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From Cheap Credit to Easy Money: How to Undermine Rural Finance and Development

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Four development decades have passed since the early 1950s. During that period we have become masters in the art of underdevelopment: at the levels of experts, institutions, governments and donors. Underdevelopment in large parts of the world has been expertly prepared, government-made and donor-supported. Of course, there are exceptional cases of successful development. Yet by treating them as such, there is little to be learned from them.

We are now rich in experience and hope to have learned from it – like the proverbial banker who invariably gains from making a loan: either in monetary terms, when the loan is paid back, or in experience, when it is not.

The Modernization Experiment

Inspired by the poverty-alleviating impact of the industrial revolution and, later on, by the effect of the Marshall Plan on the reconstruction of Europe, policy makers and experts during the 1950s and 1960s embarked on the gigantic experiment of technology and capital transfer from the rich to the backward countries of the world.

This task was not left to the technicians. Social scientists constructed a modernization theory and argued that the whole social, economic and financial system of industrial societies was to be transplanted, including values, motivations, educational and legal systems. As a preparatory step, this required a *tabula rasa* strategy, destroying, or ignoring, the obstacles to development embedded in indigenous economies and traditional social systems. As this did not leave much of an entrepreneurial base, the government took it upon itself to act as entrepreneur and banker. The good effects of their deeds were to trickle down to the poor and eventually lead to progress for all segments of the population. On a global level, whatever differences in approach existed, as between capitalism and socialism, Eastern and Western or Northern and Southern cultural systems, they eventually were to converge on a single industrial development model.

The Poverty Hypothesis

A corollary to modernization theory was the vicious-cycle-of-poverty hypothesis, which added to the poor-country approach a corresponding poor-people approach. Eighty to 90 percent of the population in poor countries are poor. They were portrayed as illiterate, improvidential, superstitious, undernourished and of ill health – a mix of facts and fiction. Without further examination, they were assumed to be too poor to save, unable to organize themselves and incapable of self help. According to that theory, countries are poor because people are poor and helpless; and people remain poor as long as their countries are poor.

The two theories are similar in etiology but different in operational approach. Modernization theorists aim at growth and attack poverty at the national or macro-economic level; poverty theorists aim at a dignified life and attack poverty at the individual or micro-entrepreneurial level. There is no abating of the controversy, as indicated by the ongoing Poverty Lending versus Financial Systems approach carried by influential lobbies even into the American Congress (Malhotra 1992).

Cheap Credit and Easy Money

Capital transfer, the poverty hypothesis, the trickle-down effect and government banking all entered into a complex equation, the solution of which was cheap credit. To offset the effects of overtaxing agriculture and to speed up the trickling-down of expected industrial growth effects, governments intervened with subsidized targeted credit. The crucial strategy adopted was credit disbursement rather than savings mobilization. Credit dependency – instead of self-reliance through self-financing – was one of its immediate effects.

When governments took it upon themselves to develop agriculture, they assumed the combined roles of planner, banker, supplier and marketing agency. Among their main financial instruments were interest rate ceilings and subsidies, credit targeting, credit rationing and agricultural price controls. Institutionally, govern-

ments fostered specialization, creating separate savings banks, credit institutions, agricultural development banks, etc.

Subsidizing interest rates on loans and directing subsidized credit to priority borrowers and crop-related activities became major development strategies, with agricultural production, rather than rural development, the objective. Institutions were instrumentalized as conduits of government funds, hampering the growth – and sometimes even the emergence – of institutional financial intermediaries and the functioning of rural financial markets. This in turn hindered rural development, including the growth of agricultural production.

As credit was only available for government-imposed and sometimes ill-defined purposes, farmers tended to take advantage of the fungibility of money. They substituted the funds for activities which they would anyway have undertaken or diverted them to other purposes. While this was frequently a rational strategy from the point of view of the farmer, it subverted project additionality. As a result, projects had little or no impact.

Due to inevitable limitations in the availability of subsidies, subsidized lending projects were narrow in scope and void of growth. Given a wide discrepancy between supply and demand for credit and a price (interest rate) far from equilibrium level, credit rationing was one of the principal strategies in credit allocation. Frequently, the wrong recipients obtained the wrong quantities of credit for the wrong objectives. Government officials and experts substituted their own rationality and decisions for those of the farmers and of the market. This led to crop and project failures, sometimes on a large scale. Farmers were practically forced into diversion of funds. Factor allocations were distorted. In some cases, the impact of development projects was negative.

