

Savings and Development



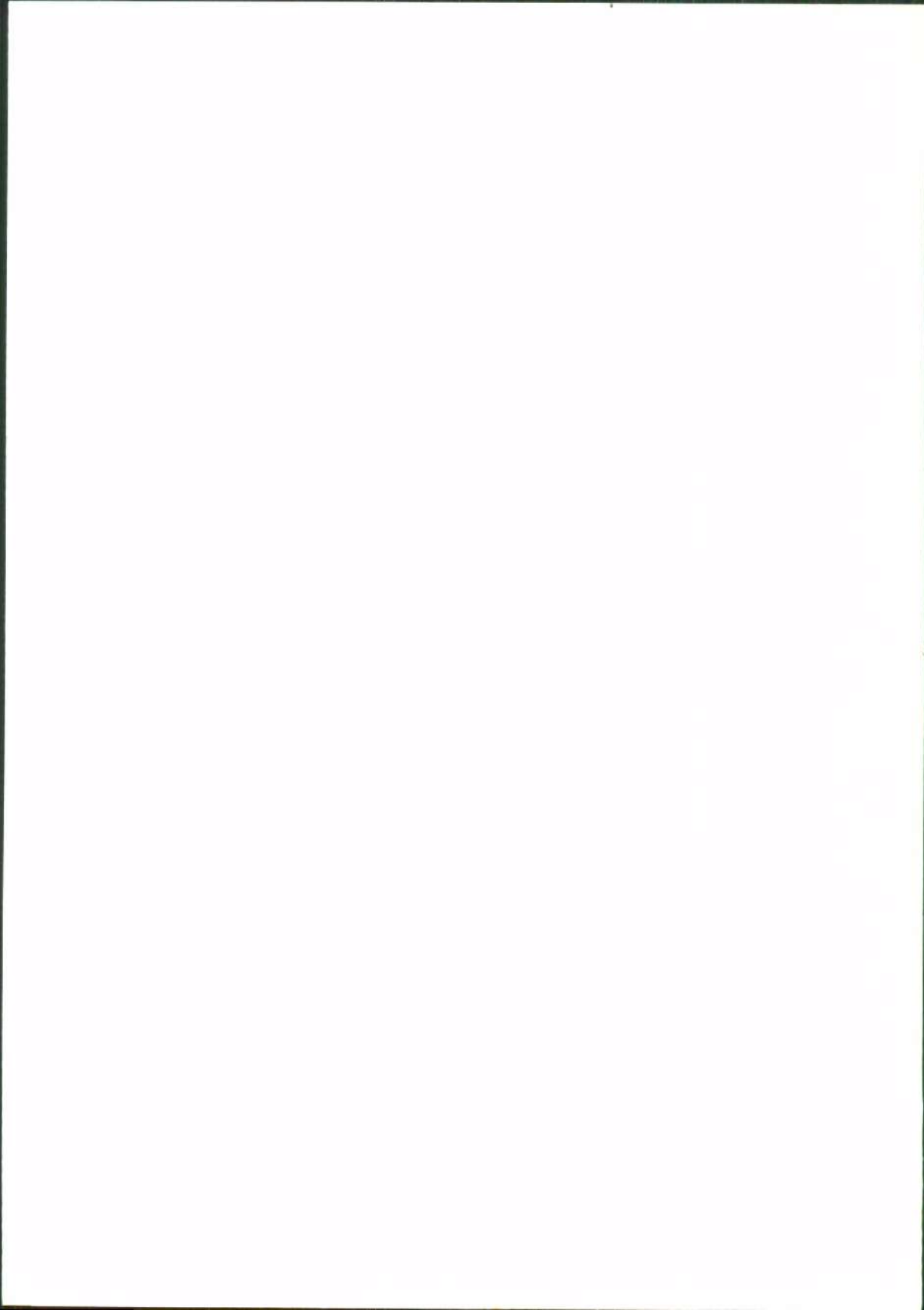
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Centre for Financial Assistance to African Countries

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Quarterly Review - No. 1 - 1986 - X



Savings and Development

Editor

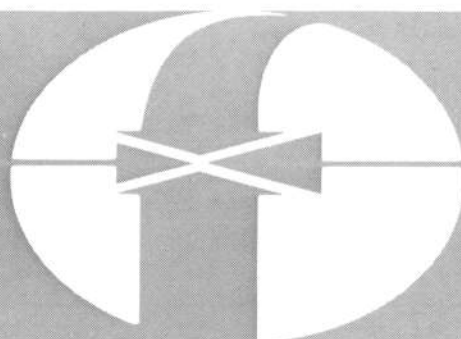
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AGRICULTURAL CREDIT POLICY IN DEVELOPING COUNTRIES *

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1. Introduction

Agricultural credit is regarded as an important instrument of economic policy in most market-oriented developing countries. Credit is used in efforts to stimulate development in a direction considered desirable on economic and social grounds. Unfortunately, results of conventional agricultural credit programs have seldom measured up to expectations. Their effects have generally been overestimated by evaluations that ignore the way rural financial markets work. This is especially apparent where agriculture is characterized by small farms, as in most developing countries.

