

THE NEED FOR AVAILABILITY OF CREDIT FOR DEVELOPMENT PURPOSES

Joachim von Stockhausen

1. Introduction

In many developing countries great importance is attached within the framework of rural development to the provision of credit for smallholdings. The reasons for this are basically twofold. The first is the assumption that inadequate access to credit results in a critical bottleneck in the adoption of improved operational equipment and modern production technology. This assumption, which J.D. Von Pischke critically apostrophizes as « the small farmer credit need-creed »¹, is reflected in numerous development plans. The second reason, closely connected to this assumption, is the belief that rural credit markets, in contrast to others, can be easily administered to conform with state development policy and that shortcomings on the rural labour and land markets can thereby be overcome. By extension, it is assumed that the provision of credit in advance stimulates the demand for credit from smallholders and that induced demand for credit is the expression of a need among smallholders for credit to increase rural income and rural well-being in general. This approach is reflected in the term coined by H.T. Patrick « supply-leading phenomenon »².

Based on these assumptions Governments feel a need for direct promotion of the credit supply at often heavily subsidized interest rates. The instrumentarium usually adopted is very diverse, ranging from direct provision of funds from the national budget, via the setting up of separate refinancing funds at the central bank to obligations imposed on the private banking sector to allocate funds for credit purposes. A common characteristic of all these measures is their external financing. The term « external » here implies that the funds concerned are not refinancing funds raised within the rural sector but funds which have been channelled into the sector from outside.

The question arises as to whether the approach roughly outlined above can in fact meet the financing needs of smallholders and, by extension, whether it corresponds with the aims of rural development as regards improving the income situation of smallholders. Since this question can only be answered in a semi-positive way, the next question concerns the measures to be taken in order to make the actual impact come nearer to the aim.

1. J.D. Von Pischke, « When is Smallfarmer Credit Necessary? » *Development Digest*, Vol. 14 (1978), No. 3, pp. 6 - 14.

2. H.T. Patrick, « Financial Development and Economic Growth in Underdeveloped Countries », *Economic Development and Cultural Change*, Vol. 14 (1966), No. 2, pp. 174 - 189.

2. Factors Influencing Attitudes Towards Financing

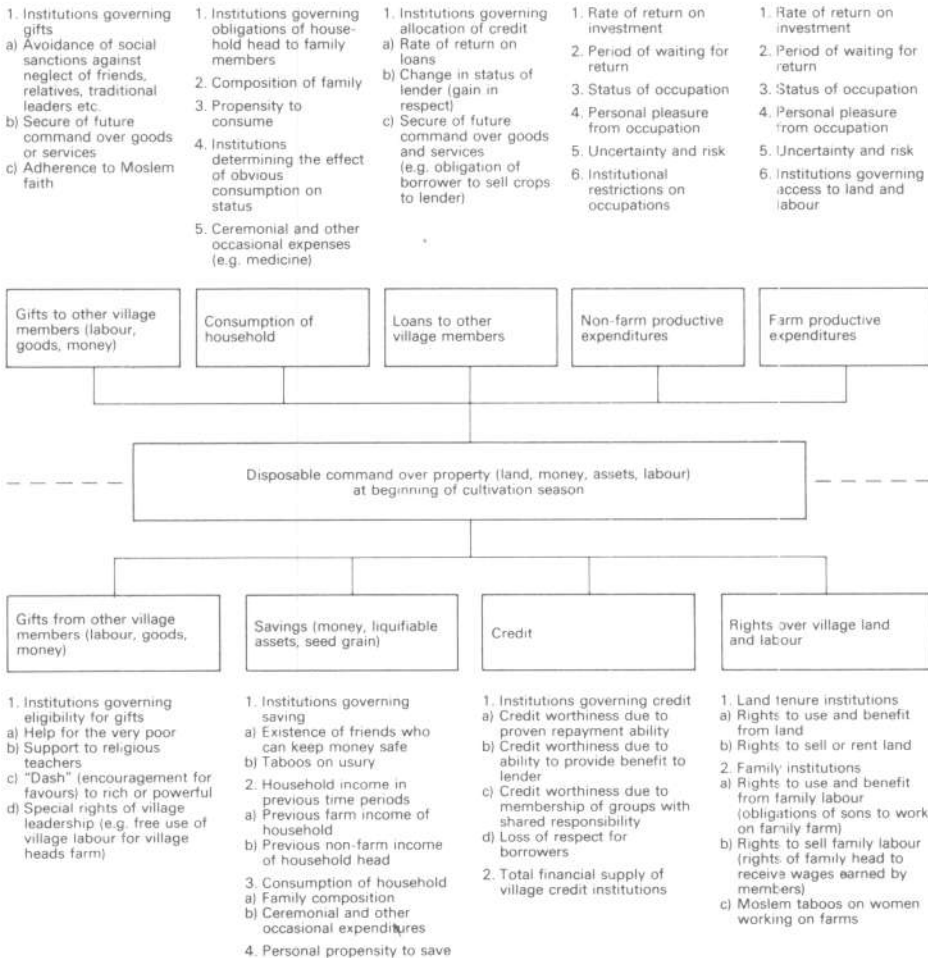
The value of the outlined approach to credit policy in terms of its contribution to achieving rural development aims is in large measure dependent on the factors which determine the smallholder's attitude towards financing. On the basis of empirical investigations conducted in Nigeria, R. King³ elaborated the system shown in Figure 1 which describes the factors influencing the farmer's input expenditure decision. From this grouping of determinant factors, it is quite easy to deduce that an increase in the importance of the lower four blocks of determinant factors of a decrease in that of the left-hand upper four blocks tends to lead to an increase in productive farm expenditure.

