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RURAL FINANCIAL MARKETS: AN OVERVIEW

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The paper seeks to present an in depth overview of rural financial markets in developing countries. Attention is given to the role of financial markets in the development process, approaches to rural finance in developing countries, and formal and informal financial markets. The pro and cons of the various financial markets were also considered.

SAMEVATTING : LANDELIKE FINANSIËLE MARKTE : 'N OORSIG

In hierdie artikel word gepoog om 'n diepte-oorsig te gee van landelike finansiële markte in ontwikkelende lande. Aandag word gegee aan die rol van finansiële markte in die ontwikkelingsproses, benaderings tot landelike finansiering in ontwikkelende lande asook aan formele en informele finansiële markte. Die voor- en nadele van die verskillende finansiële markte is ook bespreek.

1. INTRODUCTION

Rural financial markets in developing countries should be seen as a system comprising of formal and informal sectors. In the formal sector, banks, credit cooperatives and public sector organisations provide intermediation between borrowers and depositors or borrowers and the government. The institutional providers of financial services are many and varied, including public and private; regulated and unregulated firms; those primarily providing short-term debt capital and those providing equity capital. In the informal sector, private individuals provide credit largely out of their own equity. The informal sector usually has three facets:

- (1) Commercial moneylending by farmers, traders, pawnbrokers, salaried employees or professional moneylenders;
- (2) arrangements between friends, relatives, and neighbours, often at zero interest rates and

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- (3) the activities of self-help organisations, such as rotating savings and credit associations (Hoff & Stiglitz, 1992).

The availability of affordable financial capital has long been recognised as an important factor in economic development, in addition to other factors, which Mosher (1971) referred to as "the element of a progressive rural structure". Rural financial markets have been at the centre of policy interventions in developing countries over the past four decades. Many governments, supported by multilateral and bilateral aid agencies, have devoted considerable resources to supply cheap credit to farmers in a myriad of institutional settings (Hoff & Stiglitz, 1990). This emphasis on credit need has not been free of problems. Many of these programmes have required large subsidies and loan recovery has often been disappointing. The rural poor have had difficulty in getting access to these cheap loans, and it is not clear that large increases in formal lending have accelerated development. Even more importantly, many of the financial intermediaries conducting these programmes are not self-sustaining (Adams & Meyer, 1989).

2. ROLE OF FINANCIAL MARKETS

Patrick (1966) maintains that in developing countries, an efficient system of financial intermediaries is a necessary and sufficient condition for the growth of various financial assets and liabilities and for economic development. According to Gonzalez-Vega (1989), financial markets contribute to economic development in the following ways:

First, the financial system contributes to economic development to the extent to which it provides access to a wide range of financial services for a wide range of the population. This contribution rests on the provision of a growing range of services, including loans for different purposes as well as deposit facilities, mechanisms for the transfer of funds, and currency exchanges, as well as other specialised services once the market size grows sufficiently.

Second, the financial system transfers growing volumes of purchasing power from depositors with limited deposit opportunities to borrowers with better productive options. The contribution of financial intermediation to economic development precisely consists of the transfer of resources from less productive uses to activities where they can be more profitably employed. In this way, deposits substitute for less attractive uses of the funds, while loans make better uses possible. The productivity of resources is thus improved.

Third, the financial system should offer high quality financial services. A farmer is not interested in obtaining sufficient purchasing power from a loan, he also

wants the funds to be timeously disbursed, the loan procedure to be easy and flexible, the amortisation schedule to correspond adequately to his cash flow, and the loan period to be sufficiently long. All these features determine quality of service.

Fourth, the financial system contributes to economic development when it offers low cost services. This does not necessarily mean low interest rates, but rather low transaction costs. A financial system that mobilises savings, allocates capital, manages risk, eases transactions, and monitors farmers and firms is essential for economic growth and development.

3. APPROACHES TO RURAL FINANCE IN AFRICA

There are two schools of thought on the promotion of financial markets, namely, the traditional or conventional project view and the market performance view (Graham, 1992).

