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FINANCIAL REFORM AND MARGINAL CLIENTELE IN DEVELOPING COUNTRIES

by

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Abstract

This paper explores the implications of financial reform for marginal clientele in developing countries. It first surveys increasingly more ambitious attempts at reform, as a consequence of the failure of the old interventionist and protectionist strategies of development. It claims that the role of government has shifted from the control of financial prices and amounts to the preservation of macroeconomic stability and financial system solvency. Financial reform is a necessary but not a sufficient condition for increased access to financial services by marginal clientele. Actually, lack of access is due to a much lesser extent to market failure than to incomplete organization and limited institutional and physical infrastructure. Belief that the observed patterns of interest rates and limited access to formal credit in rural financial markets were due to market failure led, however, to the incorrect design and eventual failure of most small farmer credit programs. The main flaws were a generalized lack of concern for risk and for institutional viability. In addition to new policies and institutional design, however, financial innovations will be required. Local financial institutions may become sources of innovation, but cannot reduce systematic risk sufficiently. The development of financial market systems and networks will be needed in order to overcome the limitations of local intermediaries, both in a micro and a macroeconomic sense.

FINANCIAL REFORM AND MARGINAL CLIENTELE IN DEVELOPING COUNTRIES[1]

by

Claudio Gonzalez-Vega[2]

I. Introduction

These are times of extraordinary transformations. Undoubtedly, the monumental changes that have been taking place in the world's political and economic arenas have been a major part of every German's daily life in recent years but, perhaps concerned with the consequences of these transformations on their immediate circumstances, many may have not realized that these swift shifts are not merely a European phenomenon, but that rather the entire world is rapidly changing.

The transformation has been as unpredictable as it has been swift. I do believe that not very many were able to predict the extent and speed of the modifications. In retrospect, of course, one can see that the recent events have been the outcome of processes that have been taking place over many years. Some may have recognized particular dimensions of these trends, but possibly only a few were able to see the whole picture. Even today, it is

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[1] This paper resulted from a lecture by the author at the Deutscher Genossenschafts-und Raiffeisenverband E.V. in Bonn, Germany on March 25, 1992.

[2] The author is Professor of Agricultural Economics and of Economics at The Ohio State University. He is grateful for the invitation of Paul Armbruster to visit the German Cooperative Banks and for the comments of those who attended the lecture in Bonn. Most of the ideas reported here have resulted from the author's work in the Rural Financial Markets Program at Ohio State, sponsored by the Agency for International Development.

difficult to predict where all of these transformations will finally lead the world economy. Some general directions may be identified, nevertheless.

I believe that, despite some strong, but hopefully short-term protectionist feelings in several places, the world market is becoming a more competitive place. This has been in part a consequence of technological revolutions, both in production methods and in communications, and sharp cost reductions in the transportation of goods and services across boundaries. As a result, comparative advantages are shifting and production and trade patterns are rapidly changing. Everywhere, financial systems are responding to these transformations at an increasing pace.

Substantial changes are taking place in the newly industrializing and in the developing countries, as well. In part, these changes have been a response to the new challenges and opportunities in the world economy. Mostly, however, the transformation has been the inevitable outcome of the failure of strategies of economic development that were inherently not sustainable. As part of what in Latin America has been called "The Silent Revolution," many countries have been drastically revising their economic policy regimes. Leading developing countries (Chile, Mexico, Bolivia, Indonesia, Thailand, among others) have realized that future increases in the standards of living of their populations will necessarily be associated with a more competitive insertion in the world markets. After decades of inward-looking, protectionist, import-substitution strategies of industrialization and after decades of emphasis on the role of government intervention in the allocation of resources and in the promotion of economic growth, many developing countries are increasingly turning to market signals for a more efficient allocation of scarce resources.

The failure of protectionism and of excessive and misdirected government intervention in the developing countries has thus paralleled the failure of central planning in European socialist economies. In response, many developing countries have substantially reduced their trade barriers, eliminated their price controls, sold their state-owned enterprises, and diminished the size of their government bureaucracies.

II. Financial Reform

In the earlier decades after World War II, the financial systems of the developing nations were organized from the same dirigiste, interventionist perspective. They were heavily regulated, in order to control both the prices and the amounts of financial services supplied and to promote some sectors of economic activity at the expense of others. These financial policies were not sustainable and the financial systems so repressed failed in promoting growth, efficiency, or social equity.

