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RURAL FINANCIAL POLICIES for FOOD SECURITY of the POOR

POLICY BRIEF No 7 • JULY 2000

Rural Financial Services for Poverty Alleviation: The Role of Public Policy

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For poor rural families in developing countries, access to credit and savings facilities has the potential to make the difference between grinding poverty and an economically secure life. Well-managed savings facilities permit households to build up funds for future investment or consumption. Credit enables them to tap finances beyond their own resources and to take advantage of profitable investment opportunities. Credit and savings also serve as insurance for the poor. In rural areas of developing countries, short-term loans or past savings are often used to provide basic necessities when household incomes decline temporarily—after a bad harvest or between agricultural seasons, for example.

But in most developing countries, rural financial services are sadly inadequate. Those who want to borrow from the formal sector are usually deterred by the strict collateral requirements and high transaction costs involved in doing business with formal institutions. Many potential borrowers are in such need of credit that they are willing to pay substantially higher interest rates in the informal markets—sometimes as high as 80 percent per year. But the amount of credit available through informal markets is often constrained by bottlenecks in the local supply of funds.

The story on the savings side is similar. Costs involved in managing small deposits at faraway banks are high, discouraging farmers and rural entrepreneurs from making a series of tiny deposits, as they prefer to do. Many of the rural financial institutions choose not to accept deposits; others are legally forbidden to do so to protect depositors from fraud and for other reasons.

Traditional Institutions and the Rural Poor

As important as rural finances are, the task of providing credit and saving opportunities at a reasonable cost to those who have only meager assets has been neither straightforward nor easy. Until the 1980s, in many developing countries, state-run agricultural development banks—armed with subsidized funds and eloquent pro-poor directives—took the lead in establishing formal credit markets in rural areas. However, the shortcomings of the institutional principles they were based on—collateralized lending, an organizational setup without any incentives to do business with the poor, and pervasive political patronage—severely handicapped their performance. Not only did they fail to serve the poor who could not pledge collateral, their inefficiency made them so dependent on state subsidies that they became financially unsustainable. Since then, support for state-sponsored agricultural banks has greatly declined, and the need for financial market reforms to rectify distortions caused by past policies is almost universally acknowledged.

Now, the most basic roles of government—establishing macroeconomic stability, ensuring that financial markets are free to respond to economic incentives while following sound banking practices, and maintaining and enforcing a legal framework that ensures contract compliance—are beyond dispute. However, these actions alone cannot trigger development of rural financial institutions that serve the poor. This is because rural financial markets have inherent problems that make investments risky as well as costly, and formal financial institutions have been unable to devise profitable savings and loan services for the rural poor. Information about potential borrowers, especially in far-flung areas, is difficult to obtain, making loan applications excessively costly to evaluate, especially when loans are small. The poor also own few assets, making it infeasible for the financial institution to secure its lending with collateral. As a result, private investors either shy away from the financial sector or limit their services within the urban economy, where information on prospective borrowers is less costly to obtain.

This is not to say that private-sector banks will not have a role in the rural financial sector in the future. Many countries initiated serious financial reforms only in the second half of the 1980s. Therefore, it is too early to conclude that private banks, which are just now establishing themselves in urban areas, will not gradually expand their

RESEARCH PROGRAM MISSION

The research program titled Rural Financial Policies for Food Security of the Poor seeks to identify policies and institutional arrangements that help the poor integrate themselves into sustainable savings and credit systems in order to increase capacity to invest, bear risk, and preserve livelihoods.

FOCUS COUNTRIES

- Bangladesh
- Cameroon
- China
- Egypt
- Ghana
- Madagascar
- Malawi
- Nepal
- Pakistan

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services to rural areas as these become more developed and prosperous.

Lenders in informal markets do provide loans to the poor. In all these countries, informal lenders make loans without collateral, using various techniques for screening applicants and enforcing repayment. Households or even small communities may enter into mutually beneficial risk-pooling schemes; traders disburse credit to farmers in exchange for the right to market the growing crop; shopkeepers increase sales by providing credit for food, farm inputs, and household necessities; and large landholders secure access to labor in the peak season in return for earlier loan advances to laborers. In many countries informal credit and savings associations play an important role in the provision of financial services. In fact, the ingenuity of informal lenders and self-help organizations in tailoring loan products to the requirements of their clients or members makes them indispensable in both the urban and rural financial landscape of developing countries.