The belief that the provision of external credit increases productive farm expenditure is based quite clearly on two assumptions. First of all, external credit may not prejudice the availability of the three other forms of finance: as soon as external credit begins to diminish contributions from other societal agents, stop other credit sources, or limit the smallholder's saving activities, the total access to finance can become less than it was before the provision of the external credit. The second assumption presupposes that the farmer uses the financial resources at his disposal for productive agricultural investments. Such behaviour is clearly influenced by the relative profitability of agricultural investment. The latter is not only dependent on familiarity with and the availability of profitable production technology and production means, it is overshadowed both by the subjective assessment of the advantages made by the farming family concerned and by the rights and duties incumbent on that family in respect of its social environment.

In view of these considerations, a purely static response cannot cover all aspects of the productive use of credit within the farming unit. The point on which emphasis is placed in productive farm expenditure is determined by factors which, at the same time, can be viewed as the differentiating features distinguishing the various development phases of smallholdings.

3. R. King, « Farmers Cooperatives in Northern Nigeria: A Case Study Used to Illustrate the Relationship between Economic Development and Institutional Change ». Department of Agricultural Economics, Ahmedu Bello University, Nigeria — Department of Agricultural Economics, University of Reading, United Kingdom 1976.

Figure 1: Systematic representation of factors influencing input expenditure decisions of farm household heads



Source: R. King, op. cit. p. 124.

3. The Financial Development Path of Smallholdings

Smallholdings in developing countries do not form a homogeneous group. If their level of integration into the overall economic barter and money economy is taken as the differentiating factor, smallholdings can be seen to pass through a number of development phases. Five such socioeconomic development phases have been identified.

The first development phase is characterized by a dominant subsistence approach to living and producing. The aim of the farming family is to ensure the best possible provision of foodstuffs and other factors contributing to the well-being of all its members. With the aid of the equipment available, the subsistence-oriented smallholding seeks to maximize production, not necessarily to maximize profit or income. This — in the opinion of the farming family in view of the dwindling possibilities of employment outside agricultural — rational behaviour pattern helps to preserve traditional social structures in a gradually changing environment. The first moves towards marketing agricultural products occur spontaneously in the sense that they are not induced by concerted planning for surplus production by way of either reduced consumption or greater deployment of still freely available labour. A need for capital scarcely exists. The smallholdings find themselves lingering in the traditional balance: the marginal yield of new investment is so small that incentive is low.

The length of the second, transitional phase from a mainly self-sufficient to a more market oriented farming system is largely determined by the subjective value attached to new consumer goods introduced to the farming population from outside, entrepreneurial expertise, the degree and intensity of contact with strangers, and the prevailing social structure.