Ceilings on interest rates, usually combined with targeted subsidies, prevented financial institutions from charging interest rates that covered transaction costs. As transaction costs tend to be constant per loan independent of loan size, interest rate ceilings and credit subsidies led to concentrations in the loan portfolio, allocating relatively large loans to a few big farmers, to the exclusion, or neglect, of small farmers and tenants. In addition, the transfer of transaction costs to borrowers (i.e., the non-interest component including transportation costs, legal expenses, opportunity costs and also illicit charges) tended to price small farmers out of the market. Borrower transaction costs also added to the burden of the fortunate few big borrowers, frequently bringing their actual expenses close to what would have been a market rate. As banks acted as conduits of government funds, rather than developing and applying credit policies of their own making, subsidized credit created its own high risks and associated default rates. Undercapitalization and contractions in the lending volume were virtually inevitable concomitants, gradually diminishing the scope and impact of projects. In some cases an inverted interest rate structure, with interest rates on deposits above lending rates, discouraged banking, as practiced for extended periods, e.g., in India, Vietnam and the Philippines.

Subsidized funds were usually channeled through credit institutions specifically created for that purpose. Agricultural development banks and special projects are the most prominent examples. Many of them were barred from deposit mobilization. As a result, institutional facilities for the depositing of savings in organized financial institutions were notably absent in many rural areas. Specialized savings institutions, on the other hand, such as government or post office savings banks, offered negative real rates of return and lacked the sophistication to develop attractive and convenient deposit facilities. In many countries, the rural population created their own informal financial institutions on a self-help basis. Without access to refinance, these were restricted in their capacity for generating the necessary resources for growth.

Subsidized and targeted credit negatively affected loan recovery on several grounds:

1. Farmers tended to consider the loans as free presents attained through government patronage and had no intention to repay;
2. Or they diverted them to other purposes and found themselves unable to repay;
3. Or they complied with ill-founded government directives, invested into activities that were perhaps productive but not profitable due to price controls, and were equally unable to repay;
4. Financial institutions were forced to accept non-bank criteria in credit decisions, perhaps allocating the wrong loan sizes at the wrong time to the wrong customers for the wrong purposes. This inevitably led to high default rates;
5. Because banks were unwilling to take risks not covered by an adequate reserve for bad debts, governments instituted credit guarantee funds or agencies absorbing all or part of the risk. This, in turn, discouraged banks from collecting loans in arrears and further increased defaults.

In many developing countries government interventions, subsidies, loan targeting, reliance on government or foreign rather than domestic funds, misappropriation and diversion of funds, defaulting, price distortions, institutional specialization and a host of related policy and operational factors have been closely related to the underdevelopment of market mechanisms, financial institutions, agriculture and the rural economy. The results of this strategy were succinctly expressed in 1984 in the title of a book by Dale Adams, Douglas Graham and J.D. Von Pischke, *Undermining Rural Development with Cheap Credit.*

In some cases subsidized credit did have positive effects on production, though invariably at high cost.

Estimates are difficult as no country has monitored its costs and benefits. With regard to Indonesia, which until January 1990 ran a number of large subsidized credit programs, the following information may be indicative. From 1978-86, cumulative costs of the KIK/KMKP small enterprise credit project amounted to US$1.58 billion (at current exchange rates) the interest rate equivalent of which is approximately 20 percent (on top of the subsidized interest rate) and ranged, due to its foreign exchange sensitivity, up to 33 percent in 1986 (World Bank 1988). Under the subsidized agricultural credit program BIMAS, Bank Rakyat Indonesia lent a total of Rp.2.55 trillion (US$1.42 billion) over a 14 year period, or Rp.182 billion (US$101 million) per year – at a huge loss. After deregulation in 1983, the same bank introduced its non-subsidized market-rate KUPEDES scheme and lent Rp.5.28 trillion (US$2.94 billion) over a seven year period, or Rp.754 billion (US$420 million) per year – at a profit (all in 1989 prices, converted into US$ at the exchange rate of December 1989). Toward the end of the period, December 1990, BRI financed these loans fully from rural savings (Seibel 1992b: 164).

Repressing the Financial System Through Regulation

Several decades of experimenting with development have taught a powerful lesson: rigid regulation of the economy, in combination with an all-encompassing role of government in all spheres of the economy, leads to underdevelopment. This has stifled the growth of money, production, income and employment.

Production is the motor of the economy, finance is its fuel. Unless there is a functioning fuel injection system, the motor will not run. The faster the motor is to run, the more fuel it needs. It is the financial system which has to pump the money into the economy: it has to mobilize savings, provide credit and assure an adequate growth of the money supply. An undersupply of money will stall the engine, thus halting the economy; an oversupply will lead to inflation, thus choking the engine.

