



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

Discussant Reaction Paper

Comments on paper

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

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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.

Since I have no disagreement with the concepts and arguments put forward by Claudio Gonzalez-Vega in his very comprehensive paper, I propose to add value to the discussion by supplementing and supporting the arguments in three related areas covered by the paper: the macroeconomic policy impacts on rural finance deepening; the role of the state; and innovative ways of deepening rural financial markets.

Macroeconomic Policies

Macroeconomic policies have an important bearing on rural financial markets. It is widely recognised that macroeconomic stabilization, liberalization, financial deregulation and competitiveness among financial institutions are important for the deepening of rural finance. The most important macroeconomic policy is the management of public finance. When governments incur large budget deficits, especially owing to “unproductive expenditures” such as defense, these lead to high inflationary pressures, monetary policies that “crowd out” finance for investment, infrastructure expansion and rural development. This reduces the supply of finances for rural development, while the demand for credit is curtailed owing to the increased costs of finance.

The more significant impact is however the curtailment of government expenditure on capacity building in agricultural research, extension and infrastructure development. Governments faced with stringent fiscal constraints curtail developmental expenditure in the rural sector. These affect the profitability of agricultural and rural enterprise, the credit worthiness of borrowers and their repayment capacity. Deepening of rural financial markets become ever more difficult in such a context.

These macro economic policies transform into disincentives for farm and off-farm enterprise. Farmers have to face a “cost-price squeeze” as inflation increases costs and inadequate institutional support measures constrain productivity. In addition, liberalized trade policies reduce farm gate prices owing to cheaper imports.

The author has argued that: “Policy reforms that improve the performance of the agricultural sector can go a long way towards facilitating rural financial market deepening....The acceleration of rural financial deepening cannot occur without additional intervention to improve the productivity of resources in agriculture.” Financial deepening in rural areas cannot be achieved if development priorities do not focus on rural infrastructure development and capacity building in rural institutions. This requires more resources into research, an effective linkage in research and extension and more effective marketing channels for agricultural produce. Additional resources for these cannot be provided if governments are not prudent in their macroeconomic management. Deprivation of resources for agriculture has occurred both in Latin America and South Asia and has been an underlying factor for underdeveloped rural financial markets.

Another significant, though indirect, impact of fiscal imprudence is its crippling effects on economic growth and diversification. Reduced capital expenditure stifles economic diversification that reduces opportunities for

investment and enterprise in the rural economy. Consequently, this constricts the capacity for deepening financial markets, as diversified economic opportunities are a healthy foundation for deepening of financial markets. Closely related to these macroeconomic constraints is the role of the state that is discussed next.

Role of the State

One of the most important contributions of the paper is a redefinition of the role of the state in deepening financial markets. Past experience has demonstrated that direct intervention in providing credit for agriculture has proved “deplorable”. These policies have not succeeded in developing sustainable financial services for the poor; their outreach being very limited (10-15%). Antithetically, to deny a role for the state is to place rural communities in betwixt government failure and market failure.

As pointed out earlier, the role of the state begins with responsible macro economic management that ensures a climate conducive for agricultural and rural development. The “ establishment of a physical and institutional infrastructure that facilitates the smooth operation of financial markets is indispensable for rural financial deepening”. The role of the state is the provision of that infrastructure: the development of roads, transport, telecommunications, education and skill development, that are essential for the effective functioning of rural enterprise. Further, the state has a role in supporting agricultural development through adequate investment in research, extension and institution building. Investments in these are likely to bring greater long-term benefits to rural communities and thereby support the deepening of financial markets.

Ancillary to the state performing such a function is the developmental role that central banks could play in deepening rural financial markets in developing countries. First and foremost that role would be the pursuance of monetary policies conducive to the smooth functioning of financial markets and their deepening. An additional role for central banks is in institutional building to deepen rural financial markets. Central banks should not however replicate the same mistake as governments of directly intervening in the granting of credit, controlling on-lending rates and providing finance that undermines financial discipline. A central bank could perform a useful catalytic role in promoting rural financial institutions by providing valuable information, expert advice, and even providing personnel in the initial years of operation of rural financial institutions. The distinction between the role of the state and that of a central bank is that while the former would be supporting overall infrastructure, the latter could assist more directly in the development of financial infrastructure.

The issue of prudential regulations for microfinance organisations remains an unsettled controversial issue. The regulation of MFIs is necessary to ensure their transparency and financial accountability. These are requisites for their viability and outreach. This is again a role that central banks must play. But it has to be approached cautiously as regulating microfinance is very different to those of bank supervision and regulation.

Innovative Interventions

The paper has pointed out the complexity of the task of deepening rural financial markets. Therefore innovative methods are needed for financial

deepening. Microfinance is certainly one of these. MFIs attempt to combine the advantages of informal finance while minimizing the disadvantages of institutional finance.

Another means is the linkage of institutions that have large financial resources, but do not have a capacity to deliver these to small borrowers with grass roots community based semi-formal and informal organisations that have this capacity. Such linkages have been established successfully.

An important means of strengthening the capacity of grass roots organisations and institutions is by the use of social capital. By social capital is meant the energies of people to act for the good of the community without direct financial rewards. The use of such social capital would reduce costs of operating financial services and enhance the efficiency of such services, especially through the reduction of defaults. Community based financial services such as ROSCAS that continue to be significant is one such means of using social capital to upgrade services. Their savings could be used as a means of leverage for additional funds.

Financial deepening should not be viewed as being entirely within the institutional framework. Increased funds from institutions to informal lenders by increasing the supply of finance can improve the conditions of borrowing and reduce interest rates of informal lenders. Such institutional lending to informal lenders would be based on secure collateral.

Donor Assistance

Donor assistance for the development of rural financial markets must not be viewed narrowly in terms of only providing finance for rural lending. It must develop rural financial markets through support for institutional and capacity building in rural financial institutions. Support for rural infrastructure development should be an important component of such assistance. Meeting capital costs of rural financial institutions, providing skills training, research into innovative forms of rural banking and improving agricultural infrastructure are ways by which donors could assist in the deepening of rural financial markets. What donors must not do is to provide means for lending at cheap rates that would undermine the evolution of sustainable financial organizations.

Conclusion

The deepening of rural financial markets require a broader thrust than usually presumed. Proper macroeconomic management, development of physical, institutional, economic and social infrastructure in rural areas, could provide the proper environment in which rural financial organisations could be viable and sustainable. The role of the state and those of donors is to assist in the provision of such an environment.

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