The third phase, the agricultural investment phase is characterized by a rapid increase in the production of cash crops. The most important production factor in achieving this increased output is normally labour, and increasing consumer expenditure goes hand in hand with the beginnings of capital formation in the agricultural sector. This complementarity lasts as long as land is more abundant than labour and marginal productivity is not falling. Once the critical point is reached endeavours are made to increase the smallholding's production and earnings capacity by means of intensified land use and, by extension, the purchase of improved means of production. This development step often presuppo-

ses understanding of new and hitherto unknown production technologies: it can be taken only if outside support in the form of extension services, credit facilities to provide working capital, etc. is forthcoming. Measures have to take into account the fact that small farmers are disinclined to incur risks and ill-able to assume responsibilities for such risks. Their disinclination cannot be measured in terms of economic aspects alone. These are often overshadowed by social aspects. Assumption of responsibility for economic risk can endanger social status, marriage chances, or other political and cultural privileges which the individual may enjoy. These socio-cultural decision-making criteria make it necessary, in this phase of a very stable social structure, to view consumer expenditure in a differentiated way. Some consumer expenditure can be of greater importance for the development of the smallholding than investment proper, or in other words, consumer expenditure is not always to be equated with the decapitalization of the smallholding.

The accumulation of cash reserves as a result of a growing tendency to save will sooner or later lead to the investment of capital outside the farm smallholding. In this fourth development phase, the transition to extra-agricultural investment, a low level of general education, and a lack of management training imply that a large number of failures are to be reckoned with. In the initial stages cooperative forms of ownership accelerate capital formation by the pooling of individual capital reserves; increasing pressure for economic flexibility and mobility will successively reduce this form of capital formation in favour of a strengthened individualist approach. The search for capital investment possibilities outside the smallholding is not limited to tangible investment only. Liquidity considerations render capital investment an even more important alternative. This type of investment comprises not only deposits in banks, savings associations, and mutual loan societies, etc., but also the granting of private loans and participation in traditional savings and loan societies. The latter form of external investment is of even more importance to the farmer-saver if circumstances do not permit the first form of capital investment. Interest-bearing investment of savings for capital formation in the rural sector is all the more important in view of the customarily inverse relationship between investment yield and consumer expenditure.

Once investment in tangible assets outside the agricultural sphere is successfully managed, the fifth development phase, that of investment in non-tangible assets in the nonagricultural sector sets in. Typical areas for investment are the marke-

ting and processing of agricultural products. This phase marks the end of the socio-economic development path.

This admittedly very much oversimplified description of the various development phases nevertheless indicates that the financial needs of smallholders and, by extension, their demand for banking services vary considerably in the course of their socioeconomic development.

Figure 2 portrays the correlation between the socioeconomic development phases outlined above and the various forms of barter and financing customary in rural areas.

