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POSSIBLE WORLD BANK INTERVENTIONS IN RURAL FINANCIAL MARKETS IN THE FORMER SOVIET UNION

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BACKGROUND

Countries in the former Soviet Union (FSU) have similar institutions that provide financial services in rural areas, their main differences being the degree of macroeconomic stability and the extent of reform in which they operate.[1] In the past these institutions were mainly used as fiscal agents rather than as financial intermediaries. The dismantling of centrally planned economies, the loss of fiscal and monetary discipline, and inflation have wrecked these organizations. Economic chaos is dissolving their ability to fund investments in agriculture and eliminating their capacity to finance economically-justified shortfalls in the operating expenses of agricultural firms.

The effect of credit shortages on near-term agricultural production is difficult to assess. Demand for more agricultural credit can, in part, be due to economic stress and rent seeking, rather than due to the lack of funds for profitable investments. Law and order, land tenure security, availability of modern inputs, and attractive prices are stronger determinants of farm production than is credit. In some cases, nevertheless, lack of credit may hinder input and product markets in the short run. In the long run, an efficient rural financial system is essential to lubricate rural development. In large part, there are no rural financial markets in the FSU, just the institutional wreckage left from economic reforms that are twisting through the region. These markets must be reconstructed in the near future to support rural development.

This poses several questions for the Bank:

1. If the Bank intervenes in rural finance, what objectives should it pursue?

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[1]The term 'rural financial markets' encompasses agricultural credit, deposit mobilization, financial services provided to non-farm rural enterprises, and also covers formal and informal financial transactions in rural areas.

2. What lessons can be drawn from previous experiences with reforms of rural financial markets elsewhere that might be applicable in the FSU?

3. If agricultural production has high priority, can the Bank determine the severity of credit constraints, their location, and thereby decide where to focus interventions?

4. What options does the Bank have for intervention and how should they be sequenced?

OBJECTIVES

Should the Bank intervene in rural finance primarily:
A. to stimulate agricultural production?
B. to support privatization? Or,
C. to build efficient and durable financial systems?

What priorities should be assigned to these objectives? Credit programs that help to achieve A and B may make it more difficult to accomplish C. The Bank, for example, might fund an emergency credit program that targets loans at selected agricultural activities and sets terms that result in negative real rates of interest. Such a program could be targeted primarily at private enterprises and thus help to achieve objectives A and B. The fact that the Bank acquiesced to loan targeting and subsidies--thus resuscitating the old credit system--may retard future reforms. In addition, credit programs that extend traditional lending practices will likely suffer defaults. Making a clean break with the old system is an important step for the Bank to consider. This break involves using financial markets differently by allocating loans based on creditworthiness rather than on need, and also protecting the interests of depositors.[2]

In most FSU countries the volume of funds that the Bank might provide for rural credit will be small compared to the size of the agricultural sector. It seems reasonable to focus these limited funds on reinforcing the growth of private firms, rather than on spreading them more thinly over the entire sector. The non-reformed firms have more latitude to make barter arrangements that partially substitute for finance and likely have more access to traditional sources of credit than do private firms.

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[2]A creditworthy loan is based on the ability and willingness of the borrower to repay borrowed funds. Loans based on need emphasize other lending criteria.

EXPERIENCE IN OTHER COUNTRIES

Finance activities in low-income countries and in countries that have substituted market forces for central plans may provide some insights that are useful in the FSU.