3.1 The traditional/conventional project view

Assumptions underlying the traditional or conventional project view can be grouped into two main categories.

- (1) Saver-borrower behaviour - the common assumptions are that the rural poor cannot save and will therefore not respond to incentives or opportunities to save, that most farmers need cheap loans and supervision before they will adopt new technologies and make major farm investments, and that loans in kind are used in the form granted.
- (2) Lender behaviour - the common assumptions are that most informal lenders are exploitative and charge such rates of interest that result in large monopoly profits, that the rural poor do not receive formal loans because formal lenders are overly risk averse, that nationalised lenders can be forced to ignore their own profits and losses to service risky customers and the rural poor, and that all formal lenders can be induced to follow government regulations in allocating services (Adams & Graham, 1981).

Criteria used to allocate credit critically affect the performance of credit programmes. Such criteria include (inter alia) credit needs, credit demand and the easing of credit constraints. These criteria ignore the subtleties of risk and confidence and deny the possibility that there may be alternative ways to achieve development objectives. When these dimensions are considered, it is

clear that equating credit with need, demand or easing credit constraints easily overstates the role of credit (Von Pischke, 1991).

The traditional strategies commonly used by government and development assistance institutions to achieve their objectives at the frontier are flawed mainly in the following respects (Von Pischke, 1991):

- (1) Overemphasis of credit : Even though this could be adopted as developmental strategy, it has its limitations. Von Pischke (1991) mentioned three weaknesses : it does not produce good loans and is therefore ultimately unsustainable; it ignores savings mobilisation and therefore retards intermediation; it disregards alternative means of stimulating investments and therefore tends to be both inefficient and inequitable. The design of the traditional agricultural credit programmes was characterised by borrower domination. All practices and operational procedures were designed to promote the interest of the borrower in mind while the interest of the depositor or of the institution was itself largely disregarded. Borrower-dominated institutions have also been characterised by the absence of a clear concept of risk in their operation (Gonzalez-Vega, 1989).
- (2) Use of targets and credit quotas or ceilings : governments use lending targets and credit quotas to push lenders through the frontier at a faster pace than they would otherwise undertake (Von Pischke, 1991). Governments influence lender behaviour. The techniques used to target loans through regulations can be grouped into five categories - loan portfolio requirements, rediscount facilities, crop or loan insurance, regulation on bank branching and nationalisation of banks. (Adams & Vogel, 1984; Johnson, 1974; Fry, 1988). These instruments have a number of shortcomings. They do not generate good loans and they tend to weaken controlled lenders because the approach does not address the problems that make lenders reluctant to advance the frontier voluntarily, in that they are usually designed without reference to the cost of their implementation (Von Pischke, 1991).

Credit ceilings reduce efficiency in two ways. First, they limit all banks equally, even those that are more efficient at lending or those that have the most dynamic entrepreneurs as their clients. Hence credit ceilings impose an uneven rationing criterion because of the customer-market nature of bank credit. Second, credit ceilings reduce efficiency by destroying competition for deposits. Once the ceiling is reached, extra deposits represent idle cash reserves and so are not wanted. Banks stop making

efforts to attract deposits and to provide good services to existing depositors. Alternatively, they may reduce deposit rates of interest. The overall effect of credit ceilings is to increase the spread between gross cost of borrowing and net returns to lenders. Indeed, credit ceilings deliberately reduce financial intermediation (Fry, 1988).

The fungibility of funds has frustrated attempts to control the marginal use of resources, while rationing, needed in view of excess demand, and excessive supervision have both increased transaction costs for the banks as well as for the borrowers. These implicit costs have been especially high in the case of small loans. Rigid credit programming, while usually fruitless, has thus been expensive for all (Gonzalez-Vega, 1989).

