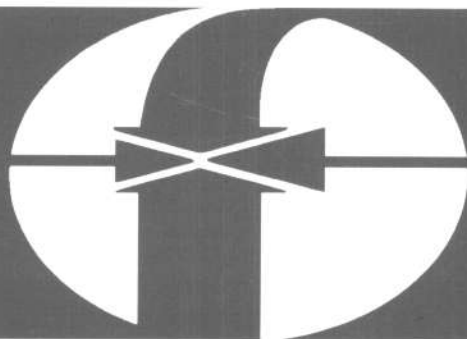


# **Savings and Development**



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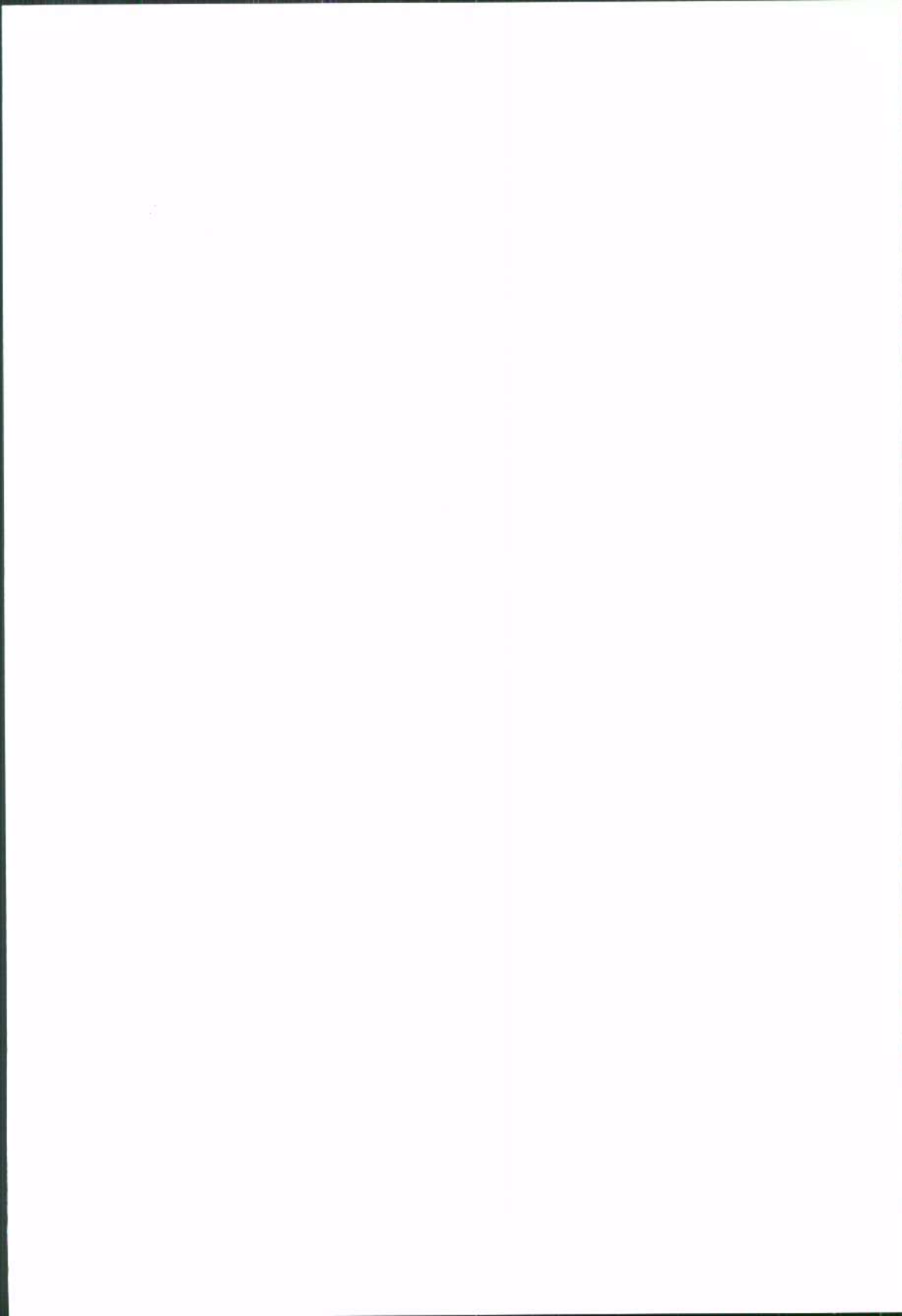
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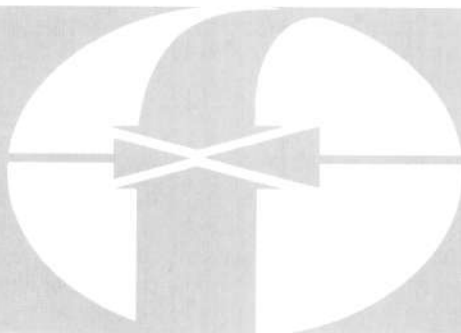
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# OLD AND NEW PARADIGMS IN DEVELOPMENT FINANCE

Robert C. Vogel, Washington, D.C.

