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Theme: Rural Finance Outreach and Sustainability

The Evolution of Institutional Issues in Rural Finance Outreach, Risk Management and Sustainability

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Introduction

A revival of rural finance seems to be getting underway. This paper provides a generalized overview[1] of the opportunities that have evolved in donor-funded rural finance which are presented in institutional terms. Institution as used here refers to organizations and also to practices, standards and other structures that organize behavior. The five parts in this paper attempt to put the renewed challenge in perspective:

The Past reviews the costs of inappropriate technical efforts in a hostile political environment. The Past provides cautionary lessons.

The Continuing confronts possible areas of residual weakness that remain from The Past and the risk management challenges they may pose.

The Recent discusses how institutional changes that gained momentum around 1990 enlarged the role of financial markets and created more opportunity to move the frontier of formal finance down market so that more poor people could be served. It also draws some hypotheses about how important institutions of microfinance might relate to the rural finance revival, and notes the rise of commercial providers.

The Open addresses some of the possibilities that lie ahead and outlines new institutional forms and responses that could help more poor people through rural finance. These suggestions include possibilities for funding institutions that are not commercially viable but that could be sustained by strong donor commitment. These speculative proposals are intended to pave the way forward in project design, donor etiquette, public responsibility and empowerment.

An Annex lists institutional features or attributes that may be helpful to donors in their searches for entities that would implement their interventions in rural finance.

The paper's progression is chronological because rural finance project history since the 1960s is an important check and guide for constructing viable institutions that are capable of meeting the tests of the microfinance triangle devised by Manfred Zeller and Richard L. Meyer.[2] The triangle consists of financial sustainability, outreach to the poor, and impact.

The triangle provides a very useful framework that can be expanded. An historical perspective produces transparency as a fourth element that is essential for risk management. The *finance project pyramid* includes transparency because the rural finance revival will not occur without taxpayer funding. In this framework, transparency is required. Without it the other three fundamentals are less likely to be achieved, or if achieved, at higher costs than necessary due to rent seeking or other defects in governance. Transparency is especially important in endeavors that are funded by taxes and face soft budget constraints, and that are not subject to competition based on consumer choice. Low levels of choice are characteristic of remote areas, and also define poverty. Rural finance as used here refers to savings, credit, insurance and payment services in areas where agriculture is a significant part of the local economy and where population is sparse, remote and often poor. Target group is used to denote actual and potential clients served by a financial institution that has created a market niche that attracts such clients.

The Past: Institutions Based on National Economic Management

For about 25 years beginning in the 1960s the quest for food self-sufficiency in poor countries was an important policy goal. A large proportion of the labor force lived and worked in rural areas in developing countries. Import substitution was a development objective, all the more so with decolonization. It appeared that a number of positive impacts could be achieved simultaneously if more food were produced: smaller food deficits and increased food security, a more productive rural economy, and saving foreign exchange by reducing food imports.

It was also clear that the majority of farmers were poor and that the profitability of agriculture was problematic. How could they be enlisted to help meet national economic goals in such a way that they would also prosper? Many things might have been done to help, but credit was selected as the solution of choice. Finance was considered a binding constraint by the policy elites. And, just about every farmer who was ever asked wanted credit or more credit, especially when the questioner looked more prosperous than the peasant being queried and worked for a foreign aid organization or the government. No minister of agriculture ever declined a credit project.

Many types of agriculture, such as basic grains required for food security, are not very profitable in poor countries while production is subsidized in rich countries. It seemed only logical that subsidy would be appropriate and productive in poor countries, and that this could be delivered easily through low interest rates. The returns to the economy as increased food security and rural prosperity ricocheted through the economy would surely swamp the amount of subsidy that would be required to get the process underway.

Projects for the Poor

An early focus on large scale agriculture occurred because these operations were in some cases the most progressive, adoption of improved husbandry would be rapid, and large farmers had political weight. Transaction costs would simply be lower and results would be reasonably predictable. In the 1970s, however, smallholder agriculture emerged as a major focus. Peasants were often food insecure and constituted the majority of the population. Poverty alleviation required more attention on humanitarian grounds and also to build democratic states. Robert McNamara's 1972 speech to the Board of Governors of the World Bank and the IMF in Nairobi focused on poverty, providing a platform for action. In 1964 Theodore W. Schultz, from the University of Chicago, wrote *Transforming Traditional Agriculture*[3] which made a convincing case that peasants are rational. No longer were they ignorant, misinformed and lazy.[4] Their rationality provided a basis for constructive interaction with modernity and technology.

USAID was instrumental in promoting farm credit. In 1973 it published the Spring Review of Small Farmer Credit. This study produced a number of volumes on farm credit in a number of countries, which took up about two feet of shelf space. An impartial sampling of this incredible documentation would have led to caution, in that so many schemes were defective in sustainability, outreach or both. But, AID used the Spring Review as a mandate for massive expansion of farm credit projects, unleashing the herd instincts of other donors.

The Planning of Change

Lending was targeted at specific groups of farmers, specific areas or regions, and specific crops. In some cases governments specified lending quotas for different targets to be met by banks. This was known as "directed credit." Commercial banks were also often required to place large reserves (as a percentage of deposits) with central banks, which in turn used these funds to

finance the national budget. High reserve requirements and directed credit reduced the role of banks in allocating credit. This task was performed by the ministries of finance or planning.

Agricultural lending often focused on modern inputs, such as improved seeds and fertilizers that would more than cover their cost through bigger harvests. Donors provided an analytical tool kit of farm models based on agricultural economics. This made it possible to determine which crops would be the most appropriate, based on expected costs and returns. Many farm credit agencies in developed countries used this type of analysis and similar decision making structures based on future rather than current productivity. Lots of research, academic instruction and training were provided by donors to help ministries and financial institutions master and apply this approach.

The analytical tool kit would currently be called lending technology. Loans were made against income expected from the investment purpose for which the loan was issued. Current or without-the-project income, from which repayment would have to come if the investment failed, was usually much smaller than projected income, based on the promise of improved husbandry and the new seed varieties that became available with the Green Revolution. A high percentage of incremental costs were covered by the loan, usually between 80% and 100%, or even more in some cases where the loan financed family living expenses between planting and harvest. In sum, loan obligations were large relative to farm income before or without the loan, making the risk of nonrepayment quite high. Farmers in favorable environments often reported that one year in five was a bad year, while those in less favorable circumstances reported a higher incidence.

Beyond the farm level, justification of recommendations was achieved by aggregation of financial models. Further analysis calculated a return to the economy, using adjustments to compensate for financial prices that did not indicate true scarcity because of taxes, monopolies and subsidies. The economic returns were subjected to sensitivity tests by assuming that costs increased by 10% (or any other percent), while income decreased by some other arbitrary percentage. These subsector models could even fit into national economic planning as represented by the five-year plans then in vogue.

Risk Denial

The sensitivity tests of economic prices were mechanistic, not based on patterns of actual historical risk. The analysis using financial prices was not even subjected to these tests, and more importantly, was not burdened with the common sense question: “What is most likely to go wrong here?” Farmers have a keen sense of what can go wrong, yet farm budgets or plans that were used to determine input use and loan size were based exclusively on the normal year, often tweaked by optimism rather than realism, which helped keep donors’ money moving. Donors were not very attentive to risk and had few incentives to explore and manage it. Risk never made a project look better. Development economics trumped development finance, which made it impossible to create good financial institutions in many countries. Without effective institutions to interact with, small farmers never had a chance.

Fast disbursements were appealing. An array of state-owned financial institutions (SOFIs) awaited, and donor money flowed to these convenient wholesale or retail recipients for lending to farmers. Cooperatives also participated through cooperative banking systems, savings and credit cooperatives, and agricultural supply and purchasing coops that made production or storage loans to their members.

Most SOFIs and many of the cooperative finance institutions were inefficient. Costs were high, procedures were ponderous, loan approvals were slow and often late relative to the agricultural calendar, donors demanded lots of information, and low interest rates guaranteed that the banks could not make much money on these deals. Low ceilings imposed on interest rates reflected "financial repression" or the direction of financial flows based on state institutions and policy rather than on market forces. Some donors believed that financial institutions could cross-subsidize agricultural credit, using profits from more lucrative business to support strategic business that lost money. This usually failed. Many institutions had little lucrative business.

Bad agricultural years made farmers much less likely to repay, but even in normal years formal agricultural lenders were often not very good at collecting loan repayments.[5] Loan recovery rates of 75% or 80% were often considered "satisfactory" by donors. Some cooperatives were greatly weakened by subsidies when members and leaders concluded that the "cold money" provided by outsiders could of course be treated differently from the precious "warm money" deposited by members.

