



**Paving the Way Forward for Rural Finance
An International Conference on Best Practices**

Discussant Reaction Paper

Comments/reactions to

**“DEEPENING RURAL FINANCIAL MARKETS:
MACROECONOMIC, POLICY AND POLITICAL DIMENSIONS”
by Claudio Gonzalez-Vega**

**By Carolina Trivelli
(Instituto de Estudios Peruanos)**

This paper was made possible by support provided in part by the US Agency for International Development (USAID) Agreement No. LAG-A-00-96-90016-00 through Broadening Access and Strengthening Input Market Systems Collaborative Research Support Program (BASIS-CRSP) and the World Council of Credit Unions, Inc. (WOCCU).

All views, interpretations, recommendations, and conclusions expressed in this paper are those of the author (s) and not necessarily those of the supporting or collaborating institutions.

The paper by Dr. Gonzalez-Vega opens the discussion about rural finance and rural markets in different ways. The paper seeks to provide elements and to shape a new framework to promote

financial rural markets deepening based on a new conceptual and policy framework. I will present a comment organized in 6 points based on what I consider the more interesting issues discussed by Dr. Gonzalez-Vega.

1. In the first place, the idea of working with the concept of financial services instead of centering the analyses on credit and savings, makes more attractive and more complex the analyses. One important and powerful message of this conference and of Dr. Gonzalez-Vega's paper is that rural people could benefit from a more developed financial system in several ways, not only through credit. The more rural people benefits from the existence of different financial products, the better products and greater probably that more credit will be delivered to rural households.

The broader perspective of financial system and financial services helps to abandon the analyses centered primarily on the supply side (mainly of credit) to a more complex one based on the entire market. Market analyses include studies on the supply, demand, and on the environment in which markets operate. Traditionally, studies and government intervention have centered on the supply side seeking to control, expand and direct the resources in the market. However, in the last years, studies done all over the world have showed that supply approaches are not enough. Supply studies now deal with efficiency and sustainability of suppliers; demand studies work on issues of outreach and access to financial services through the market; and several studies have shown how complex and significant are the conditions in which markets operate. Research on transaction costs, information flows, among other topics have made substantial contributions to understand market failures and its impact on financial markets, specially in rural areas.

The whole new approach has provide important signals of what is possible and what not in a very realistic way. Fair diagnostics of the problems and limitations faced by rural financial markets have been produced. Dr. Gonzalez-Vega recognizes the importance and development of better diagnosis as a reason to be optimistic about the promotion of rural finance. Agreeing with the idea that knowing better will lead as to make better decisions, the main challenge is how to really use this better diagnosis. Most of them are not taken into account by policy makers in the developing world, and usually are seen as extremely complex to be disseminated.

2. Secondly, the inclusion of the political dimension to understand the differences between what technicians recommend and what governments do, becomes crucial to understand the complex and sometimes non-rational policies adopted in some developing countries. A good example of this type of differences is the recent creation of Agrobanco, the new version of the agricultural development bank, in Perú. Agrobanco was created based on an electoral promise with little or none technical evaluation (an worst than that with little support of the officials responsible of its implementation). This case, as many others, show how powerful electoral processes and political pressure are in defining and redefining governmental interventions in the rural financial sector. The question that stills pending is how we are suppose to deal with political intervention? Politicians will not stop doing promises and will expect, in most cases, to have results in the very short term. Pressure to make promises and to seek for short term results is augmented by the crisis of political parties. A significant portion of governments in the developing world come from independent movements, who know their movement will probably disappear when the government period has end, eliminating most long term objectives from their actions.
3. In the third place, an interesting element, present in most recent rural development literature, is the consideration of the rural ambit as the space to develop financial services, in contrast with the traditional agrarian bias of most of the past work on financial issues dealing with rural matters. Rural instead of agrarian opens the scope for economic diversification and in that way for a better environment for financial services to develop, but also opens questions about the agrarian bias (or not) of the services offered in the market. Some country experiences show that rural financial institutions, mostly microfinance institutions, are less and less willing to offer products to serve agricultural activities. If this is a general trend, the broader scope of rural markets is a way of developing the non agricultural rural financial sector, leaving us where we started, with a lack of credit for agricultural activities. Agricultural activities still account at least for half of the incomes

of rural people, so cannot be set aside so easily. The old question of how to serve the agricultural demand for credit with competitive products and with sustainable institutions remains unanswered.

4. In the fourth place, the paper reviews several sources of hope for the development of financial system in developing countries: a) The structural adjustments and the financial reforms that, although their mixed results and different pace of implementation, provide a better macroeconomic environment and relatively more stable economic settings. and b) the lessons learned from past failures and from the microfinance recent developments, specially in urban areas, constitute an important set of new knowledge of what works and what does not.

But the paper also recognizes some limitations. Dr. Gonzalez-Vega recalls the existence of a rural lag and a set of binding initial conditions that make the route for financial deepening not so straight forward. Again, agreeing with most of the reasons for hope (conditioned to the degree of political interference in each country) and with the existence of the rural lag and unfavorable initial conditions, the main question is how to use the new knowledge on good practices and on limitations faced to promote financial deepening in rural areas. Further than that, and recalling my second point, how could we avoid that political intervention in financial market or in related markets worsen the gap or the initial conditions to develop rural financial markets?.

