

FINANCIAL ACCESSIBILITY AND RURAL SECTOR DEVELOPMENT *

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1. Introduction

The lack of access to financial services is considered one of the major constraints to increasing investments and productive activities in the rural sector of LDCs. It is estimated that about 50% of rural households and micro-entrepreneurs may not have access to adequate financial services. Incidentally, the majority of the population in LDCs live and work in the rural areas. Of this, the greater majority are engaged primarily in agriculture, often as smallholder farmers. This, in addition to the fact that in most LDCs agriculture represents the largest sector of LDC economies, supporting over 50% of the population and contributing substantially to the GDP, and to export has led to the belief that most LDCs depend on the rural sector. Essentially, it is the shared belief that future development in most LDCs will depend, in part, on the successes and failures in nurturing, supporting and developing the rural areas and the rural economy, particularly in improving the plight of rural inhabitants, including support for their activities. The rural sector, however, is served primarily by the rural financial markets, a market often characterized as grossly inadequate, poorly developed, small and shallow. It comes as no surprise, therefore, the heightened interest and efforts on the part of LDC governments and Development Assistance Agencies (DAA) to strengthen and deepen the financial markets, particularly the rural financial markets. By strengthening and deepening the financial markets, it is envisaged financial services to rural inhabitants will be increased.

This paper examines the rural economy and the rural financial markets, exploring in the process strategies for increasing accessibility to financial services for rural inhabitants. The paper examines, in particular, strategies that will deepen the rural financial markets, forge collaboration and linkage between the financial markets, minimize risk of servicing the rural sector and enhance capacity building.

2. Structure of Rural Economy

The rural economy is characterized by the activities of rural inhabitants. The majority of these inhabitants in most LDCs are engaged in agriculture, often as smallholder farmers. Only a small number of rural inhabitants are engaged in non-agriculture, off-farm, income generating activities (IGAs), often to supplement their agriculture-based income or as the only earning activity and source of income. This latter group which dominate the

* The opinions expressed in this paper are purely the authors and not that of the World Bank where the author was previously engaged as consultant.

activities of the rural sector only in a few LDCs operate for the most part micro, small and medium scale enterprises (MSMEs)¹.

2.1 Agriculture

Agriculture represent the largest sector of LDC economies, supporting 50% of the population and contributing substantially to the GDP and to export earnings.

The agriculture sector is often characterized as comprising two-sub-sectors: the smallholders who often cultivate on traditional or customary land, and the estate operators who manage leasehold and/or freehold land. Within each category, other classifications are possible, based on the size of land or holdings. To provide a complete picture of the rural sector of LDCs, one must add another category comprising of operators of small scale non-agricultural enterprises.

Reliable data on these categories for LDCs as a whole is not available and available data for some countries for these categories, often vary and at times incomplete.

2.2 Smallholder Farmers

The family is the primary source of labor in the smallholder sub-sector. Technology is very rudimentary in the smallholdings, and land management is generally poor.

The majority of smallholders are subsistence cultivators with very low cash income levels, with a small proportion of their income coming from crop production and a much smaller proportion from off-farm IGAs. Generally, households with large land holdings tend to earn more than smallholders, and depended less on off-farm IGAs.

Expenditure priorities among smallholder generally vary with land holding, and so is the relative importance of the expenditure items. The smaller the land holding, the greater the importance of expenditures on food. Insufficient capital and a lack of access to credit have been explicitly recognized as one of the critical factors influencing and limiting the growth of the smallholder sub-sectors in LDCs, particularly, in adopting basic agricultural technologies, and in engaging in other off-farm income earning activities. Other constraints impacting on rural households productive capacity in some LDCs include limited land for expanding the area under cultivation and mounting population pressure which is contributing to the increased fragmentation of holdings and encroachment into marginal lands. The increasing cost of external transportation, poor rural infrastructure, the limited

1. Mostly non-corporate.

access to information and insufficient human capital amid policy environments that generally are not effectively supportive have all contributed to the lack of growth in the smallholder sub-sector of LDCs.

2.3 Estate Operators

In most LDCs characterized by an estate agriculture subsector, the estates have been known to operate on leasehold land and/or freehold land, and often occupy large portions of land. These estates generally specialize on the cultivation of cash and export crops, and employ for the most part rural inhabitants. Unlike smallholders, estate farmers have generally benefitted and favored the most by formal sector lenders and even by government programs targeting the agriculture sector. For the most part, they have suffered less from the lack of access to credit and critical technology that characterize smallholders. Nevertheless, they all share in certain common problems, including insufficient investment capital, limited arable land, particularly, in those LDCs with population pressures.

2.4 Micro, Small and Medium Enterprises

Micro, small and medium enterprises (MSMEs), also, play an important role in the survival of rural households. Available studies on rural households have normally differentiated the constituents of the sub-sector by sizes of loans distributed. Although very little is known about the actual size and operation of MSMEs in LDCs as a whole, it is believed to be considerable. The estimates also vary from country to country. MSMEs in rural LDCs are engaged in a variety of activities including production, trade and services, but mostly in the latter two areas.

The activities of MSMEs run across various categories of the rural household. Generally, MSMEs tend to engage in off-farm activities either part-time to supplement agricultural income or full-time as the main source of employment and earnings. Many MSMEs, like the majority of rural households, are faced with a shortage of capital, and have no access to institutional finance. Existing financial institutions do not cater to these groups for several reasons, including (a) the lack of collateral and (b) a preference for handling sizeable loans rather than smaller loans. In addition, the procedures for obtaining credit are generally, too cumbersome for a largely illiterate, rural poor. Without alternative opportunities brought about by specific developments in terms of resource mobilization, accessibility to credit facilities, and an enabling policy environment, the expansion of small-scale industries and off-farm IGAs are generally hindered and/or limited. The expansion of this sub-sector is particularly important for rural development in the face of

increasing land constraints in a growing number of LDCs.

3. The Rural Financial System

In this section, recognition is made of the fact that the majority of LDCs depend heavily on agriculture, which accounts for over 50% of all exports and occupies the time of over 60% of the population, the majority who are smallholders and a small number who are engaged in non-farm IGAs. These smallholders and MSMEs constitute the clients of the rural financial markets, and their financial needs will have to be addressed, if growth is to take place in the rural sector. Equally important, is the fact that a properly functioning and well developed rural financial system will be needed, if the sector is to survive and continue to contribute significantly to the overall development. Incidentally, the rural sector and the rural population of LDCs have not been adequately served by the rural financial system. Access to financial services remains limited, and in some cases access to formal finance remains non-existent. In fact, the lack of access to formal financial services, is considered one of the major constraints to increasing investments and productive activities in the rural sector of LDCs. It is estimated that about 50% of rural households and micro-entrepreneurs may not have access to adequate formal and informal financial services particularly, the former.

3.1 The Market Structure

The rural financial system of LDCs comprises the activities of formal and informal financial markets², together with their respective institutions. The former, also, consists of semi-formal financial institutions (SFFIs), non-banking financial institutions (NBFIs) and formal organizations providing a variety of financial services. Only a few Formal Financial

2. The activities of Formal Financial Markets (FFMs) / Formal Financial Institutions (FFIs) are regulated and are subject to official and direct monetary controls. This contrasts with the activities of Informal Financial Markets (IFFMs) / Informal Financial Institutions (IFFIs) which are often not subject to review and control by monetary authorities. For a general and elaborate discussion and usage of the terms "formal" and "informal", See Gladson Nwanna, "Stimulating Savings in the Informal Financial Sector of Less Developed Countries *The Journal of Social, Political and Economic Studies*, Washington D.C. (Vol. 14, No. 3, Fall 1989; Anan G. Chandavarkar, "The Non-institutional Financial Sector in Developing Countries: Macroeconomic Implications for Savings Policies," p. 129; Holst, Jurgen, "The Role of Informal Financial Institutions in the Mobilization of Savings," in Dennis Kessler and Pierre-Antoine Ullmo, eds., *Savings and Development*. Paris: Economica, 1985. Note: The term FFM is used in this paper to include the activities of Semi Formal Financial Institutions (SFFIs) such as development financial institutions.

Institutions (FFIs) are actively engaged in providing services to the rural sector. They, for the most part, tend to specialize in other types of clients or activities. That in several LDCs many of these FFIs are still dependent on the government and/or external donors, and many are yet to be viable and self-sustainable continues to create concern.

Informal finance, on the other hand, continues to play a significant role in meeting the credit needs of rural inhabitants and MSMEs. Their contribution, however, is limited by a host of factors, including inadequate financial resources and legal constraints. Despite the role played so far by both formal and informal finance in LDCs, it is evident that the needs of the rural sector are still poorly and inadequately met by both formal and informal finance. The rural financial markets, in particular, continues to be characterized by a number of weaknesses including³ (a) limited access to rural customers, (b) high cost of services, (c) absence of savings facilities, (d) financial nonviability, (e) lack of active competition, and (f) inability to expand services to respond to and create opportunities. Finding effective methods of deepening the rural financial markets and making more financial services available remain as challenges facing the LDC governments.

3.2 Rural Financial Sector (RFS)

The financial sector in most LDCs comprises two main subsectors: the formal and the informal sub-sectors. The role and activities of these sub-sectors are largely complementary and do overlap. The financial system, on the whole for the majority of LDCs remain small and undeveloped with very small and limited money market and capital market activities. Several LDCs do not have a well developed stock market.