Low-income countries

The Bank and other donors have four decades of experience with agricultural credit in low-income countries.[3] Until the 1980s these efforts were characterized by concessionary interest rates, both on credit lines from the central bank to the ultimate lender, and on loans made to farmers--even lower interest rates were imposed on depositors. It was also common for these program to target loans at selected economic activities, investments, regions, or groups. Negative real rates of interest, hefty administrative costs, and loan defaults caused these programs to be chronically dependent on outside funding. Many of the agricultural credit institutions supported by donor efforts have since become insolvent or disappeared. The unsatisfactory performance of many of these programs caused several donors, including the Bank and the Agency for International Development (A.I.D.), to avoid agricultural credit activities during the late 1980s and early 1990s.[4]

Support for these traditional agricultural credit programs was further weaken by uncertainty about whether loans were vital in stimulating production, use of new technologies, or investments. In some cases additional lending was associated with more production, adoption of new technologies, and investments. But it is unclear how many of these changes would have occurred without loan programs to support them. Major portions of the Green Revolution in Asia during the late 1960s and early 1970s, for example, occurred without the assistance of targeted credit programs; the large increase in production of cocaine in Latin America during the 1980s also happened without credit support. Several countries--Brazil, Sri Lanka, and the Philippines being examples--suffered sharp declines in the real value of agricultural credit during the 1980s with little change in growth of aggregate farm output. Several studies in the Philippines found that product prices, availability of modern farm inputs and their prices, investments in infrastructure, and

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[3]Evaluations of some of these programs are provided by Donald (1976) and the World Bank (1993a).

[4]The "Levy Report" was the main reason for the Bank's backing away from agricultural credit (World Bank, 1989a). Criticism of traditional credit projects and a shift in development priorities explain A.I.D.'s down grading of agricultural credit programs.

economic stability were more important determinants of agricultural growth than was volume of credit (Sacay, Agabin, and Tonchoco; Rosengrant and Herdt).

Traditional credit programs were also criticized because they increased income concentration and proved to be unsatisfactory second-best policy options (Gonzalez-Vega; Malik and others). Subsidies in credit programs were distributed regressively because they were proportional to the size of loan: large loan, large subsidy; small loan, small subsidy; no loan, no subsidy. Since only relatively well-off people receive loans--especially large loans--they usually ended up with most of the subsidy. Due to fungibility, subsidized and targeted credit proved to be ineffective in offsetting the adverse effects of other policies or conditions; cheap credit did not make unprofitable activities profitable. Excess demand for cheap credit often resulted from subsidy seeking rather than from a surfeit of high return investment opportunities.

These problems culminated in a World Bank Task Force report in 1989 and the World Development Report in 1989 that both called for less credit subsidies and targeting to stimulate production and investments, and more emphasis on strengthening financial markets. The Inter-American Development Bank made similar changes in policies during the late 1980s and early 1990s.

Former centrally-planned economies

Reforms in financial markets in Eastern Europe are underway and, as a result, have not been systematically studied. Earlier reforms in Chile and the Peoples' Republic of China (PRC) have been partially documented. Chile's reforms resulted in extremely high real rates of interest on agricultural loans in the late 1970s (Corbo; Diaz-Alejandro; McKinnon 1991). Accompanied by a breakdown in bank supervision, this led to extensive adverse selection in lending, loan defaults, and a collapse of the banking system. At the same time the extremely high real rates of interest discouraged loan demand for purposes that had expected returns which were otherwise attractive, but lower than the high real rates of interest. This led McKinnon (1991) to conclude that fiscal and monetary reforms, leading to moderation in inflation, are prerequisites for interest rate liberalization. There is no aggregate information to show that turmoil in financial markets seriously crimped agricultural production in Chile during this period (Valdez and Quiroz). Attractive farm prices and profitable export opportunities more than offset the adverse effects on production of high interest rates.

Reforms in the PRC since 1978 were more gradual and caused much less disruption and inflation than is occurring in the FSU. As a result, the formal rural financial system--largely comprised of the Agricultural Bank of China and a large number of Rural

Credit Cooperatives--was not disrupted by reforms. Large amounts of rural deposits comprised a substantial portion of the funds lent and interest rate policies protected deposits. In large part, the rural financial system in the PRC has been increasingly used to intermediate between surplus and deficit units, rather than as a channel for targeted credit and subsidies. Increases in rural incomes also allowed farmers to self finance and to extend informal loans to others. The low profile of formal credit in agricultural development in the PRC is reflected in the lack of attention paid to this topic by students of China development, such as Perkins and Yusuf. Nevertheless, recent research by Feder and others shows that an expanded and more efficient formal financial system would ameliorate inefficiencies in resource allocation. Cho provides evidence from Korea that supports Feder's findings.