Commercial banks and many other credit institutions are not well adapted to financing agricultural development, leading many governments to create and fund state or quasi-state agricultural credit agencies to implement their credit policy. These lenders are intended to guide the scope and direction of on-farm investment. They also serve as channels for funds supplied by bilateral and multilateral development assistance agencies. Some governments also try to influence traditional informal rural financial markets, and to create farmers' self-help organizations to provide a better supply of credit to small farmers. This process is still at an early stage.

2. Conventional Credit Policy Role and Objectives

The agricultural credit policy of many developing countries was first framed as part of colonial economic policy. The main goal was to promote commercial production to supply the colonial power, as exemplified by the tropical plantations of trading companies. Credit for this purpose was supplied by metropolitan financial markets. Farm production for local markets got hardly any credit support, except through traditional sources.

Some colonial powers attempted to influence traditional financial markets by, for example, prescribing interest rates (India), licensing moneylenders and forbidding the mortgaging of land (Malaysia), or indirectly by excluding native farmers from formal borrowing altogether (East Africa). The principles and mechanisms of state intervention in

* The views and interpretations in this article are those of the authors and should not be attributed to the World Bank, to its affiliated organizations or to any individual acting in their behalf.

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rural financial markets established in the colonial era have influenced the post-independence credit policies of many developing countries.

In newly independent states credit policy has often been reoriented toward promoting food self-sufficiency, acquiring foreign exchange and creating jobs. This change in policy was not necessarily opposed to the interests of the former colonial powers and for that reason was usually supported by them; in particular, trained personnel from those countries continued for some time to occupy key positions in the private economy, and even in government agencies.

The previously neglected production for local markets was emphasized as a new area for intervention with the objectives of stimulating the introduction of modern techniques and feeding the population from domestic production. This was viewed as necessitating institutional credit and led to the establishment of new farm credit institutions. Extensive state-subsidized agricultural credit programs were implemented through these institutions.

This early approach brought only limited results and left the mass of the farming population practically untouched. These realizations led to changes in agricultural credit policy, with credit viewed as an integral part of a complex of measures to promote development. Supervised credit was a first step in this direction. It combined extension and credit services. To this were later added input supply and marketing, two commercial services that were perceived as not being adequately available in the private sector of most developing countries. In this view, they had to be provided and integrated with extension and credit to obtain a breakthrough in farm production.

The concept of the integrated rural development project evolved from experience with the provision of these four services. But through the addition of other services, especially non-agricultural ones such as education and health, integrated rural development projects often became very complex and required sophisticated management. As a consequence of experience with these projects their concept appears less appealing, although the importance of linking extension, credit, input supply and marketing remains valid.

3. Credit as an Activity of Rural Financial Markets

Conventional approaches to agricultural credit policy considered only the demand for funds and overlooked the supply of savings. Most of the newly created credit institu-

tions typically did not accept deposits, but were only retailers of state loan funds. To a significant extent these funds have been raised through international financial assistance on terms and conditions that — relative to commercial sources — are favorable to borrowers. The conventional approach not only overlooked rural savings potential, but in emphasizing cheap credit based on foreign aid and treasury subsidies undermined the will to save (3)¹.

More recent approaches to agricultural credit policy seek to activate rural savings potential and to take the noninstitutional aspects of saving and credit into account. But thus far little is known about the functioning and potential of rural financial markets. Prejudices dominate public opinion, such as the notion that rural moneylenders charge unreasonable rates of interest. Research findings indicate that many farmers are not at all better served by state credit institutions, and therefore continue to deal with moneylenders (4).

Also, little is known about rural savings potential. It may be assumed that this potential is considerable (3), for the seasonal nature of agricultural production suggests that farmers have liquid reserves between harvests (48). Moreover, fluctuations in crop yields from season to season are surely an incentive to build up reserves. Research is beginning to address this question, and agricultural credit policy will certainly be influenced by the results.

4. Credit Delivery Systems and Their Problems

Since small farms dominate the agrarian structure of most developing countries, the principal task of agricultural credit policy is to provide a large number of small farmers with credit. This task is especially difficult because the cost of providing credit is independent of the amount of the individual loan. The smaller the loan the higher the interest rate required to cover the lenders' costs. But since interest rates on institutional credit are prescribed by the state in almost all countries, the banks' desire to do business with small farmers is understandably slight. In addition, small farmers often lack registered property rights and cannot secure loans by mortgages. This limits their access to medium and long-term credit, but they rarely even qualify for short-term

1 Numbers in parentheses refer to items listed in the bibliography.

credit. The question may therefore be raised whether credit extended selectively is an adequate strategic basis for achieving objectives defined in terms of broad popular participation. Credit is the most exclusive device among the conventional instruments of rural development policy. Medium- and long-term loans generally involve an especially thorough examination of the applicant and his situation, and hence are especially exclusive.

