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Role of Government

Issue 4

Governments often face the fundamental problem: agriculture and rural areas are underserved in terms of credit and other financial services. How can governments expand rural and agricultural finance, without repeating the mistakes of the past? Instead of being a direct provider, governments can be far more effective by establishing and enabling environment for the private sector to supply financial services to rural and agricultural sectors.

INTRODUCTION

Rural areas and the agricultural sector in developing countries have often been underserved by conventional financial institutions due to the higher transaction costs of these operations and the higher real and perceived risk associated with agricultural lending. In seeking to promote rural development, and considering the relative importance of agriculture in many of these economies, many governments have struggled to expand rural and agricultural finance. In the 1970s and 1980s, governments saw it as their role to step in and provide credit, either through state agricultural banks or through directed credit programs facilitated by commercial financial institutions. While these programs may have had an immediate effect on the growth of targeted agricultural sub-sectors, loans available under these programs typically were costly to administer and included subsidized interest rates. Further, for political or social reasons governments often would treat the loans as grants, resulting in a culture of non-payment. As a result of the subsidized government loans, offered on soft terms, any private sector activity that might have been taking place in the area was driven out. In the long run governments could not sustain these programs, and the agricultural sector and rural areas were left with even less access to credit.

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THE AFTERMATH OF THE LIQUIDATION OF BANCO AGRARIO DEL PERU (BAP)

In assessing the costs and benefits of liquidating BAP, a failed agricultural development bank in Peru, it was assumed that the private sector would quickly fill the void left in the rural financial market. Five years after its closing, however, commercial banks only filled about half the breach, and the government was forced to use alternative, less efficient channels, to provide agricultural credit.

From Vogel, Robert, Costs and Benefits of Liquidating Peru's Agricultural Bank, AMAP Microreport, 2005, available at www.microlinks.org

The failure of these directed loan programs provided several other lessons that are relevant to the development of rural and agricultural finance:

- Agricultural projects may not be competitive at a market rates, and as a rule should not be financed at artificially low, unsustainable interest rates. Despite expectations, monies “saved” through a lower interest rate were not necessarily invested in the same projects.

- Financial needs are broader than just credit—farmers, other rural residents and rural, non-farm businesses need a range of financial services; needed services include savings, transfers, insurance, and short and long term credit for non-agricultural needs. Further, financial institutions should offer a range of products and services to diversify their risk.
- Deposits should be mobilized—in addition to providing critical depository to rural persons and businesses, rural deposits may be intermediated into funding for rural and agricultural finance. Frequently, however, commercial banks will source deposits in rural areas but will re-lend them in urban areas.
- Direct government intervention in the credit markets undermines and displaces private financial institutions—once financial institutions withdraw from a market, they are reluctant to re-enter.

Despite the failures of the past, governments often still face the fundamental problem that agriculture and rural areas are underserved in terms of credit and other financial services. How, then, can a government expand rural and agricultural finance, without repeating the mistakes of the past? What is the appropriate role of government? This note considers these questions, first by laying out some general guidelines, then exploring possible government interventions in both the financial and agricultural sectors.

GUIDELINES FOR GOVERNMENT INTERVENTION

Governments should not try to displace a competitive private sector.

The efficiency of a private market, motivated by profit and guided by competition, is remarkable. Profit encourages firms to act on market opportunity and competition weeds out inefficient providers. Government-owned enterprises and activities rarely operate as efficiently as private sector firms. Although there are cases of state-owned enterprises and private businesses competing in the same market resulting in a wider range of compete

tive services, this guideline suggests that **government should encourage private providers to enter the marketplace, rather than entering the market directly itself.**

Government intervention should seek to correct market failure.

Sustainable provision of financial services to rural areas and agriculture requires bankable projects. This, in turn, assumes a certain amount of market infrastructure and sufficient economic activity in rural areas so as to be viable. Viable financial institutions must also exist, and have some outreach to rural areas. On the agricultural sector side, in addition to producers, entities such as input suppliers, traders and processors, warehouses and transportation firms make the sector more profitable and thus more bankable. In countries where these entities do not exist, governments should strive to identify and remove policy-related obstacles that prevent the private sector from creating them. The economic system that arises from a continuing government subsidy or direct government involvement is less

efficient, affordable, and sustainable. Overall, this guideline underlines the concept of **government's primary role as creating an enabling environment** for private industry to thrive without direct government support.

Government intervention promoting social equity should be cost effective and affordable.

Government interventions to address equity issues or provide social protection (e.g. food security through affordable bread) should be driven by a desire to increase market efficiency. Therefore, dialogue on such programs should focus on minimizing the cost of the intervention and seeking the least disruptive alternatives to secure the same objective. For example, bread vouchers for the poor might achieve the same social benefit with a less distortive effect on the agricultural sector than would government price controls on grain. In addition, such government interventions should be "affordable," that is, where debt produced by government expenditure does not grow faster than GDP over the long term. Restated, this guideline

addresses the role of **subsidies and grants, which should be transparent and temporary, and facilitate but not replace** the effective working of the private sector. In the long run such governmental support should lead to the strengthened role of private sector operators.