4. Formal Finance in the Rural Sector

The formal financial sector (FFS) of LDCs consists largely of a central bank, commercial banks, finance houses, building societies, development finance institutions (DFIs), savings institutions and insurance industry. The latter often comprising of a series of insurance companies and brokers, as well as pension and provident funds. Of these, only a small number⁴ typically, commercial banks, the Post Office Savings Bank and a number of Non-Banking financial institutions is actively present or engaged in providing

3. J.D. Von Pischke, Dale W. Adams and Donald Gordon. *Rural Financial Markets in Developing Countries: Their Use and Abuse*, p. 227.

4. J.D. Von Pischke, *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*, p. 173.

financial services to the rural sector and to MSMEs. The majority of FFIs in LDCs tend to be located, and their services concentrated primarily in the urban sector.

The reasons for the inadequate investment financing and other financial services to the rural sector are many and varied for both the formal (FFS) and the informal (IFS) sectors. FFS often view most rural sector activities as non-bankable, among other factors, because of the (a) high risk of default associated with small operations (b) high transaction costs (c) the absence of suitable collateral and (d) the lack of banking experience among rural households. Other related reasons have included the uncertainty of the production patterns, to unfavorable investment climate, often, due in part to prevailing government policies. The IFS, on the other hand, has developed appropriate tools and techniques for providing financial services to the rural sector and to micro-enterprises, but often lack the breadth, depth and term transformation to provide the full and appropriate range of financial services.

4.1 Commercial Banks

The presence of Commercial banks in the rural sector is limited to savings mobilization. Although commercial banks have been instrumental in providing credit to the rural sector of some LDCs; much of the credits however, have often gone primarily to finance estate agriculture⁵. Incidentally, very little or no credit is provided the majority of smallholders and microenterprises that dominate the rural sector. In several of the LDCs whose financial sector is undergoing reforms, particularly those whose economic programs have aggressively been supported and or backed by the IMF and the world Bank, the financial sector reform efforts are envisaged to provide an environment that will encourage as well as increase the commercial bank and formal finance presence in the rural sector.

4.2 The Post Office Savings Banks

The POSB plays a leading role in savings mobilization in rural LDCs, and in some countries believed to be holding perhaps the largest amount of rural savings with FFIs. In many LDCs the POSBs command the most visible presence among FFIs operating in the rural sector. In addition, it often has the most extensive network of deposit taking facilities nationwide, a large number of which are located in the rural areas.

The close proximity of the POSB facilities to rural savers, its wide-spread rural

5. Arnaldo Mauri, *A Policy to Mobilize Rural Savings in Less Developed Countries*, p. 17.

locations have all contributed to its growth and popularity in LDCs. In some LDCs, the competitive interest rates and tax exempt interest income status of post office savings have also contributed. In many LDCs the POSB however, is only legally mandated to mobilize domestic savings, hence cannot engage in credit allocation to the private sector. This inability to extend credit to the private sector, in effect, have often limited the ability of POSBs to provide a wide range of financial services. This, discourages some rural savers, particularly, those who plan to borrow from their banks⁶. Clearly, the POSB has the potential to become a much more effective institution in intermediating between the financial markets and reaching more rural households. To be able to do this however, the operation of the POSB needs to be strengthened and its mandate expanded to allow it to engage in resource allocation through expanded mandate that will allow them to take savings.

4.3 Non-Banking Financial Institutions (NBFIs)

NBFIs activities in the rural sector of LDCs, and in servicing MSMEs are limited. The range of financial services provided by these institutions to MSMEs and rural households include: credit, savings facilities, training and business advisory services. Most of these institutions, nonetheless, with a few exceptions, are engaged primarily in resource allocation, being for the most part prevented by law from mobilizing domestic resources. This, coupled with the fact that a good number of these NBFIs continue to experience some difficulties and are yet to be self-sustainable, raises concerns about their ability to continue to provide services to the majority of their target group. Many continue to depend on the government and foreign donors. The lack of independence, inadequate resources, and a restricted mandate are all contributory factors that need to be addressed if they are expected to contribute significantly to rural development. Of importance is allowing some of these institutions to broaden their activities and to engage in both resource allocation and mobilization. A more immediate need, however, is for these institutions to be strengthened and sustainable.

4.4 Experiences of Formal Finance

Formal Finance presence and activities in the rural sector of LDCs generally remain small and limited to just a few institutions. Most FFIs have not been particularly active in

6. Arnaldo Mauri, *The Potential for Savings and Financial Innovation in Africa*.

the rural sector. They have basically been urban-based and urban and non-agricultural focused. Their reluctance to service the rural sector and small businesses has been attributed to a variety of factors, some, that have been noted earlier. Even among the formal and semi-formal institutions presently providing services to the rural areas of LDCs many are still not as active as expected nor have many been as quite effective and successful in fulfilling their mandate. The lack of independence from the government for most of the institutions, the legal restrictions on their activities, inadequate financial and human resources are all constraints that continue to limit their services. This is in addition to management related problems and the usual institutional and operation problems of dealing with the rural sector, the latter, ranging from poor infrastructure and inadequate training, to high loan delinquency and low recovery rates.

4.5 Constraints

In general, formal finance activities in rural LDCs have been adversely affected by a host of factors and constraints both internal and external. The net effect on rural development, however, has varied, fluctuating more or less with the health of the economy. The decade of the 80s was particularly noteworthy to several LDCs as a period characterized by many economic uncertainties that included external shocks and high inflation. These uncertainties continue to contribute to existing constraints, creating a situation which continues to hinder formal finance institutions' ability to mobilize savings and extend credit to the rural sector. In addition, it created gaps for rural financial services that the informal sector must continue to fill. By and large, the economic situation as always, continue to provide a challenge for the LDC governments and the impetus for government interventions.

5. Informal Finance in the Rural Sector

The Informal Financial Sector (IFS) plays a highly important and significant role in the allocation and mobilization of resources in the rural sector of LDCs particularly, in providing financial services to more rural inhabitants and MSMEs at a comparatively lower cost and risk than FFIs. Principal institutions in the informal financial markets in LDCs include

7. A popular form of Savings and Credit Associations is the Rotating Savings and Credit Associations (ROSCAs). For detailed discussion on ROSCAs, see Bouman, F.J.A. "Indigenous Savings and Credit Societies in the Third World: A Message," pp. 181-214; Nwanna (1989); World Bank: *World Development Report*, 1989: Financial Systems and Development, p 114.

Moneylenders, Traders, Estate Owners, Grain-millers, friends, relatives, neighbors, business and employers. They also include Mutual and Social Welfare Associations, such as Saving and Credit Associations (SCAs)⁷ and Cooperative Savings Associations (CSAs). In some LDCs it also includes Community Funds (CFs).

The factors that account for the existence of these institutions in developing countries and that explain their activities and popularity among rural households and microenterprises elsewhere seems to be the same across the majority of LDCs. These factors include: (1) autonomous factors (which relates to the functioning and organization of the indigenous economy); (2) the characteristics of the informal financial markets (which relates to the unique and informal nature of its activities); (3) repression of formal and semi-formal financial markets; and (4) prevailing macroeconomic environment (conditions and policies).

Whereas, FFIs remain reluctant in servicing the rural sector and considers the rural sector activities as non-bankable among other limiting factors, the IFS, on the other hand, has developed appropriate tools and techniques for providing financial services to the rural sector and to micro-enterprises, but often lack the breadth, depth and term transformation to provide the full range of financial services. For the most part they are often unable to meet the demands for their services due to inadequate resources and the inability to access formal finance.

Although the actual size and financial contributions of IFIs to rural development in LDCs are not known for certain, due to the inherent characteristics of the market, it is believed to be considerable⁸. Credit supplied by the IFIs to rural households goes to finance and support a variety of activities, including consumption, investment, and savings. The majority of the loans, however, are used for productive purposes. Depending on the type, IFIs charge various rates of interest on their loans. The rates range from zero nominal rates often charged by friends, relatives and neighbors, to up to 100% per month by some moneylenders. The majority of the loans from IFIs are short term loans, partly due to the nature of their funding and income sources.

5.1 Experiences of Informal Finance

Informal Finance in LDCs is both extensive and diverse, accounting for most of the financial services provided to the non-corporate and rural sectors. IFIs have been

8. J.D. Von Pischke, Dale W. Adams and Gordon Donald. *Rural Financial Markets in Developing Countries: Their Use and Abuse*.

instrumental in mobilizing and allocating resources in rural areas of LDCs, especially, the latter function. Their contributions in the area of resource allocation have been, primarily, in providing mostly short-term (cash and/or input) credit to rural households and MSMEs. In addition, they have provided financing for larger, long-term investments, although to a much lesser degree. For the most part, IFIs do not have the capacity to lend long-term and, therefore, rarely provide term financing. Much of the credit provided by the majority of the IFIs does not require the traditional and formal forms of collateral, and is interest-free, or commands very low nominal rates. Of crucial importance, is the overall relatively high level of satisfaction often reported by MSMEs and rural inhabitants particularly, about the services provided by IFIs vis-a-vis FFIs. Whereas IFIs is embraced, in part, due to factors⁹ such as the speed in processing and extending credit, flexibility concerning repayments, the "non-formal" atmosphere of activities and the minimum of formal requirements and protocol they often cite the relatively high cost of dealing with the FFM as reasons for dealing with IFIs. These include¹⁰ inefficient administration, lengthy application procedures, untimely arrival of credit, inflexibility of repayment procedures, and necessity for proof of collateral, as well as the cost of bribes.

5.2 Constraints

Several constraints prevail in the IFS, many of which limit, not only the growth of IFIs, but the ability of IFIs to expand and to contribute more to rural development. Some of the constraints are partly the result of government policies and development strategies that have been passive and unsupportive and, at times, have worked to their detriment, making it more difficult for them to provide more services to rural households and to small businesses. This is in spite of the sector's potential impact on macro-economic management and on rural development. The apparent lack of real interest in the sector perhaps explains the paucity of data and the limited number of studies on the rural financial sector in majority of LDCs.

