THE SHIFT FROM DIRECTED AGRICULTURAL CREDIT TO A FINANCIAL MARKET DEVELOPMENT APPROACH TO FINANCE

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Abstract

The design of traditional directed agricultural credit projects was such that governments—often supported by international donors—established specialized credit institutions to channel cheap credit to rural areas. Yet, these programmes neither reached the rural and urban masses nor achieved growth. They bypassed national resource mobilization, undermined the viability of financial institutions and jeopardized the evolution of a differentiated financial system. The dismal experience with regulated, subsidized credit schemes made the shift to a new course of financial systems development inevitable. The new approach places emphasis on prudential deregulation, savings mobilization, development of the financial infrastructure, institutional viability, and sustainable financial services.

Introduction

Supply-led and directed credit programmes were the dominant tool used to spur agricultural development during the three decades prior to the 1990s (Coffey, 1998). The assumption behind these efforts was that many farmers faced liquidity constraints that limited their ability to make farm investments and to use additional modern inputs. Relaxing these constraints by providing them with loans, therefore, was thought to be an easy way of stimulating farm investment, boosting the use of modern inputs, improving rural income distribution, and facilitating small farmers’ integration into the market economy (Huppi & Feder, 1990; Coffey, 1998; Klein et al., 1999).

It was further assumed that most farmers were too poor to save, that informal financial markets were dominated by monopolistic money lenders who charged usurious interest rates, and that commercial banks were too conservative to lend to most farmers, (Coffey, 1998). Based on these assumptions, governments and donors developed and funded numerous directed credit programmes around the world that focused on overcoming these problems. Most of these efforts were heavily subsidized by charging concessionary interest rates or tolerating loan defaults.

A common arrangement for providing rural financial markets with donor or government funds was to open concessionary rediscount windows in the country’s central bank to disburse funds to selected groups, regions, or activities (Coffey, 1998). Banks and other financial institutions were stimulated to grant targeted lending by making concessionary funds available from the rediscount window. The interest rates on these funds were typically lower than the rates lenders were paying for alternative sources of funds. In some cases, the availability of rediscount funds was augmented by imposing loan portfolio requirements on commercial banks. These requirements were intended to compel banks to either make more loans for purposes targeted by the government, or to lend on concessionary terms to other institutions, especially agricultural development banks that were doing targeted lending. In some countries, subsidized loan guarantee schemes were also established to further encourage agricultural lending. The assumption behind these schemes was that by transferring part or all of the loan recovery risk to the insurance programme, lenders would be induced to do more of the lending preferred by policy makers (Coffey, 1998).

The support for these traditional directed agricultural credit efforts began to wane in the 1980s and by the end of the decade, most donors and some governments sharply reduced their support for
agricultural credit due, in part, to the unsatisfactory performance of these efforts (Coffey, 1998). Critics increasingly argued that relatively few of the credit subsidies were captured by poor people and that subsidized and directed credit had a weak effect on farm production and investment. The directed agricultural credit programmes were also faulted for having substantial amounts of credit funds diverted to other uses, crowding out alternative funding sources, not supporting a sustained expansion of new technologies by farmers, for low banks profits, serious and chronic loan recovery problems, dependency on outside funding, and for not servicing the total financial needs of farm households which included non-farm and off-farm activities (Coffey, 1998; FAO & GTZ, 1998; Charitonenko & Yaron, 2000).

This paper is divided into 5 sections. Section 1 is the introduction. Section 2 lists the features of directed credit programmes. Section 3 shows the problems which plagued directed credit schemes and contributed to their failure. Section 4 lists the main elements of the new financial market development approach to finance, and Section 5 contains the conclusion and section 6 the recommendations.

Features of the Directed Credit Approach
The main features of the directed agricultural credit approach to finance included the following (Graham, 1992; Yaron, 1995):

(i) Credit needs were given precedence over the creditworthiness or debt-carrying capacity of borrowers.

