Studies in
Rural Finance

Economics and Sociology
Occasional Paper No. 1899

EXPANDING RURAL LENDING THROUGH MERCHANT-CREDIT PROJECTS

by

Dale W Adams

and

Richard L. Meyer

November 4, 1991

Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099

Abstract

Merchant-credit projects offer the potential of providing short-term stop-gap informal loans to small borrowers in countries where the formal financial system is in disarray and where weak property rights hinder formal finance. Credit projects involving the Agricultural Bank of Malaysia, contract or bridge lending in the Dominican Republic, the PNN Scheme in Sri Lanka, and the NAPP program in the Philippines are briefly reviewed. The advantages and weaknesses of merchant-credit projects are summarized.

EXPANDING RURAL LENDING THROUGH MERCHANT-CREDIT PROJECTS

by

Dale W Adams and Richard L. Meyer

INTRODUCTION

The coverage and volume of formal lending to rural enterprises is contracting in a number of countries. Nowhere is this problem more serious than in Eastern Europe where the dismantling of centrally planned economies is rupturing ties between borrowers and lenders. Few of these countries have financial systems in place that can soon provide loans to a large number of individual borrowers in rural areas. In addition, major components of rural financial markets in a number of other low-income countries have recently collapsed: for example, the Banco Agricola de Bolivia, FONADER in Cameroon, the CNCA in Togo, and the Co-operative Bank of Uganda. A number of other agricultural development banks and cooperatives in these countries persist only because of continual transfusions of funds.

There is consternation among donors and governments over how to fill these voids in rural lending. Creating new financial institutions in Eastern Europe and rebuilding rural financial infrastructure in numerous low-income countries--under the best of circumstances--will not provide substantial formal financial services for several years; recent experience in restructuring rural financial markets in the Dominican Republic, in Niger, and in Indonesia suggests that it may take as long as five or ten years. What to do now before these new facilities are able to provide adequate financial services is an open question. Living with a prostrate rural financial system is not an option if agriculture is to provide the output required to sustain overall development and to enhance the standard of living of the millions of people who directly depend on it for their sustenance. Likewise, only a healthy agriculture can provide the effective demand for goods and services that stimulate the vitality of non-farm rural businesses.

While formal finance in many low-income countries is severely stressed and fragile, recent research is showing that various forms of informal finance persist and flourish in these same countries (Larson, 1988; Larson, 1991). It is likely that informal finance will also become a prominent part of the economic landscape in countries that were formerly centrally planned. In many cases, informal finance fills part of the void left by the retreating formal financial system. Despite its traditional "bad press," informal finance provides useful and durable services to large numbers of people who have been the targets of donor credit programs: owners of small non-farm firms, women, small farmers, and poor people in general. Informal loans made by traders, dealers and merchants make up an important part of these activities (Sacay and others).

Making additional formal loans to merchants who, in turn, provide informal loans to some of their rural clients may be a short-run option for filling this void in some countries. This option complements the current emphasis on expanding and strengthening the private sector in low-income countries and in Eastern Europe. This alternative can also be expanded to service the needs of small non-farm businesses, many of which are operated by women.

MERCHANT-CREDIT PROJECTS

In a well developed financial system formal lenders will automatically provide services to most merchants who are creditworthy. Many merchants, in turn, will provide informal credit to some of their clients out of these formal loans. In a stressed financial system, or in a system that is newly developed, however, creditworthy merchants may face severe credit rationing. New merchants who are emerging in economies that were formerly centrally planned may find it difficult to access formal loans because of their lack of experience, lack of a proven track record, and uncertainties about property ownership. Collateral is a particularly nettlesome hurdle for many merchants who seek formal loans in countries such as Nicaragua, Mozambique, and in Eastern Europe where property rights are changing.

Credit projects in a handful of countries have augmented the access of merchants to formal loans, with the aim of expanding the amount of informal credit for small farmers, promoting production, lowering the interest rates on informal loans, and enhancing competition in informal markets.

Several important assumptions are involved in these projects. First, it is assumed that if merchants have more ample access to formal loans they will be more liberal in extending loans to creditworthy customers. Second, it is presumed that it is less costly for merchants, who have regular transactions with clients through purchase and sale of goods, to determine the creditworthiness of borrowers of small amounts than it is for banks. Third, it is assumed that a bank usually finds it less expensive to extend loans to merchants, who are able to provide standard forms of collateral, than it is to directly extend large numbers of small loans to clients who might deal with the merchant. Fourth, it is widely thought that merchants are often more successful in collecting loans than are banks.

Studies of several merchant-credit projects show the procedures that are often found in this type of lending in rural areas.

Input-Credit Program in Malaysia[1]

The Agricultural Bank of Malaysia was established in 1969 and was immediately asked to provide loans to support rice production. Because it was a new bank, it had few offices in rural areas and rural cooperatives and farmers associations were judged to be unsuitable credit channels. As a result, the Bank implemented in early 1970 an input credit scheme aimed at operators of small rice farms through "local credit centers." The bulk of these centers were comprised of a single private firm: rice millers, licensed paddy buyers, merchants, and shopkeepers who were involved in selling farm inputs or in buying rice. These centers effectively acted as the Bank's lending agents.