Besides the lack of real recognition and strong support for the contribution of Informal Finance to rural development, most of the IFIs face the problem of inadequate financial

9. Marvin P. Miracle, "Economic Incentives for Loan Agents", in J.D. Von Pischke, Dale W. Adams, and Gordon Donald, *Rural Financial Markets in Developing Countries: Their Use and Abuse*, p. 214.; J.D. Von Pischke, *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*, p. 220.

10. J.D. Von Pischke, Dale W. Adams, Gordon Donald, *Rural Financial Markets in Developing Countries: Their Use and Abuse*, p. 239.

resources, lack of access to formal finance and the absence of linkage and collaboration with the formal sector, hence, their inability to provide services, particularly, loans to needy clients. This is understandable in the face of these constraints which in effect prevent IFIs from borrowing from the formal sector for on-lending. Incidentally, most of the IFIs have succeeded in reaching a lot more rural households and small scale enterprises than FFIs, and have had success and experience in providing financial services to these groups. It appears prudent therefore, that efforts aimed at rural development and making financial services available to the rural sector of LDCs to include strategies that will include or link the activities of IFIs as well as engage their participation. Recognition by governments in LDCs and support for the IFM, at least as a first stage approach to linking them to the formal system should, in the long-term have a net positive effect on rural development and in deepening the financial system. In the main time, IFIs continue to play an important role in meeting the needs of a growing number of rural inhabitants, and continue to complement, in most cases, the activities of the formal and semi-formal financial institutions.

6. Financial Sector Reform

As part of the efforts to restructure the economies of the majority of ailing LDC economies and to bring discipline to their troubled economies many LDCs with the assistance of the IMF and the World Bank, continue to embark upon intervention strategies. These strategies have often culminated in a series of macro-economic reforms. The reforms are particularly important as they were often aimed to provide (1) the needed foundation and ingredients to broaden and deepen the financial system, (2) propel sustainable economic growth and/or (3) support for a broader socio-economic agenda targeting rural development.

In recent years key objectives of LDC policies and reforms have included the following: (1) to maximize deposit mobilization, while promoting an efficient resource allocation; (2) to promote market determination of interest rates, and (3) to foster efficient financial intermediation based on a competitive financial system. Ongoing changes that have taken place so far in some LDCs include the discontinued use of credit ceilings and the deregulation of interest rates. Although it is envisaged that some of these reforms will have some positive effects on rural development particularly in the areas of rural savings mobilization and on credit allocation, it is not as yet clear how long the governments of many of the presently, distressed LDCs will continue to support and promote such policies.

Notwithstanding, the breadth and depth of the ongoing reform efforts in several LDCs, rural sector development continues to remain slow and lagging. Obviously, there now

appears among several LDCs an important and urgent need, not only to develop but, also, to integrate the rural sector development into the broader framework of overall national development effort. Incidentally, any successes with this effort will depend in large part, on efforts made by LDC governments to broaden, deepen and strengthen, not only the formal financial markets but also the informal rural financial markets. Only, then would access to financial services to rural households and MSMEs (a major constraint to their growth,) be increased and sustained. LDC governments could be assisted in this process by exploring those policies and programs, among others, that would link the formal and informal markets, together with their respective institutions, instruments and participants as well as those that will enhance capacity building and minimize the risks and costs often associated with servicing the rural sector and MSMEs.

7. Forging Collaboration Between Formal and Informal Financial Markets

The need to forge collaboration between the formal and informal financial markets in LDCs seem now even more urgent. It is believed that by upgrading informal financial arrangements and Informal financial institutions and linking them to Formal financial institutions, financial services, particularly to the rural sector, the poor, and to microenterprises¹¹ will be expanded and deepened. This arrangement however, must imply building upon not supplanting existing arrangements.¹²

The importance of a linkage stems from the fact that in most LDCs, despite the many Informal Financial Institutions (IFIs) in operation and the active role played by them in resource allocation and resource mobilization, not many of them have links with formal financial institutions. Additional support and relevance of the need for collaboration and linkage between the markets stem from the differences between the two sectors and the apparent "sectoral specialization" or segmentation of the financial markets. Incidentally, these differences between the institutions and markets provide an avenue for both sides to benefit. By drawing on each others strengths, experiences and advantages through collaboration and linkage, greater financial intermediation will be accomplished between those who supply and those who demand financial services. This is especially the case since linkage, in effect, helps reduce some of the key barriers¹³ to financial intermediation.

11. The term microenterprises is used here to include small and medium size businesses, mostly non-corporate.

12. World Bank, *World Development Report 1989*, p. 119.

13. This include, on the supply side, the high administrative costs, and risks associated with servicing the rural population, and on the demand side, the high cost of requesting for a loan and accessing other financial services.

With greater intermediation is the potential for the financial markets to become deepened and widened. Furthermore, accessibility to financial services for rural inhabitants will be increased.

Although various studies of the informal financial sector report significant amounts of IFIs funds deposited with FFIs for safe-keeping, these studies also report that the amount of borrowing from FFIs is considerably smaller. Only in a few and rare cases are there formal cooperation and networking between the FFIs and IFIs.

Various options and strategies could be explored by respective LDC governments to forge collaboration and linkage between the financial markets. This will include:

7.1 Strengthening Existing Linkages

Some linkages do presently exist between the formal and the informal financial markets in LDCs. These linkages, however, are limited and are largely via group lending schemes and credit cooperatives. Furthermore, the relationship and collaboration are generally weak and limited; hence, supporting the need for such relationships and linkages to be strengthened and broadened. This will require getting participants in both markets (formal and informal markets) associated with the activities of the other. It will also require adopting techniques of the other that are appropriate and beneficial, getting informal financial institutions to deposit surplus funds with FFIs and to meet their requirements of extra resources through borrowing from the FFM.

7.2 Experimenting with the Use of IFIs as Intermediaries

A number of IFIs play significant and active roles in resource allocation to rural households and microenterprises. Many of these IFIs are, however, unable to meet the loan needs of their clients. Furthermore, they are unable to mobilize or access term loans. IFIs, like rural households and microenterprises, see the increased potential for meeting their financial needs through the formal market, but are turned off, in preference of the formal market for various reasons. Although a significant number of the IFIs bank (operate, for the most part, savings accounts) with FFIs, access to FFS credit remains considerably limited. This leaves a substantial number of loan requests by rural households and small businesses unmet by the limited amount of resources available to IFIs, who traditionally provide as well as cater to their financial needs.

Given the significant size of the IFM activities in several LDCs, their prominence in the rural sector and in servicing the credit needs of small businesses, the poor and rural sector,

policy makers may consider using some of the IFIs as financial intermediaries. These institutions could intermediate in both savings and credit services between donor agencies, the governments, FFIs, and rural households.

It is envisaged, initially, with this strategy that with access to formal financial sector credit, IFIs will be able to meet the credit needs of their rural and small business clients. Once rural borrowers have come to build confidence in and rely upon these IFIs as dependable sources of funds, capable of meeting all or most of their credit needs, these intermediaries may evolve and be encouraged to take up the function of deposit taking. For the same reasons that these IFIs have survived and have become popular among rural households and microenterprises in several LDCs, particularly as a source of credit, one will expect that some of those positive factors may attract potential savers to bank with them even at deposit rates of interest smaller than available at urban-based FFIs. Although the first best approach is to encourage rural households to save with FFIs, the limited coverage and services presently provided by the FFIs make it worthwhile to experiment with this approach. In the long-term, as the system deepens and the economy becomes more developed and rural inhabitants more enlightened, one will expect FFIs to takeover and to play a greater role. Although some informal financial institutions as well as some rural households, do operate deposit accounts with FFIs they, however, continue to have difficulties meeting their credit and other financial needs through FFIs.

In practice, the use of IFIs as intermediaries would allow qualified IFIs, for example, to borrow from the FFM and on-lend to the informal financial sector. As part of the loan or on-lending arrangement and interlinking process, such IFIs may be required to open accounts with FFIs. Furthermore, it would allow some IFIs, to serve as deposit-taking institutions or operate deposit facilities independently or in collaboration with FFIs. Obviously, such a role would require legal approval. Success with such a scheme, however, will depend on the extent to which there is limited interference by the government with the traditional mode of operation of IFIs or with the very factors or structures that continue to account for their popularity and acceptance by the rural population. Increased IFI access to FFM credit may lower the cost of funds to both parties and may lower interest charges on their loans. For one thing, it may lower the cost of lending/borrowing to both the lender and the ultimate borrower. Likewise, this may lead to more competition in the delivery of services to the rural sector, thus, adding more depth to the financial system.

In their "new role," some of the IFIs, as financial intermediaries with deposit-taking

authority, may grow substantially large and graduate to formal institutions. This is the case for many building Societies in England and elsewhere, which began as ROSCAS¹⁴ and later became part of the formal financial system. In Cameroon and India, some ROSCAS have evolved into formal banks.

7.3 Experimenting with Non-Governmental Organizations (NGOs) as Intermediaries

With the disappointing and poor performances of traditional avenues for reaching and providing services to the poor and the rural sector, LDC policy makers and donors alike are beginning to show interest in NGOs. They envisage the use of NGOs as agents for reaching and servicing the poor, the rural households and micro-enterprises. Such a role for NGOs is useful, considering not only their interest in the rural sector and the poor, but also their successful methods and ability in reaching them.