(ii) Performance was measured on the basis of the number of loans and speed with which they are disbursed to a targeted clientele, the amount of inputs financed and allocated, the rate of technology adoption, and the increase in employment and output.

(iii) Loans incorporated interest rate subsidies and were granted through specialized lending institutions with undiversified and concentrated portfolios.

(iv) Lending institutions were borrower-dominated in which all the procedures and practices (including perfunctory loan evaluation, quick disbursement, and lax loan recovery) favoured borrowers’ interests.

(v) No weight was given to the sustainability of financial flows, the interests of depositors or the effects of directed credit on the health of the financial system as a whole.

Problems Associated with directed Agricultural Credit Schemes
The directed credit approach to finance failed to produce the desired results. For example, expectations that established specialized credit institutions would provide small farmers with easier access to credit proved to be unfounded. The reasons for the failure of directed credit policies and programmes included the following (Von Pischke & Rouse, 1983; Adams & von Pischke, 1984; Adams et. al. 1984; Schmidt & Kropp, 1987; Adams, 1988; Huppi & Feder, 1990; Holt & Ribe, 1991; Hettige, 1992; Graham, 1992; Saito, 1994; Gonzalez-Vega & Graham, 1995; Yaron, 1995; Seibel, 1996; FAO & GTZ, 1998; Coffey, 1998; Zeller, 1999; Fiebig, 1999; Klein et. al., 1999; Seibel, 2000; Charitonenko & Yaron, 2000; Markowski, 2001; World Bank, 2008):

(i) Credit was often limited to specific export crops while ignoring the demand for credit for other farm and non-farm enterprises as well as for stabilizing food consumption.

(ii) Subsidized credit channelled on behalf of the government led to adverse borrower selection and insufficient borrower screening.

(iii) Combined, subsidized and targeted credit channelled funds into marginal and submarginal activities.
Generous credit guarantees led to moral hazard among both lenders and borrowers. This resulted in low recovery rates and programme decapitalization and, to the extent that funds were not replenished, to credit rationing.

Given the fungibility of finance, it was naïve to assume that a substantial share of targeted credit was not diverted for other uses.

Since increased output has multiple causes, it was also naïve to casually associate it with the increase in credit rather than other factors.

Many directed agricultural credit programmes were poorly designed and failed to consider the high costs associated with agricultural lending.

As the performance of agricultural development banks was measured in terms of loan disbursements rather than in the actual number of small farmer-borrowers served and recovery of outstanding loans, funds from them were frequently skewed in favour of wealthier and more influential farmers. Not only were large farmers perceived as lower risk because they offered more collateral, but administrative costs per unit on large loans were significantly lower than those on the modest sums lent to small farmers. This was reinforced by the rent-seeking behaviour of large farmers who benefitted from the subsidized interest rates that were set by governments.

As agricultural development banks focused on providing credit rather than on accepting deposits, the practice undermined their self-reliance as well as their viability.

As agricultural banks were established to channel subsidized donor and government funds to farmers, they lacked the market discipline and incentives of commercial banks.

Since many agricultural banks were created for political purposes, they were not meant to operate as viable financial institutions as the provision of credit depended upon political decisions and interests. Frequently, political criteria of beneficiary selection loomed larger than economic criteria of customer creditworthiness or expected returns on investments.

Because they are government-owned, agricultural development banks were frequently subject to repressive financial measures such as controlled exchange and interest rates, as well as to political expediencies and vested interests.

The irregular availability of loan funds, the setting of interest rate ceilings and the periodic write-off of overdue loans seriously undermined the effectiveness of government-owned or sponsored financial institutions.

Interest rate regulation prevented banks from covering their costs and restricted the access of the poor to financial services.

Low or negative real rates on deposits discouraged savers.

In some countries, an inverted interest rate structure, with deposit rates above lending rates, systematically undermined institutional viability and made banks utterly dependent on government subsidy.

Development banks remained largely unsupervised and their de facto exemption from prudential banking regulations and from effective monitoring and supervisions of their activities brought many of them close to insolvency.