Dale W Adams, Park City, Utah<sup>1</sup>

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## 1. Introduction

Since World War II directed credit programs have been used by governments and donors as broad-spectrum policy tools.<sup>2</sup> Thousands of these programs have been employed to address poverty, to boost production, to speed investments, to promote new technology, to ease disasters, to offset the adverse effects of other policies, to win votes, to form organizations, to hasten land reform, to mollify insurgents, to show concern, to boost exports, to lessen imports, to empower the downtrodden, to promote conservation, and to benefit minorities. In addition, a sizable portion of other development efforts include lending components.

The popularity of directed credit is partially explained by the ease with which lending projects are done. It may take years to design and build roads, hospitals, dams, or schools, but a credit program can be announced immediately and disburse funds within weeks. In addition to ease, numerous policy makers also think that flaws in financial markets impede the flow of loans to individuals who have economic opportunities, but who lack funds to capitalize on them.

Directed credit projects are thought to correct these flaws. Many policy makers have also concluded that directed credit is an effective way of transferring subsidies to preferred groups and activities. These transfers are done through concessionary interest rates and casual loan recovery or loan forgiveness. A general distrust of markets in centrally planned countries and certain aspects of Keynesian thought in capitalist countries have both stimulated directed credit efforts and led to the widespread application of the Directed Credit Paradigm (DCP) in the three decades following World War II.<sup>3</sup>

This paradigm dominated development activities until the 1980s when a contending view, the Financial Market Paradigm (FMP), emerged. The new view has made inroads into development activities and resulted in substantial jousting between proponents of these vastly different paradigms. In the discussion that follows we summarize the major elements of the two paradigms, briefly discuss criticisms of the old model and then list the benefits claimed for the new one.

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1. Michael Roemer and Juan Buttari provided useful comments on an earlier version of this paper. We also acknowledge financial support from the Agency for International Development.

2. We use the term 'directed credit' to cover subsidized loans that are allocated by administrative decisions. Examples of directed credit are loans targeted to small farmers, women, microentrepreneurs, users of a selected input, and victims of disasters.

3. "...the term paradigm...stands for the entire constellation of beliefs, values, [and] techniques...shared by the members of a given [professional] community" (Kuhn, p. 175).

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We use seven common but contrasting features in analyzing the two paradigms:

1. The definition of the primary problem;
2. the developmental role assigned to financial markets;
3. how users of financial services are viewed;
4. the extent of associated subsidies and taxes;
5. the sources of funds used in credit programs;
6. the design of associated information systems; and
7. the criteria used to evaluate credit programs.

## **2. The Directed Credit Paradigm**

A variety of credit activities have been formented under the DCP. During the 1950s and 1960s many of these programs focused on stimulating agricultural production and investment and on easing rural poverty (Bauer). Later, the focus of subsidized credit programs in may low-income countries was expanded to include non-agricultural activities, such as export industries or industries that substituted for imports. More recently, the focus of altruistic lending programs has shifted to the urban poor, especially women and operators of small businesses.

### *2.1 Problem Definition*

Advocates of the DCP typically cite market imperfections as justification for directed credit (for examples, see Besley; Darling; Nelson; Stiglitz and Weiss; and World Bank 1993). These perceived imperfections include both fairness and efficiency aspects. Centrally planned economies are extreme examples of this where free markets are distrusted to do what is efficient and fair, and where lending is often an integral part of fiscal policy. In mixed economies imperfections in both financial and non-financial markets are cited to justify administered credit. These include usurious moneylenders, dispersion in interest rates on loans, poor people who lack access to formal loans, asymmetric information, and bankers who fail to recognize the social externalities of lending to people with credit needs.

This perspective leads to the conclusion that there are many potential borrowers who are credit constrained — often people who are poor — because of badly performing financial markets. Resulting problems include credit rationing where some potential borrowers are unable to obtain any formal loans, or are limited to small loans, while others may borrow too little because of internal rationing caused by high interest rates. Directed

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credit programs are thought to overcome these market imperfections and to result in loan allocations that are more efficient and fairer than those resulting from unfettered market operations.

## *2.2. Role of Financial Markets*

The DCP assigns a star's role in development dramas to credit programs. Loans are viewed as vital inputs in the resolution of growth and poverty problems. Since many people and firms are assumed to have unmet credit needs, the delivery of targeted loans becomes a major feature of development activities. During the 1960s and 1970s, countries such as Brazil, India, Indonesia, and Mexico used directed credit as their primary development instrument. Accordingly, financial markets are visualized by DCP supporters as vertical channels for directing government or donor funds through administered loans to targeted beneficiaries, while differential loan prices are seen as levers for stimulating activities preferred by planners. Subsidized and directed credit is also thought to be an effective second-best alternative to offset the adverse effects of other policy-induced distortions, such as those caused by exchange rate controls or price ceilings. Overall, directed credit is used as a way of exercising the views of planners.

Since credit is seen as part of a package of vital inputs, financial institutions are encouraged to diversify into non-financial products and services under the DCP. This may include providing technical assistance and supervision, selling inputs, and buying and selling primary products.