Among LDCs, the number, growth rate and activities of NGOs remain diverse. Whereas a number of active NGOs exist in some LDCs, in some others, there are only a handful. However, in almost every country, some of the active NGOs provided a variety of financial services, including credit allocation and savings mobilization. The majority of these NGOs were engaged primarily in financing income generating activities (IGA) as well as providing short-term, seasonal credit to farmers and microenterprises. In other words, savings mobilization was not emphasized. Only recently, with renewed interest in NGOs initiated by donors and DAAs and the resultant increase in the number of new NGOs, are some of them expressing interest in broadening their activities to include emphasis on savings mobilization.

A large number of NGOs in LDCs, like the IFIs, do not have adequate financial resources and incentives and, hence, they have been unable to meet the needs of their target groups. Most of them are small in size and poorly funded, depending, in some cases, on assistance from abroad. With few exceptions, most of their activities are limited to resource allocation. Nevertheless, with the renewed interest in NGOs and the growing interest in incorporating them into the strategy for rural development, FFIs may experiment with using the NGOs as agents for mobilizing resources. Some of the NGOs could, be encouraged to take deposits or establish some form of savings facility or arrangement to encourage savings among their members or target group. Members or beneficiaries may then be required, for example, to open savings accounts with them as a prerequisite to

14. Rotating Savings and Credit Associations. For a detailed discussion on ROSCAS, see Nwanna (1989); *World Development Report 1989: Financial Systems and Development*, p.114.

receiving assistance. Besides the obvious advantages of these arrangements to rural savers, it would enable NGOs to be viable and self sustaining. The resultant financial independence would also provide them with additional resources from which to on-lend to their members, invest, or deposit with the FFS. Alternatively, NGOs may require members to open savings accounts with FFI as a condition for receiving service from the NGO.

In effect, NGOs can provide a critical and important link between the two major financial subsectors. In many LDCs, several of the NGOs presently have savings accounts at FFIs and some have been able to borrow from these FFIs. As FFIs come to recognize their successes in servicing the rural sector and microenterprises, one would expect additional interest and participation (directly or indirectly) by FFIs. Furthermore, one would expect to see even more collaboration between NGOs and FFIs.

7.4 Improving and Strengthening Loan Recovery Efforts of Existing SFFIs/NBFIs¹⁵

Strategies aimed at fostering a linkage between the various markets has the potential for improving the major weaknesses and factors constraining the sustainability and viability of the financial institutions presently active in the various markets. Several semi-formal financial institutions (SFFIs) in LDCs continue to be very active in providing financial services to the rural sector and to microenterprises. Most of these institutions, however, are reported to be facing problems and other constraints that continue to threaten their viability. Some of these problems and constraints include legal limitations on their activities (most of them cannot legally mobilize savings), high transaction costs, high default rates, and poor loan recoveries.

Poor loan recovery and the high cost of loan transactions discourage most of the FFIs from expanding their involvement and services to the rural sector and small scale businesses. Success in minimizing the problems currently being faced by most of the SFFIs may motivate other FFIs to become involved. As these SFFIs and NBFIs demonstrate their ability to be viable and self-sustainable, and as they show real improvement in loan collection, one can expect increased confidence and interest on the part of FFIs to advance credit to them for on-lending or even directly to rural borrowers. On-lending

15. Non-bank Financial Institutions. The terms SFFIs and NBFIs are used here to represent sub-components of formal financial institutions and comprise the formal financial market. Whereas the former is used to include such institutions collectively referred to as Development Finance Institutions, the latter represent those FFIs not largely defined as bank or authorized to operate as banks.

through SFFIs that are viable and sustainable will allow the FFIs to meet the needs of small, rural households and microenterprises without incurring the high cost and risk often associated with serving this group directly. This certainly will have a positive contribution to the overall development effort.

Improving loan recovery for some of the SFFIs (especially those that lend mostly to groups and clubs), inextricably revolves around various factors. These include the degree of independence of operation, the quality of loan appraisal and monitoring, method of group formation, but more importantly, the quality of enforcement and method of assessing liability to borrows (i.e Individual liability, joint voluntary liability or mandatory joint liability). Although each method has its relative weaknesses and strengths, lending institutions that have adopted mandatory joint liability have proven to be more effective in recovering loans. Whether this translates to lower cost or whether the recoveries were cost effective is not clear. Increased use of "joint and several liability" by the various institutions engaged in group lending in LDCs warrant exploration. Despite the poor recovery experience by some of the SFFIs in LDCs, this method of liability assessment has still not been adopted nor stringently enforced by a number of the SFFIs.

7.5 Expanding the Legal Mandates of Existing SFFIs/NBFIs to Allow them to Broaden their Range of Financial Services

The limited and restrictive legal mandate is one of the constraints facing several of the SFFIs presently serving the rural sectors and small enterprises in LDCs. Many of these institutions are prohibited by law from engaging in either domestic resource mobilization, resource allocation or from extending their services to certain sectors or activities. These limitations on their activities and services have prevented them from venturing into profitable activities and from expanding their services to the majority of rural sector inhabitants and microenterprises who need them. These institutions, for the most part, operate and rely on funds from the central government and from external donors, a situation that continues to threaten their survival. To the extent that SFFIs remain active and potential sources and channels of financial services to the rural sector in several LDCs, and to the extent that they provide a potential first stage linkage between the informal and formal markets, ensuring their survival and self-sustainability are important. LDC governments should, therefore, re-examine the roles of these institutions with a view toward expanding their mandates and legal authority to allow them to provide other financial services. This would enable them to service more of the target group, while at the same time, providing them with the means of becoming viable and self-sustainable.

In this way, the linkage process between the markets would be facilitated and strengthened.

Certainly, forging collaboration and cooperation between the markets would provide a means of promoting rural development through increased access to a variety of financial instruments and services. By and large, besides having a potentially net positive effect on rural development, linkage and collaboration should lead to a better intra and inter-sectoral/market allocation of resources, as well as allow for a more effective macro-management of the economy.

As the governments in several LDCs progress with their financial reform efforts, it is important to recognize the need to forge a collaboration between the various markets. Such linkage would dictate, to a significant degree, the success in providing sufficient and timely financial services to the rural population and to microenterprises. Furthermore, it will also dictate the extent to which the system can be deepened and to which competition can begin to set in. Obviously, the more inter-linked the markets are, the more successful and effective the governments can use fiscal and monetary policy to control and regulate the economy. Any sustainable collaboration depends, to a large extent, on the government providing the direction and an enabling environment (legal & policy).

8. Deepening Rural Financial Markets

A major structural characteristic of the majority of LDCs is the limited scope of the formal financial system and the resultant lack of depth. Generally, the financial system in several of these LDCs is characterized by a large degree of market fragmentation, particularly of the formal financial market, with specialized institutions operating in distinct market niches. Equally conspicuous features of the financial system are the excessive concentration of resources, the lack of competition, (reflecting, in part, the fragmentation of the system) in some, largely, smaller LDCs, and the oligopolistic structure of the formal sector economy. Understandably, legal restrictions and past government macroeconomic policies have all contributed to the present status of the financial system in most LDCs. Recognition of the limitations placed on growth and development by the shallow rural financial system, the poor domestic savings mobilization and resource allocation in several LDCs have however, led to an increased interest on avenues to deepen the rural financial market.

Incidentally, there are some avenues that could be explored. The successes and failures of many of these options and/or strategies however, are largely depended on the belief that such strategies and efforts aimed at deepening rural financial markets in LDCs

will require actions on the part of LDC governments in particular, and the support of DAAs in creating an economic environment that will be supportive of such objectives. Such environment must foster conditions that will allow and encourage financial innovation and competition as well as broaden and integrate the financial markets. "Since financial innovations lead to a variety of specialized dealers and markets, they create a diversity of financial instruments, each with unique characteristics and features. This diversity of financial products enables both primary savers and borrowers to choose among instruments better suited to their special requirements and it, thus, stimulates savings in the form of financial assets as well as borrowing that promotes a more efficient allocation and use of investable resources. Further, the competition among this array of specialized dealers in mobilizing financial resources from primary savers tends to integrate the various financial markets".¹⁶

Incidentally, innovations may only become possible where there exists: (1) a climate of trust and confidence among market participants, (2) effective and enforceable legal framework, (3) some degree of monetary and economic stability, as this will facilitate the subjective evaluation of risk by market participants, and (4) no legal or customary obstacles to experimentation and innovation, particularly with regard to the so-called informal credit markets.¹⁷

Governments of LDCs and DAAs alike should, therefore, view their role and activities towards deepening rural financial markets as that of supporting and promoting policy interventions in these areas. Such interventions must also include those that impact on costs and risks (i.e. reducing cost and risk-increasing interventions while increasing cost and risk-reducing interventions)¹⁸, both key factors and considerations in the growth and development of rural financial markets, the rural economy, and the national economy. Furthermore, such interventions must not be one-sided¹⁹, focusing only on credit allocation, but must emphasize and encourage savings mobilization as well.

16. V.V Bhatt "Financial Innovations and Development" in J.D. Von Pischke, Dale W Adams, and Gordon Donald, (eds) *Rural Financial Markets in Developing Countries*, p.46.

17. Ibid, p.47

18. Risk and cost-increasing interventions will include, for example, policies that opt for interest rate ceilings, credit allocation quotas, and directed credits. Risk and cost-reducing interventions, for example, will include policies that opt for deposit insurance, credit guarantee schemes, as well as those that will improve access of farmers and microenterprises to financial and technical consultants.

19. J.D. Von Pischke, "The pitfalls of Specialized Farm Credit Institutions in Low-income Countries", in Von Pischke et al (eds 1983) pp.178-180.