Continued donor support kept some programs alive. It was widely assumed that as state-sector entities, the banks would enjoy perpetual access to additional funding for strategic ventures such as agricultural finance. Since these banks were in the political arena, certain people had to be taken care of, too. Politicians helped, some of the most notable being candidates for public office in India who "promised" that no farm loans would have to be repaid if they were elected. Low interest rates gave the relatively rich and well connected incentives to colonize small farm credit programs. Bankers often went along because the costs of loan processing do not vary much in proportion to loan size. Larger farmers seeking large loans were cheaper and easier to serve than numerous small farmers seeking small loans, encouraging banks to take the easy way out.

In many countries donor money and encouragement set the pace for agricultural or rural finance. This led to a separation between aspirations and results, while incentives were lacking for financially responsible behavior. However, donors' influence was not very strong in large countries such as India, Mexico, Brazil and China, which had domestic programs that were much larger in money terms than the funds provided by donors. These large domestic programs were highly politicized and often turned out to be unsustainable, although some achieved considerable outreach.

The Changing of Plans

Very little data was routinely available on the financial performance of credit projects launched by donors. In the mid-1970s the World Bank had an agricultural credit division with global reach that maintained summary data on the financial performance of the farm credit institutions it funded. A reorganization led to regionalization of agricultural credit operations and these data were no longer compiled. Not having data routinely gathered and organized made lending easier in an atmosphere in which there was little responsibility for project outcomes. Assistance was widely regarded as a good thing in itself and the locals could always be blamed for the poor implementation, however elegantly designed were the donor-funded projects.

Money doubtless has an impact, and credit surely helped rural households in some ways. However, impact on agriculture was usually less than the projected rates of returns that donors used to justify intervention in rural finance. The projections based on farm models often varied greatly from observed farmer behavior, which might be expected when the farm is only one component of the rural household economy. By the early 1990s abundantly clear evidence had accumulated regarding agricultural credit, and the paradigm endured withering criticism. Donors exited. Rural credit projects were simply discontinued. No attempt was made to design a better farm credit project.

The scope of the demise is illustrated by data from the Inter-American Development Bank. IDB's rural finance operations that provided direct support for rural credit began in 1961. From 1976 to 1980, total funding was $626 million. During the period 1981-1985, the total was $1.7 billion, and in 1986-1990 the amount was $1.6 billion. From 1991 to 1998 the total was $61 million.[6]

Two anomalies that received little attention could have provided clues about the role of credit in smallholder agricultural development. The first was that production did not seem to decline in any general or measurable way when subsidized credit was discontinued. Second, the role of credit in the Green Revolution was not rigorously explored, although Richard L. Meyer and Geetha Nagarajan indicate that credit officially allocated for specific agricultural purposes did not achieve its desired impact on the Green Revolution.[7] These observations challenged the credit paradigm: that is, a) peasants too poor to be able to buy modern inputs, when given b) cheap credit to buy modern inputs, which with c) better husbandry would achieve d) larger harvests.

An additional hallmark of The Past was that the role of savings in development and in household welfare was largely neglected.[8] This raises an interesting problem: in many countries rapid inflation has outpaced interest rates paid on deposits over a period of 10 to 20 years, often because of economic crises. Should poor people in such countries be encouraged to build nest eggs in formal financial institutions?

The Continuing: Institutions Based on Donor Grants and Loans

Poverty remains widespread and disgusting,[9] and the bulk of the poor live in rural areas.[10] Greater efforts to do something about it produce a tug of war between two approaches. One consists of charitable efforts to provide immediate relief. These lighten burdens but are not sustainable activities on their own. These may reach target groups consisting of millions, with different levels of intensity. They are limited by the extent of foreign assistance, government budgets and private contributions. The second approach consists of efforts to create institutions that will bring very large numbers (billions) out of poverty in the longer run in a way that is self-reinforcing. No silver bullet has been discovered.[11]

Finance clearly has a role to play in each approach through credit or more broadly through financial institution or sector projects, as discussed later in this paper. Interest remains focused on those beyond the frontier of formal finance: small farmers, microentrepreneurs, small and

medium enterprises, the very poor and those in remote areas. And there is room for expansion in areas where some services are already available.

One now somewhat diminished legacy of The Past is an instrumentalist view of finance. Instrumentalist refers to the use of finance for some specific purpose, for specific changes in behavior over a relatively short period of time, which are thought by their sponsors to be helpful. An example was credit for cultivating high yielding varieties of grain. The contrasting view is that finance is a positive social end in itself in that more efficient financial markets provide a richer array of benefits to many more people in the long run.

The instrumentalist view is *dirigiste* and concerned about impact measurement, while each view can benefit from market research. The financial markets view is liberal in the classical sense of promoting freedom of choice. This view is endorsed by those trusting in a certain rationality by users of financial services that results in better choices and results overall than those available within a more restricted set that is designed to change clients' behavior in specific ways. Market research is favored more than impact analysis by those holding the financial markets view. But, impact analysis and market research are closely related, and market research is increasingly included in impact studies.

The role of the financial sector from the financial markets perspective is to encourage productive use of resources and to enforce contracts. Each requires effective institutions. An important element in productive use of loans and contract enforcement was highlighted by Sayre Schatz's work in Nigeria in the 1960s. He made the distinction between true and false demand for credit.[12] False demand consists of poor projects that have problematic sponsors and poorly structured financing. True demand consists of good projects with credible sponsors properly financed. Sorting out these differences is the task of institutions that want to achieve sustainable outreach.

More importantly, some of the incentives of donors that provide grants or loans (as opposed to equity investment) have not fundamentally altered very much, although their behavior has improved. In the realm of credit projects and guarantees, these donors' progress in designing and selecting better interventions is difficult to evaluate because of insufficient transparency. However, these donors have encouraged some of those who implement their projects to become more transparent, with very positive results incorporated in "best practice" standards.[13] There is a broad range of donor behavior. Virtually all public sector donors offering grants and loans have at least a few good finance projects, and some are exemplary promoters of productivity.

The herd instinct remains. It may result in the more rapid spread of effective interventions, or it may simply lead to more unproductive efforts. Actions may be driven by disbursement targets, the natural bureaucratic or nonmarket quest for expansion regardless of efficiency, and internal political and foreign policy imperatives that have little to do with finance or poverty alleviation. Will new, politically selected quests by donors giving grants and loans methodically factor in lessons from the past? This is unlikely to occur where there is little or no punishment for designing and implementing projects that fail the tests of sustainability, outreach, impactand transparency.

CGAP's recent synthesis report on donor peer reviews[14] suggests that at a certain level little has changed in the way that donors conduct their financial sector operations: imperatives to move money override technical concerns, lack of clarity of goals, a narrow view based on objectives that resonate with citizens of the country providing the assistance rather than in response to local

concerns in recipient countries, staff who are not well versed in institution building or microfinance, etc

The largest continuing threat posed by donors' efforts to create a better world through credit projects and provision of other financial services is inconsistency in creating or selecting institutions that are capable of implementing donors' visions within any given public policy milieu. This has to do with their herd instinct as well as with the tremendous market power that some donors have in some places. Where donors set the pace in a new venture, they in effect determine the outcome, but without necessarily bearing any responsibility for it. This was the case with the abandonment of farm credit around 1990 without further efforts to design better projects.

The Recent: Institutions Accommodating Markets and Incentives

Financial reforms swept the free world in the 1980s and were part of the transition from socialism to productivity in the 1990s. Policy changes that promoted financial liberalization were based in part on the experiences of the Gang of Four (Taiwan,[15] South Korea, Hong Kong and Singapore) in the 1950s and 60s. These economies experienced unprecedented growth after moving toward market-based policies governing trade, foreign exchange, interest rates, commercial bank reserve requirements, credit controls and restrictions on entry into the finance industry. Scholarly work by Gurley, Shaw, McKinnon, Goldsmith, Fry (see bibliography) and others was instrumental in explaining how this bit of progress occurred. Many donors promoted liberalization.[16]

The transition from state to market was not easy in many countries as the economic distortions produced by state control and ownership were exposed while new risks were created.[17] The immediate results included instability in many nations, but liberalization offered a framework for much more productive financial sectors. Structural adjustment programs funded by donors were intended to accomplish the task while providing a cushion to government budgets. As the positive results of liberalization began to accumulate in financial markets, a consensus emerged that the proponents of financial liberalization were correct: financial sectors "repressed" by controls were too small, relative to the rest of the economy, limiting overall growth and efficiency.