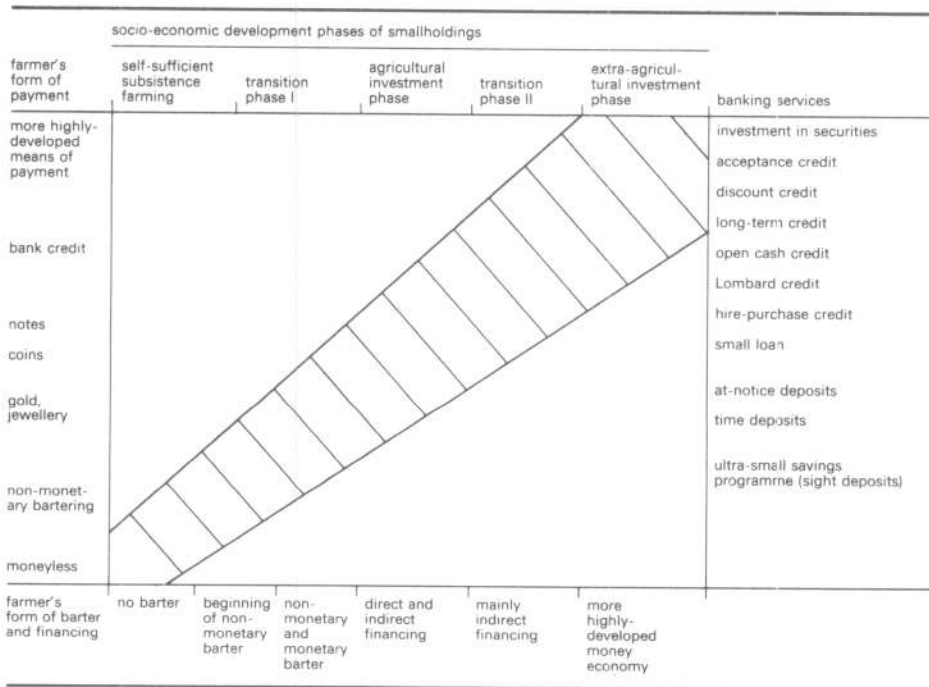
In the self-sufficient subsistence economy phase, by definition, no goods are bartered and farming people therefore have no need for money as a means of payment. The transition to the agricultural investment phase (cultivation of cash crops) is accompanied by an initially nonmonetary form of barter which gradually develops into a monetary form of barter. As financial development begins to take shape, self-financing still predominates. The first moves towards direct financing (direct finance and credit relations between economic agents without the intervention of banking institutions), develop as a consequence of the setting up of barter relations. These include credit in kind, the nonmonetary payment of workers, and sharecropping, of which the last is the most important. In the direct monetary financing system which then gradually takes shape, the main means of payment are at first gold and jewellery and later coins and notes.

The degree of monetization among farmers, expressed by the proportion of goods and services which are exchanged on a monetary basis, is still very low; estimates indicate that it lies around 60 percent (figures as of 1969/70). Countries of which such a level of monetization is typical throughout the economy include Malawi, Ethiopia, Nigeria, and Rwanda ⁴.

Once the agricultural investment phase sets in, direct financing successively loses ground to indirect financing (intervention of banking institutions). One of the reasons behind this retarded development of indirect financing is the fact that a transition to direct monetary financing is psychologically and institutionally easier

4 A.G. Chandavarkar, "Monetization of Developing Economies", *International Monetary Fund Staff Papers*, Vol. 24 (1977), p. 679.

Figure 2: Financial Development Path of Smallholdings



than is a direct transition to indirect, i.e. bank financing, a considerable advance which implies the development of institutions and a substantial change in the traditional behaviour patterns of the rural population.

Increased monetization within the agricultural economy presupposes a drop in the consumption of self-produced goods. The concomitant transformation of tangible savings into non-tangible savings and the effects of this on the composition of the money supply are at first determined by the investment policy of rural households. The decision as to whether savings be kept in cash or put into sight deposits is of decisive importance; investment in time deposits or savings accounts is not practised until a later stage. Whether the above-mentioned alternative in fact exists is in no small measure dependent on whether such appropriate bank services are available.

These observations on smallholders' willingness and capacity to save are substantiated by a number of empirical investigations which have shown that smallholders are notorious money hoarders and are at the same time burdened with high rates of interest on loans. This conclusion permits the following interpretation: small-holders have on the one hand access to alternative sources of finance, namely self-financing or outside financing, and they intentionally pursue a risk-averse financing policy on the other. This observation explains the findings which indicate that at the beginning of the agricultural investment phase, public credit programmes do not so much stimulate agricultural production as finance consumer expenditure or replace unorganized credit. For example, an investigation conducted in Zambia showed that credit was not a suitable instrument for persuading farmers to adopt improved production technology; it was, however, able to incite those farmers to increased use of improved technology who had already self-financed experiments in this direction⁵. According to this theory credit is particularly inclined to accelerate the introduction of technological progress if, before and during such introduction, the farmer disposes of own capital (in appropriate measure) to serve as the risk-bearing capital.

These findings correspond in full with those pertaining to the substitution effect of public credit programmes, according to which it is maintained that where no

5 R.A. Roberts, « The Role of Money in the Development of Farming in the Mumbwa and Katete Areas of Zambia ». A.I.D. Spring Review of Small Farmer Credit, Vol. VI, Washington D.C. 1973.

public credit programmes exist the target group would have made the same investments (although sometimes at a slightly later date) using other means of financing. An investigation commissioned by The World Bank brought some interesting results. The average level of substitution in the five credit programmes examined amounted to 40 percent. Not only the level but also the kind of substitution is revealing. Surveys conducted among the farmers sponsored showed that almost 50 percent of such substitution took place in favour of the farmers' own resources. This percentage ranges from 33 percent in Mexico to 83 percent in Pakistan. Credit from commercial banks and dealers is a further important alternative source of financing ⁶.