Creditworthiness is generally regarded as a function of ability and willingness to repay. Ability is ordinarily measured against two criteria: (a) the value of the security offered, and (b) the increased income available for loan repayment. Both include a margin to cover estimated risk. If tangible security is given priority, credit allocation tends to contribute to preserving the *status quo* of wealth and income. On the other hand, if the estimated increase in income has priority, it may be possible to promote the development of less wealthy but managerially competent, technically progressive farmers.

Whether the estimated increase in income will suffice to cover the debt service as well as the borrower's increased consumption expectations depends in part on loan repayment terms. At a given interest rate the annual debt service is lower the longer the term of the loan. An effective lending policy must therefore include realistic criteria for establishing repayment terms.

4.2. *Forms of loan security*

The lack of tangible security is often regarded as an obstacle to agricultural credit programs for small farmers. This obstacle usually arises from the absence of registered land titles or tenancy contracts. But even where owners and lenders' claims may be registered, laws or procedures that make registration or foreclosure difficult can also impede the flow of credit. In India, restrictions on creditors' rights kept the banks from lending to small farmers (8; 33). Even when no legal restrictions exist, banks are often cautious about extending mortgage loans to small farmers because of the risk that the auction of defaulters' farms may be boycotted.

When the estimated increase in income is used as a major criterion of creditworthiness, tangible securities are generally disregarded or at most required only to prevent the acquisition of additional debts. The prerequisite is a relationship of trust between creditor and debtor and the creditor's access to other means of collecting debts. These include standing orders and instructions with produce buyers to remit delivery proceeds to the lender, and effective legal recourse against defaulters. These conditions often do not exist in state credit programs, which may help to explain their failure.

Intangible sureties such as guarantees by third parties can be especially useful in agricultural credit. Even when the estimated increase in income available for repayment is the most important criterion of creditworthiness, the creditor may still seek security to safeguard his position. The corporate liability of groups and associations is especially interesting as a means of enhancing credit access, as discussed later in this paper.

Insurance may also be used as loan security (31; 41). One of the biggest agricultural banks in South America, the Caja Agraria in Colombia, includes a life insurance policy in its loan contracts. For a premium of one percent added to the interest rate, the loan balance is repaid by the insurer if the borrower dies. Crop insurance and livestock insurance are also used to protect both creditor and debtor against damage and loss. The premiums necessary for all-risk coverage are so high, however, that they must be subsidized in order to be attractive to farmers. In Mexico the estimated risk of 13 percent is borne half by the farmers and half by the state. In Kenya the government has attempted to promote large scale maize and wheat production by a subsidized guaranteed minimum return sufficient to repay operating capital loans for qualified growers of these crops. Although combining insurance with credit could assist agricultural development, the costs associated with risk assumption may be high and the performance of all-risk programs in most developing countries in which they have been tried has not been encouraging.

4.3. *Control of credit use*

Institutional credit in agricultural development programs is often intended by lenders to be used only for specific purposes regarded as especially worthy of encouragement. This limitation is intended to prevent state funds from going unproductively into consumption, and is enforced by inspections, loan documentation procedures, and by furnishing inputs in kind.

Superficially these controls often appear effective. They cannot, however, prevent farmers' from using their own funds, which would otherwise have been used for the purpose for which the loan was taken, for other purposes including consumption. The fungibility of financial resources — often overlooked in agricultural credit policy — sets fairly narrow bounds to the control of credit use and impact (50).

It is also questionable whether financing consumption on small farms is necessarily unproductive, since farm and household form an integrated whole. The subsistence of

the family is essential to maintaining production, and vice versa. Consumer credit for small farmers, provided primarily by informal rural lenders, can in effect be productive.

4.4. *Viability of credit institutions*

It is relatively expensive to provide credit to small farmers, and there are few examples of formal credit institutions that are financially successful in this field. (The low-interest rate policy of most governments contributes to this lack of viability.) As a rule such institutions need other sources of income, such as loans to large enterprises or trading in agricultural equipment and products, to remain financially independent (12). While the administrative cost of lending (not counting the cost of capital) often runs between 15 percent and 30 percent of loan balances outstanding and sometimes even more (53), the interest rate is seldom higher than 12 percent. In addition there are losses due to non-repayment of loans that may amount to more than 20 percent of funds loaned and occasionally exceed 40 percent in the case of state credit agencies. These losses undermine the viability of many agricultural credit institutions and could lead to their ruin if governments did not intervene and provide liquidity out of public funds.

Credit institutions that have financial difficulties are not in a position to attract deposits, and generally they do not even offer this service. If they had to pay interest and bear the administrative overheads of savings deposits, their costs would be still higher, for the funds supplied from the national treasury or through the central bank are ordinarily available at low cost. International development aid for agricultural credit channelled through this type of system contributes to preserving a mechanism that neglects the savings potential of the rural population.