Partial reforms

Fragmentary information from countries that have done partial reforms provides additional insights. Several countries, for example, have recently privatized and liberalized their fertilizer markets--Bangladesh, Egypt, Kenya, and Ghana being examples. This, in turn, caused a refocusing of credit. Formal loans to farmers for purchase of fertilizer decreased, more lending was done to agents participating in the import-production-marketing of fertilizer, and informal loans emerged to facilitate transactions not directly supported by formal loans.[5] At least in Egypt, fertilizer dealers felt compelled to provide informal loans to compete for customers. Liberalized product prices in several countries, including Egypt, also enhanced the incentives farmers had to use fertilizer.

During the 1960s and 1970s the Indonesian government fomented several phases of a large traditional agricultural credit program, under the acronym of BIMAS, that involved subsidies and loan targeting. BIMAS collapsed in the early 1980s because of loan defaults and government fatigue from continual requests to recapitalize the program. Instead of abandoning the financial infrastructure created by BIMAS, the government substantially reformed the system, liberalized interest rates, stressed deposit mobilization, revised bank employee incentives, and switched from making loans on the basis of need to making creditworthy loans. Almost immediately, recovery performance substantially improved and in less than a decade the system was mobilizing more deposits than were being lent (Yaron, 1992).

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[5]See Ghate and also Chandra for descriptions of how informal credit arrangements in Asia support various types of marketing transactions.

Perhaps the most interesting feature of this experience was how quickly a poorly performing system was transformed into one that better supported development (Patten and Rosengard). This suggests that similar rapid changes may be possible in the FSU if proper policies are adopted and agricultural production is profitable, as was the case in Indonesia.

Summary of lessons

The reforms in the FSU are off-the-scale when compared to recent reforms in other countries. They involve turning political systems inside-out, civil turmoil, a tearing apart of production and marketing units, rampant inflation, dealing with huge price distortions, major declines in living standards, and a transformation of the financial system from one that was largely passive, to one that is an active participant in the economy. Further, there is little memory in the FSU of how a private sector operates--unlike China and Poland--and many people in the FSU have deeply held prejudices against individuals involved in private markets.

Experience from low income countries, from other formerly centrally planned economies and from partial reforms provides useful guidelines on what to avoid and some insights on the elements that are necessary to build durable financial systems in rural areas. These experiences also suggest that agriculture in general has a good deal of staying power and is able to muddle through for a time when financial markets are disrupted. These experiences also show that farmers are creative in devising substitutes for formal finance including barter, self finance, and informal finance. Most importantly, it is obvious that farm prices, availability of critical inputs and new technology, and the prices of purchased inputs are far more potent in influencing farmers' production decisions than is credit.

CREDIT CONSTRAINTS

Although often attempted, estimates of credit demand are problematic, especially where financial systems are used to process loan-default and interest-rates subsidies. The effective demand for any subsidy is virtually infinite.

Estimation problems are worse when potential borrowers are stressed by depressed prices or yields, and by other economic turmoil. Questions about credit needs elicit self-serving answers when subsidies are expected. The refrain that I'm from the government and I'm here to help is often responded to by the reflex "we need credit." Selecting cases where borrowed funds can be used efficiently and repaid, from many cases of credit need is the main task of an efficient credit system. Resources cannot be efficiently allocated within a complex economy unless this screening is done effectively. In part, centrally planned economies collapsed because financial markets were not allowed to screen; loans went to units that were least efficient in their use of marginal resources instead of to those that were most efficient, thereby wasting resources.[6]