Liberalization Has Expanded Sustainability and Outreach through Microfinance

Two enormous changes created by liberalization provided the possibility for sustainable expansion of outreach at the bottom end of financial markets dedicated to serving the poor. The first major change was greater freedom of entry into finance, including closing and privatization of SOFIs, which increased the number and competitiveness of banks. At the same time, liberalization reduced the required reserves that commercial banks had to maintain at the central bank along with directed credit quotas imposed on banks. This new liquidity encouraged banks to expand, which could include entry into micro and rural finance.

However, in most countries commercial banks did not view microfinance or rural finance as attractive propositions, especially in competition with the new opportunities in other sectors that

were created by liberalization. Some critics viewed this as market failure, but government failures also destroyed bankers' incentives to move down market, primarily lack of secure title to assets, lack of effective recourse to defaulters who would have pledged assets as collateral, and regulations that restricted the range of acceptable collateral. Lax enforcement of rural loan contracts by official lenders in the past had also destroyed social capital, creating bad traditions that imposed costs on lenders who might enter this area.

Greater freedom of entry offered an alternative to banks by permitting the development of different types of financial institutions such as microfinance NGOs and a range of institutions with different levels of banking powers based on their required capital. Probably the best known example is a corporate form established in Bolivia, the "private financial fund," that enabled microfinance institutions to make loans and accept certain kinds of deposits.[18] Some of these nonbank institutions later became commercial banks. These institutions created market niches based on a target group orientation.

The second big change was decontrol of interest rates. Microfinance institutions could charge interest rates and fees that would cover their costs, which at times were greater than 50% of average loan amounts, after adjustment for inflation. Of course, these rates also often covered operating inefficiencies, but these could be exorcised over time by the invisible hand of competition and to some extent through donor vigilance since, de facto, donors set the pace and terms of microfinance operations in many countries.

At the same time, directed credit greatly diminished. This term refers to special allocations of credit by government plans, policies and institutions, usually at subsidized interest rates. Directed credit was intended to assist very specific groups or activities. Liberalization gave this job increasingly to the market.

Target group orientation by subsidized microlenders is not the same as directed credit provided by the state because the subsidy goes to the microfinance institution, not the transaction. The subsidy is defended as ranging from assistance to the poor to covering the start-up costs of commercial microfinance institutions that are intended to become sustainable without continued injections of subsidy. Another important difference is that the subsidy is selective and therefore flexible, as opposed to The Past when every borrower was subsidized, almost as an entitlement. Subsidy can be phased out after a start-up period, and its withdrawal in other circumstances disciplines institutions that do not meet donors' expectations. In other words, subsidy is now more likely to be used to build effective institutions.

Whatever its rationale, subsidy has made institution building possible at the small end of the market. Recipient institutions following best practice[19] price their services aggressively at the start of their operations, at levels that are likely to cover their costs when they obtain the scale necessary to operate efficiently. That is, the microfinance institution adopting best practice charges rates and fees that would lead to sustainability as its operations grow. This creates room for competition, which increases incentives for efficiency, which helps drive interest rates down and attract a broader clientele while expanding the range of services offered.

Focus on Incentives

Another development beginning in the 1980s was the New Institutional Economics, which views behavior as a function of information and incentives, rather than only of costs and benefits as in Neoclassical Economics. From this, New Development Finance emerged in the late 1990s. The New Development Finance[20] views institution building as essential in creating structures that will serve the poor and others at the small end of financial markets, where transaction size is modest. Institution building is considered a function of information and incentives. Governance forms incentives and information into strategies and actions that determine results, and therefore governance is an important area of exploration by the New Development Finance. (Governance is defined as "the efficient and effective management of public institutions and private firms," and as "the range of institutions and practices by which authority is exercised."[21]

Good institutions have three characteristics according to Reinhard H. Schmidt, one of the founders of the New Development Finance:[22] 1) they provide services which are desired and paid for by the relevant target group, 2) their activities and services have identifiable impacts on the lives of their clients, which are valued by their clients, and 3) they are strong -- financially sound and stable in the sense of being able to pursue business opportunities with confidence.

Donor support has helped create between 50 and 100 microfinance institutions that appear to have the potential to achieve sustainable outreach without continued injections of subsidy, and many more that do not. While representing only a small minority of the number of specialized microfinance providers, these institutions command a disproportionately large market share. In addition, some nonspecialized microfinance providers such as commercial banks have ventured into microfinance as a product line, which also implies a strategy of covering costs, and credit unions have long served the small end of the market.[23] Savings services are increasingly included in outreach to the poor.

The opportunities and discipline provided by liberalization had institutional consequences. As it became clear that agricultural credit was experiencing difficulty, donors became interested in microfinance. There was evidence that microentrepreneurs, like peasants, were rational decision makers. Many of them were women, and the feminist agenda could be advanced along with help to the poor, a two-for-one for donors that certainly improved the welfare of many households. The microcredit target group were entrepreneurs, which was attractive to many policymakers in and following the Reagan/Thatcher era.

Funding target group oriented financial institutions that can cover their costs from revenue earned is a tremendous step forward in donors' efforts to develop financial markets. First, cost recovery is the only viable way of doing business in the long run, especially in poor countries where perpetual subsidy is difficult and unlikely because the tax base is small and revenue collection is not dependable. Second, donor-funded farm credit programs and guarantees have traditionally failed to create sustainable institutions, as demonstrated during the heyday of credit projects between 1970 and 1990. Money-losing financial institutions supported by donors have generally not had incentives that empowered them to create real economic progress in a sustainable manner. SOFIs and coops lost favor as channels for development assistance.

Power Diffusion and Transparency

Another extremely important development was that the focus on the poor that legitimized microfinance did not include any specific approach, in contrast to the analytical toolkit that drove

farm credit. Grameen Bank developed a credit technology that fascinated many people and became a standard for replication, but at the same time other approaches such as village banking were also underway along with individual lending.

Devolution of power from donors to implementing agencies in the field, mostly NGOs, made things much easier while creating space for experimentation. The goals were also more diffuse – alleviating poverty rather than producing a specified number of tons of grain – and therefore more difficult to measure. This ambiguity allowed money to flow easily, as had occurred earlier in farm credit but for different reasons. In both cases, hindsight would focus on incentive structures.

Donors took more responsibility by launching impact analysis, particularly to ascertain how microfinance helped poor households, given the goal of escaping poverty. USAID has been a leader in developing impact analysis.[24] Methodological issues abounded, but norms have been developed and greater interest in market research has emerged.

At the same time donors were becoming more interested in promoting transparency on the part of their clients. This was probably due in part to the large number of microfinance providers and their NGO pedigrees: a new breed that were interesting to track. Their number required that donors do some sorting, and in this process much more information emerged. Donors ended up promoting the measurement of results, with *The MicroBanking Bulletin* (www.mixmbb.org) launched by Bob Christen being the best example. However, the degree of transparency available today remains limited, and microfinance should not be considered a panacea. In addition, donors and practitioners have worked to identify best practice,[25] and the serious NGOs and commercial microfinance providers have an interest in getting involved in this search in order to remain competitive in the scramble for grants.

Other positive developments quickly followed. Efforts were made to commercialize microfinance by "upgrading" NGOs to become banks and by "downscaling" commercial banks, each with varying degrees of success or failure. Other financial services are increasingly offered by microfinance institutions (MFIs), based on the realization that target groups want safe places to save money and also to send and receive money transfers or have access to other payment services. Finally, risk is no longer a four-letter word (except possibly when it actually happens). MFIs do not have the luxury of continued, unquestioned losses that seemed to be a source of comfort for SOFIs. Hence, many of the objectives that were distant hopes or dreams in the heyday of agricultural credit have been realized in microfinance. In sum, more attention is focused on institutions and on their performance in increasingly competitive markets. Sustainability is possible.

Why Insist on Sustainability?

But why should commercial sustainability be an objective in rural finance where risks are high and many households are poor, in microfinance which is designed to serve the poor, or even in small and medium scale lending which can build a productive middle class and create employment? A short answer is that poor countries already have too many failed and failing institutions that do not behave in a manner that permits them to become sustainable. That is why they remain "stubbornly poor."[26] Should donors increase the number and size of such entities?

