AGRICULTURAL FINANCE REVISITED

AGRICULTURAL FINANCE: GETTING THE POLICIES RIGHT

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PART I

1. Performance of Agricultural Credit

Since the early 1950s governments and donors have spent large amounts on agricultural credit programmes. The World Bank alone committed over US$16 billion to these efforts from the mid-1950s to the late 1980s and other donors also spent substantial amounts. In several countries, such as Brazil, India, Indonesia, Mexico, and Sri Lanka, supply-led and directed credit programmes were the dominant tool used to spur agricultural development during the three decades prior to the 1990s. In centrally planned countries directed credit was likewise a prominent instrument used to implement agricultural production plans. However, directed agricultural credit programmes continue to play a strong role in some developing countries, e.g. the Philippines (see section 3).

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, and augmenting farm production. It was further assumed that most farmers were too poor to save, that informal financial markets were dominated by monopolist money lenders who charged usurious interest rates, and that commercial bankers were too conservative to lend to most farmers. 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 subsidised 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. 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 the later 1970s, for example, the central bank in Indonesia administered nearly 200 directed credit lines, many of which were aimed at agricultural activities, and most of which were subsidised.

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 Thailand, for example, during the 1970s and 1980s the government required all banks to lend an increasing percent of their total loan portfolio to farmers. If they were unable to comply directly with this requirement, they were allowed to fulfil their obligation by lending money at concessionary rates to the Bank for Agriculture and Agricultural Co-operatives (BAAC, see p. 8). In some countries subsidised 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.

As part of this process, many countries formed or expanded agricultural development banks to handle the bulk of the targeted lending. Ministries of agriculture typically played a dominant role in these banks, and in the formulation and implementation of associated policies. In some cases, especially in Latin America, these banks and ministries formed supervised credit programmes that tied technical assistance and training to subsidised lending, especially during the 1960s. In many countries political considerations were involved in loan approval and loan recovery decisions. Government-mandated loan forgiveness in Bangladesh and Loan Melas (fairs) in India during the 1980s being examples of such political interventions in financial sector operations.

Shifts in political priorities and donor preferences have often resulted in substantial changes in roles assigned to rural financial markets. Sometimes farm production and farm investments were stressed, while at other times poverty alleviation, pacifying the countryside, or disaster relief were the primary objectives of directed credit efforts. In several countries such as the Philippines and Indonesia, major segments of the

Box 1
Increased Outreach to Thai Farmers: Bank for Agriculture and Agricultural Co-operatives, BAAC

Thailand has been characterised by stable macroeconomic and open market policies for the past decades. In 1997 before the currency and financial sector crisis, the Thai government estimated an annual economic growth rate of 7-7.5%, while maintaining inflation at 5%. Economic growth and stability are expected to result in a more equal distribution of income, alleviate poverty and improve the quality of life of the Thai people. In an attempt to achieve these objectives, clear targets are set by the Ministries of Finance, Commerce, Communication, Central Bank, Budget Bureau, Office of National Economic and Social Development and private sector bodies.

In the economic development process, the agricultural sector is expected to play a major role. Past government policies have emphasised the accessibility of farmers to agricultural credit at affordable costs. The government created the Bank for Agriculture and Agricultural Co-operatives (BAAC) in 1966 with the objective of attending small farmers, agricultural co-operatives and farmers' associations. However, despite government concerns, directed credit failed to meet the total farmer demand. This led to a mandatory requirement for commercial banks to lend a minimum fixed percentage of their total lending to the agricultural sector (lending directly to farmers or lending money to the BAAC at concessionary rates) and this measure has had a significant impact on increasing the volume of lending to farmers. In 1997, 80% of all Thai farmers are registered as borrowers with BAAC, either individually or through membership of co-operatives and associations.

The charter of BAAC sets the framework for its credit operations, where lending is possible only to farmers and until recently, exclusively for agricultural purposes. Restricting lending to farming activities affects BAACs ability to attend the financial needs of small-scale farmers who, due to the small size of their holdings, are also dependent on off-farm employment and non-farm activities for additional income. A proposal to amend the charter to allow all-purpose rural lending, thereby allowing a diversified loan portfolio, is under consideration at parliament and is an essential pre-condition for the profitability and continued viability of BAAC.