4.5. *Credit coordination*

Coordination of agricultural credit with other services has been found necessary and useful. These services include agricultural extension, provision of inputs, and marketing and processing of agricultural production. From the technical point of view the advantage of coordination lies in the fact that the goods and services necessary for productive use of credit are available in sufficient quantity at the right time, and that no bottlenecks develop in marketing the increased production. From the financial point of view the credit institution's risks are reduced by this coordination, which also helps to ensure loans will be used for the purposes for which they are advanced.

Under certain conditions the integration of credit with other services may be expedient. In Malawi each regional development project has a credit division that operates hand-in-hand with the extension division and the marketing and input supply organization; there is no national agricultural credit institution. In Ethiopia (before the revolution of 1974) the state agricultural bank had turned over small farmer credit and its risks to the nationwide « Minimum Package Program », but made available funds for lending and offered legal facilities for debt collection. In these two examples loan repayment rates attained far higher levels than in most countries with unintegrated programs.

In Malawi and Ethiopia the impulse toward integration came from extension. In other countries credit agencies have taken the initiative of incorporating the services that were not adequately available to farmers from other sources. In numerous cases government credit institutions supply seed and fertilizers, and some even provide farm machinery. The stimulus for integration of credit and marketing is explained by the opportunities for profit it offers, especially when the government gives the credit agency monopoly trading or import rights. Losses in lending can be offset by profits from trading; but what this amounts to is that farmers fund interest subsidies and cover the high costs of small loans by paying high, monopoly prices for inputs or machinery. Farmers who take no loans and pay cash must also pay these high prices, which of course reduces the incentive to pay cash. In some cases bank managers who were astute businessmen have extended their trading activities to the point where credit has become a sideline. But the exploitation of monopoly trading or artificially restricting the link between credit and trade is questionable agricultural credit policy.

Private banks play little direct part in the integration process, because they concern themselves with loans to small farmers only marginally or not at all. A parallel involving some private enterprise is to be found only in multipurpose farmers' cooperatives which combine lending with input and equipment supply and the marketing of agricultural products. These are discussed below.

5. Farmers' Self-Help Organizations

Side by side with moneylenders and state credit agencies, farmers' self-help organizations have an important function in small farmer credit. They range from RoSCAs to large, modern cooperative structures that include a banking system. The transition

from noninstitutional to institutional credit is blurred here, as is the transition from independent private forms to state-influenced organizations.

5.1. *Cooperative development*

Industrial market economies formerly characterized by a preindustrial small-farm agricultural structure, such as Japan and the Federal Republic of Germany, have to a great extent developed their agriculture by means of cooperatives. Cooperative credit has played an important part in this process, based on the savings of cooperative members and on cooperative liability for external borrowing. The role of the state was restricted to providing a legal framework and retaining the right of supervision. Along with savings and lending cooperatives there arose input supply and marketing cooperatives, dairy and other processing cooperatives, and also multipurpose cooperatives combining several of these services. They were the engine of development in credit and marketing in the small farm agricultural system. With industrialization they have not lost, but rather strengthened their dominant position.

The success of cooperatives in industrialized market economies led to their introduction in the developing countries. The legal foundation for modern cooperation was often created in the colonial period; in India in 1904, for example (37; 55). In many countries, however, active efforts to organize small farmer cooperatives did not occur until after independence, and have produced only limited results. Exceptions are the Republic of Korea and Taiwan, where farmers' cooperatives have attained a strong position similar to those of cooperatives in industrialized countries.

It is unrealistic to assume that rural moneylenders, private banks, and state credit institutions in most developing countries will be in a position to perform the role that cooperatives have played in the successful development of small-farm agricultural structures in Europe, Japan, Taiwan and the Republic of Korea. There is no precedent to suggest that a small-farm agricultural structure can be developed without an effective system of cooperatives. Accordingly the reasons for failure of cooperatives in developing countries raise important questions.

5.2. *Causes of failure*

The possible causes of cooperative failure in many developing countries are suggested by comparison of their beginnings with those of agricultural cooperative movements in industrialized countries. The first savings and loan societies established by

Raiffeisen in Germany followed the principles of small membership, simple field of activity, honorary (volunteer) management, and unlimited liability (37). It was only with the extension of cooperative self-help to input supply and marketing that larger cooperatives gradually evolved, with full-time, paid management and limited liability. The movement derived its initial strength from the spontaneous initiative of farmers, the desire to save, and the willingness of leading local personalities to donate their time and skills as unpaid managers.

In most developing countries, on the other hand, the state thought that it had to seize the initiative and unite the farmers in cooperatives. The model generally adopted was the big, multipurpose cooperative with professional management, offering marketing and input supply as well as financial services. But bigness precludes management from working directly with most of the members at the level of the primary society, and as a consequence no personal relationship of confidence develops between manager and members. In credit cooperatives, this impersonal organizational form often fails to stimulate either the inclination to save or a sense of obligation to repay loans, and may be accompanied by mismanagement and corruption. (Cooperatives that process and market export crops are often exceptions. They usually have a large enough turnover to remain financially stable, and members' loan repayment is often effected by deductions from their crop delivery proceeds).