The local credit center received formal loans from the Agricultural Bank and was responsible for the screening of borrowers, the extension of loans, and loan recovery. The loans extended to farmers were short-term and were often in the form of coupons validated to purchase a given amount of inputs. Some cash loans were also made to farmers to cover labor expenses. Competition was fostered by allowing farmers to freely choose their credit center and also their input source. Loan recovery was largely the

---

1 Most of the information in this section is drawn from Wells' work.

responsibility of the rice traders. By the end of 1974 the program was extending informal loans to about 17 thousand rice farmers in five regions of the country. The primary limit on expanding the scheme was recruiting creditworthy merchants.

Contract Lending in the Dominican Republic[2]

A relatively large number of agribusiness firms in the Dominican Republic provide informal loans to operators of small farms through contract lending, locally called bridge loans. In most cases the agribusinesses doing this lending fund at least part of their operations through formal loans, thus providing a bridge between farmers and banks. These firms specialize in the processing, sale, and sometimes exports of various agricultural commodities such as cantaloupes, cocoa, milk, peanuts, rice, tobacco, and tomatoes.

A variety of arrangements are involved in this contract lending. In some cases the firm provides most of the purchased inputs on credit to the farmer, may also provide technical assistance, with the borrowing farmers agreeing to sell their final product to the firm. In many cases the firm provides a guaranteed price for the product and may also extend cash loans to cover labor costs. Most loans are repaid by the agribusiness withholding part of the crop receipts. The lending procedures are simple for both the firm and the borrower, loan recovery rates are high, and borrowers are generally satisfied with the services provided by the agribusiness firms. In the mid-1980s more farmers

---

[2] Information in this section is largely drawn from a study by Ladman and others done in 1985.

received loans through these contract lending arrangements than obtained loans directly from the Agricultural Development Bank.

The Praja Naya Niyamaka (PNN) Scheme in Sri Lanka[3]

In 1988 two government owned banks in Sri Lanka began a program to link informal lenders with the formal banking system. The scheme focused on making formal loans to creditworthy borrowers (PNN) who might on-lend to poorer individuals. Many of these PNN are merchants and petty traders in rural areas who are able to provide satisfactory loan collateral. The PNN receives formal loans at an annual rate of interest of 18 percent and then were expected to on-lend these funds to poorer people at rates ranging up to 30 per cent per annum. The PNN bears the loan recovery risks. The initial target was to appoint 14,000 PNN throughout the country.

A major objective of this scheme is to enhance competition among informal lenders and thereby reduce the costs of borrowing for low-income people. Because of the civil turmoil in the country, the expansion of the program has been slower than originally planned.

The NAPP Program in the Philippines[4]

In the latter part of 1984 the Philippines government launched a National Agricultural Productivity Program (NAPP) aimed at stimulating the production of 12

---

[3] Most of the information in this section was extracted from Sanderatne's chapter.

[4] We draw heavily on Esguerra's work in this section.

agricultural commodities. A major part of this effort was the provision of government funds at concessionary rates to expand agricultural lending. Because of weaknesses in rural banks and cooperatives, part of this lending was channeled through informal lenders. These lenders included food and feed processors, agricultural input suppliers, various types of traders, and rice millers.

These merchants were able to access government funds through commercial banks and were allowed wide latitude in how they extended informal loans to ultimate borrowers. In all cases the merchant bore the loan recovery responsibility and risk. Generally, the loan repayment was handled through some marketing tie. That is, the borrowers contracted to sell their produce to the lender, or some other cooperating agency, and the payment for the loan was withheld from the receipts of the sale.

ADVANTAGES AND WEAKNESSES

Advantages

Merchant-credit projects offer several potential advantages. They can be implemented relatively quickly, they build on the strengths of both formal and informal financial markets, and they capitalize on information that both formal and informal lenders often already have regarding potential clients. This combination of formal and informal lending also minimizes the transaction costs incurred by participants, especially when compared to direct formal lending to a large number of borrowers of small amounts. In large part, it does this by providing financial services at transaction points that already exist, thus realizing scope economies for both lender and borrower.

Spreading formal loans to a number of merchants also segments failures. If a small number of merchants are ineffective in successfully screening for creditworthy borrowers, their failure need not result in a systemic failure.

In addition, policy makers and banks may find it easier to enhance the creditworthiness of a relatively small number of merchant borrowers than it would be to enhance directly the creditworthiness, in the eyes of the formal lender, of thousands of small borrowers. Finally, merchant lending may be a way of enticing risk-averse formal lenders into more extensive rural lending later.

Weaknesses

Enhanced merchant lending will not be a panacea for rural finance problems that plague many countries. Some of these problems will only be resolved through the slow process of building strong, efficient, and durable formal financial systems. A major component of this will be widespread deposit mobilization, a vital financial function that is excluded from merchant-lending programs. Financial intermediation must operate on two legs: lending and deposit mobilization. Merchant-lending programs should be viewed as a stop-gap technique that is only emphasized until efficient formal financial intermediation is in place.