Solving LDC problems is by no means a task that lends itself to easy or quick solutions, nor are the problems they face subject to a general or homogenous approach. By and large, experimentation and innovation will remain one of the few available avenues, and so are efforts and strategies for deepening the rural financial system.

8.1 Expanding the Role and Activities of Formal Financial Institutions (FFI)

Success in deepening rural financial intermediation in LDCs require government re-examination of the mandate and legal status of existing formal financial institutions. Evidence abound in the literature of a variety of restrictions and factors that have more or less prevented active participation and presence of FFIs in rural development. Identifying these factors and restrictions and genuinely tackling them should be a priority as this would be a positive step. Governments should provide the incentives and framework for FFI to expand their present activities in the rural sector. Incidentally, a number of FFIs (particularly semi-formal financial institutions) are currently active in reaching the rural sector (rural households, microenterprises, women, and the poor). Their activities, however, remain limited by law to deposit-taking or to credit distribution with an apparent bias towards the latter function²⁰. Allowing these institutions to engage in providing full financial services, including savings mobilization, and to experiment with appropriate instruments will deepen the financial system. Furthermore, it will enable them to become viable and sustainable, a capability which most of them are presently lacking.

8.2 Recognition, Support and Integration of Informal Financial Market/Institutions

An important observation in most LDCs, particularly in the rural areas, is the role of informal finance and the prominence of informal financial institutions (IFIs) with their non-traditional instruments and operational framework. Well recognized to be a large and growing sector in several LDCs and an important source of financing for rural development, LDC governments are yet to seriously embrace this sector's activities and players. Consequently, not much effort has been made to integrate them into the national economic plan. Their activities and position in the rural and national economy is often relegated to a secondary role with little or no coherent policies for nurturing, assisting and integrating them. Notwithstanding the role of the informal financial sector in financing rural develop-

20. As Von Pischke (1991, p.95) succinctly notes "more people can be served by providing savings facilities than by offering credit."

ment and the potential impact of their activities on macroeconomic policy, most LDCs in practice have continued to pay little attention to the informal financial sector. No doubt, many of the activities and participants in this sector remain unregulated, clandestine, unsupported and illegal, leaving them and the rural economy unable to meet their credit needs and in need of other financial services. It has also deprived the rural and national economy of the opportunity to take advantage of the positive and unique features of the IFM, including its institutions, instruments and *modus operandi*. For development, movement between informal and informal financial markets should remain unrestricted by barriers other than those arising from cost of providing competitive services²¹.

Despite the activities and performances of IFIs, the credit needs of rural inhabitants and microenterprises are still inadequately met. For most of the IFI institutions, the absence of any sustainable and formal linkage with the formal financial market continues to make it difficult for them to expand and improve on their services to the rural sector.

8.3 Accommodating Informal Financial Institutions and Linking their Activities

To the extent that IFIs continue to play a significant role in filling the financing gap in rural areas of LDCs, it becomes important not to suppress their activities. Instead, the focus should be in creating an environment (legal and economic) suitable for the cooperation and co-existence of both the formal and the informal sector, in forging a link between them and in using that linkage to deepen and expand on existing services in the rural sector. This will foster competition, expand the existing pool of institutions and instruments, and deepen the financial system. The resultant wider geographic coverage of IFIs will provide additional impetus for economic growth and the alleviation of rural poverty. Informal sector activities should not be discouraged. Rather, as the financial system develops a more efficient mechanism for mobilizing and allocating financial resources, the formal sector will gradually replace and/or complement their activities, drawing on their strengths and good qualities.

Most informal sector activities are focused toward credit provision, and IFIs have developed instruments for carrying out this task. These institutions could serve as financial intermediaries and be used to on-lend funds. Similarly, some could also be allowed to establish deposit facilities independently or in conjunction with established formal financial institutions. Savings is an important motive in forming a number of the IFIs in

21. J.D. Von Pischke, *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*, p. 214.

LDCs (e.g. ROSCAs), yet most of the IFIs do not offer deposit facilities. Allowing some of these institutions to officially engage in both resource mobilization and allocation and to be linked with FFIs has the added benefit of providing a framework for monetizing the rural household. This is more so since these institutions are already better positioned to offer acceptable varieties of financial assets. Obviously, the participation of these institutions will require appropriate legislation and other operational details. Presently, their activities remain limited and ignored and, in some cases, unsanctioned and underground. As more and more LDCs explore innovative ways to deepen both the rural and national financial markets, it may be just time for policy makers in LDCs and donor and DAAs alike to boldly confront this untapped frontier. Success with providing increased financial services to the majority of rural residents may come, in large part, from finding new frontiers, including new institutions and instruments to deepen rural finance. It may also result from the integration of FFM with IFM whose mode of operation and instruments appear so far to be well suited, accepted and, in most cases, preferred to those of the former.

Although in the short term, the transformation and expansion of the legal mandate of some of the formal and informal financial institutions will add depth to the financial system, it remains doubtful if such expansion will be adequate or if it will substantially increase formal financial services to the rural sector and to microenterprises. This leaves the option of setting up and encouraging the formation of new, broad-based financial institutions capable of providing a variety of services to the rural sector. To ensure viability and sustainability (the new buzz word among donor agencies), and to minimize some of the problems presently limiting existing Development Financial Institutions (DFIs), such institutions should be independent of the Government. Furthermore, they should be run along commercial lines and with a broader mandate to explore and use alternative financial instruments and assets suitable for rural savers and borrowers and microenterprises alike.

8.4 Engaging Non-Governmental Organizations

Efforts to deepen the rural financial system should, in like manner, engage the activities of NGOs. As national governments and donor agencies alike look up with optimism to the growing number of NGOs as an alternative mechanism for reaching the poor, the rural sector and microenterprises, consideration could also be given to allowing the NGOs to engage actively in resource mobilization. Although there are just a few well organized NGOs in most LDCs, many of their activities appear concentrated more in resource allocation than in savings mobilization. With appropriate incentives, encouragement and

legal authority, they may be able to provide a wider range of financial services to the rural population.

Across a growing number of LDCs efforts are being made at reforming the financial system. Some of these reforms have included revisions or abrogation of existing legislation, or enactment of new legislation aimed at adding depth and breath to the rural financial markets and the financial system as a whole.²² In several of the countries that have moved along these lines, some of the legislation are expected to provide a framework for a new direction of monetary policy, among other features that (1) rely on indirect rather than direct monetary instruments (away from direct control of credit and interest rates), (2) provide for the development or enhancement of capital markets, (3) are aimed at expanding and deepening the money markets, (4) provide stability to the national economy and (5) stimulate growth.

Together, these legislation and accompanying changes are aimed at providing as well as strengthening the legal and operational framework needed to deepen the level of financial intermediation in the system. The ongoing reforms, including the liberalization of interest rates, are useful if further deepening is to be accomplished as this may encourage the formation of new, broad-based financial institutions and may motivate existing institutions to experiment with alternative instruments and services. What may be very much needed, in addition, is capacity building and infrastructural support for existing as well as new institutions. Such support and encouragement with appropriate incentives will be needed in the development of financial instruments and institutions, especially those institutions that will target the rural, informal and MSMEs sectors. With the entry of more formal financial institutions (FFIs) into the rural market, competition will emerge and the rural financial markets will deepen. As part of the strategy for deepening rural financial intermediation, there will be a need, also, to include those institutions that are already involved in the rural sector and that are better positioned to expand their services to the sector.

By and large, success in deepening rural financial markets in LDCs, at least in the short term, will depend on success in creating competition in the system. This may come about through introducing and/or encouraging broad-based financial institutions to service the rural sector, expanding the role and activities of existing formal financial institutions servicing the sector, and linking the activities of the formal and informal markets. Ultimately, rural financial deepening will come from the increased financial innovation and

22. World Bank, *World Development Report 1989*, pp. 122-130.

competition that will emerge between the markets in servicing the rural sector, the variety of financial instruments and services that will be made available to rural inhabitants, and the opportunity to venture into capital market activities. For maximum success, and on a more serious note, LDC governments and DAA must keep up with the momentum, at least in line with the growing number of structural and financial reforms already taking place in a number of developing countries and in the rural sectors of these countries. The reality of the economic condition of the majority of LDCs clearly lend itself to a sustained interest and clear policies on the part of LDC leaders. It also lends itself to sheer guts in mustering the political will to explore new economic growth paths and to be seriously committed, not only to deepening the financial system and forging collaboration between the formal and informal markets but also to increasing capacity building of institutions, as well as minimizing risks often associated with providing service to the rural sector.

9. Risk Management

The high cost and risk often associated with the rural sector has often been cited as a major development constraint. In particular, it remains one of the most important factors accounting for the limited presence and activities of formal financial institutions in the rural sector of LDCs. It comes as no surprise, therefore, that the prevalence of these risks remains an impediment to the growth of the rural financial markets and rural development as a whole. Similarly, it comes as no surprise that risks continue to remain an issue of great concern to policy makers and among FFIs in LDCs. In fact, among rural FFIs, the management of these risks continue to occupy most of the time of the majority of managers of these institutions. Finding avenues, and exploring various approaches and strategies that LDC governments as well as FFIs, in particular can take to minimize these risks become an engaging task and an important one for the development and growth of the rural financial markets and the rural economy.

Risk Management for rural financial institutions (RFIs) in developing countries is focused primarily, toward resolving two most common problems: (i) how to ensure efficient and relatively low cost operational procedures in administering financial services, such as screening borrowers, processing loans, monitoring loans, mobilizing and servicing voluntary savings, and (ii) how to achieve adequate loan collection to improve the possibility of self-sustainability.

