaction costs for clients and intermediaries. This is possible. But: it will be impossible to have access to finance for all.

2. „Helpers“ should support institutional experimentation, innovation and up-scaling FOR, WITH and BY the poor

- Market failures can lead to lack of institutional innovation. However, institutions that work against market principles will not be sustainable.
- Accept that there is no blueprint but only different types of institutional models that need to be adapted by, with and for the poor to their specific socio-economic and agro-ecological context.

- The „poor“ are not a homogenous group: Demand for financial and non-financial services differs among them. But: The poorer the target group, the more emphasis should be placed on financial services contributing to consumption stabilization.
- Institution building requires political will, time and resources.
- The above requires to move away from short-term projects to long-term frameworks for financial system development, capacity-strengthening and institutional building. More clearly: Governments and donors should shy away **from projects with no long-term plan for linking the MFI with the banking sector.**

- Thank you.
- Danke.
- Merci.
- Gracias.
- ….