In most countries, merchants and informal lenders are viewed with suspicion. Their functions are poorly understood and politicians and demagogues often subject them to verbal floggings. In some cases these biases must be addressed and moderated before a merchant-lending program can be implemented.

Politicians and donors may also find that merchant-lending schemes will not permit effective loan targeting at priority groups and activities. It is also unlikely that many of the informal loans handled by merchant lenders will directly reach the poorest-of-the-poor. Many of these individuals are not creditworthy and informal lenders must screen out many of these individuals if their lending operations are to persist. Merchant lending will likely be most successful where the marketable surplus is largest.

OVERCOMING COLLATERAL PROBLEMS

One of the major stumbling blocks to increasing merchants' access to formal loans, especially in Eastern Europe, will likely be the lack of appropriate collateral. One way of easing this problem might be to develop bonded warehouses that provide negotiable receipts which can be used as loan collateral. Several countries have experimented with this, the Philippines probably having the best documented experience (Bautista).

Development of bonded warehouses might complement projects that focus on providing more formal loans to merchants. These warehouses might allow merchants to overcome some collateral hurdles and also enhance their general liquidity.

NEXT STEPS

Further work on merchant-credit projects might involve five steps:

1. It would be useful to analyze the design, operation, and results of a handful of the most successful merchant-credit projects. This may provide guidelines and lessons useful in forming new projects.

2. In several low-income countries where donors or governments are interested in developing a merchant-credit project, pre-project studies might be done on the structure and performance of existing informal and formal credit arrangements that are associated with merchants who operate in rural areas. This might include an analysis of their creditworthiness, their access to formal loans, and identifying the hurdles that block their further access.

3. Because of the flux in financial markets in Eastern Europe, pre-project studies there may not be very useful. Some insights into what might be expected to evolve, however, can be gleaned indirectly from studying the changes in financial arrangements that occur with privatization of large firms in low-income countries. For example, chemical fertilizer markets have recently been privatized in countries such as Egypt, Bangladesh, and Ghana. A study of the changes in formal and informal finance in several

of these cases may be the best predictor available of what to expect in Eastern Europe.

4. In some cases a merchant-credit project may also address collateral bottlenecks that limit the creditworthiness of merchants and thereby reduce their access to formal loans. A careful study of bonded warehouses in several countries may show the extent to which they might be a useful element in merchant-credit projects.

5. The final step would be to design several projects that focused on expanding formal loans to merchants who also provide informal loans in rural areas. This might include designing parallel studies to document the extent to which the project enhances the creditworthiness of participating merchants, and also the extent to which merchants provide additional informal loans to their clients. These results could then be used in making decisions about developing additional merchant-credit projects.

REFERENCES

Bautista, E. "Operations of Agricultural Credit Risk Guarantee Schemes: The Philippines Experience." Unpublished paper, Agricultural Credit Policy Council, Quezon City, Philippines, 1991.

Esguerra, Emmanuel F. "On the Use of Informal Lenders as Conduits for Formal Credit: The Case of The National Agricultural Productivity Programs in The Philippines." Economics and Sociology Occasional Papers No 1351, Department of Agricultural Economics and Rural Sociology, The Ohio State University, May, 1987.

Ladman, Jerry R., Jose de la Vina, and Roberto Liz. "Contract Lending to Small Farmers in the Dominican Republic." In Informal Finance in Low-Income Countries, edited by Dale W Adams and Delbert A. Fitchett, Boulder, Colorado: Westview Press, forthcoming, pp. 303-312.

Larson, Donald W. "Capacity of Informal Financial Markets to Provide Increased Financial Services in Rural Honduras." Unpublished report prepared for the Inter-American Management Consulting Corporation, Key Biscayne, Florida, September, 1991.

Larson, Donald W. "Marketing and Credit Linkages: The Case of Corn Traders in the Southern Philippines." Economics and Sociology Occasional Paper No. 1539, Department of Agricultural Economics and Rural Sociology, The Ohio State University, September, 1988.

Loria, Miguel and Carlos E. Cuevas. "Basic Grains: Marketing Channels and Financing at the Farm and Wholesale Levels." Economics and Sociology Occasional Paper No. 1077, Department of Agricultural Economics and Rural Sociology, The Ohio State University, January, 1984.

Sacay, Orlando J., Meliza H. Agabin and Chita Irene E. Tonchoco. Small Farmer Credit Dilemma. Manila: National Publishing Cooperative Inc., 1985

Sanderatne, Nimal. "Informal Finance in Sri Lanka." In Informal Finance in Low-Income Countries. Edited by Dale W Adams and Delbert A. Fitchett, Boulder, Colorado: Westview Press, forthcoming, pp. 83-98.

Wells, R.J.G. "An Input Credit Program for Small Farmers in West Malaysia." In Rural Financial Markets in Developing Countries, edited by J.D. Von Pischke, Dale W Adams, and Gordon Donald, Baltimore, Maryland: Johns Hopkins Press, 1983, pp. 218-224.