In the absence of a financial system that is effectively screening borrowers, there is no systematic way to estimate the extent to which credit constraints hinder farm investments and production. One is forced to use proxies for this. If production units are stable, representative case studies of farm investment opportunities shed light on credit constraints. These case studies may also illuminate the extent to which self finance, barter arrangements, leasing, and informal financial provisions are substituting for formal loans. It may also be possible to use economic data on production units assembled by planning offices to sort out the importance of credit constraints on units that have not been reformed.[7]

If production units and markets are being reformed and prices are distorted, studying farm markets may shed light on credit constraints. For example, sharp declines in the use of inorganic fertilizer and farm chemicals may be due to credit shortages--they may also be due to market disruptions or to major increases in input prices, combined with expected low product prices. The importance of credit in this must be determined on the ground by individuals who understand local agricultural practices and markets.

Until farm production units are reformed and rural financial markets are strengthened it will be difficult for the Bank to quickly develop credit programs that extend loans to large numbers of farmers on the basis of creditworthiness. This may force the Bank to concentrate its interventions on relaxing credit constraints that may impede farm markets, instead of lending directly to farming units.

ECONOMIC AND FINANCIAL ENVIRONMENT

FSU countries lie along a continuum of economic conditions. On one end of the continuum--the relatively stable end--are the several countries that have moderate rates of inflation, are at

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[6]This important point was clarified by McKinnon and Shaw in books published in 1973.

[7]Documenting credit constraints is one thing; designing credit programs that effectively relieve these disparate constraints is a separate and, often, an even more difficult problem.

least part way through reforming their production and marketing enterprises, have liberalized prices, have effective fiscal and financial controls, and which enjoy political stability. Countries at the other end of the continuum--the chaotic end--may suffer civil war, have no competent fiscal system, have few effective financial controls, have serious price distortions, have unreformed production and marketing systems, and have escalating inflation. The Bank has a number of traditional options for intervention at the stable end of this continuum, but has few options--aside from waiting--in countries at the chaotic end. The most challenging situations are among those countries in the middle of this continuum that have turned the reform corner and are becoming more stable.

The Bank's decision to intervene might turn largely on the following criteria: the rate of inflation, agricultural pricing policies, interest rate policies, extent of privatization, and willingness of the government to allow existing or new financial institutions to make creditworthy loans.

Inflation

Inflation is a useful measure of the degree to which a country has its fiscal and monetary house-in-order (McKinnon, 1991). High rates of inflation, especially if these rates are accelerating or are unpredictable, dissolve financial intermediation. The Bank should avoid funding agricultural credit until annual inflation rates decline below 50 percent and are predictable. If governments are stoking inflation by printing money, they have the option of directing additional funds to agricultural credit without the Bank's assistance, assuming credit shortages are critical. Local governments should be able to discern these shortages more accurately than can the World Bank from afar.

Prices

Economically, farm income is more than a one-to-one substitute for borrowed funds. If farm incomes are depressed due to unfair pricing of farm products, the government is withdrawing purchasing power from agriculture to the benefit of other sectors of the economy. These low prices are essentially taxes that depress the rates of return producers expect from investments, lessen the ability and willingness of farmers to self finance productive activities, and undermine loan collection.

Concessionary loans fail to treat these problems for two reasons: they do not alter the low returns caused by the price controls, and it is virtually impossible to match the subsidy tied to the loan with the tax imposed by price controls. A firm that is substantially disadvantaged by product price controls may receive no loan or only a small loan, for example. At the same time, another firm may receive a large loan and subsidy, but bear none of the tax because it avoids producing the commodity that suffers the worst price distortion.

The Bank might justify a policy or sector loan if it is conditioned on adjustments in food prices, but it is awkward to encourage these types of policy changes through credit projects. Higher prices would allow more self funding, increase the rates of return on farm investments, irrigate informal financial markets, and enhance loan repayment capabilities. If the government refuses to rationalize farm prices, it is assigning a low priority to agriculture. Bank interventions in rural financial markets cannot be effective until priorities are adjusted.