- (3) Neglected transaction costs : government policies, presumably intended to benefit individual farmers and firms, paradoxically tend to increase loan applicants' and depositors' transaction costs. Lenders who face an onslaught of questionable applicants, attempt to control costs by the imposition of transaction costs in the form of opportunity cost of time. This is accomplished by demanding lots of documents to support an application; by restricting service, which requires applicants to queue; and by soliciting bribes. Some researchers mention that, of course, the ultimate weapon against a loan applicant is to lose the file containing the application and accompanying documents, which occurs occasionally when lenders find the going extremely rough. The transaction costs imposed on depositors are similar to those imposed on the borrowers by intermediaries who are not anxious to seek new clients at the frontier. The transaction costs tend to be high when the financial institutions do not depend upon deposits as important sources of funds. These approaches constitute a real cost to society. According to Von Pischke (1991) increases in transaction costs tend to make borrowers' and depositors' cost of funds roughly equal to the cost of alternative funds/savings that they could obtain/deposit elsewhere.
- (4) Overlooked incentives : most credit programmes tend to disregard incentives that motivate individuals and institutions. According to Von Pischke (1991) this results in failure to address the role of confidence in financial relationships. Confidence in finance is built only when both parties to a transaction or relationship have incentives to consider the interest of the other party or to behave as if they did.
- (5) Emphasis on institutions rather than instruments : governments and donors are often more interested in establishing specialised institutions

than in finance itself. They become involved with agricultural credit institutions, co-operative credit societies, small enterprise development funds, special credit programmes, among others, and they establish these at the expense of financial products or services which are the financial vehicles needed to ensure good transactions (Von Pischke, 1991).

The Traditional/conventional credit view further exhibits the following features:

- (1) In the design of specialised financial institutions the financial viability of these institutions is not regarded as a prime objective (Gonzalez-Vega, 1989). Such schemes evaluate their performance according to the number of loans and speed with which they are disbursed to a targeted clientele, the amount of inputs financed and allocated within the project, the rate of technology adoption, and the increase in employment and output. Given the fungibility of finance, Graham (1992), pointed out that it is naive to assume that a substantial share of targeted credit is not diverted for other uses. It is also naive to associate increase in output with the increase in credit rather than with other factors; increased output has multiple causes (Graham, 1992). Credit needs are given precedence over creditworthiness or the debt-carrying capacity of the borrower.
- (2) It is characterised by borrower domination. All practices and operational procedures are geared towards the interest of the borrower. The interest of the depositor or the institution itself receives little or no attention (Graham, 1992; Gonzalez-Vega, 1989). According to Gonzalez-Vega (1989) borrower dominated institutions have been characterised by the absence of a clear concept of risk in their operations. They have attempted to channel funds to target clientele, for specific purposes, rather than to evaluate the borrower's repayment capacity and the degree of risk taken in each case.
- (3) Traditional credit programmes have mistrusted the market and have minimised the role of interest rates as a major instrument of resource allocation (Gonzalez-Vega, 1989). Thinking in these programmes has been dominated by the notion that it is appropriate to extend agricultural loans at low interest rates in order to promote agricultural development and to assist the rural poor. (Donald, 1976 ; Adams & Graham, 1981). Rates of interest on agricultural loans may even in nominal terms be as low as zero and do not often exceed 12% per year in most low income countries (World Bank, 1975). Interest rates assigned to savings are simultaneously less than the concessionary rates charged on loans.

- (4) Rural finance projects in low income countries (LICs) have stressed low interest loans for agriculture and have neglected savings mobilisation, the other half of rural finance (Adams & Vogel, 1984; Gonzalez-Vega, 1989).
- (5) Most of these supply-led credit programmes and their specialised institutions have not been financially viable because of high overhead costs and low loan recovery. According to Graham (1992), their transaction costs have been greatly underestimated, and in many cases they have collapsed into expensive, one-shot, income-transfer schemes to the non-poor. Both borrowers and savers incur transaction costs, monetary as well as non-monetary, which can be several times the interest paid on loans (Adams & Vogel, 1984).