One would expect, that based on the better diagnosis governments and practitioners could define a common agenda to direct public investment in order to reduce transaction costs due to geography or cultural issues, or to avoid unfair competition from public sector organizations, for example. However, little or none of this has occurred. I would think that one needs to consider the hopes and weaknesses mentioned by Dr. Gonzalez-Vega as real and relevant, but also needs to recall that they are immerse in a general context where politicians rule their decisions based on electoral results, governance objectives and rent-seeking interests, and where institutions are weak and not independent from political pressure.

5. The fifth point has to do with how to organize what could/should be done Dr. Gonzalez-Vega proposes a suggesting approach in which to accelerate the rural finance deepening three gaps need to be closed. The inefficiency gap, distance between the supply and potential supply of financial services, could be closed with incentives to allow efficiency increases in the supply side. The insufficiency gap, that separates the potential supply from the legitimate demand, could be closed with technology innovation and institutional development. And, the feasibility gap, that separates the legitimate demand from unrealistic political promises. Gap that could be closed if politicians and public opinion assume and understand the new views and understandings of how financial markets could really develop.

The challenge of closing the first two gaps seems to capture most of the work that is being done by a significant group of practitioners and researchers in many places. Developing and adapting financial technology, improving information sharing systems, strengthening financial organizations, improving risk management systems, etc. However, there stills a significant space for public sector counterparts actions. Reducing transaction costs with better infrastructure through public investments, improving research and development of technologies, strengthening regulation systems, passing better legislation, etc. All tasks oriented to close the gaps need to be done in a coordinated way. Public and private agents should have some sort of agreement and means of communication. But, how is this achieved? who is responsible of promoting communication and coordination? who should design the sequence of things needed to be done?.

On the contrary, the third gap has received little or non attention from the private agents, and less from the public sector. Probably no actions have been designed, nor implemented in order to close this third gap. The question is to what extent something can be done? and, who should do it?

What will be the impact of making efforts to close only the first two gaps?

(THIS FOLLOWING COMMENT IS CURIOSITY I HAVE, MAYBE SHOULD BE DROPPED, AT LEAST FOR THE PRESENTATION.)

A minor comment, actually mostly questions, on the gap analyses based on the proposed framework of Production Possibilities Frontier. Why we have a concave PPF? It means that one institution decides between how much financial services will be provided for rural and urban areas based on a fixed endowment and technology. I would explore the possibility of a PPF composed by linear segments. A rectangle in the extreme. Because resources managed by financial institutions are not that fixed and technologies either, so scarcity of production inputs maybe is not necessarily binding. Institutions could be working in these two markets with relatively independent functions, based on different endowments and technologies to serve each sector. Moreover, several institutions are specialized in one of the two sectors and have marginal or none participation in the other.

The other questions has to do with where is the optimal point. Obviously, it is on the PPF, but given that urban profitability weighted by risk would be extremely high in comparison with the one in the rural sector, one would expect corner solutions in which institutions will only serve urban clients. How to define the optimal point on the PPF? What is the utility function for society? Again, if utility reflects well being of urban and rural people probably the function will be as the Leontief one, again suggesting corner solutions.

Being very interesting as framework I would like more discussion on the logic of each gap and its incidence in the global financial market gap. This analytical framework could become an interesting tool for further analyses and policy design.

6. Finally, Dr. Gonzalez-Vega's approach organizes nicely his proposals and delivers some sort of a "plan" that is one of the most difficult things to find. The "plan" of closing the three gaps suggests the idea of different instruments needed to close each gap, and different actors involved. However, what I found to be the main contribution is the general statement which asks for the adoption of new policies, but to adopt them in a different way, based more in what we know and less in what we would like things to be. The need to define a complete strategy to promote financial deepening arises as the central conclusion.

Dr. Gonzalez-Vega ends the paper with a long section full of ideas and suggestions of what needs to be addressed in order to deepening financial services in rural areas. The list is impressive, going from what needs to be considered to promote demand expansions, how to deal with risk, what needs to be taken into account to promote supply expansions, and how to build a process of continued innovations. All points are well supported by studies and/or theoretical relationships and show how one of the mentioned gaps could be closed. However, what is presented in the paper is the idea and maybe the outline of the "plan". Details need to be included to make it a real plan, or a useful tool to help practitioners and policy makers to organize their policy suggestions, opinions and actions. The how and who is absent in the present outline. Knowing that the who is a very local decision, the how things should be addressed could make the approach become a useful tool. Complementary, one would need to know the cost (economically and politically) of closing each gap.

The main questions I would like to ask Dr. Gonzalez Vega is how this strategy has to be designed and implemented (where to begin?), who should take responsibility of what, and who should pay for this with what resources?. Donors and governments should ask themselves these questions in order to maximize the benefits of their interventions and support. In order to make any strategy feasible, I would like to place the question of how good practice, informed opinions, strategies, and research and evaluation results should be disseminated, not only like here among convinced people, but to general public, to voters, to practitioners, and politicians in order to make this new approach viable in political terms and in that way dealing with the feasibility gap.