BAAC is under pressure to enhance the scope of its lending to cover an increasing proportion of the poor farming population, while at the same time, it is required to operate in a viable way. It receives support from the government for specific lending programmes, while effective management and use of appropriate financial technologies have enabled BAAC to meet the challenge of viability and equity.

rural financial system were attached to crop production programmes. In other countries such as Egypt and Brazil large subsidised credit efforts were justified on the basis of compensating farmers for other economic distortions in the economy, such as food price controls or over-valued foreign exchange rates.

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. In part, this decline in support was due to the unsatisfactory performance of these efforts. Critics increasingly argued that relatively few of the credit subsidies were captured by poor people and that subsidised and directed credit had a weak effect on farm production and investment. Serious and chronic loan recovery problems, dependency on outside funding, and overall costs eroded the support for these efforts. Poor performance and the lessening of donor and government support led to the collapse of many public agricultural development banks and rural (government directed) co-operatives in the 1980s. In some countries such as Peru and Bolivia traditional agricultural banks were closed (see p. 6). In other countries such as The Gambia and ex-USSR all or part of the development banks were sold or privatised. In still other countries these development banks and rural credit co-operatives persist but their financing activities have been sharply reduced, such as in Guatemala, Nicaragua, and Uganda.

Several major forces led to the collapse of many of these directed credit efforts and to the general disillusionment with the directed-credit approach. With the benefit of hindsight, it is clear that many of these programmes operated in hostile economic environments that were not conducive to the development of healthy financial markets. Cheap food policies, subsidised food imports, farm price controls, unfavourable terms of trade for agriculture, and distorted foreign exchange rates all contributed to this hostile environment. 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. Rural financial markets cannot thrive and grow if their clients lack creditworthiness, lack the ability to repay loans, and are unable to save because their incomes are depressed.

Box 2

Directed Credit Leading to Institutional Collapse:
Banco Agrario del Peru (BAP)

The predecessor of the agricultural development bank in Peru (Banco Agrario del Peru, BAP) was formed to provide loans (directed credit) to cotton, sugar and rice producers in the coastal region. Shifts in focus occurred throughout subsequent decades and were pronounced with changes in political power. Throughout the 1970s and early 1980s the number of employees and BAP branches rapidly expanded to provide an increasing number of subsidised loans to remote areas (e.g., from early 1975 to late 1979, the number of employees increased by 46 percent). The adverse effects of this expansion on the administration costs was compounded by hefty inflation that substantially exceeded the nominal interest rates charged on BAP loans. In the late 1980s the government instructed BAP to disburse loans to disadvantaged areas at zero nominal interest rates with the promise to reimburse BAP the interest rate subsidy, a promise that was not kept.

During this period, BAP did achieve considerable outreach, growing from 4 percent of all farmers to 25 percent. By the late 1980s, BAP extended loans to farmers who cultivated approximately half of the total land area. The growth of BAP caused a crowding out of commercial banks. In the 1950s, BAP provided about one third of all formal agricultural credit, the remainder being provided by the commercial banks. However, by the late 1970s, BAP captured more than 90 percent of the formal agricultural loan market and 80 percent thereafter.

In addition, the importance of savings mobilisation as a source of funds declined rapidly throughout the 1980s when BAP became increasingly dependent on donors and Central Bank funding. It was cheaper for BAP to utilise external funds than to mobilise deposits from rural households. In addition, such dependency increased the vulnerability of BAP to political intrusions and donor fads.

BAP faced both internal and external problems. Among the external forces, which were beyond the control of BAP, were an unstable macroeconomic environment, poor financial sector policies (forced interest rate ceilings, limiting the ability to price financial products according to their costs and risks) and forced political directives (sometimes loan approval and loan repayment decisions were made outside the bank). Among the internal problems were lack of deposit mobilisation, dependency on external funding, non-banking culture and huge administrative and transaction costs. Close ties with the Ministry of Agriculture resulted in BAP recruiting individ-

Box 2 (Cont.)

Directed Credit Leading to Institutional Collapse: Banco Agrario del Peru (BAP)

uals with a knowledge of agriculture rather than banking. Success was measured by the number of loans disbursed, crops planted, investments funded and size of the organisation. Little or no attention was paid to transaction costs, to administrative costs, to quality of service, or to financial innovation. In some cases the bank was required to charge the least for loans that were the most costly to administer. BAP was constructed and operated in line with the old directed credit paradigm, compatible with subsidies, suppression of market forces and central planning. As in many other countries with the onset of market liberalisation, BAP collapsed and left a void in servicing small farmers and rural households.