In summary, policies and programmes directed along the conventional wisdom held under the traditional view have resulted in high delinquency and default rates (Boakye-Dankwa, 1979; Sandertne, 1978), thereby reducing the lending capacities of many financial institutions. The criteria used in these programmes have not necessarily been compatible with the institutions' survival (Gonzalez-Vega, 1989). These developments have led to increasing criticisms among observers and researchers concerning the formal rural financial markets (Von Pischke, 1978; Lipton, 1976; Gonzalez-Vega, 1989).

3.2 The market performance view

The deficiencies in and the results of programmes conducted according to the traditional vision have led to a change of approach in the analysis and promotion of rural financial markets (Gonzalez-Vega, 1989). The alternative approach has been labelled "the market performance view" (Graham, 1992). This new approach operates on a different set of criteria.

In contrast to the traditional credit view, the market performance view regards good loan recovery, low transaction costs in lending and deposit mobilisation, increases in the number of people with ready access to financial services (both loans and deposits) and the proportion of total funding that comes from locally mobilised deposits as its main criteria of success (Graham, 1992). Its main characteristics are as follows:

- (1) The market performance view emphasises the mobilisation of domestic deposits and savings as a strategic ingredient in any recipe for building healthy financial institutions (Graham, 1992). It regards local deposit mobilisation as a powerful tool of ensuring viability of financial institutions. Local savings accumulation contributes to the creation of

resources for self-finance on the one hand and on-lending on the other hand. Moreover, savings schemes can serve more rural households than credit ever will (Adams & Vogel, 1985). Saving mobilisation involves the rural community in financial operations and simultaneously educates them in the sense that local savings provide the resources for lending activities (IFAD, 1988).

Smoothly and competitively functioning savings and lending institutions ultimately reduce the interest rate spread between savings and loans. The rate paid on deposits rises and the lending rate decreases. Thus, the propensity to substitute consumption and in-kind savings for financial deposits decreases (Schrieder & Heidhues, 1991).

- (2) The market performance approach views the identification of expected real rate of interest as well as unsubsidized interest rate as major determinants of borrower, saver, and lender behaviour. Real rates are thought to strongly influence the overall performance of the financial markets (Adams, 1978; Gonzalez-Vega, 1989; Vogel, 1979). Subsidised lending rates have no place in this school of thought.
- (3) Thirdly, the approach emphasises the reduction of transaction costs and the use of cost-and risk-reducing financial innovations as means to support a sustainable flow of untargeted financial services (Graham, 1992).
- (4) Other tenets of this view include the recognition of the importance of the informal financial markets (Adams & Graham, 1981; Begashaw, 1978). It argues against packaging loans and the use of other similar non-market rationing devices, since these diminish the most attractive and useful property of finance, namely fungibility (Von Pischke & Adams, 1980). Examples of such undesired devices are the allocation of loans in fixed quotas, loans in kind or efforts to specify the ultimate use of a loan.

In conclusion, this approach predicates a system in which numerous and diverse market participants are linked through flows of funds and of information. Thus, economic agents who borrow in one segment, lend in another and thereby reduce transaction costs, ensuring viability of the financial institution and protection of the depositor.

However, it must be pointed out that with all these virtues, there are also some limitations to this approach. In its strictest form, very few loans go beyond the most risk-free clients. According to Graham (1992), there is a need to arrive at

some reasonable compromise between the default-ridden, borrower-dominated development bank model, which has collapsed into bankruptcy in practically all countries of Sub-Saharan Africa on one hand and the extremely risk-averse, saver-dominated private bank model on the other. Some balance of risk and returns is required to arrive at a compromise.

4. INFORMAL FINANCIAL MARKETS

Indigenous, informal or unlegislated financial institutions abound throughout the developing countries. However, they do take different forms and perform different functions in different parts of the World. In Asia, indigenous financial institutions such as the curb market in Korea, the finance companies in India, and chit funds in Thailand tend to engage in a considerable volume of business and trade finance for even large-scale enterprise. In Africa, the predominant form of indigenous financial institutions is the rotating savings and credit associations, called ekub in Ethiopia, djanggi in Cameroon, tontine in Benin, chilemba in Malawi, Uganda, Zambia and Zimbabwe, susu/esusu from Zaire to Liberia (Fry 1988), and stokvels in South Africa (Lukhele, 1990).