GOVERNMENT ROLE IN FINANCIAL SECTOR DEVELOPMENT

Financial sector development is the most significant role for government in enabling rural and agricultural finance, because these activities have a cross-cutting, beneficial effect for all sectors of the economy. There are three main areas of activity for government in financial sector development:

Enable a variety of viable financial institutions that can provide a range of credit instruments, deposit services, and other financial services. Governments in emerging economies are rightly concerned with the stability and safety of formal financial institutions, hence may opt to create a single class of bank with high capital requirements. The result is a financial sector that includes a few large banks and a range of informal financial mechanisms such as ROSCAs and moneylenders. Rural and agricultural sectors are better served by a range of fi

financial institutions including those that require less capital for more limited functions. These can be structured so that they can particularly serve niche markets, including agriculture and rural areas. Examples include equipment leasing companies that specialize in farm equipment, as well as agricultural cooperative savings and loans. Financial sector regulation also must be robust enough to allow the function of NGOs and self-help groups that can provide financial services to very poor people and those in remote rural areas, who are unlikely to be served by formal financial institutions under any expansion. USAID facilitated the adoption of a new microfinance law in Morocco in 1999. Under this law, which has been critical to the proliferation of microfinance services, NGOs are permitted to deliver microfinance services and are exempt from the interest rate cap adhered to by banks and finance companies.

In its role as the licensor of financial institutions, the central bank or other authorizing agency also has a critical role as the regulator of formal financial institutions, which are subject to prudential norms to ensure their

integrity as repositories of savings. This function, of course, has a far broader impact on the financial system than just an importance to access to rural and agricultural finance. As a part of this regulatory function the central bank needs to remain current on innovations in the financial services industry, so that appropriate use of such innovations is not restricted. This aspect of regulation may be particularly significant for development of rural finance: for instance, advances in remote transactions through cell phone technology hold tremendous promise in serving rural areas. The central bank needs to stay on top of such innovations to assess the risk involved and encourage adoption if they are found to be more efficient and cost-effective.

Provide a suitable legal and regulatory framework for financial transactions.

This would include contract law and property rights, as well as mortgage and bankruptcy laws.¹ Of particular interest to enhancing rural and agricultural finance is broadening the types of as-

¹ RAFI Note No. 4, Legal Foundations of Effective Rural and Agricultural Finance, discusses the appropriate legal and regulatory framework for RAF.

sets that are eligible as collateral, including crops, accounts receivable, equipment, and rural land.

Maintain support institutions.

Even a well-designed legal and regulatory framework is ineffective unless backed up by appropriate support institutions such as a functioning courts system, property registries, and certification agencies. For instance, allowing banks to take equipment as collateral is not meaningful if there is no workable collateral registry. Warehouse receipts, or even a pledge of crops, are not useful as collateral without inspection systems for public warehouses. Support institutions are critical for the enhancement of credit to all sectors, but loom particularly large with respect to rural and agricultural finance because of the limits to available collateral and the nature of the loans generally needed by agricultural producers. While real property registries are more common in the capital city, for instance, agricultural land, even if properly titled, may not be recorded in such a way that can be easily searched. Even if these support institutions are in place, accessibility may still be an issue because the distance and transportation issues associated with rural areas may amplify the time and transaction costs for rural borrowers of dealing with institutions such as courts systems. In Central America, Costa Rica, El Salvador, Guatemala, and Honduras are currently at various stages of creating national

electronic registries for movable property. There is high public support for these reforms. In fact, Guatemalan farmers actually demonstrated peacefully this summer to demand adoption of the collateral registry system. USAID is funding technical assistance to ensure that the registries not only meet the needs of each country, but also so that they are harmonized to create a larger market that will attract more lenders. A number of international banks have already expressed a desire to provide collateral lending services in the larger, harmonized market.

ROLE OF GOVERNMENT IN AGRICULTURAL SECTOR DEVELOPMENT

Because of the relative importance of agriculture to emerging economies, the agricultural sector tends to be over-supported or protected, or alternately is expected to bear proportionately more costs, through special taxes or price restrictions, than other sectors. In general, agricultural policy should be directed to assisting farms and

agricultural businesses to operate as profitable private concerns. This in-

cludes eliminating or lowering taxes that seem to target the agricultural sector such as excessive duties on imported fertilizer or high tax rates on exported agricultural produce. Such taxes increase production or product costs to uncompetitive levels, thereby reducing the profitability of agricultural enterprises, making them less attractive to lenders and investors. The government should also liberalize agricultural trade and product prices, eliminating both ceiling and floor crop prices. Overall the more freely agricultural businesses are permitted to operate, the more attractive they are as credit clients.

Governments can also help improve the bankability of agricultural enterprises by directly providing or supporting private sector provision of a range of agricultural support services and activities. These include such elements as agricultural research, market information, and food safety (SPS) certification services. These services increase product quality, leading to more competitive, profitable businesses. In Kenya, the Ministry of Livestock and Fisheries Development (MLFD) played a critical role in improving the access of rural fisherfolk to lucrative European Union (EU) markets by establishing the Competent Authority to ensure proper inspection,

monitoring, and export documentation. Because of the stringent processes and procedures, Kenya meets the processing systems and health standards required by the EU for export.