Source: Dale W. Adams and Juan Jose Marthans., "Benefits and Costs of Liquidating an Agricultural Bank in Peru" and "The Rise and Fall of an Agricultural Bank in Peru", 1997.

Development of rural financial markets was further impeded by repressive financial sector policies. Interest rate ceilings were common on both loans and on deposits. This limited the ability of lenders to charge cost-recovery rates on their loans and limited their ability to mobilise deposits by paying attractive interest rates. Excessive legal reserve requirements were effectively a tax on deposit-taking and further lowered the rates of interest that could be paid on deposits. Limits on bank branching and on the formation of new financial institutions restrained competition and efficiency improvements in the sector. In addition, design flaws in what has been called the traditional directed credit paradigm contributed to the problems encountered in many rural financial markets. 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 markets. Credit planning, credit directing, and credit subsidies are inconsistent with allowing free markets to allocate scarce resources.

2. Directed Credit and Financial Market Development: Difference between Concept and Reality

The directed agricultural credit programmes proved to be subsidy dependent, prone to disasters, and ineffective in helping to achieve important goals. Instead of building a sustainable financial infrastructure, many of the directed credit programmes undermined the development of a viable financial market. Critics of the old paradigm increasingly claimed that cheap credit was ineffective in alleviating rural poverty, in stimulating agricultural investments and in spurring agricultural production. The flaws of directed credit in the 1990s led to the formation of a new paradigm, labelled the financial market approach. This new paradigm is markedly different from the directed credit approach[3].

For purposes of differentiating old policies from new policies it may be useful to briefly outline six major features and to compare the two paradigms on the basis of these features.

2.1 Problem Definition

The existence of market imperfections is often used to justify directed credit. These imperfections may be seen as too few loans being made to poor people or to small farmers in general, exploitation of borrowers by moneylenders, lack of loan collateral, or monopoly power in rural financial markets. Other more sophisticated statements may include concerns about asymmetric information between lenders and potential borrowers that may limit the ability of lenders to determine accurately the creditworthiness of some individuals, thus creating a so-called market imperfection. In the past, there has been an over-emphasis on credit as the cure for all small farmer ills. At the same time, there was little or no consideration given to high transaction costs and to new financial technologies that would reduce these costs. It is generally recognised that

[3] The new "financial system" approach covers all financial institutions, financial markets and instruments, the legal and regulatory environment and financial norms and behaviour (BMZ, 1994).

providing banking services to farmers is more costly and difficult than attending urban clients. With traditional banking practices, dispersed small farm households will, as a result, have limited access to financial services.

This problem definition suggested three general policy avenues to overcome the observed imperfections. The first was to expand the formal financial system as rapidly as possible to fill some of the gaps in rural financial markets. Second, this expansion, combined with regulation of informal finance might be instrumental in tackling the supposed monopoly power of local moneylenders, thus forcing them through competition to lower their loan charges. Third, efforts to overcome market imperfections were directed explicitly at specific areas, activities and disadvantaged population groups.

In contrast, the new financial market approach focuses on the high costs and risks associated with rural lending and on ways to overcome these problems. Since many of the financial transactions in rural areas are small—both for loans and for deposits—the transaction costs per unit of money involved are necessarily high compared to larger transactions. Distances between clients and financial intermediaries, transport and communication difficulties, and the risky nature of agriculture that is vulnerable to natural disasters boost these costs. Weak land titling and cumbersome and costly court procedures also compound the problems of providing conventional collateral for loans in rural areas, thereby further increasing the risks of rural lending. Reducing these costs and risks is the focal point of the new financial market development approach. These issues are dealt with in greater detail in another publication in the Agricultural Finance Revisited series; "Better Practices: Doing it Right".

2.2 Role of Financial Markets

Those supporting the directed credit approach assign numerous duties to financial markets. These include poverty alleviation, stimulating production and investments, boosting production, moderating the effects of disasters, helping to implement central planning, and providing employment opportunities. Directed credit programmes were a major feature of government and donor efforts to solve many development problems. It is paradoxical that proponents of the directed credit approach assign many tasks to financial markets on the one hand, but on the other hand pay little attention to maintaining the financial infrastructure needed to carry out these assignments. The extensive use of agricultural development banks during the 1960s through the 1980s to administer large numbers of targeted credit lines and their subsequent debilitation or liquidation being examples of this paradox.