But innovative and useful as the informal sector may be, it frequently runs up against severe constraints. Informal credit markets, by their very nature, are segmented. A "market" typically consists of a single village community. And informal lenders seldom manage savings deposits. Hence, financial intermediation in the sense of providing a common clearinghouse for borrowers and lenders does not take place to the fullest extent possible. As a result, the supply of credit is limited, resulting in either severe credit rationing or extremely high interest rates for some lenders. Also, especially in agricultural regions, risks arising out of droughts or floods affect both informal lenders and borrowers simultaneously, so a credit supply crunch is likely to take place just when the demand for credit peaks.

Overall, it is clear that the task of delivering financial services to the rural poor cannot be left entirely to market forces.

The Promise of New Institutions

Successful financial outreach to the rural poor requires institutional innovations that reduce the risks and costs of lending small amounts of money. So far, most innovations in microfinance have come from nongovernmental organizations (NGOs) that do not have commercial profit as their principal objective. By taking fresh approaches, these new microfinance institutions have penetrated rural financial markets and serviced an underclass of borrowers in a way that was unimaginable some 20 years ago.

Far from being one-shot transfers, loans from such institutions have helped poor families make permanent positive changes in the quality of their lives. Of course, lack of capital is only one factor keeping poor rural households from improving their welfare. In rural areas of developing countries, illiteracy is high, basic social and market infrastructure is lacking, and many people are in poor health. When seed or irrigation water for the farmer, market access for the rural producer, or elementary bookkeeping skills for the would-be entrepreneur are absent, the returns to financial services will be low or sometimes even wasted.

Public Policy for the Future

One important lesson that is becoming increasingly clear: there is no single institutional blueprint for success. Recent experience with institutional innovations has shown that programs must be designed to harness a community's particular strengths in order to reduce costs of screening participants, monitoring financial activity, and enforcing contractual obligations. The group-based system has worked well in Bangladesh, whereas several programs in Indonesia successfully use local agents to assess borrowers' creditworthiness.

Designing, experimenting with, and building financial institutions for the poor require economic resources and adequate consideration of longer-term social returns. In the last two decades, NGOs have taken the lead partly because the support they receive from donors and government organizations make it feasible for them to invest in innovations. Just as public policy should play a role in promoting technological innovations that generate social benefits, it should also help promote institutional innovations that assist the disadvantaged or address intrinsic market failures. As policymakers seek to make rational policy choices, they must weigh the social costs of designing and building financial institutions for the poor against their social benefits. Of course, some experiments in institutional innovations will succeed, while others will fail. Public policy will need to support and evaluate this experimentation process and nurture those designs or institutions that hold promise of future success. Governments, donors, practitioners, and research institutions must work together closely to pinpoint the costs, benefits, and future potential of emerging financial institutions.

In the long run, the payoff to public investment in institutional innovations will lie in the transformation of now nascent microfinance institutions into full-fledged, financial intermediaries that offer savings and credit services to smallholders, tenant farmers, and rural entrepreneurs, thus alleviating poverty. Evidence of this transformation is already emerging in countries such as Bangladesh, Indonesia, and Thailand. The payoff will also come from the development of viable lending methodologies that private commercial banks can readily adopt to profitably provide savings and loan services to the poor. This is already happening in some parts of the world: in urban Latin America, for example, private commercial banks have started to adopt group-based lending methods developed and tested by nonprofit organizations that initially depended on public support. With the right combination of public policy, private initiative, and objective research, public investments in financial institutions designed to serve the poor in other rural areas of Africa, Asia, and Latin America will bear fruit as well. ■

ABOUT IFPRI

IFPRI's mission is to identify and analyze strategies for meeting food needs of the developing world, with particular emphasis on low-income countries and the poor.

IFPRI is a member of the Consultative Group on International Agricultural Research (CGIAR).

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