AGRICULTURAL CREDIT REFORM IN BANGLADESH:
LESSONS LEARNED FROM A PILOT PROJECT*

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ABSTRACT

Subsidized interest rate policy has been identified as the major pitfall of the past credit programmes. Findings of a pilot project has been reported to illustrate the viability of charging higher commercial, even if not real, rates of interest and mobilizing private savings in rural financial markets.

INTRODUCTION

Providing access to credit has long been a key component of assistance programmes seeking to modernize agriculture in developing nations. Donors have invested an estimated $5 billion in rural financial market (RFM) projects over the last several decades (Adams and Graham 1981). Developing countries too have committed substantial resources to expanding agricultural credit. Traditionally, these programmes have featured subsidized credit with concessionary interest rates as their basic tenet for encouraging agricultural modernization and confronting the causes of rural poverty. Cheap credit policies have often yielded negative real rates of interest, undermined the potentials for mobilizing rural savings, and misallocated credit resources (Adams and Graham 1981).

This note reports the results of a pilot rural finance project in Bangladesh that was designed to test the acceptability among farmers of loans with nonsubsidized interest.

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THE CASE OF BANGLADESH

Bangladesh has been subjected to most of the low-cost credit approaches in vogue during the last several decades. Between 1976 and 1982, total disbursements for agricultural credit amounted to an estimated $600 million (Anholt and Wennegren 1983). Most of these funds and the related credit programs have come from donors, led principally by the World Bank, the Asian Development Bank, and the Agency for International Development (AID).

The urgent need to increase agricultural output has motivated this considerable effort. Bangladesh is one of the world's most densely populated countries, with a population of about 92 million, 86 percent of whom reside in rural areas. An annual population growth of about 2.5 percent keeps an incessant pressure on the limited land base and intensifies the demand for greater food production. Farmers are constrained by multiple cropping and are currently cultivating at an average land productivity of about 15 percent. Low average per capita incomes and diminishing financial and poverty exacerbate an already difficult situation. In addition, Bangladesh is highly dependent on external sources to provide public investment funds. In 1982, donor assistance approximated 68 percent of the amount allocated by the Government of Bangladesh (BDG) to development programs (Wennegren, Anholt and Whicker 1984).

The formal agricultural credit system is under the overall guidance of the Bangladesh Bank (BB). Agricultural credit is provided by the Bangladesh Krishi Bank (BKB), six nationalized commercial banks (NCBs), and the Bangladesh Samabaya Bank Limited (BSBL), which serves as an apex federation of sixty-three subdivision-based Central Cooperative Banks (CCBs). Additionally, 400 Thana Central Cooperative Associations (TCAs), which lend through village-based cooperatives are financed by the Sonali Bank, an NCB. In 1982, 4,470 bank branches of all classifications were in operation. New agricultural loans during that year totaled Tk. 4.0 billion (U.S. $180 million) (World Bank 1983). The volume of agricultural loans is a fairly minor part of the total formal credit. Furthermore, the amount of agricultural credit reportedly loaned in 1982 represented only 4 percent of the Gross Domestic Product for agriculture. By comparison, subsidized agricultural loans in Honduras was as high as 27 percent of the nation's agricultural product during 1951-79 (USAID 1983).

Most credit programs in Bangladesh have featured subsidized interest rates as one policy response to stimulate agricultural output. Excess demand has developed for
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credit at these low interest rates. Much of the excess demand has come from nonagricultural borrowers who have been able to access the agricultural credit and divert it to nonagricultural investment. Donors have responded with loan restrictions to target the money to agricultural groups within the sector which have simultaneously increased both the administrative complexity of the process and the misallocation of credit resources. Higher loan transaction costs for both lenders and borrowers have limited the availability of credit from agricultural banks, and farmers have continued to turn to informal sources, such as local moneylenders who charge significantly higher rates of interest, rather than accept the long delays and administrative obstructions inherent in formal lending institutions (Church and Adams 1979). Estimates vary, but one survey found that 45 percent of the total amount borrowed by farmers in Bangladesh came from noninstitutional sources and among the smallest farmers who have less than 1.5 acres, as high as 85 percent was borrowed from informal lenders. Annual interest rates from informal sources reported in the survey typically averaged over 100 percent (Ministry of Land Administration 1981).