For more than two decades, policy makers endeavoured to promote formal financial markets in their attempts to direct more credit into rural areas in pursuit of production and income goals. Informal financiers, especially moneylenders, have often been considered to be exploitative and a hindrance to modernising agriculture. Policies have often been employed with an explicit objective of increasing formal finance and diminishing the role of the informal financier (Meyer & Nagarajan, 1992). The poor performance of the formal finance sector in some areas - ironically, areas where formal finance temporarily displaced informal finance - caused the informal sector to re-emerge as the main source of financial services for most rural firms and households. Heidhues (1985) estimated informal finance to constitute over two-thirds of all agricultural credit in Africa.

Informal finance includes a heterogeneous set of individual and group financial arrangements. Most fall outside the scope of government support and regulation, although some countries have usury and other laws intended to cover them. Some types of informal institutions are autonomous, while others emerge as a reaction to the repression of formal finance (Chandavarkar, 1986). Some have strong links to formal finance such as the input supplier who borrows from formal institutions and sells inputs on credit, while others operate completely outside the formal system.

4.1 Traditional views

The informal financial sector has for decades been subjected to criticism. Critics including poets, prophets, playwrights and politicians, have claimed that its performance is bad or insufficient in virtually all respects (Holst, 1985). Others have pointed accusing fingers at informal lenders and have questioned the comfort of their after-life (Adams, 1992). According to Adams (1992) pejorative and emotive terms such as monopolist, usurer, shylock, loan shark and exploiter have been used for informal financial lenders.

Other terms used to describe informal finance in the past were unorganised, and non-institutional. Over time, however, the term informal have replaced these earlier terms. Tun Wai (1992) pointed out that research has increasingly shown that many forms of informal finance are well organised and that some of these forms are deeply entrenched social institutions.

Informal finance has, in the past, been regarded as rural related. Again, research have disproven this thought. It increasingly appears that informal financial arrangements can be found almost everywhere - including urban areas - where there are market transactions and cash income. It occurs among and between all economic classes - it is not just rich individuals lending to poor people (Tun Wai, 1992). It is used by the rich and the poor but often it is the only source for the poor, while it is an alternative source for the rich (Meyer & Nagarajan, 1992). In recent years, an increasing number of experts have began to evaluate the costs and benefits of informal financial institutions in a more objective manner in terms of responsiveness to the needs of savers and borrowers, economic efficiency, use of market power in setting interest rates and the allocation of resources (Holst, 1985).

4.2 Attributes of informal finance

Meyer and Nagarajan (1992) list several attributes of informal finance:

- 1) Heterogeneity - informal finance includes a wide variety of institutional forms and a variety of financial contracts between savers and borrowers can be found within any one type. Informal financial institutions are used almost exclusively to finance household consumption, investment or very small-scale business enterprises (Fry, 1988). Informal finance offers both loans and savings, unlike supply-lending finance institutions which often ignore savings. Many types of informal finance institutions also offer marketing and other services.
- 2) Specialisation - some informal financial arrangement serves a broad clientele, but information problems often encourage specialisation. For

example, money keepers, moneylenders and trade lenders often provide only one type of financial service that is limited to those clients of whom the supplier has good information.