As agricultural banks focused exclusively on agricultural lending, they were exposed to a high concentration of risks. This required frequent rescheduling of overdue loans, thus further undermining the loan recovery efforts and the loan repayment discipline of both bank staff and farmers. Such preferential credit programmes also tended to curtail rather than expand their outreach to small farmers and other customers in rural areas.
Often the aggregate cost to society of maintaining continued operations of the institutions involved, including the value of the subsidies in the form of access to cheap and subsidized sources of finance was not properly disclosed. Thus, the maintenance and continued operation of many of the credit programmes turned into an extremely costly drain on government budgets which support these efforts.

Deficient financial reporting practices often made it impossible to determine when and which payments are overdue and what part of the loan portfolio was non-performing or beyond recovery.

Many of the financial institutions were associated with heavy losses generated by either inadequate indexation in a highly inflationary environment or by dismal loan collection in a stable economy.

To contain losses, development banks increased loan sizes, thus restricting their outreach, while commercial banks refused to bank with a sector that was considered both unbankable and unprofitable.

Under the combined pressures of governments and donors, development banks were forced to apply criteria of social rather than commercial banking. As a result, they frequently allocated the wrong loan sizes at the wrong time to the wrong customers for the wrong purposes. This neither benefitted the banks nor the beneficiaries.

While governments in many developing countries adopted donor roles, the banks were unable to act as financial intermediaries between savers and borrowers, restricted either by interest rate policies or by a legal framework which provided either for specialized savings or credit institutions and barred commercial banks from branching out, thus eliminating competition. As a result, the financial system remained repressed and, in many cases, inoperative.

Many of the directed credit programmes operated in hostile economic environments that were not conducive to the development of healthy financial markets. Cheap food policies, subsidized food imports, punitive export/import taxes and tariffs, domestic commodity price controls, unfavourable terms of trade for agriculture, and distorted foreign exchange rates all contributed to this hostile environment and depressed earnings in agriculture. In addition, little investment in rural infrastructure, lack of law and order, and failed land reform efforts further dampened economic incentives in some rural areas.

Excessive legal reserve requirements were effectively a tax on deposit-taking and further lowered the rates of interest that would be paid on deposits.

Limits on bank branching and on the formation of new financial institutions restrained competition and efficiency improvements in the financial sector.

Both external and internal factors contributed to the poor performance and high costs of most agricultural development banks. The external factors included several urban-biased macro-economic and sectoral policies and an inadequate legal and regulatory environment that have been present in many developing countries. The internal factors revolved around the unclear mandates and duality of objectives most agricultural development banks faced, as they were expected to maintain their institutional viability as a “bank” while simultaneously acting as an income-transfer agent of the government, serving as a disbursement window for concessional credits funded by grants or low-cost borrowed funds, while often being discouraged from mobilizing deposits.

Support for the directed credit paradigm was further undermined by the world-wide shift in development philosophy from one that stressed central planning to one that stresses free
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markets. Credit planning, credit directing, and credit subsidies were inconsistent with allowing free markets to allocate scarce resources.

The New Approach of Financial Market Development

The poor experiences with directed credit programmes, reflected to some extent in the failure of agricultural development banks and other rural lenders to reach low-income producers with affordable credit has led to a search for other arrangements (Braverman & Guasch, 1989a, 1989b). The new financial market approach stresses the shift away from the administration of directed credit programmes that rely on continuous government subsidies to an approach that emphasizes intermediation and focuses attention on the performance of financial institutions. The main elements of the market performance approach include (Graham, 1992; Klein et al. 1999; Coffey, 1998; Markowski, 2001):