## *2.3 Users*

Directed credit programs are usually targeted at individuals, firms, or groups who are called beneficiaries. Borrowers benefit from directed loans they would otherwise not receive because of supposed market imperfections, and they also benefit from subsidies tied to loans. In a few extreme cases, DCP advocates view borrowing as an entitlement, a right of all people. In other extreme cases, the relationship between lender and borrowers is patronal, where loans are used to reward behavior deemed proper by planners. The DCP focuses on borrowers and pays little attention to depositors as users of financial services - the paradigm is borrower dominated. A primary objective in the DCP is to form a financial system that is fairer to targeted borrowers, and advocates may view themselves as benefactors.

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## *2.4 Sources of Funds*

Because directed credit always involves subsidies, including interest rates that are usually concessionary, the bulk of the money lent is inevitably provided by governments or by donors. In some cases, however, commercial banks may be forced to channel some of their deposits to targeted purposes at concessionary rates of interest. Since most people in low-income countries are assumed to be too poor or too unsophisticated to save, especially in financial forms, the DCP ignores voluntary deposit mobilization. In some extreme cases proponents of the DCP denigrate deposit mobilization, arguing it will lead to funds flowing out of rural or poor areas (e.g., World Bank, 1993 p. 79). In other cases, DCP proponents argue that the supply of rural deposits is highly interest rate inelastic and therefore nearly impossible to mobilize through voluntary means (Desai and Mellor).

A variety of techniques are used to insert funds into financial markets for directed lending. These include equity investments in lenders, grants that are used by lenders as revolving loan funds, endowment funds, compulsory loans from commercial banks, and a variety of concessionary rediscount facilities managed by central banks or by other second-story lenders. Foreign borrowing, expansion in the overall money supply, counterpart funds generated by donor programs, and hefty reserve requirements on bank deposits are additional sources of funds for targeted lending.

External sources of funds are preferred by directed-credit lenders because they are less costly than are voluntary deposits. High reserve requirements and other taxes on deposits - policies usually associated with the DCP - further increase the costs of mobilizing deposits. Subsidized guarantee programs for loans made with external money can further increase the relative attractiveness of using outside funds compared to voluntary deposits.

## *2.5 Associated Subsidies and Taxes*

The litmus test for directed credit is using loans to transfer subsidies to borrowers, be they financial intermediaries or final borrowers. Subsidies are thought to attract participation in credit programs, stimulate targeted individuals to act in ways that accomplish planners' objectives, induce financial institutions to handle directed credit, and reorient the financial system in directions preferred by planners. Accordingly, a subsidy dependence is a defining feature of directed credit (Yaron).

These subsidies emerge in several ways: The first, and often the most important, enters in the form of subsidized interest rates. A rate is subsidized if it is fixed below the market rate (and becomes negative in real terms if the rate of inflation is greater than the

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predetermined nominal rate). Credit forgiveness is the second form of subsidy where partial or total loan default (or forgiveness) results in borrowers repaying less than the amount they owe.

Loan guarantee programs may provide a third type of indirect subsidy, where some of the risk, and thus costs, associated with loan recovery is transferred to a third party (Meyer and Nagarajan). A subsidy is involved when the full costs of the risk transferred are not covered by insurance premiums.

As with any subsidy, however, someone must be taxed to provide subsidies. Directed credit is supported by a variety of additional policies that tax various individuals and the public at large to subsidize borrowers. These include portfolio quotas that constrain loans to borrowers preferred by lenders, high reserve requirements against deposits, and low interest rates paid on deposits resulting from other restrictions or from concessionary rediscount lines. Taxpayers and depositors bear the brunt of the taxes imposed by application of the DCP.

## *2.6 Information Systems*

The DCP involves collecting and processing large amounts of information - it is data dense. This is a result of the primary reasons used to justify directed lending: satisfying credit needs through administered loans. A substantial portion of the data collected, processed, and reported focuses on documenting compliance with lending targets. This involves collecting data about the characteristics of borrowers, the intended uses of loans, the effects loans had on borrowers' activities, loan disbursements, and compliance with lending targets or quotas. As with the flow of funds under the DCP, the reverse flow of data is primarily vertical, from bottom to top.

Typically, organizations involved in directed lending are managing multiple lines of credit aimed at different target groups or activities. A government-owned agricultural bank, for example, may be administering several dozen lines of credit for different products and farm sizes, some of which are funded by the central government and others by donors. Each credit line may have unique objectives and reporting requirements in terms of format, data, and timing. The basic rationale for directed credit is that various target groups have specific credit needs, so that reporting requirements are idiosyncratic. In a few cases, a funding or loan guarantee agency may require lenders to forward copies of borrower business plans along with loan application forms to them for approval. In virtually all cases, the funding or guaranteeing agencies require periodic reports showing compliance with directed credit objectives.

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Various types of credit-impact studies aimed at measuring the results of a directed credit project are also commonly a part of this data gathering process; bank audits usually check on compliance with these targets. Pressures to provide documentation of directed credit activities generally lead to dense, but fragmented data flows under the DCP.