In view of this situation there can scarcely be any doubt that in the agricultural investment phase considerable importance is attached to the farmers' own resources as the risk-bearing capital, while outside capital assumes more the role of supplementary financing and a guarantee of liquidity. This qualitative valuation of outside financing has significant implications for the banking services offered. During the consolidation period of the agricultural investment phase, the smallholder needs forms of financing which are not statically bound to specific balance relations but are geared to the optimization of entrepreneurial potential while safeguarding its risk-oriented liquidity and financial stability. This aspect is often overlooked, e.g. when the financing of consumer expenditure is prohibited.

4. The Setting up of a Closed Rural Credit System

The task of the rural finance markets is to provide members of the rural economy with means of payment and all the banking services connected therewith at the least possible expense to the overall economy and in accordance with local economic, social, and sociopolitical aims. Such money market measures seek to render rural finance markets independent of state and foreign capital flows and

⁶ The World Bank, « Operations Evaluation Report: Agricultural Credit Programs », Vol. II, Washington D.C. 1976, p. 59.

to assist them in their development into net capital surplus markets as smallholders advance along the path of financial development. The measures required as regards money market and banking system should be designed to set up and consolidate circulation of capital which is endogenous to the rural economy and the rural banking system. A rural credit system, the essence of which is such an endogenous circulation of capital, is designated as a closed credit system. The basic elements of the closed rural credit system are shown in Figure 3. The unbroken arrows indicate endogenous capital flows and the broken arrows exogenous capital flows, i.e. capital flows which are directly channelled by the government via the central bank. The thickness of the arrows indicates the breadth of the capital flow. The dotted arrows indicate nonbanking services.

In view of the poorly developed financial spread-effects, i.e. the low establishment rate of finance agents in rural areas, an endogenous circulation of capital necessitates a strengthening and stabilization by financial instruments. The introduction of savings insurance schemes can reduce the risk to the saver as well as to the bank holding the savings. Rural savings programmes must be conceptualized on an integrated basis — they must be closely linked with accompanying credit and insurance schemes and they must afford the savers the opportunity to participate in the management of the banking institutions and in credit programmes refinanced with their own savings. Such an approach encourages the establishment of all-purpose banks as well as the development of private sector banks. On the credit side a need exists for twofold credit risk transformation — as much for the lending bank as for the recipient smallholder — as the efficient circulation and intensification of the endogenous capital flow is ultimately dependent on a continuous and stable capital service capacity on the one hand and the inclination to save and the scope therefore among the rural population on the other.

The closed rural credit system is characterized by a centralized agricultural credit policy implemented by the central bank and a decentralized gathering, transformation, and transmission of capital undertaken by largely autonomous units within the banking system. This credit system exerts an integrating influence on the rural banking systems. Table 1 shows the most important promotion areas, promotion objectives, and promotion measures in the development of closed rural credit systems.