Financial repression actually induced a contraction of the real size of financial systems as well as processes of formal disintermediation, currency substitution, and capital flight. Savers were penalized with low (if not negative) real returns on deposits, while a few borrowers received highly concentrated subsidies and formal financial intermediaries lacked viability. Thus, on the their own initiative and/or at the recommendation of international agencies, in recent times many developing countries have attempted more or less ambitious financial reforms as part of their structural adjustment programs.

Both the non-financial and financial policy reforms associated with structural adjustment programs have had a major impact on the operations and performance of

financial institutions in developing countries. In general, the aggregate macroeconomic environment in which these institutions operate has experienced deep modifications, while the nature of the rules and regulations that constrain their behavior has substantially changed.

In particular, the role of government has shifted from the control of prices and quantities (in substitution of market forces) to the promotion of the stability of the monetary system and the protection of savers. Financial intermediaries have been granted freedom to set the terms and conditions of the contracts with their clients: interest rates have been liberalized, controls on credit allocation have been removed, and competition has been encouraged, while prudential supervision has become the foundation of the new approach centered on stability. As a result, the monetary authorities (central banks) are expected to keep inflation low and the superintendencies of banks are expected to keep the system solvent, while the allocation of the command over purchasing power is left to market forces.

III. Access to Financial Services: Markets and Institutions

If one of the major objectives of these financial reforms is to facilitate access for large segments of the population to a wide set of financial services, including not only loans but, very importantly, depositing and money transferring facilities, then an important and difficult question would be: what do all of these reforms mean for the provision of financial services to marginal clientele (small farmers, microentrepreneurs, risky undertakings in low income countries). At a preliminary level, the answer is that these reforms are a necessary,

but not a sufficient condition, for increasing access of marginal clientele to financial services. Let us explore why.

In the 1950s and onwards, the question of access to credit by marginal clientele was answered from an interventionist and protectionist perspective. The main assumption was that the observed lack of access to credit and the high and variable rates of interest charged by moneylenders and other intermediaries in informal markets were a reflection of market failure. It was assumed that informal lenders possessed excessive monopoly power and that limited access to credit resulted from all kinds of market imperfections that needed correction. The government had to do something about it. The answer were the special credit programs and specialized development banks that have managed subsidized, directed, supervised credit portfolios.

Market failure was not the only possible explanation for the patterns observed in informal, rural financial markets, however. An alternative explanation is incomplete organization. Under incomplete organization, the physical and institutional infrastructure needed for the smooth operation of markets does not exist:

- property rights are not sufficiently well defined,
- contracts cannot be easily enforced, and
- information is not readily available or it is too costly to acquire and to transmit.

Eastern Europe faces today similar problems. In addition, however, the developing countries suffered because of the absence of a physical infrastructure; there were no roads, no bridges, no telecommunications and, as a result, markets were highly segmented. Thus, prices, including interest rates, differed widely from one location to another. No arbitrage

brought about uniform prices. This was not due to the presence of market distortions and imperfections but rather to the absence of a well-developed physical and institutional infrastructure, as a result of which both transaction costs and risks were extremely high.[3] This is not merely a theoretical distinction. In those earlier decades, an incorrect diagnosis of the reasons for the observed patterns of informal finance in the developing countries led to an inappropriate design of the cure.

IV. Traditional Small Farmer Credit Programs

I am particularly familiar with the performance of the public agricultural development banks and small farmer credit programs. These programs were created under the assumptions that:

- all producers need loans all of the time,
- small producers cannot save and do not need access to depositing facilities, and
- credit, particularly if it is subsidized, is a powerful instrument (a panacea) that can correct all of the problems faced by farmers.

As a consequence, these programs:

- focused only on loans, rather than on financial intermediation, and totally ignored savings mobilization,
- insisted on targeting credit to particular clientele and for specific purposes and on strictly supervising the use of loan funds, and

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[3] One cannot but be extremely impressed by the quality of the German physical and institutional infrastructure. Given this as well as political stability and complete absence of inflation, it must be comparatively easy to be a banker in Germany.

- were unwilling to charge market interest rates.

Because the three basic assumptions that guided the design of these programs were wrong, they have been a failure. Over several decades, however, governments and international agencies poured thousands of millions of marks into small farmer credit programs all over the world. There is nothing easier than to give money away. If economic development could be brought about simply by giving money away, we would already be well in our way toward development.

Development is, however, about:

- creating institutions that promote and protect creative productive behavior,
- building the physical and institutional infrastructure that increases productive capacity, and
- accumulating human capital in order to accelerate per capita real income growth.

Throwing money away cannot bring about development and it can only alleviate poverty in a temporary fashion. Moreover, many believe that, in the long-term, throwing money at them only worsen the fate of the poor. What matters is to increase the productivity of resources. The development of financial markets is part of this process. Unfortunately, the development of viable financial institutions was stunted and retarded by financial repression policies.