### *2.7 Evaluations*

Since the objective of directed credit is to push or assist something or someone, evaluations of these efforts typically focus on measuring the impact of loans on borrower activities (see Sebstad and others for an example). Impact may include changes in income, investment, employment, production, yield, use of particular inputs, or improvements in the well-being of beneficiaries. Although directed credit programs often are predicated on assumed market imperfections, DCP evaluations seldom document the extent to which market imperfections exist and are overcome through the targeted lending effort.

Impact studies take two forms. One uses the before-and-after method, and the other applies the with-and-without technique (David and Meyer). The first involves collecting information about borrowers' activities before obtaining loans and then later measuring changes in their activities after borrowing. The with-and-without approach compares activities of a sample of borrowers with parallel activities of a control group of non-borrowers. The differences between the two groups are then attributed to loan use - the impact of loans.

Success stories are still another, less formal, way of reporting on the impact of directed credit programs. This involves ad-hoc case studies that describe the accomplishments of several borrowers. These case studies are popular because they are less costly and less time consuming than are more formal and more representative impact studies.

Because projects are justified on the basis of what they do for beneficiaries, bank examiners under the DCP emphasize compliance with lending targets, rather than common measures of financial institution performance such as solvency, liquidity, profits, and management and asset quality. Since deposit mobilization is not important in the DCP, relatively little emphasis is given to prudential regulation and the collection of information that is useful in this regard.

## **3. Criticisms of the DCP**

Major criticisms of the DCP emerged in the early 1970s with the review of small farmer

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credit programs done by the Agency for International Development (1973) and in the concurrent academic work of Shaw and McKinnon. Additional concerns surfaced in subsequent academic research, in an FAO-sponsored conference in Rome (1975), and especially in a 1981 colloquium in Washington, D.C., sponsored by the World Bank and the Agency for International Development (Adams and others, 1984).

Initially, concerns about the DCP concentrated on loan recovery problems. Some of the directed credit programs had chronic loan recovery difficulties that increased in severity over time, and many of these efforts only sustained lending through periodic subsidies (Donald; Lieberman; Rice). In cases including several countries in Latin America, the Philippines, Bangladesh, Sri Lanka, and in Indonesia, large subsidized credit programs collapsed in the 1970s and early 1980s adding to the criticism of the DCP (see Sacay and others).

Subsequent criticism focused on six additional issues: (1) that the DCP boosted transaction costs for both borrowers and lenders; (2) that credit subsidies and associated taxes were distributed regressively, (3) that the DCP discouraged deposit mobilization; (4) that directed credit weakened financial institutions; (5) that directed credit had a weak and ambiguous effect on production and investment decisions; and (6) that evaluations of DCP projects gave misleading results.

### *3.1 Transaction Costs*

Researchers have documented substantial increases in transaction costs - for both lenders and borrowers - caused by the DCP (for example, see Cuevas and Graham). The expenses incurred by lenders in complying with DCP monitoring and reporting requirements entailed in managing multiple lines of directed credit boost these costs. The excess demand for subsidized loans also allows lenders to add conditions to DCP loans - non-price rationing devices - that raise borrowers' loan transaction costs. This includes the opportunity costs of time spent in navigating cumbersome borrowing procedures, transportation costs of visiting the lender a number of times to transact loans, costs of providing acceptable collateral, and, in some cases, paying bribes to influence lending decisions.

### *3.2 Regressivity*

Critics also contend that directed credit fails to ameliorate poverty and may, instead, help mostly individuals who are relatively well-to-do. This argument includes four parts: First, interest rate subsidies, as well as the income transfers captured by borrowers who



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default, are directly proportional to the size of associated loans. Large borrowers capture large subsidies, small borrowers capture only small subsidies, and individuals who cannot access subsidized loans receive no credit subsidy. Since loan access is highly correlated with borrowers' income and assets, subsidies attached to loans are distributed regressively. Empirical evidence from Brazil, Costa Rica, and Jamaica are cited by supporters of the FMP to justify this assertion (Vogel and Gonzales-Vega, Adams and Tommy; World Bank 1993, p. 159).

Second, the additional transaction costs imposed on borrowers by the non-price procedures used to ration subsidized loans weigh heavier on borrowers of small amounts than they do on borrowers of large amounts. If, for example, these procedures impose uniform additional costs of \$100 on each loan transacted, borrowers of \$1,000 for a year at a nominal interest of 10 percent incur an annualized borrowing cost of 20 percent, while borrowers of \$100,000 for a year at the same 10 percent interest rate would incur borrowing costs equal to only 10.1 percent of the value of their loans. These major differences in effective borrowing rates - though explicit interest rates charged on the loans are the same - partly explain why borrowers of small amounts may prefer informal loans that carry higher interest rates than do subsidized credit programs, but which impose much lower transaction costs than does directed credit.

Third, subsidized loans cause financial intermediaries to pay below-market interest rates on deposits. These low rates "tax" depositors and transfer subsidies to borrowers. Normally, the average depositor has fewer assets and lower income than does the average borrower. This is especially true when financial markets are repressed through interest rate controls. Relatively wealthy individuals typically have more savings options, including moving their funds abroad or buying foreign currencies, than do relatively poor people and are thus able to avoid the "taxes" placed on deposits more easily than poor people with fewer options.