Interest rates

Prices in financial markets are likewise important. Providing financial services in rural areas is expensive and depositors should be paid positive real rates of return on their savings. If governments insist on providing cheap credit they are consigning the rural financial system to subsidy dependency (Yaron, 1991a). Political intrusions into the lending process, loan targeting, and loan defaults foster the dependency syndrome. Bank interventions in rural financial markets work best where farm prices and interest rate policies have been liberalized. In cases where distortions remain, price reforms should precede bank funding of agricultural credit programs.

Even when interest rates have been liberalized, credit projects are still problematic in highly inflationary economies. If loans are properly indexed to compensate lenders for all inflation, a Bank credit program is likely to encounter loan disbursement problems. Farmers are often unwilling to pay nominal interest rates that are variable and which may involve three digits, especially when they are uncertain about the prices they will receive for their products. Lending at extremely high nominal interest rates is likely to attract many borrowers who may not repay their loans (Stiglitz and Weiss).[8]

Privatization

If the Bank decides to focus most of its credit assistance on the emerging private sector, thus encouraging reform, a significant number of private farmers and private agribusinesses should be in place before the Bank provides funds for agricultural credit. If they are not present, any Bank credit programs should foster formation of private firms.

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[8]The Egyptian proverb, "A Bankrupt and a usurer do not disagree," conveys the same message.

Capacity to make creditworthy loans

Banks accustomed to satisfying credit needs lack capacity to make creditworthy loans. It will take several years to develop this capacity by either forming new institutions and training new employees, or by reforming existing institutions and retraining their employees. Developing this capacity might be the objective of a regional training project along the lines outlined in a recent World Bank regional training project proposal for Russia (World Bank 1993f). Bank assistance in rural finance might be made contingent on a country beginning this retraining.

The inability to make creditworthy loans will likely restrict the Bank's funding of rural credit projects for the next several years in most countries in the FSU.

INTERVENTION OPTIONS AND TIMING

Bank options for intervening in rural financial markets depend on macroeconomic conditions and on the status of reform in each country. Possible interventions might be arrayed along the continuum mentioned earlier, from chaotic to relatively stable.

Chaotic

Countries that lack fiscal and monetary discipline, that have done little privatization, that suffer high rates of inflation, and that maintain low food prices offer few opportunities for Bank interventions in rural finance. Substantial interventions must await further reforms, liberalization of prices, and more stability--liberalized product prices being the most crucial precondition.

To prepare foundations for future projects in rural finance the Bank might consider three initiatives: starting policy dialogues on what should be done once economies are more stable, strengthening and reforming institutions that train employees of rural financial institutions, and encouraging legislation that supports a reformed financial market. Beyond this, designing projects around the fringe of finance should be viewed as stop-gap measures.

Few policy makers in the FSU appreciate the difference between loans based on need and those based on creditworthiness. They are likewise vague on the difference between using financial markets as fiscal instruments and employing them as financial intermediaries. It would be useful to expose these policy makers to the new thinking about rural finance that has become conventional wisdom in Washington and to also assist them in making contact with people having similar interests outside the region. The Economic Development Institute may be able to conduct policy seminars along these lines and the Food and Agriculture Organization might establish a regional credit association that ties professionals in the FSU who work in rural finance to individuals with similar interests in other countries.

The Economic Development Institute might also help upgrade the capacity of training institutions in the FSU that deal with rural finance. Modern data processing, new accounting procedures, making creditworthy loans, deposit mobilization, and employee incentives are a few of the topics that might be emphasized in this training-of-trainers.

Financial transactions lean heavily on contract and banking law. This includes laws affecting loan collateral and bank regulation. The bulk of these laws should be in place before creating rural financial markets.