In contrast, the new market approach assigns a more modest role to financial markets. Instead of involving financial institutions in distributing subsidies and directing credit, the new approach stresses the importance of the process of financial intermediation. The primary goal in improving this process is to enhance the efficiency of resource allocation in the economy. This is done by efficiently mobilising deposits from savers who, otherwise, have only low-return options for investing their surplus funds, and then efficiently allocating loans to creditworthy borrowers who have too few funds to capitalise on viable investment opportunities. Critics of the old paradigm argue that using financial markets to direct credit weakens the ability of these markets to efficiently intermediate between savers and creditworthy borrowers. However, the transition from the old to the new paradigm continues to encounter strong political resistance in many countries, as outlined in section 3.

2.3 Users of Financial Services

Under the directed credit approach the recipients of targeted loans are often called beneficiaries. They are seen as benefiting from the efforts of credit planners or providers of subsidised loans, for example, for people who merit sympathy and special attention. Such altruistic views may be later engaged to justify slack loan recovery procedures, thus further expanding the magnitude of the credit subsidy. It is a short step from justifying an interest-rate subsidy on loans for people because they are poor, to justifying loan forgiveness because poor borrowers later turned out to be “too poor” to repay their loans.

Under the new financial market approach there are no subsidies associated with loans so there are no favours associated with lending. Financial intermediaries must treat their borrowers and depositors as valued clients if they are to stay in business. This forces intermediaries to be attentive to the quality of services they provide, to the transaction costs they impose on their clients, and to financial innovations that reduce these costs.

2.4 Sources of Loanable Funds

Financial institutions that provide directed credit usually rely on "outside" funding: government funds, donor resources, or concessionary loans from other financial institutions. In some cases, institutions that provide subsidised loans are not involved in the mobilisation of their own internal funds, and in other cases they do capture some deposits, but without much enthusiasm because using external funds is less costly. Likewise, subsidised interest rates on loans force deposit-takers to offer even lower rates of interest on savings, thereby weakening the incentives of savers to deposit surplus funds in banks.

Financial institutions that are heavily involved in channelling subsidised credit tend to become left handed-the left-handed portion of finance being lending and the right-handed portion being deposit mobilisation. The users of financial services in a system strongly influenced by directed credit tend to be borrowers rather than depositors; the system is borrower dominated. By contrast, the new financial market approach stresses the importance of mobilising local deposits, and efficiently intermediating between savers and borrowers.

2.5 Role of Subsidies and Taxes

Subsidies play an important role in directed credit and are, perhaps, its distinguishing characteristic. There is little logic in attempts to direct credit without subsidies. These subsidies can take the form of concessionary interest rates on funds provided to lenders, subsidised interest rates on loans made to beneficiaries, implicit subsidies involved in loans that are not repaid and written off, government or donor grants to cover costs of institutions involved in directed credit, and subsidies for supporting loan guarantee schemes.

The old adage that there is “no free lunch” applies to credit subsidies. For every subsidy there is a tax. Someone must pay for subsidies through explicit or implicit taxes. The incidence of the tax associated with directed credit subsidies will vary from case to case, but is likely to involve some or all of the following: explicit taxes on the citizens of the country that are used to fund government subsidies, explicit taxes on people in foreign countries that fund donor aid programmes, implicit taxes on holders of financial assets imposed by inflation caused by monetary issuance to finance credit subsidies, and implicit taxes on depositors who receive low rates of interest on their savings as a result of subsidised credit programmes.

An important objective of the new financial market approach is to eliminate subsidies in rural finance, especially those related to low lending rates, that do not cover all financial intermediation costs, or loan default. Market forces, instead of subsidies, are relied upon to mobilise funds from savers and enforce financial intermediaries to improve their loan allocation and loan recovery. Any subsidies should be temporary and transparent and not linked to lending activities but rather to institution building. To help reduce transaction costs, for example, training for bank staff in new lending practices or for banking operations and automation may be subsidised.

The absence of subsidies allows financial institutions to focus on financial intermediation. Since financial institutions are not processing subsidies under the new system, they are much less susceptible to rent seeking and corruption, common features of the directed credit approach.

2.6 Credit Information and Evaluation Systems

Typically, the volume of information associated with directed credit programmes is substantial. Each directed credit line typically has its own idiosyncratic data requirements, including collecting extensive information about characteristics of final borrowers and measuring the impact of credit on beneficiaries. Each credit line may require lending organisations to submit periodic reports to the providers of funds. It is not uncommon for the ample amounts of direct-credit information to crowd out other information flows that might be more useful to managers of the financial institutions. Managers of directed credit programmes may be able to provide detailed information on data required by funds providers, but be unable to generate critical up-to-date management information, such as the status of loan recovery. Concerns about meeting lending targets may also deflect policy makers from monitoring the overall performance of rural financial markets.