Fourth, financial markets that process subsidies attract rent seekers. Typically those who are most successful in capturing these subsidies are individuals and firms that already receive special considerations in the society: the politically powerful, the owners of the bank, military leaders, traditional bank clients, people who are relatively well-to-do, or individuals who have connections inside the financial institutions administering the subsidy. When large subsidies are involved, especially over prolonged periods, employees of the intermediary may feel justified in seeking to share in the largess by eliciting bribes to process subsidized loans.

Because the demand for subsidies is essentially infinite, large and experienced

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borrowers have strong incentives - and usually wrangle the opportunity - to capture as much of the subsidized credit as they can. Attempts to overcome these tendencies by granting preferentially-low interest rates on small loans exacerbates these problems by forcing lenders to charge the lowest rates on the loans that are the most costly for them per-unit-of-money lent. Likewise, attempts to impose a ceiling on loan size is easily evaded by making multiple loans -each under the ceiling - to preferred clients. Critics of the DCP argue that subsidies associated with directed credit heighten, rather than lessen, the credit-equity problems that initially induced policy makers to promote subsidized credit. Under directed credit, relatively well-off borrowers continue to capture most of the borrowed dunds, and, in addition, they capture most of the subsidies attached to the loans.

### *3.3 Deposit Mobilization*

Critics also argue that the DCP discourages deposit mobilization (see Agency for International Development, 1991, and Sacay and Randhawa for examples). As noted above, low interest rates on loans force intermediaries to pay even lower rates on deposits, thus decreasing the relative attractiveness of deposits as a saving alternative. Access to low-cost external funds further discourages intermediaries from seeking deposits that may be more costly to mobilize than funds drawn from directed credit lines. Sustained access to cheap external funds typically deflects lenders from mobilizing potentially larger amounts from individual depositors. Reserve requirements and other taxes on deposits - policies commonly associated with financial market repression and the DCP - further discourage deposit mobilization.

The lack of deposits renders the lender more vulnerable to the whims of the government and donors. In extreme cases this may involve extensive use of the financial system to allocate political patronage under the guise of targeted lending, thereby exacerbating loan recovery problems.

### *3.4 Weakened Institutions*

Critics further argue that losses from loan default and from margins that do not cover lender costs undermine the economic vitality of institutions handling directed credit. This makes them subsidy dependent and also makes them more vulnerable to colonization by rent seekers. The collapse of part of the rural banking system in the Philippines, insolvent development banks in countries such as Bolivia, Jamaica, Nicaragua, and Peru, and weakened credit unions in many countries such as the Dominican Republic, Honduras,

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and Uganda are cited as evidence of the corrosive effects of subsidized credit on participating institutions (Bourne and Graham, Gonzalez-Vega).

### *3.5 Production/Investment Effects*

Critics of the DCP also argue that fungibility - the dominant characteristic of money — dilutes the ability of planners to stimulate selected activities through directed credit (Von Pischke and Adams). This feature of money allows borrowers to exercise diversion and substitution of funds when it is in their best interests to do so (see the following section). Critics argue that subsidies can be used to induce individuals to borrow, but that these subsidies do not alter the relative desirability of investment, production, and consumption options available to borrowers. Rational borrowers will direct the additional borrowed liquidity to the most desirable alternative available to them, be it the objective of the directed loan or not. This diversion is impossible to control when large numbers of loans are involved, especially in rural areas. Only if the highest return alternative is the same as the objective of the directed credit will the interest of planners and the actions of borrowers coincide. If they do coincide, there is no need for directed credit in the first place - targeting is redundant.

An extreme example illustrates this point. During the 1980s, the U.S. Government attempted to discourage the production of coca (the plant from which cocaine is derived) in Peru and Bolivia. This included providing subsidized loans to farmers cultivating coca to allow them to diversify into other crops such as corn and rice.<sup>4</sup> Since the credit was subsidized, farmers were induced to take loans, supposedly to substitute other enterprises for coca production. After securing the loans, however, farmers had overwhelming incentives to invest the borrowed liquidity in cultivating additional coca that promised relatively secure net returns of thousands of dollars per hectare, rather than in rice or corn that promised riskier net returns of a hundred dollars or less per hectare.

### *3.6 Misleading Evaluations*

Criticism was also leveled at the techniques used to measure credit impact. This includes two general reproaches: (1) that traditional credit impact studies systematically overestimate the benefits of credit use; and (2) that they also systematically underestimate

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4. These credit programs ignored the fact that most of the coca farmers were awash in funds resulting from the extremely high prices paid for illegal coca products during the mid-to-late 1980s. Many farmers had ample funds, without borrowing, to invest in alternative enterprises, but decided not to do so because of the relatively low rates of expected return from alternative activities.



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the costs of directed credit programs (Adams).

Many credit-impact studies use the before-and-after approach to document credit impact, in which changes in borrower performance over the period studied are attributed to loan use. Most of these studies, however, do not control for the positive effects on borrower performance of other factors that change independently, but concurrently, with loan use. For example, most of the additional income realized by rice farmers from one year to the next may be due to increases in rice prices, favorable weather, or improved technology, and only slightly due to loans used to sustain fertilizer applications. Assigning all of the positive changes to loan use may substantially overestimate the actual impact of credit when other favorable changes occur in the economy.