Credit cooperatives are often kept alive by the state through subscriptions to their capital stock and by involving them in subsidized loan schemes. They thus may become implements of the state and subject to political influence. These captive cooperatives hardly differ from state rural credit agencies and exhibit the same characteristic shortcomings; low levels of savings deposit mobilization, lax credit morality, and poor loan collections. These problems generally make it impossible for them to provide credit to more than a small fraction of small farmers.

5.3. *Development of precooperative structures*

Failures have led to new approaches to cooperative development in a number of countries. In particular it has been realized that too much has been attempted in too short a time, and that the initiative for self-help must come from the farmers themselves. Some planners have examined cooperative features of existing rural social orders, which has led them to adopt Raiffeisen's early principles of small membership, limited field of activity and volunteer management.

In agricultural credit policy in developing countries the main objective has often consisted not in creating the financial basis for credit through mobilizing savings deposits, but in finding an effective credit delivery system which can provide a large number of small farmers with credit at relatively low cost. Thanks to international aid oriented toward rural development, there is generally no shortage of resources for the establishment of a credit program. However, these funds are often exhausted by inefficient distribution which results in high costs, including those arising from slow loan repayment and bad debt losses, not covered by interest income.

The requirements for an improved system, therefore, are low distribution costs and high rates of repayment. One solution for this problem is sought in group credit, in which a group of farmers unite for joint borrowing and are responsible as a group for repayment. Group credit is being introduced in an increasing number of countries, but with varying degrees of success (5). It performs especially well in Malawi, where the previous cooperative system had completely broken down. This example suggests that cooperative performance depends less on the mentality of the farmers than on the system.

Credit groups in Malawi are formed to obtain production credit, principally for seed and fertilizer which is delivered by the input supply monopoly to a location specified by the group. Groups consist of about 20 to 30 farmers, including three in managerial positions who are elected by the members and serve without pay. There is no difficulty finding capable people for these positions.

Groups are formed anew each year before loans are contracted. Loan documentation involves a credit contract signed by all members which specifies loan terms and conditions, including the details of the group's corporate liability. Permanent credit groups were originally planned, but annual reformation was found to be advantageous, permitting members an opportunity to manage default risk by adjustments in group composition. Individual groups have tended to concentrate in an increasingly smaller area, often a village or, within a village, in one family group. This flexibility strengthened group cohesion, reduced risk, and facilitated management. From 1973, when group credit was adopted in the Lilongwe Land Development Project, until 1978 the number of groups grew to over 1,200 including more than 28,000 farmers. Two thousand groups could have been formed in 1979 if a bottleneck had not developed in the importation of fertilizer.

Group credit competed with individual credit in the Lilongwe Project. Loans directly to individuals expanded, but their volume was far outstripped by group credit. The chief attraction of group credit for the farmers was the interest rate of 10 percent against 15 percent on individual credit, and an additional attraction may be that the transaction costs of group credit are lower.

To provide some loan security and to help ensure that applications are bona-fide, credit groups in Malawi must deposit an amount equal to 10 percent of their loan in a guarantee fund. If the loan is not paid back in full, the loss is charged to the guarantee fund. The fund balance with interest is distributed to the members when loan collection activities are completed. In four of the first five years of group credit operations the repayment rate was 100 percent. Only in one bad year was there a loss, equal to about one percent of the loans issued.

Group credit in Malawi was preceded by group input supply. The state trading monopoly offered a discount on purchase of fertilizer by the truckload plus free delivery to the location specified by the buyer. These terms led to the spontaneous formation of purchasing groups all over the country and prepared the ground for group credit. Other beginnings of group credit come from group extension based on farmers' clubs, or from group marketing as in Niger.

Rotating savings and credit associations are also interesting as a preliminary stage of cooperative development. They are scattered over many developing countries (10; 26) and demonstrate that even small farmers with low and irregular incomes are capable of making regular payments into a common fund. These associations do not suffer from political meddling; they exhibit high payment morality and are flexible. They have demonstrated that they can survive and co-exist with official credit institutions.

These examples show that farmers in developing countries can get together voluntarily if they expect a solid advantage to result. Groups of a small size can be managed by leaders among the members at no direct financial cost. The parallel with the early Raiffeisen cooperatives is unmistakable. The evolution of these types of groups into modern cooperatives with more complex functions should therefore be possible. Even if this does not occur rapidly, RoSCAs are an appropriate part of a credit system serving a developing small farm agricultural structure. Agricultural credit policy should recognize the contribution of RoSCAs and provide an institutional basis and incentives for the development of financial mechanisms for small farm rural structures.