Food supply problems may compel the Bank to fund stop-gap programs aimed at augmenting agricultural production in the midst of economic chaos. Targeted credit programs are a tempting way of doing this because they are easy to design, can be used to move large amounts of money, may disburse rapidly, and demonstrate a response to critical problems. The Bank may want to answer several questions before funding such programs: If borrowers are required to pay positive real rates of interest will the Bank's funds disburse? If the funds are disbursed, will loans be repaid? Will the program retard policy and institutional reforms? Will the program have the desired effect on borrowers' production decisions? Will the program leave a residue that may hinder the future development of efficient financial markets? Are there better ways to stimulate production than credit? It is possible to answer these questions by long distance?

Instead of funding credit programs under chaotic conditions, the Bank might consider programs around the fringe of finance that more directly affect agricultural production in the near future. If farm prices are repressed, freeing them will have a much larger impact on production than will any credit program. Likewise, if critical input markets have collapsed the Bank might focus projects on creating these markets. This could involve providing critical inputs such as fertilizer or farm chemicals, using sealed-bid auctions to sell these goods to the highest bidders, and then recycling the local currency proceeds into activities that reinforce economic reforms.[9] Such projects

[9]The International Fertilizer Development Center and the Agency for International Development have successfully used such auctions in Romania and Albania to distribute farm inputs.

would foster market prices, distribute inputs to producers who are most willing to pay for them, reinforce privatization, and not stain the financial system.

Emergency programs in product markets will be more difficult to implement, but some experimentation in quasi-finance activities may be appropriate. If transportation problems and lack of competition are major problems, for example, a project might focus on establishing organizations that provide vehicles to private entrepreneurs through lease-hire or truck-leasing. Such arrangements might provide employment for ex-military personnel, accelerate the replacement of inefficient vehicles, and also foster competition in product markets. In some cases, donors in Western Europe may be willing to provide vehicles for such projects. In other cases, these project might stimulate local manufacturers to produce more efficient vehicles.

Another alternative would be to focus projects on developing information systems that support product and inputs markets. This might involve forming or strengthening exchanges that centralize information on goods available for sale on a cash or barter basis, along with developing techniques for disseminating price information. Creating bonded warehouses, in some cases, may also facilitate marketing and allow private banks to provide short-term loans on storable commodities.

Becoming more stable

The Bank has more intervention options in countries that are further through economic reforms, that are increasingly exercising fiscal and monetary discipline, that have declining rates of inflation, and that have liberated most prices. Because of debilities in the financial system these interventions should continue to focus on farm markets, on finance substitutes, and on training.

Under increasingly stable conditions it might be possible for the bank to fund projects with major credit components that directly strengthen farm input and product markets. A project might focus on developing a fertilizer marketing system, for example.[10] The credit component of the project would provide loans to private firms in the fertilizer producing-and-marketing-system. Some of these firms, in turn, would be expected to offer informal loans to grease fertilizer sales. A fledgling financial system may be able to effectively screen a small number of marketing firms even though it is unable to sort a much larger number of potential borrowers who are farmers.

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[10]Similar projects might be developed for seed markets and animal concentrate markets.

If the formation of new private firms is a Bank priority, it may also be possible to design projects that promote equity-funding arrangements. These equity funds might be invested in promising new firms that provide marketing services or in those that handle agricultural exports. Because the mortality rate among new firms is high, even under the best of circumstances, financial institutions avoid lending to these enterprises. On the one hand, if half of the borrowing firms fail, and do not repay their loans, lenders lose half of the money lent, even if the other half of the firms fully repay loans. On the other hand, if new firms are largely assisted through equity participation, capital gains from some firms that are highly successful will offset at least some of the loses inflicted on the provider of funds by firms that fail. Venture capital may be a more appropriate intervention than is medium- or long-term credit in promoting formation of new firms for this reason. Equity is also easier than debt for entrepreneurs to manage.

Strengthening the capability of the financial system to provide financial services in rural areas could also be the focus of additional Bank attention in FSU countries that are moving toward stability. Large numbers of people must be trained to make creditworthy loans, central banks must create the capacity to prudently examine and supervise banks, and bank managers must be trained to operate financial institutions that support a market economy. It will be impossible later to extend many creditworthy loans and mobilize deposits without this capacity.