A better answer to the question of why commercial sustainability is important is that stable and efficient institutions help make financial markets function better. Better performing markets are an essential ingredient for improving welfare generally in the long run. Financial markets play an especially important role in development because they link all markets.[27]

Of greater importance, clients want commercially sustainable financial institutions. In the early days of farm credit in the 1960s and 70s and also to a lesser extent in the early days of microfinance, some advocates had a booster rocket theory. This belief is that a loan will increase the productivity and wealth of a household, boosting them to an improved level, which they can then maintain or enhance without the benefit of further credit. This theory is no longer accepted. The target group wants continued access to credit – not necessarily being indebted for long periods of time, but on occasions when shocks occur and when opportunities arise for the productive use of a loan. Hence, sustainability of credit sources is of extreme importance to the people, households and firms at the small end of financial markets. The case for sustainability becomes even stronger when the objective is to promote use of financial services rather than merely provide credit. Poor people want to be able to save in a safe place.[28] Losses of their savings through the failure of deposit-taking institutions are especially tragic. Not to create sustainable financial institutions is a disservice to the people we seek to help.

Institutions Serving the Small End: Two Examples

As donor focus moves back to agricultural finance, efforts will be made to adapt existing institutions that might be enlisted at the new frontier. Two examples of adaptation that are part of The Recent may be instructive in highlighting the types of problems that are likely to arise and what might be done to alleviate them. The first is the type of lending technology to employ. The second example consists of efforts to downscale commercial banks so that they serve smaller enterprises and poorer clients.

The group credit lending methodology has for long been considered by many as the best way to reach the poorest who qualify for microfinance, and the evidence indicates that group credit procedures are indeed easier to target at clients taking very small loans. In many cases the rural poor may be poorer in general than the urban poor, who are the main clients of microfinance institutions. So, it would appear to be a logical step to roll out group credit to serve the rural poor and other hard-to-reach clients in remote areas. However, the appeal of group credit has come under criticism from several angles.

Group and individual credit

Group credit may be defined as arrangements in which women of similar social and economic status form groups, usually ranging in size from five to thirty, to receive credit. Loans are often issued at the same time and the length of the repayment cycle may be identical for all members of the group. In some cases everyone receives the same loan amount, while in others, or as experience is gained over several loan cycles, different members of the group receive different size loans. Groups assemble at fixed intervals, such as weekly, bi-weekly or monthly, when repayment installments are due.

The group may share joint liability so that any member's inability to repay is supposed to be covered by the others in the group. If the others fail to cover the unpaid amount, all members of

the group are barred from receiving further credit. In contrast, there are also mentoring and monitoring group credit arrangements under which only the defaulting member is barred from further credit. The purpose of the group is to help everyone cope and follow the rules, with assistance from the stronger members to help the weaker ones.

Group lending programs are typically managed by NGOs or by microfinance banks that have evolved out of NGOs. In many cases a loan officer would deal with a number of groups each week, serving up to 300 borrowers. Group credit is popular with donors because of its rapid outreach: the number of borrowers rises quickly. One group credit program in Uganda funded by USAID, for example, used groups of 30, and expanded its outreach district by district. Eighty percent of the new groups in one district were formed spontaneously. Thirty women meeting the program's requirements would show up and ask to join. This type of rapid growth encourages donors to provide more funding for such schemes. Scale economies are quickly realized.

Individual lending is more flexible, but minimum loan sizes are almost always larger than those received by members of credit groups. Within broad limits, loan sizes and tenors are negotiable, tailored to the borrower's activity. Loan amounts and maturities increase as the borrower demonstrates prompt repayment and acceptable loan use. In one popular individual credit methodology, loan officers are responsible for the relationships with their clients (excluding handling cash and accounting transactions). Loan officers receive a base salary and become eligible for bonuses based on the number of clients they serve and on the size of the portfolio they create and its quality. The overall portfolio of the institution grows slowly, one loan at a time. Scale economies are realized more slowly and loan officer training takes longer than in group credit arrangements.

One argument against group credit technologies has to do with the economies of group and individual lending technologies. Reinhard H. Schmidt and Claus-Peter Zeitinger[29] argue that group credit arrangements tend to deteriorate over time, while individual lending can go from strength to strength if good institutions can be built to provide incentives for repayment. They argue that individual lending is the superior methodology when based on loan officer information and incentives. The interaction between loan officers serving groups is less intensive than those serving individuals, and both the group and the loan officer require supervision. A lot of information that has a bearing on loan use, client creditworthiness and economic context remains within the group and is not communicated to the loan officer. In individual lending, the loan officer has financial incentives to obtain lots of information from each client, and in the process learns a lot about different types of entrepreneurial activities and commercial behavior. Organization and use of this knowledge throughout individual lending institutions leads to better performance in the long run.

In addition, groups tend to become unstable over time. If some borrowers take loans that are large relative to the average loan size, the social control by other group members over these borrowers declines, weakening solidarity. At the same time, the opportunity cost of group participation is large because periodic meetings at fixed times take several hours that might otherwise have been devoted to the borrowers' businesses, activities at group meetings may not be directly related to credit and its use, and other rigidities or transaction costs arise from the collective nature of the activity. Schmidt and Zeitinger argue that within some intermediate time period, possibly three to seven years after establishment, the information economies of individual lending overwhelm the scale economies of group lending.

Elisabeth Rhyne has concluded that the flexibility of individual credit attracts many members of group credit arrangements who do not want to bear the risk or transaction costs of default by others, prefer loans tailored to their cash flows rather than fixed in amount and with uniform issue dates and maturities for all group members. Several microfinance organizations and institutions based on group credit have modified their credit technology or abandoned it altogether, as predicted by Schmidt and Zeitinger and Rhyne. Robert Christen and Deborah Drake likewise note that microfinance generally is moving toward individual loans.[30]

What are the implications of these realizations for application to agriculture or to other rural activities that have marked seasonality? Could group discipline be maintained if members did not assemble at frequent intervals to repay loans, instead paying larger lump sums after harvest? Would group members find it useful to assemble periodically before harvests to repay token amounts? Possibly they would, largely for social purposes, but would this be a durable arrangement?

In addition to the dynamics explored above, systemic risks intrude. How can a group cope when all members are hit with the consequences of drought, floods or other hazards? Can any form of insurance be obtained on a sustainable basis? It appears that group lending would be less successful in rural and agricultural areas than in urban areas. With regard to individual lending, the higher costs of service would tend to direct lenders to larger smallholders and those with diversified income-earning enterprises.

What role for existing financial institutions?

Some banks have moved down market spontaneously, providing microfinance and other services that serve a clientele that is poorer or harder to reach than those they had served previously. Many more banks have not done so, and donors have encouraged some of these to serve microentrepreneurs and small businesses.

Commercial bank downscaling as used here refers to donor initiatives to get bankers to do what they would otherwise not do in the absence of donor support. Downscaling so defined consists of voluntary efforts by commercial banks to move down market, facilitated by donors. Downscaling is a temporary intervention intended to establish systems that will serve the small end of financial markets. The observations provided here are based on two sources of instructive experience: transition economies and Latin America.

Downscaling has been attempted most aggressively in transition economies. New, usually privatized, banks were formed out of the old state banks, new private local banks appeared, and foreign banks entered directly or indirectly in partnership with local interests. The European Bank for Reconstruction and Development (EBRD) has sponsored several downscaling activities beginning in Russia in 1994, in Kazakstan in 1998, and elsewhere.[31] The Inter-American Development Bank (IDB) has promoted commercial bank downscaling though its Microenterprise Global Loan Program which began in 1990.[32]

Lessons from downscaling identify the barriers or potential barriers that have to be overcome to move a bank down market, which makes these experiences relevant to the rural finance revival. Those noted below illustrate information and incentive problems that can arise when donors engage new players from the commercial portion of the financial sector.

Different objectives: The donor wants outreach, relatively rapidly. The banker is concerned about profits, which may lead to cautious exploration before large commitments are undertaken. Paradoxically, if bankers are skeptical, quick results may be especially important in overcoming their reticence. Quick results may be difficult, however, when banks' procedures are highly bureaucratic. Also, plants and animals take time to grow, and their seasonality may provide only a few opportunities each year to make new agricultural loans, slowing ascent along the learning curve.

Christmas trees, bells and whistles. Some donors impose restrictions that have little to do with creating more efficient financial markets. These include loan eligibility specifications, loan terms and conditions, limitations on the nationalities of technical assistance providers, requirements regarding the source and importation of project goods, impact studies, reporting requirements that the banker does not consider useful in establishing creditworthiness, and other impositions that bankers find onerous or foreign to their view of business. In short, these restrictions raise bankers' costs, which diminishes their enthusiasm. While subsidies last, bankers may play along.