6. Agricultural Credit Policy Instruments of the State

6.1. *Making Resources Available for Lending*

Private banks in most developing countries have little interest in agricultural credit and seldom participate in credit programs for small farmers; their resource mobilization function often does not greatly benefit rural financial markets through direct provision of loanable funds. On the other hand, many state credit institutions are not in a position to attract savings deposits. Rural cooperatives, too, often neglect savings. Agricultural credit programs thus largely rely on government funds. The power to provide resources for lending is a very effective instrument of state credit policy, and governments increasingly draw upon international capital aid to obtain funds for the purpose. By mid-1979 the World Bank had lent about \$2,400 million for agricultural credit projects². In addition, the International Fund for Agricultural Development (IFAD) and regional development banks, such as the Inter-American Development Bank, the African Development Bank, the Caribbean Development Bank and the Asian Development Bank, are active suppliers of funds for agricultural credit. The various Arab development funds, the European Investment Bank, and the bilateral development agencies also support rural credit projects.

Development assistance was initially almost exclusively limited to funding medium and long-term loans to farmers, as it was believed that only these types of loans served development. Short-term lending, if provided at all, was left to the governments of recipient countries. This often resulted in no short term facilities for farmers participating in agricultural credit programs. However, medium and long-term loans supporting investments in livestock, mechanization and land acquisition, for example, generally create a demand for short-term credit to fund increases in working capital. Programs not offering complementary short-term funds often suffered quite decisively from this omission.

When new seed and fertilizer technology triggered the « Green Revolution » in the 1960s the importance of working capital for the development of small-farm operations was confirmed. International development aid has responded by increasing the funds available for short-term credit.

2 By mid-1985 cumulative total commitments for agricultural credit projects exceeded \$ 6,095 million (The World Bank Annual Report 1985, p. 166-167). This figure and that above presented in the German original exclude credit components of other types of agricultural and rural development projects, understating Bank involvement.

The original restriction of international capital aid to the foreign exchange costs of an agricultural project has gradually been removed, for agricultural development requires relatively little foreign exchange. Foreign exchange costs are steadily decreasing in many countries as imports of farm machinery, fertilizers, and plant protection materials are replaced by local production.

Rediscounting of agricultural loans is widely used to increase the supply of funds for agricultural lending. Public funds for rediscounting are provided either directly in the budget or through the central bank, and international aid is also often channeled through this mechanism. Low discount rates are supposed to enable farm lenders to strengthen their capital and reserves or to finance credit programs at cheaper interest rates than would otherwise be possible. However, these lenders are often compelled to finance government programs having costs that far exceed the margin of profit even at low rediscount rates, and formation of capital and reserves too seldom occurs.

Nor does central bank refinancing stimulate farm lenders to mobilize funds by offering farmers saving deposit facilities. Access to cheap central bank funds may actually lead banks to use their resources for other purposes, and the supply of agricultural credit fails to increase (1). Schemes to facilitate rediscounting may lead to perverse results in terms of agricultural credit policy.

To increase agricultural lending by private banks, governments of many developing countries have established loan quotas prescribing that a specified percentage of each bank's total lending must be for agricultural purposes. Such provisions, however, are often evaded by ascribing to the quota loans that only marginally have anything to do with the rural sector. Banks that are active in agricultural finance may also sell loans exceeding the quota to banks not able to meet the quota, often just for the reporting date. If additional resources are actually directed into the rural sector by quotas, other sectors are deprived of these resources. The economic costs of this deprivation are almost never measured.

A number of developing countries have nationalized private banks and redirected their lending towards agriculture and other « priority » sectors, as in India (6). While priority lending targets have usually been attained, the damage done elsewhere from crowding out non-priority sectors remains to be investigated. Problems associated with forced lending suggest that real economic incentives are probably more effective than coercion by the state.

6.2. *Regulation of Interest Rates*

A widely used instrument of agricultural credit policy in developing countries is regulation and control of interest rates. By differentiating rates according to the purpose for which credit is issued, governments attempt to promote certain investments and lines of production. As a rule, the interest rates prescribed for agriculture are low in comparison to those in other sectors of the economy. Controlled agricultural rates are also low in relation to the economic value of capital and the costs of providing credit. Often they are even lower than the inflation rate, or negative in real terms.

The grounds for low interest rates are numerous. The notion is widespread that investments in agriculture do not produce a high yield, requiring cheap credit to encourage innovation. It is also believed that poor farmers cannot afford high interest rates. These stereotypes and assumptions are supposed to apply particularly to small farms and small farmers, many of whom are assumed hardly to have shared in technical progress and to be exploited by moneylenders. Others believe that low interest rate policy is traceable to the political influence of the rural elite, who profit from cheap loans. International capital aid is said to support this policy intentionally or unintentionally when it provides funds on concessional terms.