Perhaps, most importantly, the subsidized credit policies of the BDG have played a major role in rendering the formal agricultural credit system incapable of economic viability. Low loan recovery rates and high administrative costs, in combination with the low interest rates on loans, have contributed to rather widespread insolvency. Continuous infusions of funds from the BDG and donors have been needed to insure continuation of the formal credit system. Management and personnel incentive deficiencies have added to the problem by limiting the recovery rates on outstanding loans.

The subsidized credit policy appears to have blunted the mobilizing of domestic resources through savings. The commonly accepted thinking has been that extensive savings cannot be voluntarily generated in rural areas. The underlying assumption is that rural people have no margin to save and will not respond significantly to the earnings potential associated with interest-bearing savings. By maintaining this orientation and policy stance toward rural financial institutions, the BDG has not taken advantage of the forces that drive financial markets. Because subsidy has replaced profitability as a focus, banks have not been motivated to effectively manage their loan portfolios to meet savings, interest obligations and administrative costs. Thus, they obviate the process that would permit private investment to replace public resources as a support for a portion of the nation's development efforts.

THE EXPERIMENTAL PROJECT

In 1977, USAID and the BDG agreed to initiate a pilot Rural Financial Experimental Project (RFEP). The project was for three years at a total cost of about $7.0 million. The purpose of the RFEP was to identify one or more rural financial systems that could satisfy the needs of rural producers not then being met by institutional credit sources.
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 обслуживали 8 различных кредитных систем и банковские учреждения, участвовавшие в проекте по стране. В целом, восьмь банков, расположенных по всей стране, участвовали в проекте. В проекте принимали участие два типа банков: кооперативные и коммерческие. Кооперативные банки, в свою очередь, были разделены на две группы: сельскохозяйственные и городские. Коммерческие банки были разделены на две группы: сельскохозяйственные и коммерческие.

В рамках проекта использовались следующие кредитные системы: кооперативные, коммерческие и микрокредитные. Кооперативные банки использовались для сельскохозяйственных проектов, а коммерческие банки - для городских. Микрокредитные системы использовались для финансирования малых проектов.

Кредитная система рассматривалась как основной инструмент для управления кредитами. Она обеспечивала прозрачность процесса кредитования и позволяла кредитам быть более эффективными.

PROJECT RESULTS

Результаты проекта были опубликованы в марте 1982 года. Результаты проекта были важны для страны, так как они подтвердили эффективность кредитных систем.

CREDIT USAGE

В рамках проекта кредиты были получены большинством сельскохозяйственных хозяйств (42.219 семей, включая 51% сельскохозяйственных хозяйств). Было получено 1.648 кредитов, равных 119.0 миллионам. Средний размер кредитов составил 103.813. Позже при получении кредита были получены сельскохозяйственные кредиты (RRP), включающие в себя кредиты, состоящие из одного кредита. Среди кредитов были 81% сельскохозяйственных кредитов, 85% сельскохозяйственных кредитов, 86% сельскохозяйственных кредитов. Среди кредитов было 4% кредитов, соответствующих 46% сельскохозяйственных кредитов. Было получено 22% сельскохозяйственных кредитов. Средний размер кредитов составил 12%.

Во всех банках средний размер кредитов составил 37% (World Bank 1981).
There are some dangers in “before” and “after” comparisons of this type, since variations that might contribute to changes were not controlled. Some changes may have occurred during the four years of the project even without its stimulus. Still, the changes are sufficiently impressive to give confidence that the project outcomes exceeded the normal level of change. For example, the low default level on loans accorded the project was likely influenced a great deal by the requirement that entitlement additional loans was predicated on repayment of prior loans. The ratio of number-loans-to-borrowers was 1.7, which suggests that about 30,000 borrowers took more than one loan. Since an estimated 85 percent of the loans went to the targeted group, this means that those with less than Tk. 6,000 annual cash income or two acres of land borrowed and repaid most of their loan obligations, even at the higher rates of interest.