- 3) Collateral - very few loans involve collateral. However, in the extreme end collateral substitutes are used to enforce repayment in the informal credit market (Esguerra & Meyer, 1992). The informal financial sector has developed effective collateral substitutes through interlinked contracts, peer monitoring and group lending (Meyer & Nagarajan, 1992). Other forms of collateral substitutes used in some developing countries include - :
- third party guarantees ("sureties") where the loan is given on the strength of a guarantee provided by a third person, usually someone with the means to pay the loan if the original borrower defaults,
 - linked markets/contracts or tied contracts where the loan is given on the promise or agreement that the lender will be the sole buyer of the produce at a mutually acceptable implicit interest rate. The mortgaging of tenancy or cultivation rights which affords the mortgagee to derive actual and beneficial use of the land which yields him returns over and above the earnings derive from the principal, and
 - threat of loss of future borrowing opportunities which for as long as it represents a credible threat is an effective means to keep the integrity of the loan contract (Llanto, 1990).
- 4) Interest rates and transaction costs - money lenders have often been criticised for charging exploitative interest rates on loans, but at the other edge of the scale, some other types of informal lenders, such as friends and relatives, often charge no interest at all. Fry (1988) pointed out that informal finance is characterised by higher lending rates than formal finance. However, non interest costs of borrowing from the banks are often substantial (e.g. transaction costs), whereas they are virtually non existent in informal financial markets.

The real issue of interest is rather: Does the informal financial market increase overall efficiency in the rural economy? The desire to use it explicitly suggests that it facilitates both consumption and input use during the periods between planting and harvest. If for some reason the activity of trader-lenders who provide the funding during the interim period were to be prohibited, the most likely outcome would be a lower

level of consumption and production, and over the long term less wealth accumulation (Fry, 1988) - and hence, retrogression in rural environment.

Ahmed (1984) estimated the gross cost of borrowing from money lenders in rural Bangladesh to average 86% a year of the loan rates, while that of commercial banks averaged 108% per annum. It's study pointed at sizeable non interest costs of bank borrowing, including travel, entertainment, bribes and the opportunity cost of time involved in securing the loan. He provides an explanation on why delinquency and default rates are higher in formal than informal finance. In the case of formal finance, gross costs of bank borrowing drops sharply as the maturity of the loan increases, since a large proportion of the cost consists of front-end transaction cost. This creates strong incentives to postpone repayment. In contrast, interest forms the bulk of the gross cost of informal borrowing and since the marginal cost of lengthening the maturity of a loan from the informal institutions is always positive in real terms, there is little or no incentive to postpone repayment unnecessarily.

What tends to distinguish informal finance is the relatively low transaction cost to savers and borrowers because of close proximity; a minimum of formal procedures (Meyer & Nagarajan, 1992); better knowledge concerning their clients (and thus, lower risk) on the part of lenders, and thus the minimum information costs; no regulation of interest rates and therefore an ability to adjust fully to market forces; informal finance is furthermore not subject to the reserve requirements that are imposed on formal institutions (Fry, 1988).

Whereas formal institutions may be subject to asymmetric information - which denies the rural borrower effective access to financial resources, - informal finance does not suffer from this problem to the same degree. Informal lenders are able to hurdle the information barrier in rural credit markets and to maintain low transaction costs which make their lending operations cost effective. The rural borrower and the informal lender literally know each other quite well; this enables the latter to form a more accurate probability distribution of the farmer's default propensity and to factor it into the loan contract. The information wedge can easily be eliminated because both transactions operate within the same socio-cultural and economic milieu (Llanto, 1990).

Notwithstanding all these desirable attributes, informal finance is however not able to sustain the credit needs of a growing rural economy and to intermediate the rural surplus. Because resources of informal lenders are inadequate and ill-

suited for modernisation, they are unable to lend for assets and market-purchased modern yield-increasing inputs. Hence the growth of informal lenders has been inelastic (Mellor, 1976).

Informal lenders have not been able to mobilise financial deposits on a large scale because their deposit facilities are inadequate, unsafe, untrustworthy, or less remunerative (Von Pischke *et al*, 1983). The informal credit market is fragmented, imperfect and isolated (Desai, 1976).