<u>Relatively stable countries</u>

Where low rates of inflation, substantial private sectors, and liberalized prices exist the Bank can more directly expand the volume and variety of financial services in rural areas. This should include helping to strengthen or form financial institutions, stimulating deposit mobilization, and making short-terms loans. Inventing ways to provide financial services that lower transaction costs for both lender and borrower should also be a major objective. This, in turn, will allow the formal financial frontier to expand gradually (Von Pischke). Care must be taken to foster a financial system that is competitive by encouraging informal finance to expand and to also encourage various forms of formal finance to emerge.

The first step in this process should be to strengthen and, where necessary, to form financial institutions that are willing to make creditworthy loans and also mobilize deposits in rural areas. It is unlikely that private banks will play a significant role in this in the foreseeable future. Some combination of government banks, development finance companies, new grass roots organizations, and cooperatives must be developed to provide these financial services. The extent to which the residual financial infrastructure of the former Agroprombank and the

Savings Bank can be used in this rebuilding is an open question. In the FSU there were about 3,500 branches of the Agroprombank and a major portion of the 75,000 branches of the Savings Bank that were located in rural areas. In many rural localities a branch of the Savings Bank was the only formal financial facility available. It seems prudent to include some of these branches in any new institutional configuration. The exact makeup of the configuration must be crafted on a country-by-country basis and should involve a variety of institutions, not just a single agricultural development bank owned by the government.

This institutional development may start before financial markets are fully restructured, as long as the new program is consistent with the objectives of overall financial reform. This includes making loans on the basis of creditworthiness, avoiding concessionary interest rates, and providing high quality financial services (World Bank 1993c). Whatever results from this restructuring, other alternatives to the state owned banks must be developed to provide financial services in rural areas. In some cases these alternatives might be grassroots organizations that are built along the lines of credit unions. In other cases, multipurpose farm cooperatives might be developed to provide financial services.[11] In still other cases, the government may be forced to take the lead in developing a new rural financial institution. If this is the case, it may be appropriate to design the institution so it converts to non-government ownership in a few years. The traditional cooperative principle of withholding a small percentage of a borrower's loan, which is then used to buy shares in the financial institution, is one way of accomplishing this gradual conversion.

After an institution has been identified, the following sequence of steps should be taken to further develop the system:

- Provide relatively small amounts of money for short-term lending, emphasize employee training, expand the program gradually, and provide high quality services.

- Design employee incentives that are performance driven, that stress loan recovery, and that make each branch a profit center.

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[11]The experience with using multipurpose cooperatives to provide financial services is checkered. Such programs promoted by the U.S., France, Germany, and the United Kingdom in low-income countries have generally been unsuccessful. The Japanese were more successful in developing self-sustaining farmers' associations in Korea and Taiwan, largely because they avoided subsidies, and also because they stressed deposit mobilization.

- Allow lending for any creditworthy purpose in rural areas, especially to those agents who might, in turn, on-lend informally.

- Once the institution is properly regulated, stress deposit mobilization and adjust employee incentives accordingly. Set a goal of mobilizing through deposits, within a few years, most funds needed for lending.

- Reduce transaction costs for the institution, borrowers, and depositors.

- Begin to lengthen the term structure of loans. Avoid making long-term loans until the institution is well established.

- Encourage additional organizations to provide financial services in rural areas to stimulate competition.

- Identify additional financial services that might be provided by financial intermediaries: examples being, checking, transfer of funds, foreign exchange, insurance, leasing, pawnbroking, and equity funding by a subsidiary.

THE MUSLIM FACTOR

In countries that have sizable muslim populations finance programs might require special molding because of religious beliefs, particularly those regarding interest payments.[12] Returns on deposits, for example, might be labeled as dividends or maintenance-of-value payments rather than interest. Likewise, payments for loans might be termed service charges instead of interest. Lenders may also be forced to enter joint ventures with merchants so that markups on merchandise, rather than interest, can be used as remuneration for lending. Various types of profit-sharing arrangements might also be made between lender and importers, manufacturers, and also traders. Despite these types of innovations, it will be very difficult to develop financial services for farmers and consumers if Islamic laws on interest payments are strictly enforced. Adherence to the Quran's dictums on interest rates is an extreme form of financial repression: forcing the system to charge nominal interest rates that are zero.