Risk Management for financial institutions serving rural the rural sector of LDCs is carried out amid a host of adverse factors. These factors include legal constraints, poverty, illiteracy, poor communication and infrastructure, poor information and lack of timely

access to required information, and an almost complete dependence on agriculture. Furthermore, it is carried out amid a number of national policies whose impact on the RFIs and their risk minimizing strategies have often, not always been supportive. The latter include national policies and strategies that foster economic instability, stall economic growth or infringe on the ability of RFIs to price, contain and manage perceived risks. The common policy practice of LDC governments of setting interest rates and credit ceilings, and directing subsidized loans often to compromises RFI's ability to manage perceived risks. However, recent reform efforts in these areas, (often at the urging of the World Bank and IMF), including efforts being made toward stimulating growth across all sectors of the economy, does have the potential for minimizing risks for most of the RFIs. In essence, risk management among RFIs in LDCs is affected by factors both internal and external to their economies, external factors include those relating to price of export products, of imported inputs, and the price and availability of foreign exchange.

RFIs in LDCs generally are confronted by, and regularly occupied with, managing a number of risks. These risks include credit risk, portfolio risk, interest rate risk, foreign exchange risk and risks related to off-balance sheet items.

- Credit Risk: The basic risks inherent in lending. This include the risk of default and non-payment.
- Portfolio Risk: The risks inherent in the composition and management of a portfolio, including those relating to capital inadequacy.
- Interest Rate or Pricing Risk: The risk that the interest yield on portfolios of assets and portfolios of liabilities may vary. This risk often occurs at the maturity of financial assets²³.
- Maturity Risk: The risks resulting from mismatching of assets and liabilities by maturity and/or rate structure.
- Foreign Exchange Risk: The risks related to increased foreign exchange transactions.
- Off-Balance Sheet Risk: The risks resulting from commitments entered by the RFI, such as contingent guarantees, foreign exchange coverage, collateral, etc., including the quality of coverage of related collateral.

Of these risks, credit risk appears to be the most important and of particular concern to rural financial institutions in so far as providing financial services to rural households and

23. J.D. Von Pischke, *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*, p.29.

MSMEs. Other risk-contributing or related factors affecting the provision of financial services to the rural sector include the high cost of transactions in servicing the sector, the lack of suitable collateral and in some LDCs, the uncertainty inherent in agriculture.

Devising alternative strategies to minimize credit risk and reduce transaction costs, as well as searching for collateral substitutes, becomes an engaging task for RFIs in LDCs. Success in this area may determine, in large part, the success in making more financial services available to the rural sector of LDCs.

Most of the financial institutions presently providing services to the rural sector of LDCs are engaged primarily with credit. Many of these institutions, particularly, those receiving much of their financial support from the government or from external donors are yet to be independent or self-sustainable. Inadequate financial and human resources continue to limit their activity. Most of them continue to face problems with their loans, in terms of large and growing delinquency rates and poor recoveries. For these institutions, credit risk management will continue to be of concern. This is more so, if they are to improve and expand on their credit services while remaining viable.

A number of strategies, however, are available to RFIs in LDCs to manage credit risk and other risk-related factors. They include: group lending, insurance, collateral, stop-orders, credit guarantee schemes, and interlinking a particular loan with present and/or future transactions in other activities or markets. Although experiences with these approaches have been mixed and have varied from one institution to another, they have generally had some positive results. Incidentally, not every RFI has employed nor taken advantage of the good aspects of some of the approaches. In other cases, some of the strategies have not been properly implemented to minimize any weaknesses that may be associated with the strategy.

Similarly, different approaches that RFIs can adopt to minimize their overall risk exposure in serving the rural sector especially, the risk associated with lending. These approaches for the most part, focus, as well as draw, on various processes involved in the administering of loans. They include:

9.1 Portfolio Diversification

This approach draws on the familiar advantages of efficient diversification. Lending patterns among RFIs appear to be highly skewed, often, towards farming activities. Furthermore, it has been observed in a number of LDCs, a bias in making loans in favor of males. Considering the volatile nature of farm production in several LDCs, diversifying credit activities to include more and more non-farm and non-agriculture activities may

minimize the uncertainties in income flow resulting from reliance on farming and agriculture. Similarly, shifting more of available credit in favor of women may reduce the comparatively high delinquency and low recovery rate that have been reported with lending to males²⁴. Besides, these options also have the added advantage of making more resources accessible to women.

9.2 Group Lending

Some of the institutions that provide credit to the rural sector in several LDCs do not use the group lending approach. Although there are potential weaknesses²⁵ inherent in the principles underlying group lending, such as the tendency to foster moral hazard and "free rider" problem, it has been found to be largely effective and useful especially where self-help groups are naturally formed (bottom-up), are small in size, and homogenous. Group lending is particularly attractive because of the potential to improve loan recovery rate²⁶ and to reduce risk of loan default through joint liability of members. Further, it has the potential of reducing administrative cost²⁷, and hence, credit transaction costs, a problem often cited as hindering FFIs from actively servicing the rural sector.

As part of a group lending strategy, **loan sanctioning** could be employed by RFIs. This arrangement requires that loans be sanctioned and approved, for example, by a committee (of presumably, knowledgeable and competent reviewers), before it is granted. To the extent that the use of loan sanctioning via committees does not delay decisions, it may be an option worth trying by some of the RFIs. This may be useful, particularly with large and term loans.

9.3 Effective Loan Recoveries

Minimizing the risk of lending to the rural sector and MSMEs requires efficient loan recovery strategies. These will include taking aggressive preventive measures, including better project analysis, strict supervision and enforcement. Employing suitable incentives

24. ABD/UNESCO (January, 1992). *Malawi: The Promotion of Income Generating Activities for Women*.

25. A. Braverman and J.L. Guasch, (April 1990), "The Theory of Rural Credit Markets".

26. Higher recovery rate has been reported for group lending in the seasonal credit program. World Bank, *World Development Report, 1989*, p. 116. Also see B.M. Desai, "Group Lending in Rural Areas", pp. 284-288 and Walter Schaefer-Kehnert "Success with Group Lending in Malawi", in both J.D. Von Pischke, Dale W Adams, and Gordon Donald, *Rural Financial Markets in Developing Countries: Their Use and Abuse*, p. 278-283.

27. B.M. Desai, "Group Lending in Rural Areas", in J.D. Von Pischke, Dale W Adams, and Gordon Donald. *Rural Financial Markets in Developing Countries: Their Use and Abuse*, p.284.

will also contribute to better loan recovery.

RFIs in LDCs employ one method or the other to gauge who qualifies for credit, and particularly, who has the ability and willingness to repay. Similarly, they employ a variety of strategies to ensure repayment. The results of lending activities by some of the RFIs in LDCs, however, have not been satisfactory. A high rate of loan delinquency continues to pose problems to some of them. Notwithstanding the difficulties generally incurred with servicing rural households and MSMEs, the process used in screening potential loanees has in many cases often been poor. Incidentally, this poor performance has at times been attributed to a lack of qualified credit personnel. Just as lax enforcement and monitoring procedures would increase the risk of default to the lender, so, too, will the failure to take preventive measures through a strong and efficient screening process. Obviously, not everyone qualifies for a loan, and a good screening process should reflect this and, consequently, should lead to reduced risks.

Lax enforcement procedures also contribute to high delinquency rates on the part of loanees. Most of the RFIs that have adopted group liability in some LDCs have not carried through with their threats and punishments to non-compliers. It is important to establish credibility at the outset with a strong enforcement policy. Effective loan recovery strategies may, also, include using indirect controls and measures to raise the cost of defaulting to borrowers. This could be achieved by (a) imposing a penalty on arrears (b) disqualifying the borrower or group from future loans even if the loan is paid off, or (c) disqualifying the borrower or group from future credit until existing arrears are settled.

Recoveries could, also, be improved by providing more incentives to borrowers to repay early and to staff to collect more early. To encourage borrowers to pay, and pay on time, most of the rural financial institutions have relied mostly on such borrowers becoming eligible for future available credit and/or receiving an increased amount of loans in the future. RFIs should explore as an alternative, using interest rebates or reducing total expected payments as an incentive to encourage timely payment. Rural households in LDCs by and large are attracted to interest income and profit opportunities, and are likely to take advantage of any offers that will benefit them. Similarly, the absence of an incentive system for the staff, especially those who maintain direct and constant contact with borrowers may contribute to sub-optimal performance. Appropriate incentives will lead to increased accountability and high degree of staff motivation. These incentives could be both monetary or non-monetary. They could take the form of yearly bonuses based on a percentage of branch, department, or section profit, or they could be based on number of loans executed, loans collected or savings mobilized. Non-monetary compensation

could include trips, plaques and certificates of recognition and appreciation or special treats and certainly, promotion.

9.4 Collateral

Most of the RFIs do require one form of collateral or another, usually, land, equipment and real estate. Alternative collateral might include blocked accounts, or requiring the borrower to open a joint savings account with the institution, or providing additional guarantors or co-signers. Despite the problem of the invasion of privacy that the latter approach may entail, the use of additional guarantors or co-signers does have advantages to the lender similar to those of group lending. Collateral could, also, take the form of interlinking or loan hypothecation. Hypothecation requires the temporary transfer of legal ownership to the bank of an investment item or future production from loan project financed by the bank. In a way similar to interlinking of loans, hypothecation has the potential for reducing risk to the lender. With some modifications such practices could be adopted by other RFIs. Interlinkage and hypothecation of loans will certainly be much more effective strategies, particularly, where a significant amount of collaboration, cooperation and information sharing exists between institutions.