The evidence about the sorry performance of the small farmer credit programs steadily accumulated. In the mid-1970s, the AID Spring Review of Small Farmer Credit provided evidence from over 100 countries that already suggested the failure of these

programs all over the world.[4] Research at The Ohio State University and elsewhere has extensively documented the extent and the reasons for this generalized failure.[5]

Despite the massive flows of funds disbursed, access to credit remained limited; by the mid-1970s only a small proportion of the farmers of the developing world had received loans from formal intermediaries. On the average, only 15 percent of the farmers in Asia and Latin America and 5 percent of the farmers in Africa had ever received institutional agricultural credit.[6] Although there has been some progress since then, limited access continues to be the key issue in rural financial markets, both from an efficiency and an equity perspective.

Continued, reliable, low-cost, permanent access to financial services, both loans and deposit facilities, is the goal. Moreover, contrary to expectations, small farmer credit portfolios showed much concentration. A few among the numbers of borrowers (typically 10-20 percent) captured the largest portion (over 80 percent) of the funds disbursed and of the associated subsidies. Income distribution worsened.[7]

Furthermore, despite the massive volumes of funds disbursed, there was little evidence that they had contributed (to the same extent) to the growth of output and of

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[4] Agency for International Development, *Spring Review of Small Farmer Credit*, 20 volumes, Washington, D.C.: Department of State, 1973.

[5] Dale W Adams, Douglas H. Graham, and J.D. Von Pischke (eds.), *Undermining Rural Development with Cheap Credit*, Boulder: Westview Press, 1948.

[6] Gordon Donald, *Credit for Small Farmers in Developing Countries*, Boulder: Westview Press, 1976.

[7] Claudio Gonzalez-Vega, "Interest Rate Restrictions and Income Distribution," *American Journal of Agricultural Economics*, 59: 973-76.

productivity or that they had promoted technological change. In particular, attempts to target credit by beneficiary and by use of the loan funds increased transaction costs for both lenders and borrowers.

Targeting reduced the quality of the financial services provided because:

- disbursements became untimely and insufficient;
- procedures became rigid and onerous; and
- the non-interest portion became the most important component of the costs of the borrowed funds.

In sum, subsidized credit turned out to be quite expensive, particularly for small borrowers. High transaction costs do have indeed more adverse and regressive consequences than high interest rates.[8] Targeting resulted in high operating costs for the lenders, as well. The spread between deposit and loan rates of interest was not sufficient to cover the costs and risks of lending to these marginal clientele. Massive operation losses followed. At the same time, portfolio delinquency soared, and many institutions became decapitalized.

V. Institutional Viability

The main problem of rural financial institutions has been their lack of viability. A viable financial institution is self-sustaining and valued by its clientele. This requires an

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[8] Imagine two borrowers who are charged 20 percent interest on their loans. One, who borrows 100 marks, pays 20 marks of annual interest. The other, who borrows 10,000 marks, pay 2,000 in interest. If transaction costs (e.g., the cost of trips to the bank's branch) of 40 marks are added (assuming equivalent fixed costs), the cost of funds for the first borrower is 60 marks (equivalent to 60 percent of the loan amount) and for the second 2,060 marks (equivalent to 20.6 percent). The smaller the loan, the greater the incidence of transaction costs, reflecting their regressive impact on distribution.

agency that is able to cover its costs, that provides high quality services, that reaches an increasing number of customers, that is dynamic in providing new financial services and products, and that actively searches for ways of improving its efficiency, as reflected, by the level and the degree of dispersion of the transaction costs incurred by its depositors, its borrowers, and the intermediary itself. Viable institutions possess credibility and are able to mobilize deposits from the public, collect their loans, and retain good management and staff.[9]

The lack of viability of many rural financial institutions has been reflected by the steady reduction of their relative importance within the financial sector of the developing countries, as most of them have not been able to increase and, in many instances, even to sustain the flow of their loanable funds, in real terms. On the contrary, frequently their lending capacity has sharply decreased over time, because they have not protected their portfolios from inflation; they have not vigorously collected their loans, in order to be able to grant new credit; they have not aggressively mobilized local resources, in order to be able to widen the range of their services; and because, in view of the poor quality of their services and the high transaction costs that they impose, they have lost the support of their clientele.