Furthermore, one never knows what the borrower would have done without the formal loan - the counterfactual question. Financial instruments, particularly money, are fungible, and one source of liquidity can be readily substituted for another. Thus, tailors needing funds to buy cloth - but unable to obtain formal loans - may purchase the material using informal credit from merchants or use their own funds to buy cloth. If tailors, instead, can obtain formal loans, they may simply use these borrowed funds to substitute entirely or partially for other sources of liquidity available to them, including informal loans and their own funds, especially when given the opportunity to capture subsidies attached to formal loans. Given the substitution alternatives that are available to many borrowers, it is extremely difficult to tie borrowing with end use. Ignoring substitution is an additional source of inflated benefit claims for credit impact. At least some substitution occurs with any borrowing, otherwise the lender is inducing borrowers to do something they would completely avoid lacking the loan, an unlikely situation.

With-and-without studies have other flaws that inflate estimated benefits. The presumption behind this type of study is that all of the difference in performance between a group of borrowers and a control group of non-borrowers is due to loans. A key assumption in these types of studies is that individuals in the two groups are identical except that one group receives formal loans and the other does not. This method avoids the attribution and substitution problems mentioned earlier, but it is susceptible to selectivity bias. Credit programs with integrity should screen clients for creditworthiness, that is, for their entrepreneurship; for their economic opportunities; for their character; and for their ability to repay. This screening makes it virtually impossible to assemble an identical control group. Part or most of the superior performance observed in the borrowing group may be due to selectivity rather than to loan use. The borrower group may have shown superior performance, compared to the control group, even in the absence of loans.

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Credit-impact studies have also been criticized for underestimating or ignoring important costs associated with credit projects. These costs include the wear-and-tear or organizations channeling the funds; negative margins; loan recovery problems; corruption; political intrusions into lending decisions; and insolvency. Additional costs include the losses suffered by savers who receive low returns on their deposits because of subsidized credit, and losses by the overall economy because of the less efficient allocation of resources caused by financial market repression associated with the DCP (Shaw).

Unsatisfactory results and mounting criticism, combined with increased enthusiasm for the private sector and freer markets, caused a decline in funding for directed credit programs in the late 1980s, especially those handled by government-owned institutions (World Bank 1993). This encouraged experimentation with other approaches that led to the formation of a new paradigm that focused on development of financial markets and institutions rather than on providing administered credit (Gonzales-Vega, ed.; Krahnen and Schmidt; Patten and Rosengard). The outlines of this new paradigm were presented in publications issued by the Agency for International Development and the World Bank (Agency for International Development 1991; Buttari; Lieberman; Schmidt and Kropp, Von Pischke 1991; World Bank 1989; and World Bank 1991).

#### **4. Transition to the FMP**

The switch to the new paradigm was reinforced by general economic and financial reforms in numerous countries that provided an enhanced environment for financial markets (McKinnon 1988). These reforms included privatization, fewer distortions in exchange rates, less inflation, elimination of price controls and subsidies, liberalized interest rate policies, and less repression of financial markets. Some elements in the DCP were inconsistent with these reforms, and this encouraged adoption of the FMP.

Only a few countries such as Chile and El Salvador applied the FMP countrywide. Partial application of the FMP to specific institutions or sectors is the more common experience, with examples being the Dominican Republic, Egypt, Malaysia, Peru, the Philippines, and Uganda. Recent reforms of credit unions in Guatemala, Honduras, and Niger also used the FMP.

One of the initial applications of the FMP began in the early 1980s in Indonesia.<sup>5</sup> Previously, the Indonesian government made aggressive use of the DCP, especially in

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5. Major elements of the FMP were used during the 1950s and 1960s in developing and reforming financial markets in Taiwan and in South Korea.

rural areas. In the late 1970s the Bank of Indonesia (the Central Bank) administered several hundred directed credit lines, many of them targeted to rural areas or for agricultural purposes. Budgetary pressures and unsatisfactory performance of major directed credit programs caused the government in the early 1980s to begin experimenting with the FMP.

This change was most dramatic in the Bank Rakyat Indonesia (BRI). Through more than three thousand sub-branches, the BRI during the 1960s and 1970s had implemented several incarnations of a nationwide rice promotion program, based largely on subsidized loans. Loan defaults and the need for persistent subsidies caused the government to abandon its credit-driven rice promotion program for the most part in the early 1980s. The BRI thus faced the choice of closing most of its sub-branches or reforming the system. It chose reform and applied the FMP in doing so. Success in mobilizing deposits, extending small loans, and making hefty profits for the BRI through microfinance has been documented by observers of the program (Patten and Rosengard; Robinson).

In part, the relatively short list of FMP success stories is due to the time required to implement the paradigm, including the time necessary to carry out the more general reforms needed to reinforce the FMP, as well as subsequent institutional development. A project following DCP guidelines can lend funds quickly after a need is identified. Reforms such as those carried out in the BRI, a few development banks, and a handful of credit unions may require a decade to take root and flower. Sustained leadership and political commitment for these long-run reforms are often lacking, especially when the costs come early and the benefits only surface later.