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[12] For an introduction to these issues see Kazarian.

RECOMMENDATIONS

The Bank should avoid interventions in rural finance that retard reform by resuscitating policies which employ credit as a fiscal tool. Credit, regardless of how it is priced, will not overcome the lack of profitable investment opportunities or the lack of markets. If some profitable investment opportunities do exist, it is unlikely that credit targeted from afar will collide with these opportunities any oftener--and likely less often--than did earlier targeted credit from Moscow. Providing loans to state-owned enterprises should likewise be avoided. Credit rationing will be more severe in the emerging new private firms than in state-owned enterprises because the new firms are out-of-the-loop Moreover, if loans are useful to private borrowers they will likely be more willing to repay their loans than will state-owned enterprises.

Instead of stressing credit interventions initially, it may be appropriate for the Bank to treat more fundamental problems in farm markets and prices, training, and policies. Credit interventions are inappropriate in chaotic countries where various parts of the agricultural system are in flux or are broken. Injecting credit under these conditions is similar to putting oil in a bus that is out of gas, whose engine is dismantled, and whose driver is not sure if he will be paid for either repairing the bus or driving it when fixed. Vital engine parts (farm inputs), gasoline (attractive product price), and driver incentives (profits) must be in place before the lubrication provided by the oil (credit) becomes a limiting factor. Credit programs for farmers should be delayed until other vital economic ingredients are in place: law-and-order, moderate inflation, functioning product and input markets, and rationalized prices.

FSU countries that are beginning to put their economic house-in-order provide a broader scope for interventions in rural finance. These interventions should focus on inflating and facilitating vital marketing activities, rather than providing loans directly for farm production. Credit projects should also give priority to stimulating new private enterprises. Equity contributions and leasing may be more appropriate ways of doing this than is credit.

Countries that have largely reformed their economies and have also imposed fiscal and monetary discipline are more likely candidates for conventional Bank programs in rural finance than are countries without this discipline. These programs should start with institution building, gradually expand short-term lending, then begin deposit mobilization, later extend the term structure of loans, and still later expand the range of financial services provided by financial intermediaries. The lessons learned from earlier Bank experiences with rural credit programs provide a useful list of things to do and not to do in this process:

- avoid using the financial system a fiscal agent.
- avoid loan targeting.
- avoid establishing concessionary rediscount lines.
- avoid negative real rates of interest on loans and deposits.
- stress deposit mobilization with proper bank regulation.
- stress innovations that reduce transaction costs.
- stress quality of services to enhance loan repayment.
- stress making the rural financial system self sustaining.

The next several years the Bank must largely learn-by-doing in its incursions into rural financial markets in the FSU. Pilot projects should be stressed initially, rather than country-wide programs. The Bank should also commit resources to documenting what does and does not work in Bank projects as well as learning from similar projects carried out by other agencies in the region.[13] These evaluations should be done as projects unfold so that mid-course corrections are possible. Evaluation components should be included in most new rural finance projects. A regional capacity to sum experiences by looking across projects and countries should also be developed in conjunction with Bank projects.

Bank employees who are concerned about developing financial markets, those focusing on training, and those who primarily deal with promoting agricultural development must seek each other's advice and assistance when rural finance issues are addressed. It may also be advisable for the Bank to assign additional staff to focus on problems of developing rural financial markets in the FSU. These portions of the financial systems will be difficult to reconstruct and will require time, patience, and specialized expertise.

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[13] Unfortunately, neither the post-project evaluations done by the Operations Evaluation Department nor the more theoretical research done by other offices in the Bank fill this need.

BACKGROUND READINGS

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