While the government adopted the role of a donor, the banks were unable, or restricted, to act as financial intermediaries between savers and borrowers. The financial system remained repressed, in many cases inoperative. Foreign debts replaced domestic savings.

During the first two development decades, the role of the financial system in economic development was virtually ignored. The theory of the day was modernization through technology transfer with external capital. Domestic capital formation and resource mobilization did not enter into that theory. Well into the 1980s, many developing countries were held in its grip.

Easy Money

The logical consequence from the recognition that cheap credit undermines development appears to lie in the policy recommendation to deregulate and introduce market rates of interest, with the triple objective of mobilizing domestic resources, covering the costs of credit and achieving a balance between demand and supply of money. This raised the question of the definition of market rates. Is there a (single) market rate?

Some countries, among them the Philippines, have introduced what they call market rates for final borrowers. While rates to bank and non-bank (including NGO) intermediaries continue to be subsidized, there is now a tendency to require end-user rates to approximate commercial (sometimes: prime) rates of interest. This is, of course, not the market rate in rural lending, nor can there be a single market rate. The market rate is that rate of interest which covers the costs of funds, administrative costs, risks and an adequate profit margin. For practical purposes, costs of funds may be equated to three-monthly fixed deposit rates. Administrative costs and risks vary widely, depending on type and location of customer, availability of information, services rendered (e.g., doorstep services), collateral, etc. If governments require their banks to lend to farmers or micro-entrepreneurs at undifferentiated commercial rates, they are, in fact, demanding subsidized lending, with the same consequences as any type of subsidized credit.

The second issue concerns the source of loanable funds, whether they are domestically mobilized or supplied by donors and governments. Even when subsidies have been stopped, donors and governments frequently continue liberally to supply liquidity, which discourages banks from mobilizing their own resource base. The rise in interest rates to market level, therefore, does little in dampening the banks' demand for liquidity credit, and there is little evidence that the usual negative consequences of subsidized credit have been alleviated. Based on recent experience of which the Philippines are a case in point, one may thus arrive at the following conclusion:

A policy of easy money represses the financial system just as much as a policy of subsidized credit. The impact on adverse borrower selection, loan apportioning, moral hazard, etc., is hypothesized to be similar to that of subsidized credit. Its worst impact is on the financial system, which it prevents from developing at its own. By increasing the money supply without recourse to domestic resource mobilization, it is also a major factor in budgetary deficits and inflation. When refinanced by international loans it becomes a long-term

liability which is not matched by gains in productivity.

Once easy money is available, it becomes difficult for individual banks to escape its attraction. It is too convenient a source of funding. While some bank managers see its limiting effect on the institutional growth of their banks, their board members may be less enlightened. When combined with government credit guarantees, it appears to be a low-risk operation. Banks are lured by governments, and governments by donors, into credit dependency. In that respect there appears to be little, if any, difference between GO and NGO donors.

Market rates alone will not lead to financial systems development. Reconstructing – just as undermining – financial landscapes is most effective when tackled at all systems levels.

Systems Implications

For development to occur it takes more than the experience of underdevelopment. A systematic analysis of underdevelopment, and financial repression in particular, from a systems perspective is therefore but a starting point. There are several systems levels of financial repression.

The Total System

In many countries, the government as banker, entrepreneur, policymaker, planning and executing agency has taken control over the total system. This has resulted in a breakdown of accountability. Regardless of their ideological leaning, governments in many developing countries have implemented central planning – an unexpected form of convergence between socialist and non-socialist countries. As a side effect, this has given powerful individuals in government the opportunity of transferring the wealth of their country abroad – much of this at the expense of later generations.

The Policy Framework

On the policy framework level, regulation or deregulation of respectively, the real and financial sectors are closely interrelated. Through prices and quotas, government takes control over exports and imports of real sector goods. Overvalued domestic currencies make imports cheap, including technology. As a free flow of imports is unaffordable, government has to resort to rationing. This leads to under-the-table trading of import licenses. Import substitution becomes the guiding principle of industrial policy, rather than export promotion of finished products. Agricultural prices are controlled, to the advantage of the urban wage earners. Much of the proceeds of agriculture is taxed away directly to finance the government budget and indirectly to stimulate industrialization. Low prices, however, discourage the farmers from producing food and cash crops. This is then partially offset by food imports at subsidized prices, which further distorts local agricultural markets.