(i) Emphasis on the mobilization of domestic deposits and savings as a strategic ingredient in any recipe for making healthy financial institutions.
(ii) More attention is given to the role of financial intermediation, to reduced transaction costs, and to cost- and risk-reducing financial innovations as a means of supporting a sustainable flow of untargeted financial services.
(iii) The elimination of interest rate ceilings and selective credit policies that limit portfolio choice.
(iv) The principal criteria for measuring success are good loan recovery, low transaction costs of lending and deposit mobilization, increased number of people with ready access to financial services (both loans and deposits), and the proportion of total funding that comes from locally-mobilized deposits.
(v) A shift of focus from servicing the borrower to the fiduciary responsibility of protecting the saver. Instead of creating borrower-dominated institutions of the sort that characterize supply-lending strategies, this approach strives for a more neutral balance between borrower and saver constituencies.
(vi) Instead of quick disbursement of poorly evaluated loans to high-risk, targeted clientele, the market performance approach demands (in the interests of savers) more careful loan evaluation, aggressive loan recovery, and properly priced loans (devoid of subsidies) that reflect the opportunity cost of capital.

Conclusion

There is a growing consensus among experts in agricultural finance that a paradigm shift from the traditional, directed credit approach to a financial systems development approach has become inevitable. The directed approach had not managed to reach the poor, let alone meet their financial access needs; it was extremely costly and ultimately detrimental to overall financial development. The financial systems approach emphasizes the need for an integrated approach to financial market development and the provision of competitive and durable financial services in local financial markets. Although the financial systems approach is now being increasingly accepted and adopted, the debate continues on the nature and extent of required government interventions in the rural financial sector. For instance, the essential role of governments in establishing an enabling policy environment and laying down an appropriate legal and regulatory framework is generally accepted, but there is much less consensus on the need and extent to which government should be involved in the direct provision of financial services in the event of serious market failures. In view of the limited available resources, it has been argued that direct government interventions should be exerted on the
basis of operational efficiency and cost-effectiveness. A general consensus is that state-owned rural financial institutions should not receive special privileges that create unfair competition.

**Recommendations**

The following recommendations are important in the context of this paper:

1. There is need for a shift away from supply-led and interventionist policies towards a more liberal market-oriented approach to finance. The liberalization of the financial sector should include the elimination of regulated interest rates that led providers to ration credit based on transaction costs which are higher for smaller borrowers and the re-structuring or liquidation of state-owned agricultural development banks.

2. Rural financial market development should include the provision of both farm and non-farm rural lending services as well as essential savings/deposit facilities. This will mean the transformation of agricultural lending institutions to universal rural banks. The exclusive emphasis on agriculture under the directed credit approach that effectively ignored the income-generating potential of off-farm activities, not to mention the social and life-cycle (e.g. weddings, funerals) events that create financial pressure on rural households meant that money from agricultural loans did not necessarily go towards productive activities.

3. There is need for the creation of commercially viable rural financial institutions that can generate profits above and beyond their total financial transaction costs and can finance the development costs that are required to provide new financial products from their retained earnings. These institutions should be able to develop new financial products in response to market opportunities; provide high quality financial services to strengthen their competitiveness and ensure client trust and loyalty; and evolve a governance and management structure that protects them against political interference and distortions that are induced by government and donor interests.

4. State-owned credit institutions should be subject to prudential regulations which stipulate minimum capital adequacy ratios, limits on portfolio concentration, loan loss provisioning, and guidelines for classification of assets by potential risks associated with them. Adequate supervision is also needed to ensure that weak financial institutions are detected early or merged in orderly fashion. Inadequate government monitoring permits an environment of lax lending policies.

5. Financial reform, in general, should include: financial repair to reduce distress in banks and financial deepening to eliminate distortionary financial policies and practices, change institutions, establish greater efficiency in the mobilization and allocation of resources, and increase the outreach of financial institutions to new groups of customers. Some of the suggestions for overcoming the problem of distressed banks include presence of a stable economic environment, more private ownership, and gradual adjustment of interest rates and exchange rate. Financial deepening would also include decentralization, a more client-focused perspective that calls for product development and capacity building at the financial institution level, and consumer and financial education at the client level.

6. The political will either to close loss-making financial institutions or to implement effective reforms is also essential. The challenge is to find a way for all stakeholders — donor institutions, governments, and the rural community — to work together for reform.
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References


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