Of the borrowers, 4 percent were women. About 50 percent of the women were repeat borrowers.

Active borrowing and lending occurred for all levels of interest charged during the project (Table 2). The percentage of loan funds utilized by agriculturalists decreased slightly as interest rates increased. Still, more funds went to agricultural than to nonagricultural uses up to the 50 percent interest level. At 56 percent interest, nonagricultural loans prevailed. Within agriculture, the majority of funds were used for noncrop items.

### Table 2. Percentage of Borrowing by Stated Loan Purpose at Various Rates of Interest, 1978-81, Bangladesh

<table>
<thead>
<tr>
<th>Rate of Interest</th>
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<th>Total Non-agriculture</th>
<th>Total Loans</th>
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<td></td>
<td>Coops</td>
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<td>21</td>
<td>37</td>
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<tr>
<td>Average</td>
<td>23</td>
<td>38</td>
<td>61</td>
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</tbody>
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at all levels of interest. The most common uses cited on loan applications were for animal draft power, beef fattening, rice husking, transplant maize rice, HYV boro rice, milk cows, small grocery trading, broadcast aus rice, rickshaws, and goat/sheep rearing. Among women borrowers, about 90 percent of the loans were for agricultural postharvest purposes, mostly for purchasing paddy rice for husking and, in some cases, for subsequent processing into pulsed rice. A high degree of fungibility was likely as loan funds were often added to the families' resources and managed to meet a variety of needs, which might not always have been those indicated on the loan applications.

Group Lending

Lending to groups was tested for its potential as a means to reduce lender loan transaction costs and increase loan officer and overall administrative productivity. The results were not as expected. Group lending was less effective than individual loans in reaching the target group and did not lead to higher loan officer productivity. Furthermore, loan administration for groups had costs that averaged 16 percent per borrower higher than for individuals, and required considerably more time in arranging credit for borrowers. The group approach produced a poorer repayment performance, and it did not lead to higher savings rates. The principal drawback with group lending revolved around the difficulty of developing cohesive, homogeneous loan groups. The fact that individualism and not group organization most commonly prevail as a way of life in Bangladesh may explain much of this aversion to group action in borrowing. Other important deterrents, however, included inadequately trained bank staffs to deal with the special needs of group lending, and the generally negative attitude of the bank staff toward this approach.

Bank Profitability

The administrative costs of participating banks in the RPEP varied from Tk. 43 to Tk. 469 per loan (Table 1). When these costs were combined with those of capital and reserves for bad debts, the interest rates necessary to meet all operational costs ranged between 14 and 41 percent among banks. Five of the banks, however, met their total expenses with 24 percent interest, and only one of the banks was unable to recover all of its operational costs at 36 percent. The profitable banks were identified with high loan volumes and low overheads which, traditionally, are signs of good bank management.

Savings Mobilization

Despite the failure of the RPEP to emphasize savings mobilization, rural residents did respond to the higher interest offered at the banks (Table 1). In total, Tk. 10.0 million were placed in savings during the project which averaged 15 percent of outstanding loans. Across banks, the ratio of savings to loans ranged from 3 percent to 35 percent.
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The Agasti Bank had 35 percent of its outstanding loans in deposits, while Rupali Bank had 29 percent and Janata Bank 22 percent. In one instance, 70 percent of the outstanding loans of three older branches of the Rupali Bank were financed by savings and without any type of savings promotion activities. The only savings promotion exerted by any bank during the project was by the Krishi Bank about midway through the project, and it produced impressive results. Krishi ended the project with savings more than double those of any other bank, even though its ratio of savings to loans was reduced due to a large increase in loan volume.