Figure 3: Closed Rural Credit System

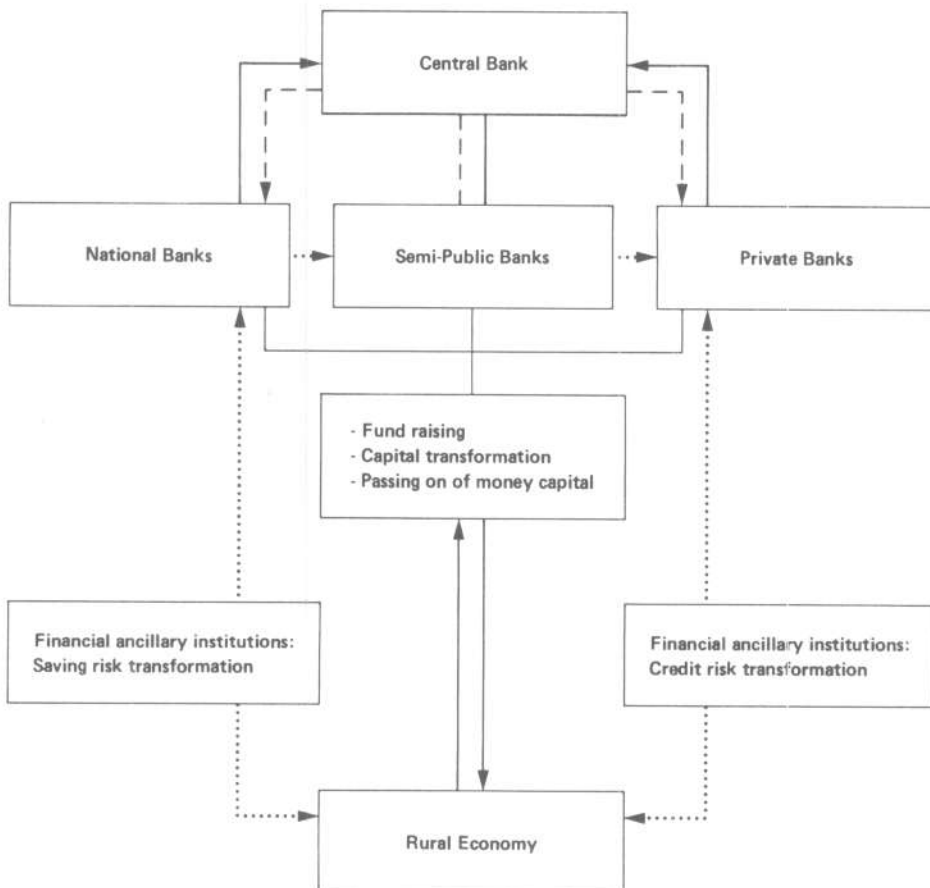


Table 1

PROMOTION AREAS, AIMS AND MEASURES IN THE DEVELOPMENT OF CLOSED RURAL CREDIT SYSTEMS

AREA	AIM	MEASURE
Rural financial market policy	Rural financial markets with a net capital surplus	Interest rates in line with actual scarcities and the opportunities offered by the economy; promotion of savings and indirect finance systems; supply of universal bank services
Legal form of banking institutions	Strengthening the private financial entrepreneurship by pluralization of the banking system and by a decentralized system of decision-making	Coordinated cooperation of public and private banks; promotion of the economic attractiveness of rural banking; establishment of financial ancillary institutions; elimination of functional and institutional discriminations
Type of bank	Offer of a bank services package with corresponds to the changing needs of the rural population	Set-up of multipurpose banks or multipurpose banking systems
Structure of banking system	Strengthening the integration of rural financial markets to widen their endogenous capital flow	Horizontal and vertical diversification of the banking system; decentralization of the banking system through branch and correspondent banking; intensifying the information flow for financial decision-making
Integration of unorganized creditors	Use of capacities and possibilities of unorganized credit delivery systems	Use of unorganized lenders as credit agents between organized creditor and rural borrower; use of rotating savings and credit associations
Financial technology	Financial technologies on the part of banking institutions which conform to the non-financial technologies of the rural population	Link small savings with credit programmes; base credit-decisions on the clients' cash flow analysis; credit delivery through credit groups to reduce loan transaction costs and to strengthen farmers' decision participation; credit guarantee associations; crop insurance system
Participation of rural population	Achieving fit between the differing social patterns of lenders and borrowers	Information feedback from the rural borrowers themselves; supporting farmer organizations as a complementary activity; planning with the people
Coordination among institutions	Removal of organizational development bottlenecks	Reshaping organizational structures (input supply, marketing, agricultural extension, agro-service centres, rural works programmes etc).

5. Institutional Implications

The above reflections on rural financing behaviour and the structure of rural banking systems have revealed a number of conclusions. The need for banking services and for its structure change in line with advancing socioeconomic development. This is especially true of the relationship between rural saving and credit possibilities. On account of differences in sociocultural situations and natural circumstances, smallholdings can in no way be described as a homogeneous economic group. Even in a comparatively small area, smallholdings which can be classified as net savers (financial surplus units) are found to exist alongside smallholdings which can be classified as net credit receivers (financial deficit units). It is the task of the rural banking system to reconcile in the most efficient way possible the rural saver's investment wishes with the credit needs of farmers wishing to invest in their holdings ⁷.