To justify the subsidies associated with directed credit programmes, it is also common for credit planners to require that credit impact studies be done on these programmes. These studies usually require collection of costly primary data that is not ordinarily assembled by lenders. The costs of managing the dense volume of information generated by directed credit activities typically augments loan transaction costs for both lender and borrower.

In contrast to the dense information systems in the directed credit approach, the financial market approach generates less but more useful data. The absence of numerous directed credit lines eliminates the need to process data for each sub-programme. Since the new approach stresses making loans based on creditworthiness, rather than on the basis of need, there is likewise much less data processed on the characteristics of borrowers and the impact of these programmes.

The focal point of data gathering and processing under the new approach is to provide information that is essential to manage financial intermediaries efficiently and prudently. The performance of financial institutions is measured by indicators such as deposit mobilisation, transaction costs, loan recovery, number of clients, and financial and operational sustainability. In sharp contrast to the costly data that are collected to measure the credit impact at the borrower level under the old approach, performance under the new approach is largely measured using information normally collected by well-managed financial institutions.

Annex 1 summarises the difference between the old and new paradigms.

3. Transition to the "New" Approach

World-wide, the switch from directed credit to financial market development is only partial. In countries such as Chile, El Salvador, Indonesia, Peru, and Uganda only a few remnants of the old directed credit approach remain. In many other countries the conversion to the new approach has been less complete. Typically, partial conversions involve interest rate deregulation and a reduction of subsidies and fewer facilities in central banks providing concessionary funds to lenders. The International Monetary Fund and the World Bank have played key roles in prodding this conversion as part of the economic reforms under structural adjustment programmes, that aim at creating economies that are less planned and more market driven.

Understandably, these conversions usually encounter strong resistance. Directed credit programmes were put in place for powerful reasons (see Box 3). Various interest groups pushed for their formation and these groups often argue for their continuance. These interest groups include donors who have found it easy to move relatively large amounts of money through directed credit programmes, politicians who are able to quickly respond to crises by announcing a directed credit initiative, managers and employees of development banks who benefit from handling directed credit programmes, and the beneficiaries who are able to capture the subsidies involved in these programmes. Since the benefits (subsidies) from these programmes are usually concentrated and the costs (taxes) diffused, it is much easier to mobilise defenders of the benefits than to organise those who bear the costs of these programmes.

Box 3

Social Concern versus Institutional Viability: India

The National Bank for Agricultural and Rural Development (NABARD) was created as an apex level financial institution in 1982 to provide guidance and focus on rural finance. It has also been given a mandate to co-ordinate, supervise and build the capacity of rural financial institutions. It sets down policies on lending rates, institutional development and regulation and supervision of rural financial intermediaries. It also provides finance to primary lending institutions for on-lending to the rural population and supplies a substantial part of the credit demand in rural areas through refinancing.

An economic reform package was launched in 1991 and to date the response of the different sectors to a market oriented private sector economy has been positive. Agriculture, however, has been subject to limited reform in the ongoing liberalisation process. The main government objectives of agricultural policy continue to be of a social and political nature. It is now recognised that subsidised directed credit programmes to the rural and farming sectors and to selected beneficiary groups within the rural population have not achieved their objectives. The social objective of poverty alleviation through subsidised credit has not been achieved and the creation of a strong rural financial system has been undermined. Policy in the past, while it concentrated on subsidised credit, also supported an expanded outreach, but financial deepening and widening and viability and sustainability of financial institutions was not part of this policy framework. New policies in the financial sector are implemented by institutions, therefore changes at policy level in the financial sector determine the shape and nature of rural financial institutions. As the government owns 85% of rural financial institutions, government interventions continue, particularly in the areas of promotion of different types of financial institutions and disbursement of credit to priority sectors.

Many policy makers and politicians continue to support directed credit. They believe that subsidised credit is an effective tool for alleviating poverty, stimulating technological change, promoting desirable investments and boosting production. It often takes time for policy makers who have been steeped in the visible hand of central planning to overcome the directed-credit habit and develop confidence in the workings of the invisible hand of the market. The mixed signals that policy makers may receive from donors further complicates the move away from directed credit. It is still common for some donors to tie their assistance to credit lines that aim to support specific target groups such as women, small farmers, and microentrepreneurs[4].