OTHER ROLES OF GOVERNMENT

In addition to the direct effect from financial and agricultural policy and support of enabling institutions, governments indirectly affect the profitability of rural and agricultural enterprises, thus access to rural and agricultural finance through other policies and programs. Major areas which touch on rural and agricultural finance are microeconomic policies, macroeconomic policies and physical infrastructure. The effect on rural and agricultural finance of government policies in these areas may affect whether it makes sense for a donor to support significant development initiatives in a particular area. For instance, if the government is not willing or able to improve the physical infrastructure to a remote rural area, i.e., through improvements to roads, it may not make sense for the donor to encourage extensive financial institution branching in that region, reasoning that those branches would be underutilized because of difficulty of access and lack of bankable enterprises.

Microeconomic Policies

Governments undertake microeconomic policy changes to affect relative prices in order to support some activities and penalize others. Effective micro-

economic policies, such as limiting protection, promoting competition, and streamlining labor market regulation, largely have a direct, positive effect on the demand for rural and agricultural finance and a positive, indirect effect on its supply. Such policies reduce input costs and raise farm-level efficiency, which will raise rural and farm incomes. In turn, rural and farm enterprises will require financing to expand or respond to market opportunities. Moreover, rural or farm businesses will have increased capacity to take on and manage debt. Consequently, the supply of rural and agricultural finance should increase. Certain microeconomic policies, such as loan subsidization or grant programs can have a more direct effect on the supply of rural and agricultural finance.

Macroeconomic Policies

Governments generally undertake macroeconomic policy changes when collective private actions produce an unacceptable macroeconomic outcome such as recession, inflation, or unsustainable growth in debt. Macroeconomic policies can have strong effects on rural financial markets through their effects on exchange rates and interest rates.

The best macroeconomic policies reduce the volatility of exchange rates and interest rates. Poor macroeconomic policies can produce long periods of boom and bust in rural areas. Periods of compressed profit margins and high interest rates in rural areas are typically associated with declining demand for rural and agricultural finance and increasing default on existing rural and agricultural debt. Governments interested in expanding rural and agricultural finance should take appropriate account of the effects of macroeconomic policies on the agricultural sector's profitability.

Physical Infrastructure

Infrastructure has an enormous impact on the profitability of agricultural and rural enterprises, for instance, limited access to markets due to bad roads can erase already thin profit margins on most crops and limit farmer opportunities to sell outside of local markets. Rather than just taking on traditional state-run infrastructure projects, however, governments should seek out opportunities to actively involve the private sector. This is particularly important for donor-dependent governments who can finance only a tiny fraction of infrastructure needs. Best practice efforts identify and remove constraints that pre-

vent private and public investment in infrastructure.

IS THERE A PLACE FOR STATE BANKS?

A favorable policy environment is a necessary, but not sufficient, condition to encourage rural and agricultural finance. The trend in emerging economies has been for a liberalization of financial sector policy; this along with the withdrawal of state banks and programs was expected to bring a surge of private sector finance to rural areas and to the agricultural sector. This generally has not occurred, because of the higher transaction costs associated with serving dispersed populations, as well as the perceived and real higher risks inherent in agriculture and agricultural lending. As a result, there has been a renewed interest in supporting state banks to provide these services.

There are some examples of successful turnarounds of state-owned banks, including Bank Rakyat Indonesia's Unit Desa System, the National Microfinance Bank of Tanzania, the Khan Bank in Mongolia, and Banco do Nordeste's Crediamigo in Brazil. While these and other examples are being studied to better understand successful reform, it is clear that success stems both from avoiding mistakes of the past, such as charging below market rates and directing lending solely to specific beneficiaries or sectors, and by capitalizing on the advantages that the bank already has, such as a broad client base and

an extensive branch network. A particularly significant factor in success has been to operate the financial institution on a professional basis, and not to allow the operation to be subject to political whims.

Alternatively, governments can be encouraged to assess the policy and institutional environment that may be hindering private sector engagement as discussed above. Donor support can be provided to help private sector banks and non-bank financial institutions minimize transaction costs and mitigate risk.

THE CHALLENGE TO GOVERNMENT

There has been a fundamental shift in the role of government in providing access to rural and agricultural finance. Instead of being a direct provider, and often the only provider, governments can be far more effective by establishing an enabling environment for the private sector to supply financial services to rural and agricultural sectors. This is done through well thought through economic, monetary, and fiscal policies, as well as through effective licensing and regulation of financial institutions. If subsidies or grants are deemed necessary, they should be transparent and temporary. If the government does have a role as a financial services provider it should compete on commercial terms, and not provide below market interest rates or otherwise engage in directed lending.

Recommended

Deepening Rural Financial Markets: Macroeconomic, Policy and Political Dimensions by Gonzalez-Vega, Claudio. 2003. Presented at the USAID-sponsored Paving the Way Forward for Rural Finance, International Conference on Best Practices, Washington, DC. Available at http://www.basis.wisc.edu/rfc/documents/theme_macro.pdf

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