Competing opportunities: Bankers who believe they can capture untapped high yield business are likely to devote attention and resources to this possibility rather than to rural business that is considered costly. For example, if credit cards for the urban middle class look promising, micro and rural finance may be given low priority and assigned low expectations and less than stellar staff. With some notable exceptions, banks that downscaled are often not the largest ones in any given country. Many big banks have a market presence that permits them to compete effectively in the most profitable parts of the local market, usually the large corporate sector. Smaller banks may not have the financial muscle, political or other connections, or possibly the analytical capacity to compete in this arena. Therefore, they seek alternatives in which they can create a market niche. This is often difficult because it involves the new and the unknown, and because governance in these institutions may not be attuned to change.

Discomfort with unconventional collateral: Usually by regulation and often by habit, bankers are wary of collateral that to them is unconventional but common in microfinance. This may require a learning period or even the advent of an economic downturn which tests the value of such collateral before a banker will be comfortable making microloans. Banks' internal audit committees may require lots of persuading about the soundness of a portfolio backed by unusual collateral.

Skepticism about microfinance loan analysis: Bankers may be skeptical about micro or rural finance loan analysis techniques, which have to be quick and cheap because loans are so small. The microfinance lending technology mentioned above that is centered on the loan officer uses frequent, ad hoc, relatively informal loan committee meetings of just two or three people. Bankers and their internal auditors may feel more comfortable with deeper analysis and greater formal oversight, which raises costs without necessarily lowering risks, and hence diminishes enthusiasm.

Public relations issues: Micro and rural finance is costly to provide, especially at the outset, and consequently it can be sustainable only when its relatively high costs are covered. Bankers may not be comfortable charging high interest rates for the poor and low interest rates for the rich. (Are bankers paranoid? Well, if everyone hated you, you would be paranoid, too.)

Inefficiency: Many banks in developing countries and transition economies are dreadfully inefficient. Their procedures are unduly costly and their administrative costs remain high because hierarchical lending and decision procedures involve lots of staff without adding lots of value. This complexity may lead to lines and limits of responsibility and authority that are blurred, ambiguous and contestable. Inefficient banks can be hard to work with and they may not be able to move rapidly in introducing new products and training staff in their promotion and implementation. Staff unaccustomed to change may resist new initiatives.

Possible solutions to these problems

Donors promoting downscaling attempt to address these problems. Many concerns boil down to costs that bankers rightly or wrongly believe they would incur. Subsidy is therefore offered in three forms: cheap money to fund a down market portfolio, risk sharing between donor and banker, and consultants who provide technical assistance that will enable bankers to reduce their costs over the medium term. For downscaling as defined here to occur at all, initial subsidy is required in many markets.

The EBRD approach sets up a special unit within a bank or in selected branches to concentrate on downscaling as a new business. Technical assistance (TA) is provided to introduce the new lending technology and to ensure that MIS (management information systems) can handle the new activity efficiently. The TA consultants hire local staff and train them using project funds. After some time on the job (e.g., six months), they are hired by the bank at a higher wage. Good people without the qualifications many banks require of new credit department staff can be effective microlenders, but they may make others in the organization uncomfortable because of their status and their bonuses (assuming the bank adopts this practice from the EBRD model).

Several strategic lessons for donors that seek to enlist existing commercial institutions in rural finance downscaling can be derived from microfinance downscaling:

- Results must be visible relatively quickly to capture bankers' interest.

- Downscaling is unlikely to work well if it is considered an extension of a bank's existing business rather than as an entirely new business. A new business requires its own structures, logic, procedures and lending technology in order to become profitable. This requires internal changes and efforts to deal with reluctance, doubt or hostility.

- Staff who are trained by technical assistance providers to become loan officers or back office support may be the only people in the bank who have received formal instruction or formalized on-the-job training. This may make them attractive candidates for other positions, especially if downscaling is successful. This leads to continual staff turnover in the downscaling unit, increasing its costs and reducing its relative performance. Better appointments may also be a source of contention if promotion is normally based on academic qualifications and seniority.

- Some technical assistance is problematic. Poor communication and failure to engage can impair effectiveness.

- Downscaling has often not worked well when it is just a tiny piece of a bank's operations. Even if it turns out to be quite profitable, its asset base may simply be too

small to make an impact or inspire attention within the bank. At some point it may be discontinued when larger, competing opportunities appear that require staff and resources. For these reasons, downscaling is often most enthusiastically embraced by small banks and by struggling banks.

• Downscaling has rarely worked when it is considered a social venture or a public relations activity. It seems to have worked best when 1) it is regarded as a new business and a new way of doing business, and 2) the effort is headed by a "champion" with sufficient seniority, respect and credibility within the bank to be given the benefit of the doubt. To succeed, this person requires "space": a sufficiently long time slot (two years as a minimum) in which to produce results, budget and staff that cannot be hijacked by other managers, and keen bureaucratic self-defense skills.

Prospects for sustainability

EBRD is not yet convinced that its client banks will continue to give priority to downscaling when it no longer provides subsidized funds for lending, risk sharing and technical assistance. The Inter-American Development Bank's experience was also less than hoped for. With the exception of a program in El Salvador,[33] very few commercial banks in Latin America downscaled until the late 1990s, when more than a dozen did so. In some cases, however, downscaling has been fragile – easily reduced or abandoned when a crisis occurs, when more attractive opportunities arose in recent boom years or when new managers with little interest in microfinance came on board as bank consolidation accelerated with globalization in Latin America. TA may be required for more than the usual two to four years under a typical project, and a champion is absolutely essential, backed up with good MIS, an appropriate lending methodology and often a slightly subsidized line of credit.

However, by 2002 more than 100 banks worldwide were involved in microfinance. Liza Valenzuela of USAID and others made two surveys of these institutions.[34] The first, published in 1997, reviewed 15 banks and three nonbanks. Revisiting these institutions in 2001, the researchers found that the microcredit operations of five had grown by more than 100% (most beginning with a small base), five grew at a slower rate, two served fewer borrowers, three closed, and one discontinued microlending but invested in a specialized microfinance institution. The 2001 survey had 42 respondents, almost half of which started microfinance operations during or before 1996. Thirty-three of these were banks. The large commercial banks in the sample reported that they were attracted to microfinance as a commercial opportunity. Small banks agreed but added social responsibility as a motive, while four state banks listed social responsibility as their primary motivation in microfinance.

The researchers noted that outreach by banks was relatively modest, with about 225,000 active loans in their portfolios and average numbers of active loans ranging from 4,280 for small banks to 19,800 for state-owned banks. Large corporate banks appeared to have the greatest difficulty in making downscaling work because of difficulties integrating microfinance into their corporate structures.

The conclusion that may be offered based on exploration of group and individual lending technologies and downscaling as vehicles for outreach is that currently there are no easy ways to transplant these features of microfinance into rural finance on a massive scale at low cost. Innovation is required.

Specialized Commercial Microfinance Institutions

An important element in The Recent is the formation of networks of specialized microfinance institutions (MFIs) that provide a variety of services to the target group. BancoSol in Bolivia was a pioneer,[35] but commercialization got underway aggressively after an MFI of this type was established in Bosnia in 1996.[36] What sets these initiatives apart is their ownership and funding. Owners are currently "patient investors" such as EBRD, IFC of The World Bank Group, the KfW Group, FMO and DOEN Foundation of the Netherlands, other similar entities and foundations, and several commercial banks.

Initial capital is provided through equity investments by these owners. Operations are launched with start-up grants from USAID or others. Funding may come from credit lines offered by these investors, and increasingly over time, from deposit mobilization. The combination of owners who put funds at risk and managers responsible for commercial success are viewed as being more likely to provide good governance of financial institutions than less formalized approaches with diverse objectives.

Many of these urban-based MFIs are also active in rural areas. They may not move aggressively into rural areas for sustainability reasons: those on the land cannot offer acceptable collateral, and systemic risk problems and cost considerations. Some commercial lenders may be tempted by subsidies, others may wish to avoid them. These very positive innovations are not discussed further here because they are commercially oriented, committed to best practice and are likely to move slowly away from donor assistance.[37] An institution in this market is probably the world leader in microfinance and small business lending transparency (see www.imi-ag.com).

The Open: Institutions Based on Creativity and Opportunity

It appears that microfinance may have passed its heyday as a donor funded venture. Major donors apparently believe that microfinance cannot contribute directly to the Millennium Development Goals (MDG).[38] Emphasis on this new global initiative seems to be making it more difficult for MFIs to obtain donor funding. This places a premium on institutions that effectively provide sustainability, outreach and impact. At the same time, and apparently unrelated to these Goals, donors now would like to apply microfinance practice to revive rural finance. In this effort, a variety of measures can be useful. A few are presented below in no particular order of importance.