As their institutional weaknesses have become increasingly evident, these special credit programs have lost the support of the international agencies that created them and,

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[9] See Richard L. Meyer, "The Viability of Rural Financial Institutions and the System as a Whole," *Report of the Fourth Technical Consultation on the Scheme of Agricultural Credit Development*, Rome: FAO, 1988, pp. 41-44.

as a result, their loanable funds have further substantially declined. Ironically, their lack of viability has been, in large part, a consequence of their strong dependency on these outside funds. Given this strong financial dependency on political agencies as well as their limited mobilization of deposits from the public, there has been a significant political intrusion in the operations of the specialized rural lenders, in the sense that the decisions about who to lend to, what to lend for, and in what terms and conditions to lend have not been autonomously made by the financial intermediary, but have been imposed from the outside by the external sources of their funds. The criteria used have not necessarily been compatible with their financial viability.

Lacking viability, their survival has been questioned by many, including their own clientele. Increasing levels of loan default have evidenced this loss of the support of their customers. Loan delinquency has been a signal that the borrowers have not been interested in the survival of the institution. Since they have not anticipated it to be able to provide a permanent service, the expected value of their relationship with the intermediary has been low, and they have not protected it with the timely service of their loan obligations. Furthermore, where they have not mobilized voluntary deposits from the local community, these rural financial institutions have lost the potential support from a mass of depositors. Where available, the quality of the services provided to the depositors has determined the extent of their support and, thereby, the institution's ability to grow on the basis of locally mobilized resources.

In general, however, traditional agricultural credit programs were not concerned with institutional survival. Their management autonomy was seen as much less important than

the non-financial objectives to be pursued: either increased agricultural output or productivity, or the adoption of technological innovations, or integrated regional development, or agrarian reform. Resources for these purposes were apparently abundant, always replenishable from outside, by governments, central banks, and international donors.

These specialized credit programs were designed with only the interests of targeted borrowers in mind; not the interests of depositors, or for the sake of the viability of the institutions. Subsidized loans were programmed for clientele chosen independently of their repayment capacity and institutional mechanisms for collection efforts were weak. I have witnessed many heads of state organize a party in order to disburse loans to poor farmers, always accompanied by scores of photographers. I have never seen them preside over loan recuperation. Institutional viability and, in the long term, survival, have been less important than patronage.

Consistent with the protectionist strategies and interventionist policies of the time, these credit programs mistrusted the market and minimized the role of interest rates as a tool for resource allocation. Despite its good intentions, targeted and supervised credit has been fruitless in increasing output, given the fungibility of funds. Thus, interest rate controls, while reducing revenues, thus contributing to the intermediary's losses, have been ineffective. Moreover, when their rewards have been repressed, savers have avoided deposits in regulated financial institutions. They have voted with their feet (or rather with their funds) against these policies, since their ability to get organized as lobbies in order to seek privileges has been almost nonexistent.

Created with the best of intentions, in practice the small farmer credit programs found it difficult to target subsidized loans, to postpone concerns about creditworthiness, to postpone concerns about risk management, and still remain financially viable at the same time. Many programs eventually withered away. Many of programs evaluated by the Spring Review in the 1970s disappeared. The landscape of the developing nations is littered with too many failed or insolvent development financial institutions.

VI. Problems of Credit for Marginal Clientele

The failure of subsidized and targeted credit programs has been well documented. It reflected an incorrect interventionist policy perspective that relied on the control of prices and of quantities in financial transactions. It also reflected an inadequate institutional design that postponed concerns about institutional viability, as well as instances of government failure, principal-agent problems, and political intrusion. The problems encountered by these programs may have also reflected, in addition, the high costs and inherent difficulties of providing financial services to marginal clientele; that is, the consequences of the incomplete organizational framework that had been ignored by the interventionist approach of the time.

To the extent to which the failure of the specialized credit programs reflected incorrect policies and regulations, a better policy regime was needed. To the extent to which failure reflected inadequate institutional design, new institutional models were required. These have been the roles of financial reform. Although good policies and

correct institutional design are necessary conditions for success, however, they may not be sufficient.[10]

The provision of financial services is not an easy task. It is particularly costly when the clients are small, heterogeneous, and dispersed in not densely populated areas. In part, these difficulties are not unique to the provision of financial services: it is generally not easy to bring services (health, education) to remote, sparsely populated areas. In addition, however, finance is particularly difficult because of the intertemporal nature of the transactions involved. What is exchanged is purchasing power now, for a promise to repay in the future. The promise may or may not be fulfilled. Financial markets are about the management of this risk. The ability to successfully screen potential borrowers implies the choice of appropriate financial technologies. These technologies are intensive in the use of information and in mechanisms for the enforcement of contracts.