This function of reconciliation will be discharged all the more efficiently once the institutional agents within the rural banking system become multipurpose banks in the sense of both savings and credit banks or cooperatives. This observation does not imply that a smallholder is obliged to save a set sum before being granted a credit allowance which is dependent on the sum saved. Its essential implication is that the credit sums made available can be refinanced to a greater extent than in the credit strategy described above from funds which are raised by people with whom the credit recipient feels himself to be socially and economically bound.

Another point for consideration is the question as to whether rural finance intermediaries should limit their activities exclusively to savings and credit operations transacted in cash. In both the development phase in which the monetization level is low and very often in so-called unorganized credit sectors, cash and noncash transactions are very closely interlinked. If an organized financial intermediary wants to break into this transaction system, then it is as much in its own interest as in that of its rural customers that it can offer at least the same servi-

⁷ See, e.g. M. Masini, « Appropriate Technologies and Financial Development in the Rural Areas of Developing Countries », *Confederation Internationale du Credit Agricole, Sommaire*, XXVIII e Année, September 1978, No. 58, pp. 35 - 37.

ces packages as its unorganized competitors (moneylender, dealer etc) ⁸ Newly established financial intermediaries in rural areas of developing countries should be oriented less towards examples operating in well-functioning economic systems of highly industrialized countries; they should instead incorporate as many of the traditional local forms of credit provision as possible.

NECESSITE DE DISPONIBILITE DE CREDIT POUR L'ENCOURAGEMENT DU DEVELOPPEMENT

SOMMAIRE.

Dans un grand nombre de pays en voie de développement on attribue une grande importance, dans le cadre du développement agricole, à l'accord de crédits aux petits holdings. Cela est dû fondamentalement à deux raisons. La première est que l'on retient qu'un accès inadéquat au crédit conduise à un embouteillage critique dans l'adoption d'équipements opérationnels et de technologies de production modernes. L'on retrouve cette même conviction dans de nombreux plans de développement. La seconde raison, étroitement liée à cette conviction, est la croyance que les marchés de crédit agricole, contrairement aux autres, peuvent être facilement administrés de façon à s'aligner aux politiques gouvernementales de développement et que les effets négatifs sur la main d'oeuvre agricole et sur les marchés fonciers peuvent être de cette façon éliminés. Compte tenu de ce qui précède, on retient que l'accord de crédit à l'avance stimule la demande de crédit de la part des petits holders et que la demande induite de crédit est l'expression d'une exigence de crédit de la part des petits holders dans le but d'augmenter les revenus agricoles et le bien-être agricole en général.

Sur la base de ces convictions les Gouvernements ressentent la nécessité de promouvoir directement l'accord de crédit à des taux d'intérêt souvent lour-

⁸ B.M. Desai, « Formal and Informal Credit Sources in Tribal Areas: A Case of Dharampur Taluka », Artha-Vikas, Vol. 12 (1976), No. 12, pp. 1 - 18.

dement financés. L'ensemble des instruments normalement utilisés est très composite allant de l'allocation de fonds provenant du budget national, au moyen de l'institution de fonds séparés de refinancement à la banque centrale, à des obligations imposées au secteur bancaire privé pour allouer des fonds en faveur de crédits. La caractéristique commune de toutes ces mesures est leur financement extérieur. Le terme « extérieur » indique ici que les fonds considérés ne sont pas des fonds de refinancement recueillis à l'intérieur du secteur agricole mais plutôt des fonds canalisés dans ce secteur du dehors.

La question qui se pose à ce point est si la méthode ci-dessus décrite peut satisfaire d'une façon réelle les exigences de financement des petits holders et, par extension, si elle correspond effectivement aux objectifs de développement agricole pour ce qui a trait à l'amélioration des revenus des petits holders. Puisqu'on ne peut répondre à cette question que d'une façon à moitié positive, la question qui suit concerne les mesures à prendre pour s'approcher d'une manière vraiment concrète des objectifs prévus.