The Trade

An area that holds keys to the operation of rural finance is input supply and produce marketing in the private commercial sector, which has been largely overlooked by development assistance, excluding donor assisted cooperatives. (Neglect may reflect difficulty in finding ways to channel subsidies through the trade.) Input suppliers and produce buyers provide a lot of informal credit to farmers in all market-based economies. In development circles, relatively little is known empirically about the volume of this business and the terms on which it is conducted. It seems

reasonable to assume that the strengths of the trade include knowledge of clients through diversified channels; incentives to provide credit in order to sell inputs or compete for purchase of harvests; links to larger chains of credit, supply and processing; measures to control risk; massive outreach and ubiquity.

The trade has two major problems. One is a lack of transparency regarding the cost of credit. The second is its role as the defenseless scapegoat of the non-commercial elite and populist critics who distrust markets and accuse the trade of gouging clients and allege the trade's responsibility for market failure and other odious behavior. In response, donors should pave the way in finding out more about the trade in its various incarnations. This research should explore the incentives and information of the trade and their sources in financial markets, commodity markets, government regulations and other areas. Efforts to create more effective markets that serve the poor should override sector or institutional boundaries and popular prejudices.

So Much Progress in Agriculture and Finance, So Little in Rural Credit![39]

The major issue is the extent to which The Past, The Continuing and The Recent offer guideposts that will be incorporated into donor policy, given that donors create new worlds for which they become basically responsible, but on a non-recourse basis.[40] Donor promotion of agricultural and rural finance has had a hiatus of more than 10 years. There has been relatively little documented experimentation during this period that readily provides a basis for new initiatives, although some positive rural microfinance experience has developed and the Past, the Continuing and the Recent have been well documented in Asia.[41] Donors have little institutional memory, and 10 years is a generation in a bureaucracy without a history.

Are the mistakes of the past behind us and will whatever lessons that might be drawn be placed in context? Fortunately, financial systems have changed enormously for the better, making some historical lessons redundant. And, information is available. Mark D. Wenner of the Inter-American Development Bank has assembled a comprehensive exposition of experience and lessons that should serve as a guide.[42] The agricultural credit revival provides an opportunity for a New Rural Finance (NRF) distinguished by its objective, method and legitimacy.

The objective is to create more efficient rural financial markets that fill up more and more of the space inside the finance project pyramid, as defined by financial sustainability, outreach to the poor, impact, and transparency. This objective deserves priority for two reasons. First, because it includes all components of the pyramid. Second, because no three of the four components offer a sufficient basis for 1) efficient use of resources within the economic framework of the New Institutional Economics and its emphasis on governance *and* 2) promoting social welfare.

> Robust financial markets are correlated with rapid agricultural growth in Asia. The PRC [People's Republic of China] is the only country in the region that has experienced rapid agricultural growth without the benefit of a strong market-oriented rural financial system. No country in the region has developed a strong rural financial system without [also] having a progressive agricultural sector. Moreover, rural financial institutions are part of the overall financial system; it is logical that no strong rural financial institutions exist in a country with a weak financial sector.[43]

The method of the NRF is institution building. Institutional innovations occupy the interior of Zeller and Meyer's microfinance triangle.[44] Only through good institutions can markets and nonmarket initiatives yield productive results. Because the focus is on financial markets, the institutions that matter most have to mobilize deposits and other market-based funding, offer credit, facilitate transfers and payments, and provide insurance. Other institutions that may also be important include regulatory bodies, credit information systems and providers of subsidy.

The legitimacy of the NRF is based on outreach and impact. The principal goal and test of the New Rural Finance is that well functioning rural financial markets have to address effectively the problem of seasonal shortages and the havoc these cause to rural welfare.[45] Therefore, donor assistance can be legitimized only (but not exclusively) if it moves the frontier of finance down market, serving more poor people with savings, credit and insurance products.

Any nonfinancial goals included in rural finance should be secondary, and must be secondary if they are ultimately to be achieved. This strategy is the only one that ensures the possibility of creating sustainable institutions engaged successfully in rural finance over the long run.

Related to this concern is that agricultural progress has only two certain outcomes: cheaper food and fewer farmers. Therefore, more attention should be accorded to how poor rural families get out of or reduce their participation in agriculture. A characteristic of agriculture is that some families go to the wall every season. How does or can credit accelerate or delay this process? How can rural finance be used to help families get out of agriculture as painlessly as possible? How do rural land markets and credit markets interact?

The Role and Usefulness of Failure

Missing in the unfortunate saga of The Past, as well as in much of the Continuing and The Recent, is curiosity about the socially beneficial aspects of failure. Failure is helpful when three conditions apply: 1) The decisions that produced failure were based on the best information available at the time they were made. 2) The failure was made only once, and 3) its causes were made transparent, communicated in detail to all those with a need to know. In disciplines where failure results in punitive consequences, it is studied rigorously[46], and donors should adopt no less a standard because of the influence they have or could have over the lives of lots of poor people.

If history is any guide, all sorts of projects are likely to be attempted, and a rush to get lots of projects started is the smart bureaucratic response to politically-driven goals. For this reason and as the fallback, *any project that is designed and funded should be accepted for implementation*, because it will be anyway. Accepted because failure is socially useful when the three conditions apply. In a post-Enron, post-Clintonian world this requires investment in carefully measuring and reporting results, so that:

a) each project is monitored and evaluated by one or more third parties in a meaningful manner, with conflicts of interest duly noted;
b) monitoring and evaluation includes analysis of financial performance according to accepted accounting standards but including the Subsidy Dependence Index and other performance measures that have become recognized as microfinance best practice, and others that may evolve in rural finance;

c) nonfinancial project activity may also be freely monitored and evaluated to determine impact or other effects;
d) results identified by routine monitoring and evaluation, or by special study or investigation, be made transparent to the public, on a friendly website, and include the names of the donor agency(ies), the implementing agent(s) and possibly the professionals responsible.

This exercise in social and fiscal responsibility may require some sort of watch dog organization that would debate and recommend standards and that would offer sanctions, primarily through public exposure, of lapses in implementation and follow-up, or of refusals to cooperate. (Watchdogs of this breed often have no teeth. The question is how loudly they bark.)

The failure that is increasingly mentioned is market failure,[47] which in welfare economics is said to occur when information is insufficient to provide a basis for informed action, and when incentives for those in the market are not aligned with those that would better benefit society at large. The reluctance of commercial banks to lend to small farmers has often been portrayed as a market failure. Bankers were sometimes characterized as uninformed, selfish, oligopolistic, not socially aware and lazy. Two possibilities were often left unexplored: 1) bankers had concluded that the rural credit market was not worth serving because of transaction costs and risks (which govern incentives), and 2) any presumed market failure presents an opportunity for innovators to explore.[48] Microfinance suggests that this possibility is not fanciful.

The welfare economics response to allegations of market failure is government intervention, which was commonly thought to be remedial and good for society. However, those who would intervene also have information problems, such as a lack of familiarity with the lending business or the rural economy or target group cultural norms.[49] Their incentive problems may include the quest to build larger state bureaucracies and hire more staff as a symbol of bureaucratic power. Hence, *market failure is a perfect public policy wild card*. It allows those with money and power to impose their values on those active in any market, at least for a time, behind the cloak of the public good. Critics also note that there is surprisingly little empirical data to support the classic textbook cases defining market failure.[50] (I cannot recall any farm credit project in which market failure was a motivation that performed well. At the least, market failure was a smoke screen invoked to help get projects approved. It deflected or diluted potential criticism of problems in project design, such as lack of credible measures to improve loan recovery.)

State-owned financial institutions and state-sponsored cooperatives provided sufficient evidence of a different phenomenon: government failure. Government failure occurs when governments or their agents do not have the information or the incentives to behave in ways that contribute to national welfare. Possibly the largest government failures that kept bankers away from rural areas and the poor was failure to protect citizens' property rights,[51] the fundamental rationale for government in a liberal society. Governments failed by not having or not exercising laws and credible enforcement mechanisms that would make assets acceptable to banks as collateral. Land titles were lacking or could not be enforced. Trade and ownership disputes would require many years to sort out, depending on who could best bribe the judge and afford to pay others in the legal system.[52] For some reason, government failure was not discussed in development assistance agencies with the same fervor unleashed on market failure. It remains a major issue, and donors should take the lead by providing more disclosure regarding their own operations.