Developments in financial theory during the past two decades, associated with principal-agent problems and asymmetric information, have been useful in explaining the complexity of these lender-borrower relationships.[11] While the lender emphasizes loan safety (repayability), the borrower focuses on profitability and wealth accumulation. The goal of the lender is to effectively screen applicants and to induce a borrower's behavior that

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[10] Partial financial reforms, particularly those that exclude marginal clientele as an exception, allowing a "preferential" treatment, lead to the worst of both worlds, since they further reduce the incentives (and capacity) to supply financial services to marginal clientele. They turn out to be counterproductive.

[11] See the September, 1990 issue of *The World Bank Economic Review* on a Symposium on Imperfect Information and Rural Credit Markets.

coincides with its goals. Inducing such behavior is costly. We do not have sufficiently cost-effective technologies to provide financial services to most of these marginal clientele.

Risk management through signalling, screening, monitoring, and collecting activities remains at the core of the financial intermediation problem. Perceptions about risk and tools for dealing with risk were not part, however, of the organizational culture of the specialized credit programs. Because of financial repression and inadequate incentives, technological innovation in finance was retarded.

Recently there has been an increasing interest in the role of local financial institutions, such as credit unions, municipal banks, non-government development organizations (NGOs), and self-help groups in providing financial services for marginal clientele. Local institutions posses comparative advantages in (inside) information and in contract enforcement (social sanctions) that allow them to reduce the risk of default. They can also operate at low transaction costs for their clients and at low operational costs for the lender. This is the traditional advantage of the moneylender. They can break even with a small volume of operations.

Local financial institutions are extremely vulnerable, on the other hand, to exogenous shocks, which causes excessive portfolio risk. They suffer from a severe lack of opportunities for portfolio diversification (e.g., a flood wipes out the entire clientele of the local lender). This explains the high interest rates and low transaction costs associated with moneylenders. Local financial institutions thus have strengths, but also important weaknesses. One must go beyond them. This implies a systems approach.

A microeconomic reason for the development of financial market networks and systems is therefore the need to protect the stability of individual financial intermediaries. There is also a macroeconomic reason, however. From the perspective of an increased productivity of resources, financial intermediation over a wider space leads to the integration of capital markets and to the increased efficiency of investment. This is the role of finance in economic development.[12]

VII. Conclusion

Many microenterprise and poverty-lending programs have been designed as relief programs rather than genuine credit activities. They are not true credit programs, because they have not been concerned with creditworthiness; they have not been especially devoted to recuperating loans and to pricing them correctly. There is nothing wrong with charity, of course. Social and economic development cannot be built, however, upon philanthropic efforts. Efficient, cost-effective financial intermediation is a critical input in any process of economic development. This requires appropriate policies and institutional viability.

Much has been learned by now about the determinants of the success of credit programs for small producers. Among the major determinants of success is institutional viability. Moreover, beneficiary gains (increased employment and income) have been closely correlated with the viability of the financial intermediary. Such viability usually reflects a strong institutional and managerial desire for self-sufficiency and growth, a clear

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[12] Ronald I. McKinnon, *Money and Capital and Economic Development*, Washington, D.C.: The Brookings Institution, 1973, and Edward S. Shaw, *Financial Deepening in Economic Development*, New York: Oxford University Press, 1973.

understanding of the value of money, a strong concern for the extent and nature of the risks involved, and sound financial policies. Successful financial intermediaries treat interest rates as prices. Financial management matters for them. They diversify their portfolio, mobilize savings and collect their loans.

After ambitious financial reform efforts in many countries, the new environment looks promising. Within the new policy regime, financial institutions for marginal clientele will find greater opportunities for increased profitability and growth. They will no longer suffer the financial repression that characterized the old policy regime. They will be able to more freely mobilize deposits from the public and other local resources and thereby diversify their sources of funding. Excessive dependency on governments, central banks, and international donors constrained their growth and allowed a significant political intrusion that reduced their viability. The objectives and agendas of the donors resulted in conditionality criteria that not always protected the viability of these financial institutions. With their greater independence will come increased viability, but also increased accountability.

Major changes in the economic environment in which these financial institutions operate are already having a significant impact on their performance and on their opportunities to survive. Some will accept the implicit challenges, will undertake the appropriate transformations, and will come out strengthened. Others will miss the opportunity to grow, quantitatively and qualitatively, and will eventually not survive. Still others, completely obsolete in the new environment, will have to disappear. Their resources will then be reallocated to other activities, where they will be more productive, and the

services that they have provided will be supplied by other agents, with a stronger comparative advantage in doing so. New institutional designs will emerge and, hopefully, the development nation's organizational framework will be strengthened by them.