It has also been difficult for donors to support the FMP strongly. Some of them are still committed to the DCP, and others are internally divided on which paradigm to use. Some donors find it difficult to support the FMP because they cannot use traditional donor technology in the process. Donors have found it particularly difficult to reconcile moving large amounts of funds through loans or grants with the promotion of deposit mobilization. Political mandates for donors that involve targeting of assistance further complicates support for the FMP. Almost never are depositors targeted by political mandates. Support for directed credit by a large number of non-governmental organizations (NGOs) applies further pressure on donors to continue using the DCP.

## 5. The Financial Market Paradigm

The differences between the DCP and the FMP are fundamental. Advocates of the DCP tend to view loans as one-time treatments for beneficiaries' problems, while FMP

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advocates stress developing durable and sustained relationships among financial intermediaries, creditworthy clients, and depositors. DCP supporters are also less concerned with the well-being of financial infrastructure than are FMP promoters. The DCP involves using loans to transfer subsidies, while FMP supporters argue that loan subsidies weaken financial systems.

### *5.1 Problem Definition*

The FMP stresses transaction costs as the dominant problem in financial markets.<sup>6</sup> This includes costs incurred by both providers and users of financial services. These costs are particularly large in rural areas, in the provision of microfinancial services, and are seen as the primary factors constraining the expansion of formal finance. In directed credit programs lenders may impose additional transaction costs on non-preferred borrowers as rationing mechanisms. Other policies may also inadvertently increase these costs or redistribute them among financial market participants. Policy changes that reduce transaction costs and cost-reducing innovations are the major ways of lowering these costs and allowing the formal financial frontier to expand (Von Pischke).

Proponents of the FMP argue that a combination of interest rates and the transaction costs imposed on users of financial services, not interest rates alone, determine the demand for financial services. FMP supporters also tend to view informal finance favorably, in part because associated transaction costs are typically low, and also because of the ability of informal finance to provide sustained microfinance. FMP advocates further argue that their paradigm fosters economies-of-scope, economies-of-scale, and efficiencies that result from specialization in financial intermediation.

### *5.2 Role of Financial Markets*

The FMP assigns a different role to financial markets in development than does the DCP. Financial activities are viewed by FMP supporters as accompanying, not leading, economic opportunities. FMP supporters also see financial markets as increasingly important infrastructure that facilitates exchange, trade, and specialization. In addition to their role as a medium of exchange and store of value, the most important contribution of

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6. Concern with transaction costs in financial markets ties into similar concerns emerging from new institutional economics. See Williamson for an example of this broader concern.

financial markets is to enhance the efficiency of resource allocation between surplus and deficit units and areas. An efficient financial system also helps lower other transaction costs throughout the economy. Under the FMP, financial institutions are encouraged to specialize in processing financial contracts.

The DCP has an anomalous, if not inconsistent, view of the importance of finance. On one hand, loans are seen as crucial inputs for production, for stimulating new products, and for promoting the adoption of new techniques by firms lacking funds. Credit is also thought to be an effective way of transferring subsidies and alleviating poverty. On the other hand, there is little appreciation by DCP supporters of the costs of financial intermediation and the losses that occur from repressing this process, thereby suggesting that finance is unimportant.

Before 1973 and McKinnon and Shaw, financial theory was largely limited to the consideration of money and its various roles. It was not until McKinnon and especially Shaw drew upon Gurley and Shaw (1960 and 1967) to emphasize the importance of financial intermediation and finance as a service industry that there was a basis for clarifying the high costs of financial market repression. Thus, under the new paradigm, finance is seen as crucial for the services it supplies, especially intermediation, but is seen as being less important than under the DCP in that it cannot substitute for trade, prices, infrastructure, and other factors that more directly foster development.

### *5.3 Subsidies and Taxes*

Financial institutions in the FMP are guided, rewarded, and disciplined by market forces. They pay and charge market rates of interest. They persist if they provide competitive financial services and fail otherwise. Competition forces survivors to be innovative in producing attractive financial products and services and also in lowering transaction costs. Since financial institutions are not involved in transmitting subsidies attached to loans under the FMP, they are also not involved in taxing financial market participants. The absence of fiscal functions allows the financial system to specialize in finance and to deflect rent seekers. Any subsidies that are inserted into the financial system under the FMP are short-term and limited to encouraging innovation and to supporting appropriate policy changes. Emphasis throughout the financial system is on maintaining independence from subsidies. FMP supporters argue that income distribution problems should be dealt with by direct transfers, rather than through distorting financial markets. They also argue that product and inputs prices, along with technology, are far more powerful and effective simulators of production than are loans.



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#### *5.4 Users*

Under the FMP, users of financial services are seen as valued clients rather than as beneficiaries. In turn, the providers of financial services and products see themselves as business people rather than as benefactors. They maintain or expand their businesses by selling high quality products that are competitively priced and using procedures that impose modest transaction costs on clients. Self interest, rather than altruism, dominates decisions throughout the system. Under the FMP, a much larger number of depositors than borrowers use formal financial services - the paradigm is depositor dominated and treats savers more fairly than does the DCP.