Donors and Appropriate Institutions

In approaching what might be done to revive agricultural finance, consider the unique opportunities donors offer. They provide funds that do not have to be repaid or that are repayable over long periods. For initiatives other than humanitarian assistance for food, health and education, and for environmental improvement, the principle of matching or of symmetry suggests that donor funding should support long run objectives that are otherwise beyond the capacity of poor countries. To do this effectively requires the creation of institutions, in the sense of organizations as well as in the sense of structures for coordinating behavior, that expand spontaneously to engage and serve increasingly larger numbers of poor people. Institutions have an unlimited life, providing the greatest leverage for and tribute to donor initiatives that launch institutions that are successful over long periods of time.

Sustainability requires self-correcting mechanisms and dynamism through innovation.[53] Competitive markets are probably the most subtle and sensitive self-correcting mechanisms because every transaction has the power to make some change, however small. Government efforts at self-correction can be useful but take longer and are less subtle. This is because they have monopoly power, which is never supple and becomes brittle with age, whether in state or private hands. To the extent that governments hold monopolies, change often requires an authoritarian approach, or major efforts to mobilize democratic opinion, or else occur when there is simply no other way out, as with the collapse of the Soviet Union, a most brittle demise.

Therefore skepticism should be the default option when market failure and public goods arguments are used as justifications for intervention. The burden of proof must fall primarily on advocates. Why? The history of donors' rural credit promotion in poor countries is one of overwhelming government failure. If intervention is inevitable, consider the "net" impact of responding to claims of market failure, which would equal the social cost of market failure plus or minus the social benefit or cost, as the case may be, of attempts to repair market failure through government intervention. Market failure is a public policy wild card, although intervention is not always inevitable if frameworks are established that create institutions that create competitive markets.

Intervention as an institutional mode in activities in which revenues are unlikely to cover costs is complex. First, it may crowd out or foreclose opportunities that markets might better perform in the long run. Second, it can start things that cannot be finished. This occurs when efforts to address market failure or the provision of public goods descend into the realm of entitlements in poor countries that are unlikely to have the institutional capacity and the tax base to provide these goods or services in perpetuity. Therefore, it is important to avoid the temptation to view and advocate rural finance as an element of global social policy unless the advocate can guarantee an almost perpetual flow of subsidy, which is an essential characteristic of the welfare state. Sustainability requires dependable sources of funding over the long term. Donors failed this test when the jettisoned farm credit around 1990. Other donor activities have met the same fate. Modest starts and learning curves, often unfortunately long, can avoid creating false expectations.

Contributing to global social policy

Many development assistance agencies advocate, or come close to advocating, global social policy, a code word or term that implies the construction of welfare states and their numerous

entitlements. These agencies will continually search for projects that are devised to extend services beyond the limits of commercial sustainability. These agencies' power and appeal will produce definitions of rural finance that focus primarily on outreach and impact[54]with a raft of NGOs to implement them. In all of these cases the institution must be subsidized, and in many the transaction must also be subsidized. What can be done to accommodate their view of sustainability as continued access to subsidy and the initiatives they devise without undermining markets?

The challenge would be to create foreign-funded welfare state structures in countries that for many years are not likely to have the tax base or the administrative tradition or apparatus that is required to run a welfare state effectively, assuming that that would be possible. Projects are not good vehicles for this task because they are short-term, with no guarantee of renewal. The benefits they produce can be lost when the project closes and the skills or funding needed for continuation are not available locally.

When market failure and public goods arguments are convincing to those who have the power to do business in these terms, when the estimated social benefits are considered by advocates to be large, and when there is little probability of crowding out private commercial initiatives, donors could still play a supportive role by providing funding over the long term. This can be accomplished through trust funds with limited purposes and lives of 25 years or longer.

Trust funds would be established for noncommercial or quasi-commercial rural finance purposes. They could sponsor and maintain group lending programs for poor women, build regulatory structures, and lend and collect savings in market segments that are costly to serve and are likely to remain so, such as the very poor and those in isolated regions.[55] Trust funds could finance provision of essential technical capability. Technical assistance, training and collaboration should be aimed at developing local expertise and institutions structured so that incentives will encourage good long run performance consistent with the values of a welfare state.

These funds should be country-specific and have a narrow, limited focus. Narrow agendas, and a multiplicity of narrow agendas, are preferred over large agendas because they are more transparent and hence easier to govern, and so that their eventual disappearance creates no more than a whimper. Their most important technical feature is their expiry, which is possible only if vested interests are relatively small and weak. Expiry provides an opportunity to re-evaluate their usefulness or feasibility. Accordingly, add-ons to existing funds should be prohibited: new funding should go to new trusts. Trust fund management companies could oversee several funds if that led to economies and synergies. Competing fund managers would be ideal.

These trust funds would be fully funded at the outset as a guarantee of a long life. The poor country inhabitants who are beneficiaries do not bear the risk of abandonment, disappointment and social loss that would occur if donors left the party. A trust fund's endowment and the interest earned over its life would be spent to accomplish its purpose. Its life would end when its principal and interest income declined to zero as predicted in disbursement schedules drawn up when the fund was formed. Donors have already used this sort of arrangement: USAID had a small and medium enterprise project in Bangladesh that had a life span based on expenditures and losses that were calculated in project design; British assistance was designed to go broke in a credit guarantee fund in Poland.

Endowment assets not yet disbursed would be held in hard currency investments and disbursed over the life of the trust fund based on an appropriate formula. (Any investment strategy other than the most conservative would be inconsistent with a fixed life of a fund: a "long life" of around 25 years offers flexibility.) These commitments would easily run into the billions of dollars, offering an unprecedented opportunity for donors.

Trust funds would require relatively complex design to ensure that their incentives were consistent with their objectives. Trustees consisting of donor institution or donor government representatives in the majority and recipient country government representatives in the minority would govern each fund if that format were required, as would probably be the case for the multilateral development banks. In other cases, funds could be privatized with trustees representing interested and competent parties against which donors could have legal recourse.

Donors and host country governments would have to have reserved powers that would permit them to pull the plug in those cases in which objectives became impossible to achieve, the activity became redundant, or abuse exceeded some level of tolerance. For example, civil war might interrupt operations or government priorities might change. Possibly the exercise of these reserved powers could be subject to arbitration by an impartial international panel. In other cases an unconditional buy-back, fixed price option could be established at the outset so that embarrassed donors could get off the hook in really egregious cases, with the proceeds turned over to the United Nations or some other designated cause. Likewise, governments should have an out to ensure that the trust fund remains apolitical and, for example, does not become a vehicle for spying. The trust funds should not be held hostage to foreign policy considerations, which seem to be increasingly in play as a tool to ration development assistance.

Incentives should be attractive: politicians in poor countries could be given credit for expanding the outreach of the state and establishment of new institutions dedicated to a worthy cause at someone else's expense. (Local resistance could be justified because in effect the trust fund arrangements formalize what development assistance based on loans and grants does, which is to outsource government, social and charitable functions.) The trusteeship format allows local politicians to duck responsibility and point the finger at the donors and the foreign trustees when unpopular courses are taken or when the trust funds resist local rent seeking.

If a trust fund's purpose and operations were satisfactory over the course of a generation in which the fund is exhausted, possibilities for continuity could be explored. These could include increased reliance on the local tax base, developed over a period of at least 25 years, to fund the insatiable fiscal appetite of welfare state structures.

Rules of Engagement for Donors Selecting Institutions Lending in Rural Areas

When starting a new activity, how should donors select partners who will implement their objectives? The door should be open to all who will help create a competitive market and make sustainability their goal. At the same time, opportunists have to be weeded out along with those whose use of subsidy would undermine the competitive positions of others working hard to develop rural finance as a commercially sustainable business. What selection criteria could appropriately be applied to consultants, government institutions, cooperatives,[56] NGOs, microfinance networks, banks and others? What institutional attributes increase the probability of effective and sustainable rural finance at the small end of the market?

Donors' criteria governing awards to microfinance providers should be elaborated, discussed and debated as the rural finance revival proceeds. The Annex that follows offers preliminary points of reference at the technical and institutional level. (The Annex is intended to complement CGAP's "Format for Appraisal of Microfinance Institutions,"[57] which is more technical in nature.) This list consists largely of questions to be answered by applicants who want to become "lenders," the term used here for donors' clients, including consulting firms managing financial institutions. The list is not meant to apply to activities unrelated to finance. "Target group" refers to rural clients who would be borrowers or users of other services included in rural finance projects. No recommendations are provided here about preferred types of responses to the questions on the list. Different donors and different investors have different objectives, and many institutional choices beckon.