Critics of cheap credit point out that interest is only a small part of the cost of borrowing. For small farmers in particular, the transaction costs of getting official credit are usually far higher than the interest charge. And, measured against the total costs and projected results from credit use, the difference between high and low interest rates is often insignificant. From fertilizing, for example, small farmers commonly expect an average increase in revenue, from higher crop yield, that is twice as large as the costs of fertilizing (i.e., a 100 percent return). In these calculations the difference between interest rates of 8 percent or 16 percent for a fertilizer loan is hardly material.

Experience also teaches that interest subsidies often have effects opposite to those intended. This is especially obvious in the case of subsidized loans to promote small farm development. According to various studies these subsidies can easily fall into the hands of big farmers (21). On the demand side this is due to the fact that with low interest rates large farmers' investment opportunities increase greatly, including those outside farming, such as in urban property. Large farmers may use the low-interest funds for farm investment they would have undertaken without the loan, leaving their own funds free for investments off the farm. On the supply side large farmers may command preference because they offer better security and because large loans in-

involve economies of scale for credit institutions. These economies are especially attractive to lenders facing interest rate limitations that make it difficult for them to cover their costs.

Restrictions on credit use that give preference to small farmers cannot effectively break this « iron law of interest rate restriction » (21). There are many ways to evade such restrictions and to camouflage actual credit allocation, such as by issuing several small loans to different members of a large farmer's family. Where state regulations are in open conflict with economic forces, the latter often get the upper hand.

Paradoxical as it may sound, small farmers clearly have better prospects of getting credit when interest rates are high. High rates limit the big farmers' investment opportunities and restrict their demand for credit. Many small farmers are accustomed to paying moneylender rates that are far higher than the highest bank interest rates. They will seek bank credit if it lowers their credit costs. These costs can be reduced by simplifying loan application procedures, reducing queuing time, and providing timely credit. Group credit arrangements may reduce lending costs, and credit guarantees from group corporate liability, especially if supported by a guarantee fund, may also be helpful. Interest rates determined in competitive markets can assist banks to build up their capital base and attract savings deposits, so that a far wider circle of farmers can be provided with credit. Unfortunately, state credit institutions often exhibit the opposite behavior. Low interest rates destroy the capital base, while savings deposits are not aggressively solicited and would hardly be attracted at the prevailing interest rate, and so the sphere of activity of those institutions remains limited. In addition, there are often great bad debt losses. These reflect the fact that in the management of state funds the lender's caution in extending loans and the borrower's sense of obligation to repay are both often lower than would be the case if the savings deposits of customers were the source of loanable funds. It is increasingly recognized that the low interest policy does more harm than good to agricultural credit.

6.3. *Other Instruments*

Besides providing resources for lending and regulating interest rates, the state has a number of other instruments at its disposal that influence agricultural credit.

Subsidies are not only reflected in low interest rates, but also take the form of state subscription to the share capital of the agricultural credit agencies and free or low cost contributions to augment their liquidity when they get into financial difficulties. With the

support of international development aid these institutions are often provided with highly qualified experts for management, extension, and training, with little or no compensation required from the host government. In the long run these subsidies benefit the borrowers; the justification for accepting them is often stated in terms of helping the agricultural sector, especially the small farmers or even « the poorest of the poor. »

Institutional measures such as creation of state credit agencies, nationalization of banks, and encouragement of cooperatives have already been mentioned as possible instruments of agricultural credit policy. As has been shown, these interventions by the state may very well be two-edged. To these measures may be added state intervention in the provision of services that are directly or indirectly related to credit, such as extension, input supply and marketing of agricultural production. As with credit, state intervention in these related activities is less promising the more that market forces are excluded.

Since the lack of registered property rights often hinders medium-and long-term lending, efforts by the state in land survey, registration, and legal guarantee of ownership of real property can be favorable for agricultural credit.

Especially in Africa there is a lack of registered property rights because traditional law has not provided a basis for this type of ownership. As an example of changing approaches to land, Kenya has created good conditions for small farm agricultural credit by combining a nationwide land consolidation program with the registration of land titles. Such programs, however, may be costly.

7. Credit Policies of Domestic Financial Institutions

Although the state tries to control agricultural credit policy and specifies interest rates in great detail, individual credit agencies usually still have wide latitude to define their internal credit policy, especially in determination of creditworthiness and loan security requirements, and also in setting loan repayment schedules.

7.1. Loan Security and Determination of Creditworthiness

A conservative approach to creditworthiness is based on the value of the security offered by the bank client. In contrast to these asset-based lending strategies, a more

progressive approach uses the increased income expected from the loan - supported investment as the yardstick. The progressive approach, known as cash flow lending, assumes that the lender is in a position to estimate more or less accurately the prospective increase in income and the additional debt capacity it creates. This requires trained personnel familiar with the agricultural sector and with agricultural investment analysis.

Agricultural finance specialists can also counsel borrowers and protect loan quality by helping borrowers attain the objective for which loans are requested. In developing countries the provision of technical or extension advice with credit under a single program is known as « supervised credit » (40).