Generally, RFIs in LDCs can minimize their risks of lending by employing some form of borrower classification system. This strategy will entail setting maximum and minimum loan sizes to different borrowers, depending on the level of risk as perceived by lender. The process will allow for larger loans, for instance, to estates than to smallholder. Typing of borrowers is presently been used by some RFIs in LDCs, and can readily be adopted by others, using perhaps different criteria as a basis for such classification.

9.5 Linkage and Collaboration

There is presently little or no linkage and collaboration among RFIs in LDCs, and between RFIs, IFIs and NGOs in some LDCs. Hence, the absence of avenues for risk reduction, such as through inter-bank market activities like information sharing and joint activities. Formal sharing of information, especially on credit clients between RFIs is virtually non-existent, in several LDCs. Similarly, joint venture undertakings between the various institutions in the rural financial market are grossly lacking even between the relatively few FFIs that operate in rural sectors of LDCs. Where some form of cooperation appears to exist, not much credit-relevant information is exchanged. Linking these institutions, as well as forging collaboration between them, will be potentially rewarding to

RFIs in so far as risk containment is concerned.

Linkage and collaboration between RFIs and other institutions and organizations active in rural development, such as the NGOs, could provide other avenues for reducing some risks associated with servicing the sector. Very few RFIs in LDCs use NGOs and IFIs as a matter of policy to on-lend funds to the rural sector or to MSMEs.

Using NGOs and IFIs as intermediaries has a number of advantages, the most relevant being the potential for risk sharing and reducing transaction cost. IFIs, such as Moneylenders and Traders, are likely to have much better information on credit worthiness of potential loan applicants. Besides, the ability to monitor the use of loans is likely to be better in the Informal Financial Market. The experiences in some LDCs of most IFIs and NGOs in dealing with rural households enables them to better withstand or minimize certain risks, and to succeed where FFIs may not.

9.6 Technical Support/Services

Improving farmers and MSMEs access to technical support and to financial and technical consultancy services can raise productivity and, thus, reduce the risk of lending. Although a growing number of the financial institutions, particularly, FFIs provide their clients with some technical assistance, mainly in the form of seminars and training in entrepreneurship, management and business skills, only a limited number of rural borrowers have fully benefitted from such programs. This is due in part to inadequate manpower and financial resources to intensify and expand upon these activities.

9.7 Crop Insurance Schemes

Crop insurance could be required of estate farmers and large smallholders, most of whom engage in the growing of export crops. RFI's lending in the rural sector goes largely to agriculture to finance the production of food and cash crops. However, most of the funding goes to estates and large smallholder, meaning that most of the risks of lending to agriculture and to the rural sector is tied with this group. Given the uncertainties of agricultural production and the potential for losses due to natural causes, RFIs may consider requiring estate farmers and large smallholder to carry crop insurance to protect them against natural disasters. In recent decades, some agriculture-dependent LDCs have suffered from a host of disasters, causing pain and suffering to farmers, rural households and the national economy as a whole. Some of these experiences could provide a starting point from which to rationalize, as well as market, such programs.

Premiums for such insurance will depend on the size of the loan, and could be factored into the loan agreement. Admittedly, crop insurance schemes are not new in LDCs, and many developing countries have experimented successfully with them²⁸. Often, it is convincing farmers of the usefulness that poses problems. This obstacle could easily be overcome with proper marketing and education.

It is important to note that whereas RFI's are risk-conscious and have employed a variety of strategies and practices to tackle the problem, risks inherent in servicing rural sector of LDCs are intricately tied to the performances and the price of their exports, including both cash and food crops. This underscores the importance to the RFI's of a crop insurance scheme, particularly, for those that depend largely on agriculture, whether funded by the farmer-borrower, or subsidized by the government through special provisions to compensate lenders of actual losses incurred. Concern for risk, of course, must be continually reconciled with cost, and to the extent that any measure or strategy employed does not reduce cost or increase returns, it may not be optimal for RFI's.

9.8 Capacity Building

Success in the efforts of LDC to develop the rural financial markets, provide more financial services to the rural sector and improve access to these services will depend, in part, on the success in creating an enabling environment. In several LDCs deficiencies persist in several areas, including intermediaries, infrastructure, institutional support, and manpower development.

Capacity building of the intermediary, in particular, is of urgent importance, as this will inevitably increase the efficiency of financial intermediaries and help improve the effectiveness of the linkage process, as well as the quality of services²⁹. Capacity building of the intermediary will entail solving those problems commonly faced by financial institutions, rural and non-rural alike. These include (1) Setting objectives and priorities (2) Becoming efficient (3) Managing change (4) Creating independence (5) Project design (6) Accounting practices (7) Personnel and organizational management, and (8) Information management³⁰.

28. Peter Hazell, Carlos Pomareda, and Alberto Valdes. eds., *Crop Insurance for Agricultural Development: Issues and Experience*. P.K. Ray, "The Role of Crop Insurance in the Agricultural Economy of the Developing Countries".
29. Maryke Dessing, (July 1990), *Support for Microenterprises: Lessons for Sub-Saharan Africa*, World Bank Technical Paper Number 122.

30. Grindle, "Capacity Building" (1987), in Maryke Dessing, (July 1990).

As many LDCs and donors alike continue to look to the various financial institutions (formal, semi-formal, and informal) in LDCs to serve and support economic development in general, and in the rural sector and MSMEs, in particular, it will be necessary that these institutions be strengthened and upgraded with appropriate incentives and support, including training and education and development of the rural infrastructure.

9.9 Infrastructure Development

Expanding the existing social and economic rural infrastructure will have a substantial positive impact on rural development in LDCs by reducing the risks of servicing the rural sector resulting from poor infrastructure. Rural areas of LDCs for the most part lack adequate means of communication and transportation. Electricity and pipe borne water are scarce in many rural areas of LDCs.

Deficient rural infrastructure is often cited as a factor preventing the adoption of new technologies. The latter, in turn affect productivity levels, and growth in real income and savings. Important experimental and pilot programs in the area of agriculture and IGAs in LDCs often have to use alternative venues and substitutes because of the lack of dependable sources of power or water. The limited presence of FFIs, particularly, commercial banks in rural LDCs, and the lack of timely access to financial services by rural inhabitants is, in part, the result of poor transportation and means of communication, as these do have a positive effect on transaction costs. Rural households and businesses located in rural areas have, also, had to face the high costs of transportation in marketing their products and services, which is, also, a result of the inaccessibility to good roads and to good means of transportation.

Improvements are also needed in the areas of institutional support through enabling policies as this could potentially reduce the risks of servicing the rural sector. Existing government policies in some LDCs have been less productive and in some cases (directly or indirectly) have been, detrimental to efforts at providing FFIs services to MSMEs and the rural sector. This is the case with interest rates that in several LDCs are regulated and credit ceilings that are often set by the central banks. Only recently, in some LDCs, however, are the issues of interest rates and credit ceilings being addressed.

Additional assistance for those institutions presently servicing the rural sector and microenterprises may be a potential successful risk-reducing strategy. Such assistance will enable some of the RFIs to improve on their activities, strengthen, and expand their operations. Particularly critical and in short supply in several LDCs, however, are resources for institutional building and strengthening. Such resources, devoted to incen-

tive³¹ systems and to guarantee adequate training, efficient and meaningful managerial information and accounting systems, will greatly enhance efficiency in these institutions and go a long way to minimizing relevant risks. Similarly, such support should provide the legal and regulatory framework that will allow existing financial institutions to diversify by allowing them to provide a broader range of services to the rural sector and MSMEs, including credit allocation and domestic savings mobilization. This will provide competition, an important and needed ingredient for deepening the rural financial system in several LDCs. Potential risk-reducing institutional support strategies may require LDC governments to provide adequate incentives, to encourage FFIs to expand their activities to the rural sector. Such strategies will minimize the risks associated with FFIs experimenting with new financial instruments that may be more suitable to MSMEs and the rural sector.

9.10 Training and Education

Propelling economic growth and development in rural LDCs as well as success in managing the risks associated with servicing the rural sector will depend, in large part, on an increased effort on the part of LDC governments in the area of training and education for both rural inhabitants and for institutions engaged in servicing the rural sector. High illiteracy rate, insufficient human resources development are all risk contributing (increasing) factors that have often been cited constantly as important development constraints for rural LDCs. The absence of a large entrepreneurial class and a large pool of competent managers in some LDCs and in rural areas in particular, continues to limit development and the provision of service to the sector.

LDCs should strive to make formal education accessible and affordable to the masses as well as to improve the quality of education. In addition, the strategy should include increasing training opportunities for farmers, MSMEs, women, field officers, and bank workers through both formal and informal avenues. At the institutional level, there is need for continuous training in project analysis, in credit processing procedures, in credit supervision, monitoring and recovery and management. Such training should ultimately minimize some of the risks associated with providing services to these group and the rural

31. Inadequate incentives contribute in part to the difficulty in providing services to the rural sector. It remains an important, but missing ingredient to rural development in LDCs. Also see Marvin P. Miracle, "Economic Incentives for Loan Agents", in J.D. Von Pischke, Dale W Adams, and Gordon Donald, *Rural Financial Markets in Developing Countries: Their Use and Abuse*, p. 213.

sector by addressing the common problem of loan default and recovery, and the effective use of resources. Training exercises aimed at improving the ability of both SFFIs and FFIs to work with rural households and MSMEs should reduce certain risks by expanding their knowledge, and facilitating efforts to provide financial services to these group. This should improve interactions between providers and receivers of financial services by minimizing the risks often associated by the former in dealing with the rural sector. At the level of rural households and MSMEs, training opportunities should facilitate the adoption of relevant technologies. Certainly, education that will improve the technical and management skills of farmers and MSMEs as well as increase their access to financial and technical consultancy services should also reduce risk and eventually lead to increased productivity in agriculture and in other income earning activities.