Housekeeping Hints

Be extremely cautious about *large initiatives* that involve *ministries of agriculture or state-owned bank*s or that are otherwise likely to be *politicized* in countries with *bad traditions* in rural finance (e,g, India, Mexico, Brazil and China), unless these have been clearly overcome. Politicization risks probably rise as rural finance institutions become larger and more successful.

Do not engage in "experimental" projects. Every project is an experiment. Goals and risks should be determined in advance and monitored in implementation. Projects labeled as experimental (excluding an excellent USAID experiment in Bangladesh) are usually replicated before sufficient information is on hand to justify their continuation. Agriculture and the rural economy yield data slowly.

Do not proclaim any project a success until it has been in operation for five years, or sooner if it has suffered a bad year and responded effectively. (A World Bank credit project in Albania was proclaimed a success by the project officer responsible *before* any of the loans issued to farmers had fallen due.) Proclaiming success in good or normal years is like playing the bagpipe – the missing link between noise and music -- but skipping the grace notes.

Work on property rights. Effective property rights exercisable by the world's poor and common folk generally would release much more productive energy and credit in a year than could fifty years of credit projects funded by loans and grants.

Finally, address the most awkward subsidy problem. Three hundred billion dollars a year in farm subsidies in rich countries pre-empt and crowd out opportunities that markets could otherwise provide to farmers in poor countries. This diminishes rural welfare in poor countries to a degree that cannot be counterbalanced by any conceivable quantity of donor-funded rural projects. Find the money to engage institutions that can make a difference, including universities (remembering Ohio State's role in curbing the nonsense in the heyday of rural credit projects), think tanks such as Brookings and Cato, environmentalists and other advocacy groups willing to contest OECD bloc farm subsidies.

ANNEX: Attributes of Potential Partners for Donors

Donors will have rural finance agendas based on many factors and including various priorities. Different dimensions of intervention – financial sustainability, outreach to the poor, impact and transparency -- will be accorded different weights or profiles. Therefore, efforts to match "lenders" with objectives requires a sorting process. ("Lenders" is the term used here for those that are selected to implement donors' plans in rural finance. They include NGOs, cooperatives, commercial financial institutions, state banks and others. Lenders would typically offer services such as savings facilities or loans or insurance or payments, or combinations of these. Some would also provide nonfinancial services.) This check list of characteristics is meant to facilitate sorting.

1. How does the lender measure and reveal results?
    - Financial sustainability
    - Outreach
    - Impact
    - Transparency

This question is a good starting point because results are important and transparency is even more important because it underlies incentives. The things that are measured display the lender's values and where energy is most likely to be focused. The four variables listed constitute the triangle of microfinance as defined by Zeller and Meyer[58] plus transparency, creating a finance project pyramid.

2. How does the lender obtain knowledge about the target group?
    - What is the definition of the target group and the geographical area to be served?
    - How does or would the lender obtain and use information about the target group?
        - Staffing for service to the target group
        - Physical presence where target group members live or work
        - Data bases that adequately track the lender's performance and target group participation in rural economic activities
        - Ability to extrapolate from and refine similar experience elsewhere
        - Lending technologies that minimize clients' transaction costs
    - What are the lender's responses to shocks encountered by the target group?
        - Idiosyncratically by small numbers of households or individuals
        - Systemically by most clients
    - What specialization in agriculture, if any, is required to achieve project objectives?
        - If required, how will it be supplied?

Knowledge of the target group is important to successful project design and execution. The lending technology and donors or lenders' objectives imply or determine the sorts of information that would be especially valuable.

3. How will the lender engage the target group?
    - What experience does the lender have in serving the target group?
    - What financial services will be offered?
    - What lending technology or instruments will be employed?
        - What information is gathered about loan applicants, and by whom?
        - What types of loans are or will be offered?

How are credit decisions made, and by whom?
How quickly are loan applications processed?
How is loan size determined?
How is loan tenor determined?
How is delinquency managed?
What is the operating cost per client and per loan made?
What sort of collateral or guarantee is obtained, if any?
How and when is collateral foreclosed?
How are interest rates and fees determined?

In what locations will lending occur?
What nonfinancial services will be offered?

What is the rationale for offering nonfinancial services?
How will nonfinancial services be funded?

What will be the relationship between the financial and nonfinancial services offered?

Staffing
Funding and budgeting
Obligations of clients for access to financial services
Expected payoff of nonfinancial services, on a with/without basis

What channels will be used to communicate with clients?
What measures will be used to cope with the seasonality of rural finance?
To what extent do gender, age, ethnicity and similar donor hot buttons figure in engaging the target group?
How many clients will the lender engage?

Classified by services used
Over what time period?

Outreach begins with the relationship between the lender and the target group member. How the relationship is structured is a governance issue that defines information and incentives that have a critical impact on the productivity of the relationship and on each party's costs of maintaining and strengthening it.

4. Reaching the break even point: What level of and strategy for pricing is required to break even from earned income? What is the projected time period required to achieve this result?

How is the project activity or institution to be financed?
What interest income and fees will the lender be able to collect?
What is the break-even level of lending activity?
What amount of funding is required to reach break even?
What sources of funding are available?
What experience has the lender had in bringing similar ventures to break even?
What are the lender's projected fixed and variable costs per loan made?
What amount of subsidy will be required per loan made and per borrower?

Annual or seasonal
Cumulative

What risks are most likely to delay achievement of breakeven results?

How long does it take for a rural lender to cover its costs? This question is critical for commercial lenders that regard covering costs as the minimum financial prerequisite for sustainability. This question is also critical for noncommercial lenders that regard sustainability

as a function of access to continued subsidy. These questions are intended to serve as a basis for evaluating the lender's business plan.

5. Governance

- What is the corporate form of the lender?
  - What are the major strengths and weaknesses of this corporate form for this activity?
  - What measures are taken to capitalize on strengths, minimize weaknesses?
  - Does this project involve a change in corporate form or governance?
  - If the lender is part of a larger group or network, what services are supplied by the larger group or network?
  - Who is on the lender's board and what are their qualifications and tenure?
  - Who are the real "owners"?
- What failures has the lender encountered within the last 5 years?
  - How large were the costs of these failures?
  - By whom were these failures addressed?
  - What measures were taken to control the problem?
  - What longer term measures were implemented to reduce the probability of recurrence?
  - How is the internal audit function organized and performed?
- How and in what form is commitment to sustainability demonstrated?
  - How is sustainability defined?
  - To what extent does pricing policy contribute to sustainability?
  - What internal policies are in place to assure sustainability?
  - If deposits are accepted, how would depositors be protected in the event of default by the lender?

What commitment of resources, including experience and expertise, will be made to achieve rural finance objectives?

- Management
- Staffing
- Funding
- Space, hardware, software, vehicles, etc.
- Continuity

Regulation

- To what regulatory regimes is the lender accountable?
- Has the lender been out of compliance at any time?
- What, if any, ratings or sanctions have been given by regulators?

How does the lender organize quantitative information internally?

- Information gathered
- Information retained, and for what period?
- Analyses based on retained information
- Accounting and management systems hardware and software
- What statistical data are extracted from information retained?
- How is information communicated to management and the board?

What disclosure will the lender provide to the public?

- What results will the lender report?
- What standards will be used to quantify and report results?
- What will be the frequency of reporting?
- What will be the time lag between reporting dates and disclosure?
- What media will be used to disseminate results?

Governance has emerged as the fundamental determinant of organizational performance within any given market or nonmarket environment. The ideal governance structure for commercial lenders begins with efforts to form a board of directors that includes “owners” who have money and reputations at stake, including donors that provide equity capital. The ideal governance structure for noncommercial lenders begins with a quest to engage directors who have connections to and credibility with the sources of subsidy, and others who provide good advice and embody the lender’s values. Because donors expand the size of institutions, their interest in governance has become deeper and more focused.

6. What is the relationship between the lender and the donor with respect to this project?
   - What subsidy is required and for how long?
   - What other sources of liquidity can the lender mobilize?
   - How will any surplus or profit be used?
   - What plans does the lender have that will permit donors to exit, and when?
   - Other than donor exit, what events would lead to project discontinuation by the lender?

Sustainability places a premium on continuing and evolving relationships. The relationship between donor and lender should not produce surprises. While paving the way forward, occasional speed bumps are acceptable, but potholes are frowned upon.

7. What other factors, not mentioned above, will help to ensure that the lender’s objectives are achieved, and/or that make the lender’s contribution unique?

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[1] I am grateful to Dale Adams, Juan Buchenau, Lucy Ito, Richard Meyer and anonymous reviewers for the many useful comments they provided.

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