5. CONCLUSION

The following policies may be suggested in the light of this exploratory analysis:

- (1) Appropriate policies should be effected to provide rural households with incentives to save and to make it possible to use these savings effectively to promote development, particularly of small businesses that are likely to be the most important sources of employment and growth of income in rural areas. Experience in Taiwan (Ong *et al*, 1976), suggest that two sets of incentives may play a prominent role in stimulating rural household savings. The first set includes price policies, new technology, marketing facilities, land tenure adjustments and public investment programs. The second set is the physical presence of savings institutions in most rural areas. These institutions may provide convenience, stability, liquidity, and the security necessary to attract savings. The establishment of rural and community banks may be supportive to the expansion of commercial banks. The strengthening of rural and community banks will be one way of reducing high transaction costs for lenders and borrowers and overcoming the collateral problem. Where permanent branches may not be feasible, mobile banks could be used. These banks should in turn embark on seminars, workshops, lecturers and symposia to mobilise rural households for increased capital accumulation through savings.
- (2) The government should provide monetary policies that would stimulate voluntary savings instead of the involuntary savings policies adopted in some developing countries. Policies like concessionary interest rates, manipulation of product and input prices and foreign exchange regulations should be avoided. These policies have often resulted in rural low income and weak incentives for rural savings. Any policy which leads to large and unstable inflation rates invariably encourages unproductive savings in real goods. An effective monetary system is therefore needed to ensure that those who hold money will have its real value preserved.

- (3) It is also vitally important to create or provide an enabling environment for the efficient operation of institutions at the interface of the formal and informal financial sectors, including rural and community banks, credit unions and stokvels. Legislation and regulation practices should be enacted in order to ensure clean and efficient markets.
- (4) Interest rates should be allowed to be dictated by market forces. Low rates discourage savers by reducing the attractiveness of intermediated financial assets. Savers are then more likely to keep their savings in cash, to invest them in tangible assets (eg. cattle) or to engage in speculation. These alternatives tend to be less efficient economically, and may lead to problems of unsustainability, eg. when such conditions lead to overinvestment in livestock and overexploitation of natural resource base. This invariably deprives intermediaries of deposits from the community as a source of loanable funds (Von Pischke, 1991). Low rates therefore encourage financial institutions' increasing dependence on government subsidies.

Low interest rates also encourage the diversion of borrowed funds to consumption purposes. Diversion is more likely with richer farmers who are less likely to be subjected to the enforcement of requirements that loans be used only for designated purposes. Interest rate ceilings force intermediaries to ration borrowers. Increased collateral requirements and reallocation of transaction costs to borrowers are often used as substitute rationing mechanisms. Hence, a flexible interest rate policy which provides adequate positive real rates of interests on rural savings will be necessary to promote rural savings. Bhatt (1979) generally attributes fragmentation of capital markets in the low income economies to the interest rate policy pursued. It is therefore believed that with the positive real rates of interest policy, these imperfections would be removed and their saving and investments would increase.

- (5) Again, credit ceilings reduce efficiency in two ways in the financial sector. First, they limit all banks equally, including those that are most efficient at lending and those that have the most dynamic entrepreneurs as their clients. Second, credit ceilings reduce efficiency by destroying competition for deposits. Once the ceilings are reached, extra deposits represent idle cash reserves. Banks stop making efforts to attract deposits and to provide good services to existing depositors (Fry, 1988).
- (6) There is a need for innovative deposit schemes and policies to facilitate these. The principle of linking deposits with lending for a specific

purpose, for example may be able to provide stronger incentives to the savers than do institutions which provide only saving facilities. Examples of such schemes are:

- the Farmer's Protection Deposit Scheme in India: In times of dire necessity arising out of crop failure, the farmer is eligible for a loan equal to double the amount of deposits in his account. The deposit earns interest and the farmer obtains the loan at a concession rate of interest. Farmers are therefore induced to save in the form of a deposit if it is linked with borrowing at a time of crop failure (Bhatt, 1979), and
- the IFAD project in Ghana obliges smallholder farmers to have savings accounts before they qualify for subsequent credit.

With these policies it is believed that it may be possible to strike a balance between the two approaches of formal rural finance, and the informal finance.

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