The Legal and Regulatory Framework

The banking law has been a powerful instrument in suppressing financial growth. Here are some of its tenets:

1. All power to the government, none to the central bank;
2. Nationalize all banks;
3. No foreign banks, no joint ventures, which bring in alien influence;
4. Allocate the turf, eliminate competition;
5. Prohibit branching out;
6. Restrict the services of each bank, eliminate universal banking;
7. Restrict deposit mobilization to a few institutions;
8. Define collateral requirements narrowly, which may exclude up to 90 percent of the population from borrowing;
9. When the financial system turns terminally ill, concentrate on curing the symptoms, e.g. using targeted subsidized credit as one of the remedies.

Institutional Infrastructure

Given the overregulation of the financial system, many governments regarded it as superfluous to impose further bank supervision through differentiated supervisory institutions. A repressed financial system does not require a differentiated institutional infrastructure. The primary objective of this infrastructure is to serve the purposes of the government as defined in the development plan. A banking industry with its own separate business interests is not to be tolerated. It appears as if guidelines had been issued for suppressing the growth of the financial infrastructure including the following:

1. No differentiated financial infrastructure and branch network required to intermediate between savers and borrowers;
2. No village banks;
3. No banks for the urban informal sector which has no collateral and is an undesirable industrial element;
4. Let every ministry and government agency run its own credit program, with its own rules, terms and philosophy;
5. Let specialized institutions handle financial transactions on behalf of government, comprising government savings banks as a source of revenue (to be invested in low-yielding treasury bills, which in turn requires low interest rates on savings); development banks as credit supply institutions disbursing the revenue; plus a few commercial banks for the formal sector.

Financial Products, Procedures, Terms and Conditions

Under conditions of repressive finance, banks are required to follow administrative procedures set by government. Banks do not learn from each other or from experience, nor is there any learning from local or informal financial institutions. Loans are uniformly allocated according to defined production goals, which leaves little room for loan appraisal or creditworthiness examination. Administrative delays in credit delivery have no impact on lending decisions. There is minimal, if any, monitoring, and loan collection is passive, with no recourse to social controls, enforcement of repayment or litigation. No efforts are made to actively collect savings.

Loan terms such as sizes, maturities and grace periods are not individually determined. They are also undifferentiated within a series of repeat loans. In production credit, collateral requirements are usually waived. Installments tend to be in long, with quarterly or seasonal intervals, ignoring individual repayment capacities deriving from other sources of income. Loans are generously rescheduled, and new loans granted before the old ones are repaid. Penalties are not enforced, nor are there incentives for timely repayment. At election time repayment may be waived altogether.

Target Groups and Beneficiaries

The world of credit-driven, supply-leading finance and social banking uses its own language, displaying a predilection for beneficiaries and target groups of channeling institutions, handling banks or conduits. In contrast, there is the savings-driven world of demand-leading finance and competitive financial intermediation with its own language: there are savers and deposit takers, lenders and borrowers, customers or clients and banks. In fact, the customers or saver-borrowers may own financial institutions, as in the case of cooperative banks.

A Systems Approach to Micro-Finance

Subsidized targeted credit for beneficiaries defined by government undermines institutional viability and systems sustainability – this is the principal lesson of the past. But how can effective financial services for all segments of the population be attained, together with institutional viability and systems sustainability?

Micro-entrepreneurs and the poor have not benefitted from financial repression. In fact they have paid most of its price. It is now being realized that a full range of financial services to micro-entrepreneurs and the poor as well as all other sections of the population depends foremost on the quality and effectiveness of financial intermediaries, and their viability in turn depends on the sustained health and growth of the overall financial system.

A financial system comprises a number of subsystems as discussed above which may be combined into the policy environment, the institutional environment and the instrumental environment – each open to external influence and intervention.

The optimal provision of financial services will ultimately depend on the successful development and integration of all levels of the financial system. However, from a systems perspective, this cannot be accomplished overnight and all at once as suggested by McKinnon (1973) and only much later revoked (cf. McKinnon 1988; 1992). In actual practice decisions are required on ground rules for interventions and strategic entry points.

Process Ground Rules

The landscape of finance is not adequately captured by the concept of the structure of the financial sector, which has been the object of most financial sector studies in the past. It now appears that a static concept of structures and component parts only befits a situation in which governments, rather than markets, possess the

power of resource allocation, with a tendency to administrative definition of financial contracts and structural frameworks, as is in fact the case in many developing countries. From a strategic viewpoint, governments in these countries have shielded the structure of the financial sector from external influences, preventing adaptation and creating an artificial stability in a world of flux and turmoil.