Banks can maintain an extension service when they are financing large enterprises capable of supporting the costs of extension. In lending to small farmers this is not possible, and banks must depend on the government extension service. In cooperation with this service they can lower the costs of credit provision by financing standardized combinations of inputs — such as one-acre packages of seed, fertilizer and pesticides — in what are called « package programs ». A still greater cost saving may be possible when banks introduce group credit combined with group extension.

Loan quality may also be protected when the processing and marketing institutions to which the borrowers deliver their products such as dairies or tea factories, are efficient and willing to cooperate with lenders. Loan repayments can be withheld by these institutions from the delivery proceeds due farmers and sent directly to the lenders, thus reducing administrative and bad debt costs. Economies of this type are common in cooperative credit linked with cooperative marketing channels.

7.2. Setting Repayment Schedules

Low interest rates enforced by governments often lead to counterproductive approaches to establishing other loan terms. For example, it is evidently believed in some circles that loans granted cheaply should be collected as soon as possible. This may help neither the bank nor the farmers. The bank's profitability is more closely related to the interest margin than to the term of the loan, and for the farmers the advantage of low interest is diminished if the annual amortization rates are high. The opposite policy would be more advantageous for both sides, as shown by a case study of the Economic Development Institute of the World Bank (54). This study demonstrates that longer term credit can be a more effective instrument of development than low interest

rates. Unfortunately, this is often overlooked. The state's low interest policy limits the use of this alternative, because low interest rates keep financial horizons short. Higher rates are required to compensate for the risks of longer term arrangements. Low interest rates easily produce deficits for banks and lead them to provide only a limited number of farmers with credit. Unfortunately, these characteristics are typical of many agricultural credit programs.

8. Prospects for Progress

If the success of agricultural credit policy is measured by the extent to which small farmers have access to institutional credit, the picture in most developing countries is not very encouraging. In spite of lending quotas the private banks can be brought to exert a greater influence often only at great cost. State agricultural banks, with few exceptions, have not achieved widespread effects in agricultural development, either. Credit cooperatives have either failed or, again with some exceptions, taken on the character of state credit institutions. The question thus arises of where to focus attention to make greater progress.

The few countries that have developed broadly based rural financial services are primarily those that have succeeded in building a workable farm cooperative system, such as the Republic of Korea and Taiwan. They are following the pattern of industrialized market economies that developed from a small-farm agricultural structure.

It is therefore in the cooperative sphere that new paths are to be sought. The flourishing of traditional rotating savings and credit associations and the success of certain group credit systems seem to point to a way that is not dissimilar from the beginnings of the European cooperative movement. State credit agencies may quite well play a part in this by, for example, encouraging and financing group credit. Direct interventions of the state in the cooperative system, however, can easily have more negative than positive long run effects. The initiative must come from the farmers themselves for self-help organizations to be successful. Creating the prerequisites and the necessary incentives for their initiatives is one of the most important challenges that confront the agricultural credit policy of developing countries.

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POLITIQUE DE CRÉDIT AGRICOLE DANS LES PAYS EN DÉVELOPPEMENT

RÉSUMÉ

Les insuffisances de la politique de crédit agricole se reflètent dans les mauvais résultats des programmes de crédit aux agriculteurs. Parmi les défauts couramment observés, on note le peu de cas qui est fait de l'épargne rurale et du rôle des systèmes de financement non structurés, et le recours excessif à l'Etat. Souvent, les programmes de crédit appuyés par les institutions d'aide au développement ne comportent pas de système de dépôt et sont assortis de taux d'intérêt peu élevés et subventionnés et de coûts dépassant leurs revenus. L'expérience contredit tout argument en faveur de

* Since the appearance of the original German version of this paper, a book of readings that contains excerpted versions of several articles cited in this bibliography has been published by the World Bank. Readers may wish to consult J.D. Von Pischke, Dale W Adams, and Gordon Donald, eds., *Rural Financial Markets in Developing Countries: Their Use and Abuse* (Baltimore, Johns Hopkins University Press, 1983).

l'octroi de crédit à bon marché aux petits exploitants. Les politiques de crédit axées sur un certain flux de trésorerie pour l'emprunteur, sur des taux d'intérêt réalistes et sur des conditions de remboursement appropriées et liées à des services de vulgarisation agricole offrent de meilleures chances de succès.

Les organisations d'auto-assistance entre agriculteurs se révèlent souvent inefficaces, surtout les grosses organisations complexes étroitement contrôlées par l'Etat. Les groupements précoopératifs de crédit organisés selon le modèle de Raiffeisen connaissent un certain succès, et les associations traditionnelles d'épargne et de crédit rotatifs paraissent solides. Les coopératives d'agriculteurs semblent être le type d'institution le plus prometteur et semblent être capables d'offrir les services de financement rural les plus larges, mais seulement si l'intervention de l'Etat dans leurs opérations est limitée.