A majority of the savings came from non-target groups in the project area. But it is significant that 42 percent of the total savings were mobilized from the target families. The average size of deposits by non-target savers was Tk. 1,058, while the target group averaged only Tk. 125. Overall, it was estimated that 42 percent of the target group households made savings deposits during the project, while 44 percent of the non-target households within the project area did likewise. Before the RFEP, only 11 percent of target group households and 32 percent of the non-targeted households had bank savings. Since savings options at lower rates of interest were available prior to the RFEP and since there were no significant improvements in per capita income during the project, it seems most likely that the higher savings were mostly a response to the more favorable savings options. The genuine motivation by the non-target group points to the higher potential for mobilizing savings when slightly more than 50 percent of the group, who did not save during the previous year, had no eligible prospects for future credit mobilization efforts.

It is noteworthy that among the target group, savers were not particularly sensitive to the small differences in savings interest rates paid on their small deposits. More savings were mobilized at 11 percent than at the higher rates. However, among non-target savers, the size of deposits was, on average, four times larger at 14 to 15 percent interest than at 11 to 12 percent. It should be noted too that with a general inflation trend of around 16 percent, none of the savings rates were positive real rates of interest.

Transaction Costs

One other interesting result from the RFEP was the implicit demonstration that transaction costs for borrowers could be reduced by easing the administrative process. It has been argued elsewhere that transaction costs to individuals interest with interest levels on loans in determining both borrower preferences and credit market shares between formal and informal lenders (Ladman 1981). Unfortunately, the RFEP provided no post-project baseline from which to assess changes in transaction costs. However, as suggested earlier, there has been widespread criticism of BDG credit institutions for the immense delays associated with loan processing. By comparison with such qualitative characteristics, the record of the RFEP was impressive. Loans were obtained
by 68 percent of the individual applicants in one week or less, and 84 percent received loans within two weeks. As high as 74 percent received their loans by making no more than two trips to the bank. Those seeking group loans, however, experienced much greater delays. Only about 30 percent of group loans were completed in less than two weeks. Reduction in the transaction costs was attributable in significant part to the decentralization of loan approval authority to branch officials and to simplifying the application form and making it available free of charge.

**IMPLICATIONS AND CONCLUSIONS**

While some problems existed in the design and implementation of the RPEP, our conclusion is that its results provide additional evidence to the growing developmental literature worldwide that is calling into question the past subsidized agricultural credit policies in LDCs. Bangladesh is among the poorest nations of the world, yet the pilot test has illustrated the viability of charging higher commercial (even if not real) rates of interest and mobilizing private savings in rural financial markets. Credit was demanded and generally repaid at relatively higher interest rates than has normally been found in agricultural credit programmes, implying that access to credit at these rates was advantageous when compared with the options offered by informal credit sources. Savings were generated at all levels of interest offered, and administrative reforms cut transaction costs to borrowers. Furthermore, many of the individual bank branches became financially viable when given the chance to operate within reasonable commercial options. These results occurred despite substantial built-in disincentives for bank managers to encourage individual savings and virtually no promotion efforts to bring the merits of the savings option to the attention of rural residents. We strongly believe that the RPEP has exposed only a portion of the private resource potential that could be mobilized in rural areas by more enlightened public awareness and interest rate policies in Bangladesh. Also, the potential impact of a viable credit system that is free of BDG subsidy, that prices credit more nearly at its scarcity value in production, and that makes credit available to producers at interest rates below those of informal markets is seen as highly complementary to the overall strategy to modernize agriculture.

Notes

1. The following description of the project and the reporting of project results are taken, exclusively from the Terminal Evaluation Report (Public Administration Service 1982). Specific footnote references for individual findings are not provided.

2. Figures are quoted throughout the study in Taka. The exchange rate from 1978-1981 averaged about Tk. 16.0 per U.S. $ 1, although the rate was rising slightly throughout the period.
REFERENCES


Lynch, Phillip B., and Gary D. Adams (1979) : "Experimental Approaches to Rural Credit", in Problems and Issues of Agricultural Credit and Rural Finance. Dhaka : Bangladesh Bank, September.