Those developing countries which have undergone a process of gradual and prudential deregulation and have submitted their financial institutions to market forces require a new conceptual approach to finance: an approach which emphasizes process rather than structure, dynamic rather than static interrelations, interactive rather than prescriptive decision-making. In a systems approach, the world of finance is envisaged as a complex open system in which the component subsystems are dynamically interrelated, with a change in one resulting in a change in all others, yet a stable equilibrium remaining an elusive state, and with satisficing rather than optimal problem solutions. From a strategic viewpoint, governments in these countries have typically exposed the financial system to external influences from within and without, thus contributing to continuous adjustments on local, national and global levels.

It is therefore not feasible to arrive at an identifiable optimal financial system, and even less so at a single definite set of steps of transition. Instead, there may be process ground rules that have to be observed for interventions to have a chance of market acceptance and success:

1. Any intervention can only depart from the state of the system as a whole at a given point in time. This also includes the cultural, social and political set-up, to which interventions have to be properly adjusted;
2. The acceptance of interventions depends on interactive rather than prescriptive approaches;
3. In a complex interrelated system, all interventions have unintended results. Careful impact monitoring is therefore necessary, which must not lose sight of other subsystems and secondary effects;
4. Interventions will at best lead to satisficing, not optimal results;
5. In evaluating the results of interventions, it is more important to envisage the overall process of change initiated than narrowly focusing on performance criteria;
6. Interventions can only succeed with the market, not against the market. This also means that the market, not the government or donor, decides over its acceptance.

Financial Infrastructure Development

In the field of micro-finance, appropriate strategies for financial infrastructure development (see Table 1) may offer entry points for strategic interventions, with a particular emphasis on local financial institutions, member-based or community-based. At least four different strategies may be discerned: (1) adapting formal financial institutions to the local environment (downgrading), (2) upgrading informal or semi-formal financial institutions, (3) linking formal and informal financial institutions, and (4) creating new institutions (infrastructural innovation).

None of these strategies is universally applicable, nor does any single one offer an optimal approach. Their appropriateness depends on local circumstances and conditions, which need to be carefully assessed. Some of these conditions, and examples, are shown in Table 1.

In a subsequent stage of intervention, infrastructural development may be followed by measures on the levels of financial product innovations, procedures and terms and conditions (cf. Seibel 1991; 1992a). This also requires coordination with measures of financial infrastructure development.

Many of the institutions that may provide the strategic entry point for interventions require institution-building and capacity-enhancing inputs which they are not able to finance from their own profits. Furthermore, if a new infrastructure is to be developed at the grassroots or village level, which may be necessary in many developing countries, considerable financial infrastructure investments are required which may not immediately pay off. Institution-building may thus become a major field for subsidies. Financial subsidies undermine micro-finance, but institutional subsidies may contribute to the development of a micro-financial infrastructure.

A friendly policy environment will greatly facilitate such an approach. In a less than friendly or hostile environment, two supportive strategies may be examined: (1) niche-seeking in the short run, and (2) supported by a joint donor effort, policy reform in the medium or long run. Experience from Indonesia before deregulation shows that even within an inappropriate policy environment viable financial services can be feasible at the grassroots level. Examples are BKK in Central Java and LPN in West-Sumatra (Malhotra 1992; Seibel 1989).

Table 1: Appropriate Strategies of Institutional Development

Strategy	*Conditions*	*Examples*
Adapting formal financial institutions to the rural/informal sector environment (downgrading)	Effective formal institutions exist	BRI[a] (Indonesia), BDB[b] (Indonesia), BAAC[c] (Thailand), NMDB[d] (Philippines)
Upgrading informal financial institutions	Effective informal institutions exist	Bank MBM[e] (Indonesia), numerous NGOs
Upgrading semi-formal financial institutions	Effective semi-formal institutions exist	Cooperative or NGO banks
Linking formal and informal financial institutions	Both effective formal and informal institutions exist	Linkage banking projects in APRACA member countries
Creating new institutions	Absence of effective formal or informal institutions	Grameen Bank[f] (Bangladesh), VBA[g] and share-holding banks (Vietnam)

[a] Bank Rakyat Indonesia: the largest rural-agricultural bank in Indonesia, government-owned but operating as a commercial bank.
[b] Bank Dagang Bali: a privately owned commercial bank in Indonesia.
[c] Bank for Agriculture and Agricultural Cooperatives: a government-owned agricultural bank.
[d] Northern Mindanao Development Bank: a private thrift bank.
[e] Bank Maha Bogha Marga: the first bank set up by an NGO in Indonesia.
[f] A self-help group-based bank, mixed ownership.
[g] Vietnam Bank for Agriculture: a government-owned agricultural bank.

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