Events in the Philippines over the past two decades illustrate the problems associated with attempts to shift from the old to the new paradigm. In the early 1980s the financial system in the Philippines was severely stressed and the government initiated substantial financial sector reforms. This included deregulation of interest rates, allowing more competition in banking, and closing most of the discount lines in the Central Bank that had provided large amounts of subsidised and directed credit. On the surface, at least, the Philippines appeared to have largely adopted the new financial market approach. Recent analysis, however, showed that directed credit is still common in the country. Research has documented about 90 directed credit programmes in the Philippines, most of which involved substantial implicit or explicit subsidies. Many of these programmes resulted from political mandates to satisfy the demands of special interest groups and a number of the directed credit programmes were supported by donors. Although the notion of charging market interest rates has been widely accepted, there are often substantial differences between interest rates charged on targeted loans and the rates that are required to cover all financial transaction costs and credit risks.

Experience suggests that rapid conversion to the new financial market paradigm only occurs when policy makers are faced with a collapse in their financial sector and/or when political leaders are not subject to strong democratic forces. Even in these cases, there are periodic calls for a return to subsidised directed credit. The more typical cases are in countries where economic crises are less intense and where leadership is more subject to democratic forces. In these cases it is common for policy makers to straddle the new and old views. This typically involves charging less subsidised interest rates on loans, but not stimulating

4 Most donors have not adjusted their rural or microfinance strategy so that it reinforces deposit mobilisation, a vital component of the new financial market development approach.

deposit mobilisation and reduction of transaction costs, which are other vital elements in the new approach.

The issue of whether to restructure or abolish state-owned agricultural development banks in the shift from directed credit to financial market development needs to addressed in many countries (see Box 4). In order to survive, such banks must first emphasise their role as financial intermediaries rather than attempting to promote the adoption of particular

Box 4

Lessons Learned From the Collapse of an Agricultural Bank:
Case: Banco Agrario del Peru (BAP)

When attempting to transfer lessons learned from one country to another, one needs to be cautious. Nevertheless, lessons learned from the collapse of the Banco Agrario del Peru (BAP) provides some useful pointers for governments that have to address bank liquidation. In many cases in the past, closing a specialised agricultural development bank has proven to be an easier option rather than assessing the reasons why the bank performed poorly and trying to resolve this.

Forcing development banks to manage large numbers of directed credit lines diminishes transparency and masks useful information. In addition, banks that provide highly subsidised directed credit discourage other financial institutions from expanding rural operations and, when they are liquidated, they leave a large void in rural areas.

Governments must recognise their role in the creation and maintenance of a financial infrastructure that supports rural development. At least they should direct prudential regulation and supervision, especially for those institutions handling deposits, demanding information that clarifies the financial performance of banks, thereby ensuring transparency. Governments may also provide seed capital for start-ups or temporary subsidies to strengthen existing financial institutions. Correct policies include allowing lenders to charge market interest rates that fully cover their costs plus allowing a reasonable profit margin.

Changing public and private sector roles and economic environment requires both incentives and time. The incentives include changes in the role assigned to new and existing organisations. The changes involved in successfully developing new finan-

Box 4 (Cont.)

Lessons Learned From the Collapse of an Agricultural Bank:
Case: Banco Agrario del Peru (BAP)

cial institutions may be similar to the changes needed to successfully reform existing development banks. If policy makers cannot effect these changes through reforming development banks, they may be unable later to effect similar changes in promoting successful new financial institutions. Indeed, policy makers may be later forced to establish new institutions using remnants from the old development bank. Conditions necessary to successfully reform a traditional agricultural development bank or to create efficient and durable alternative rural financial institutions are essentially the same. They both require favourable macroeconomic and financial sector policies that reinforce rather than destroy financial institutions, free them from political interference and instil financial discipline.

Source: Dale W. Adams and Juan Jose Marthans., "Benefits and Costs of Liquidating an Agricultural Bank in Peru" and "The Rise and Fall of an Agricultural Bank in Peru", 1997.

crops or the adoption of specific technologies. The most difficult constraint facing these banks if they are to operate in a liberalised, competitive market is to overcome the deficiencies arising from state ownership.

If policy makers wish to accelerate the pace of the conversion from the old directed credit to the new approach of rural financial intermediation, experience shows that there are systematic ways of doing this. The manner in which policies can be harnessed in this task is explored below.