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Discussant Reaction Paper

Comments on

The Evolution of Institutional Issues in Rural Finance Outreach, Risk Management, and Sustainability by J. D. Von Pischke

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As usual, J. D. has written a lucid and provocative paper that highlights crucial aspects of the post 1960s record of rural finance (mostly agricultural credit) projects in developing countries and presents thoughtful suggestions about donor involvement in the New Rural Finance so that the success rate of future projects will be much higher than experienced in the dismal past. The landscape is littered with failed agricultural credit projects and many of us have made a living analyzing this sad chapter in donor history. Unfortunately, in much of our work, as well as in this conference, we have learned far too little about the two remarkably successful cases in the developing world: the unit desas of BRI in Indonesia and the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand. In my view, we spend too much time focusing on tantalizing tales of tiny new projects and innovations, and far too little time learning from these huge proven success stories with billion dollar portfolios. I will concentrate my remarks on the opportunities and threats, most of which J.D. mentioned in his paper, to sustainable rural finance.

I. Improved opportunities for expanding sustainable rural finance. J.D. is correct in arguing that in many ways the prospects for developing and expanding rural financial services are better today than they were during the heyday of small farmer directed agricultural credit projects two decades ago. There are many reasons, and he lists most of them, including the important emergence of microfinance. They include:

- Some of the urban-biased economic policies that used to heavily penalize developing country agriculture have been reformed.
- Repressive financial policies, especially concerning interest rates, have been liberalized in many countries.
- Successful microfinance operations have demonstrated the importance of doing more than simply pushing credit disbursements. Success requires investing in institution building, paying attention to client demand, carefully designing financial products and services, controlling costs, developing strong management and information systems, paying staff incentives, using professional management, and implementing strong governance.
- Credit continues to dominate; however, there is a better understanding today that there is a demand by rural people for savings and other well-designed financial services.
- Improved understanding of firm-households as joint producing and consuming units has prompted a shift away from preoccupation over the targeted use of loan funds towards greater emphasis on reaching target groups of clients with sustainable services.
- Aid managers are implementing procedures that delegate more daily decision making to microfinance contractors and service providers while requiring stronger institutional monitoring and performance reporting with a more balanced weighting of sustainability and outreach objectives.
- Greater transparency in operations and more systematic accounting for costs, revenues, loan recovery, efficiency and productivity measures facilitate the comparative analysis of performance and the establishment of best practices.
- The emergence of specialized microfinance rating agencies provides financial institutions with the opportunity to market themselves more professionally to commercial sources of funding.

- Competitive pressures are prompting some banking institutions to reconsider business opportunities in the agricultural and rural economy.
- Greater competitiveness and sophistication exists in some segments of the rural economy.

II. Key threats to developing sustainable rural finance. Several problems continue, however, that make sustainable rural financial services as elusive as ever in most developing countries. Some problems can be ameliorated by the creative design of financial institutions and products, as occurred with microfinance, but others require broader and longer-term interventions with multifaceted investments. Including some identified by J.D., the key threats are:

- There is a widespread failure of governments, donors, and potential financial service providers to understand the implications of the basic fact stated by J.D.: "agricultural progress has only two certain outcomes: cheaper food and fewer farmers." Farmer survival in developed nations has usually meant getting bigger (and more modern) or getting out (seeking nonfarm work).
- Food prices are a critical concern for governments so agriculture is a political sector. Problems such as crop failures, excessive farmer indebtedness, and low producer prices are more likely to induce government and donor interventions (e.g. loan forgiveness) that are "damaging" for market-oriented financial institutions than is the case with most segments of the microfinance market.
- Farmers face cost-price pressures because long-term trends in real international prices have been downward for major farm commodities with few prospects for recovery in the near future.
- Greater access by developing country farmers to international markets is coupled with greater vulnerability to market fluctuations and subsidized imports. This produces arguments in favor of rolling back liberalization polices.
- Fewer opportunities exist today for the widespread adoption of highly profitable technological alternatives and enterprises in most developing countries compared to the early days of the Green Revolution.
- Higher interest rates may be needed in rural than in urban areas to cover costs and risks. But policy makers are tempted to reject market determined rates and rationalize interest subsidies and controls because of large amounts of rural poverty, the rates of return on many farm investments are perceived to be low and highly variable, and the length of rural loans often need to be longer to fit rural production and cash flow patterns. (The recent emergence of populist and religious views about finance and interest rates represent additional complications in some countries.)
- The heterogeneity of farming and the rural economy has increased as new opportunities emerged and as farm-households adopted complex survival strategies. This situation increases the complexity that financial institutions face in evaluating the credit worthiness of diverse potential clients and in mass-producing standardized financial products as occurred in the early days of microfinance.
- The demise of directed agricultural credit programs has diverted attention away from the long-term arduous work of identifying and removing constraints in the legal and regulatory environment that supports rural financial intermediation. Institutional innovations in microfinance, such as making small loans with frequent repayment and

using collateral substitutes, avoided many of these constraints. Serving clients in high-density environments helped avoid the transportation, communication and other bottlenecks in rural settings. Awareness of these problems will heighten as attention is refocused on the conditions necessary for sustainable rural financial services.

- Either because the lessons have not been learned or because short-term imperatives are overwhelming, donors rarely design long-term strategies for developing coherent sustainable rural financial systems. Effective donor coordination is more a buzzword than an operational norm, and too many projects still focus on disbursement rather than sustainability. (Witness the many add-on microfinance components in large multi-purpose projects and credit disbursement targets in major donor projects.)

III. The role of donors in building sustainable rural finance. The comments of J.D. and Rich don't provide much reason for optimism about donors becoming effectively reengaged in rural and agricultural finance. Although changes have provided better opportunities for building sustainable rural financial systems today, many old problems remain and new ones have emerged. On balance, I think the challenges are at least as formidable now as they were two decades ago. The limited capacity of donors and governments to address the challenges comprehensively in the midst of other pressing short-term development problems does not bode well for future success. The lack of broader access to sustainable formal financial services in rural areas is not going to be resolved by simply funding a handful of projects to make a few more NGO rural loans, or to create a few credit unions, or to rehabilitate a bank, as important as these activities may be in specific situations. The careful design of financial institutions and products is necessary, but not sufficient. Addressing the rural finance challenge comprehensively requires an effort at least as substantial as occurred with microfinance. But if the CGAP donor peer reviews are correct in identifying a declining interest in microfinance in spite of its massive public relations machinery, it is hard to imagine that a serious rural finance initiative, such as J.D. outlined, will ever be given thoughtful analysis until there is another world food shortage. Of course, when that happens, pressures for quick disbursements and short-term solutions will dominate the donor agenda.

The donors pursued a successful long-term strategy in the 1960s and 1970s to create agricultural colleges and research stations in developing countries. Was that a one-time event in effective donor institution building in agriculture that will not be repeated again in the near future?