The present economic condition of many rural LDCs, in light of experiences of LDCs in the past two decades, does certainly create a need for more capacity building both as a strategy for fostering rural development and as a risk-reducing strategy. Furthermore, the ability of the financial institutions to compete and to contribute more towards rural development and the development of MSMEs will depend, in part, on how successful some of the areas addressed in this paper are tackled, particularly, in minimizing some of the risks, real or imagined, often cited by RFIs and non-RFIs as constraints. Without a doubt, LDC governments have to set the proper environment through appropriate policies and directives and with fostering a stable and healthy economic climate.

10. Summary and Conclusion

Renewed and heightened interest in rural development now appears a common avowed objective among the majority of LDC leaders. Similarly, many of these LDCs and DAAs regard the lack of access to financial services as a major constraint to increasing investments and productive activities and, consequently, rural sector development. This has made urgent and important, efforts to address the issue of accessibility, to examine the rural markets, and to explore, relevant strategies to increase accessibility to financial services for rural inhabitants. That was the goal and theme echoed throughout this paper. In doing this, it was important to bear in mind the underlying belief that the future of the rural sector of LDCs and rural sector development are intricately tied to the health, future growth and performance of the economy as a whole and the rural financial markets in particular. This relationship is similarly linked to the success or lack of it in expanding and improving access to financial services for the millions of rural inhabitants.

Incidentally, both the rural sector and RFM growth and development remain stifled and

impeded by a number of constraints. Some of these constraints could be substantially lifted by exploring and, in some cases, experimenting with various strategies and options.

In this paper, several of these strategies and options have been suggested. Notwithstanding how much real success may be accomplished by LDCs who apply or adopt this route and how quickly they may be accomplished, it seems clear that the problem of accessibility to financial services to rural LDCs and ultimately, rural development in general would be better accomplished in those LDCs whose governments are committed to efforts and strategies that among others will deepen the rural financial markets, forge collaboration and linkage between the markets, minimize the risks of servicing the rural sector and enhance capacity building.

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Abstract

The majority of the population in Less Developed Countries (LDCs) not only live and work in the rural areas but have little or no access to financial services. The lack of access to financial services is considered one of the major constraints to rural sector development, particularly to increasing investments and productive activities. Poverty remains widespread in rural areas of LDCs. The rural economy is generally in poor health and growth remains stifled. This paper examines the rural economy and the rural financial markets, exploring in the process strategies for increasing accessibility to financial services for rural inhabitants.

ACCÈS AU FINANCEMENT ET DEVELOPPÉMENT DU SECTEUR RURAL

Résumé

La majorité de la population dans les Pays Moins Avancés, non seulement habite et travaille dans les zones rurales, mais a un accès limité ou nul aux services financiers. Le manque d'accès aux services financiers est considéré comme étant l'un des obstacles majeurs au développement du secteur rural est à l'augmentation des investissements et des activités de production. La pauvreté est répandue en zone rurale dans les Pays Moins Avancés. L'économie en zone rurale est pauvre et limitée et la croissance comprimée. Cette étude examine l'économie rurale et les marchés financiers ruraux, tout en explorant les procédés stratégiques visant à améliorer et à augmenter l'accès des populations rurales aux services financiers.

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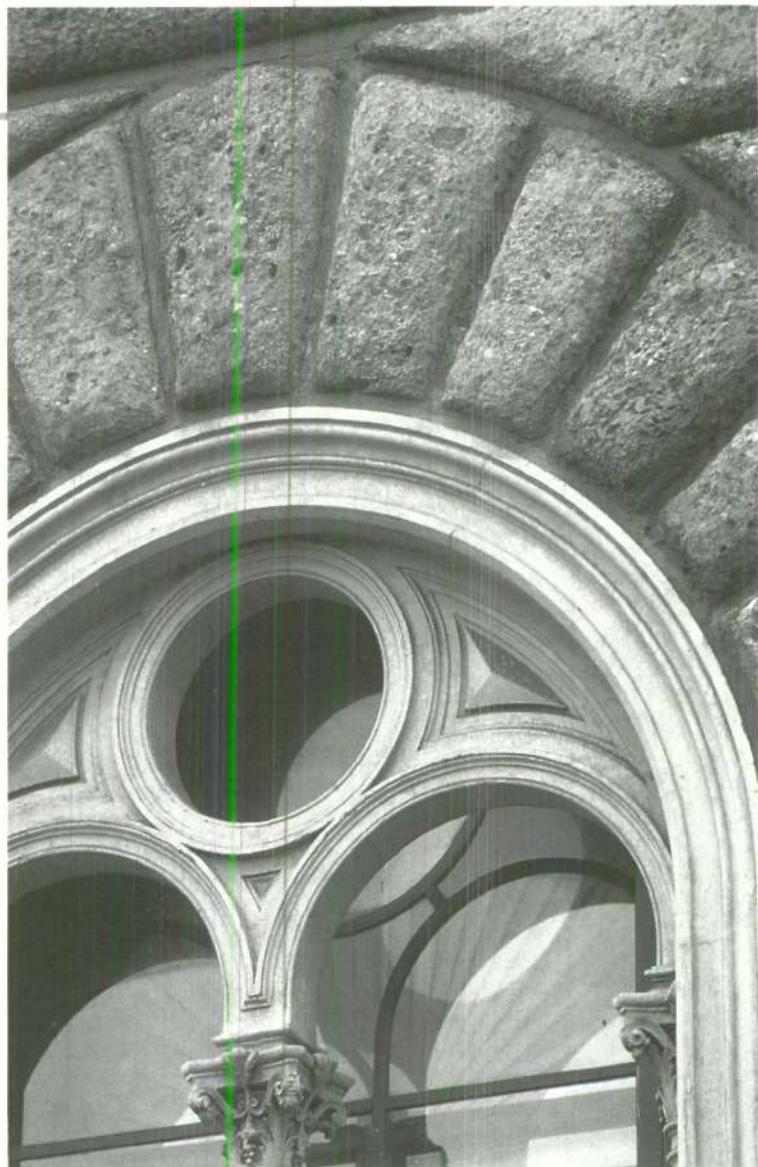
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Summary

The crucial aspect to focus upon in evaluating Africa's experience in financial sector development is its savings effort, the level and quality of financial intermediation and the efficiency in resource use. On all these scores, the African financial sector has performed very badly. Upon acceding to political independence, African governments decided to remodel their financial infrastructure by the establishment of a diversified set of financial institutions - viz - commercial banks, development banks, savings banks, co-operative banks, housing finance and postal savings banks, etc. Unfortunately, the ensuing benefits have not been commensurate with the enormous costs incurred. A great deal of effort was geared towards the provision of credit rather than the mobilization of resources. The official attitude to resource mobilization has been extremely lax partly due to foreign resource inflows and partly due to the inexpensive rediscounting terms and facilities provided by the central bank.

Commercial bank branches have not yet been sufficiently diffused in the rural hinterland with the result that Africa's resource potential in the rural areas still remains untapped. Development and Co-operative banks have literally become mere retailers of foreign loans and government funds even though many were empowered to mobilize resources in their statutes of establishment. The operations of specialised financial institutions are generally insulated from competition by various legislations, and are even provided with generous subsidies. Instead of undertaking much wider and more demanding tasks, (eg. bringing in financial innovation, developing money and capital markets, broadening the monetized sector of the economy, improving the unorganized segment), central banks

in developing Africa are confined to the narrow contours of a regulator, and are circumventing financial deepening through the provision of generous accommodation to the commercial banks and the government.

Bank credit still remains a financial appendage of certain enclaves: large-scale mineral exporters, highly protected manufacturing, foreign owned undertakings, and the parastatal sector. In contrast, small farmers and indigenous small-scale enterprises remain financially repressed although they possess quite a large share of the deposit resources on which bank credit is based. These repressive influences of the formal banking system are perpetuating the enlargement of the informal sector.

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Dr. Heli Perrett is an independent consultant, specializing in social aspects of development planning and implementation. She is the author of numerous books and reports on communication, education and behavioural considerations in rural development planning. In addition to her extensive writing, she has continued to pursue a career as educator and has taught at the Catholic University of Peru in Lima, and the American University in Washington, D.C. among others.

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Rural women have been one of the most consistently neglected groups in development planning and programming, and, paradoxically, one of the groups with the greatest unrealized potential. Direct access to credit, accompanied by savings, can become a catalyst for change that brings benefits to rural women, as well as to their families and communities. The book will address this issue as follows:

— In the introductory chapter, the reasons for direct, lending to rural women in developing countries are highlighted and women's creditworthiness is reviewed.

— A review of women's informal practices of borrowing and saving, their advantages and disadvantages is given in Chapter 2.

— This is followed by an overview of women's limited use of formal financial markets for borrowing and savings, and existing constraints on the supply of credit to women in Chapter 3.

— Chapter 4 discusses women's demand for credit, its assessment and promotion, with reference to both institutional credit and to savings.

— Chapter 5 provides an overview of institutional strategies for providing financial services to rural women, either separately or together with men, with extensive case illustrations; the variety of operational linkages that are being tried between credit and savings.

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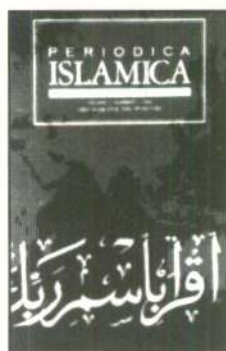
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