#### *5.5 Sources of Funds*

Voluntary deposit mobilization is stressed in the FMP (Vogel 1984). Unlike the vertical channeling of funds in the DCP; the dominant circulation of money in the FMP is horizontal. That is, most institutions in the formal financial system are expected to mobilize from depositors a large part of the funds they lend. Some flows of funds - both vertical and horizontal - between segments of the financial system may nonetheless occur to meet temporary shortfalls in liquidity or to reallocate surplus funds to higher return alternatives in other areas or sectors of the economy. The FMP stresses the importance of correct pricing of these transfers. Transfer prices must be high enough to discourage substitution of vertical transfers for voluntariness mobilized deposits.

The stress on deposit mobilization also requires enhanced prudential regulation and supervision, especially to protect depositors of small amounts. This entails collecting information that accurately reflects the financial strength of institutions handling deposits. It may also include carefully designed deposit guarantee programs that partially protect deposits, particularly those of the microsaver.

#### *5.6 Information Systems*

FMP information systems are lean and primarily used for managing organizations, screening clients, recovering loans, and for measuring the overall performance of the financial system. This includes keeping track of loan and deposit transactions, status of loan recovery, costs of operation, managing liquidity, and recording profits-and-losses. In addition, some of this information may be subdivided by loan officer or by banking unit to implement employee incentive measures. Information systems in the FMP are mostly horizontal, although some vertical information flows are needed to assure prudential

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behavior and also to allow some overall review of the performance of the financial system. These vertical flows of information, however, are much simpler, less dense, and more unified than are the vertical flows of information under the DCP.

### *5.7 Evaluation*

In contrast to DCP evaluations where beneficiary performance is the focal point, the FMP stresses employee, organization, and system performance. Overall evaluation of financial market performance concentrates on loan recovery, numbers of clients served, transaction costs, profitability, and sustainability of the system.

FMP evaluations rely on secondary information normally generated by carefully managed businesses. In contrast, evaluations under the DCP require collection of primary data about borrowers and their activities that are not normally assembled by lenders, except when they are involved in directed credit.

Under the FMP, the gains realized by borrowers and depositors are inferred from their willingness to pay and receive market prices in effecting financial transactions and in meeting their contractual obligations. If there are no subsidies attached to loans and if borrowers repay, one can infer from their voluntary actions that borrowers benefit from loan use. One can also infer that clients benefit from depositing, otherwise they would go elsewhere with their surpluses.

## **6. Conclusions**

Switches in paradigms occur slowly and are accompanied by skirmishes between defenders of the old and proponents of the new. This is especially true in the case of a major paradigm change such as is involved in the DCP and the FMP. These paradigms differ in fundamental ways: in the way they define the primary problem, in the role they assign to financial markets in development, in how users of financial services are viewed, in the sources of funds handled by financial markets, in the design and use of information, and in the way activities are evaluated. The gap between these two paradigms is so great that it is impossible, in our opinion, for those involved in development to compromise by keeping one foot in the DCP and the other in FMP. The magnitude of the gap is confirmed by the continued heated exchanges between supporters of the two paradigms. These exchanges will continue until one of the groups conclusively proves the superiority of their model, or proponents of one school-of-thought retires from the battlefield. Documenting the favourable or unfavourable performance of the two paradigms along with some

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theoretical guidance will ultimately result in one paradigm vanquishing the other.

In our opinion, the DCP is incompatible with the recent economic reforms implemented in an increasing number of countries: directed credit is out-of-step with the enhanced reliance on the private sector and on market-determined prices. Furthermore, it is increasingly apparent that the Direct Credit Paradigm is flawed. Loan defaults, subsidy dependency, insolvent financial institutions, the limited number of clients reached through the DCP, and the overall costs of programs associated with this approach caused some concerned observers to seek a less flawed paradigm. An increasing number of observers, including us, have concluded that paradigm is the FMP.



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## Abstract

*Proponents of the old directed credit paradigm and advocates of the new financial market paradigm disagree over which approach is best. To clarify discussion between these contending camps, seven common but contrasting elements of the two paradigms are described and critiqued. The elements are problem definition, developmental role of financial markets, how users of financial services are viewed, associated subsidies and taxes, surces of funds, associated information systems, and the criteria used to evaluate developmental finance programs. Authors support replacing the old direct credit paradigm with the new financial market paradigm.*

## L'ANCIEN ET LE NOUVEAU PARADIGME DE LA FINANCE DU DÉVELOPPEMENT

### Résumé

*Les partisans du vieux paradigme du crédit direct et les souteneurs du nouveau paradigme du marché financier n'arrivent pas à s'accorder pour décider quelle est l'approche la meilleure. Pour projeter un peu de clarté dans les deux champs en conflit, on a choisi sept éléments communs mais contrastants des deux paradigmes, à savoir la définition des problèmes, le rôle des marchés financiers en tant que facteurs de développement, la façon dont on perçoit les utilisateurs des services financiers, les subventions et les taxes relatives, les sources de fonds, les systèmes d'information relatifs, et les critères utilisés pour évaluer les programmes financiers de développement, et on les a décrits et analysés critiquement. Les Auteurs appuient le remplacement du vieux paradigme du crédit direct avec le nouveau paradigme du marché financier.*