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## POLICY MAKING IN THE REAL WORLD: THE PROVISION OF RURAL FINANCIAL SERVICES

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This paper describes the process of information gathering and analytical work that was undertaken for the purposes of the Strauss Commission, as a case study of public policy making. The emphasis is on ways of overcoming information constraints given the short time available for the investigation. Any inquiry of this nature has to start with the question: why change? The reasons for change in the provision of rural financial services in South Africa are investigated as a prelude to the analysis of needs and institutions in their future context.

### BELEIDMAKING IN DIE WERKLIKHEID : DIE VERSKAFFING VAN FINANSIËLE DIENSTE

*Hierdie artikel beskryf die proses van versameling en analise van inligting wat gebruik is in die Strauss Kommissie, as 'n gevallestudie van 'n beleidmakingsproses. Daar word klem gelê op maniere om inligtingsknelpunte te oorbrug waar die toegelate tyd min is. Enige ondersoek van hierdie aard moet begin met die probleemstelling: hoekom is verandering nodig? Die motivering vir verandering in die verskaffing van landelike finansiële dienste in Suid-Afrika word ondersoek as inleiding tot 'n toekomsanalise van die behoeftes en institusies betrokke by landelike finansiering.*

### 1. Introduction

South Africa is at present undergoing a transformation, the depth and breadth of which we can only dimly perceive. The transitional Constitution sets out the rules of the game for all the actors in this process, while the aims and principles of what is hoped to be achieved have been spelled out in the RDP White Paper. Virtually every sector of the economy, every line department and every parastatal has embarked on the redesign of policies, strategies and structures. These processes are taking place in the public, private and the non-government sectors, at central, provincial and local level. The rural sector of our economy and society has not escaped attention, and many agricultural economists are involved in these processes in one way or another.

The aim of this paper is to tell the story of one of these processes, to illustrate how agricultural economists can contribute to policy formulation. It is not a conventional story of problem identification, the application of problem solving techniques and making value-free recommendations to the powers that be. In the real world, problems are ill-defined and multi-faceted, it is often difficult to identify who the appropriate decision makers are and solutions are constrained by a range of social, economic, political and human factors. Policy advice that does not account for these realities will not have any influence, and the policy advisors will be doomed to irrelevance.

In the real world, time is of the essence and the luxury of text book approaches often does not exist. The challenge for agricultural economists is to improvise, while adhering to responsible methods of problem solving. This calls for an in-depth knowledge of the subject matter and the milieu within which it will be addressed.

The subject matter at hand is the provision of rural financial services. As this is at present the focus of attention of the Strauss Commission, established under the Commissions Act, we will limit the discussion to the events that preceded its establishment and the management of the research input that will eventually

guide the Commission in its recommendations. We start by posing the question that should precede any and all of these processes, namely: why change? Section two poses the main considerations that have to be accounted for in addressing this question, while section three spells out the approach to the gathering of the necessary information. The aim in section four is to highlight the most important lessons learned in the process of policy formulation in a world where *ceteris paribus* assumptions are untenable.

### 2. The main considerations

In setting up the Strauss Commission, the following main factors were taken into account:

- The extent and nature of poverty in the rural areas of South Africa, and the limited participation in financial markets by the rural poor.
- The tendency to an urban bias in public policy in this country. A good example is that the issue of subsidies for housing in rural areas has only recently been put on the agenda, and only after Cabinet approval of the national housing policy framework.
- The historical legacy of inequitable access to resources and support services for rural entrepreneurs. This includes access to land and access to the capital market.
- The seeming unsustainability of existing institutions providing financial services in the rural areas.
- The extent to which the transitional Constitution mandates changes in a number of public sector functions. This includes the possible devolution of the agricultural financing function to the Provinces and the mandate of institutions such as DBSA and the Land Bank.
- The narrow focus on credit provision by public sector financing institutions, to the neglect of other



financial services such as savings, insurance, grants, equity and transmission instruments.

- The **supply-led nature** of policy approaches to rural finance by the government.

In short, unless special attention is given to the financial needs of people in rural areas, the main source of poverty will not be addressed. This is especially true given the rapidly changing policy environment, the weakness of existing institutions and the inherent urban bias in the country.

### 3. The investigation

The Commission focused on three aspects to address these considerations. These included an analysis of the need for rural financial services, of the institutional structure of the current service delivery system in rural financial markets and of the legal framework within which it operates. On this basis, it was felt, the Commission could best make recommendations on the kind of services that have to be provided, the institutional structures required to ensure that delivery takes place, and the supporting legal and regulatory framework to ensure the sustainability of the system.

#### 3.1 The needs analysis

The first aim of the Commission was therefore to arrive at some estimation of rural people's need for savings and loan facilities, transmission instruments and other financial services. One way of measuring this need, familiar to agricultural economists, is to extrapolate from current use. However, the rapid changes in the policy environment taking place in South Africa means that conventional techniques are redundant at best, and will most probably lead to misleading results. A better solution would be to measure the **expected demand** for financial services. While this is obviously impossible, a way had to be found to get a best estimate, given the tight time constraint that the Commission had to deal with.

For this reason a decision was made to base the assessment of the level of demand for different kinds of financial instruments on three different sets of information, namely:

- An analytical description of the *status quo* at grass roots level. The purpose was to describe the reaction, with respect to the demand for different kinds and magnitudes of rural financial services, to change as it affects different people and communities.
- A description of the rapidly changing policy environment facing different categories of rural people. These policy influences range from the indirect, for example constitutional change, macroeconomic policy and banking sector regulation, to more direct policies, for example the RDP and land reform.
- For the above aspects, an evaluation of the international comparative experience with the provision of rural financial services. Here the evolution and characteristics of the rural financial services industry in other countries would have to be

examined in order to understand the requirements of a more dynamic rural sector.

The most important challenge was therefore to clarify the relationship between anticipated or desired changes in the real rural economy, changes in the rural financial services industry and the effect on rural people. The most efficient way to acquire detailed knowledge on these issues was seen as the commissioning of short papers from local and foreign analysts. These analysts were requested to apply their current knowledge and experience on rural finance to a focused subject, or to link their special expertise in a related field of policy to rural finance issues. Some 40 papers were commissioned on the basis of a detailed terms of reference. The time taken between the commissioning of the papers and the reporting of the results was less than four months.

#### 3.1.1 A descriptive analysis of the rural areas

The first set of papers dealt with a description of rural areas, the demographics of rural people and the way in which policy changes are influencing their access to and use of financial services. The following issues were investigated:

- **A definition of what is meant by 'rural areas'.** The main official sources of statistical definition were examined to reach a definition of rural areas. The Commission had to make an early decision on a definition and adhere to it consistently, rather than try and reach an exhaustive definition. If for example a choice had to be made between including areas that are really peri-urban and a definition that excludes such areas, then the former choice was preferable. Moreover, for some aspects of its work a new, second category of 'rural', had to be defined to allow an exclusive focus on more remote areas of low population density, where the predominant economic activity is agriculture and key services are relatively inaccessible.
- **A definition of what is meant by 'rural financial services'.** There are considerable conceptual difficulties in separating rural capital market transactions from transactions in other markets, because transactions are often interlinked. For example, a farm worker may have a contract in the labour market that is also a contract in the credit market, because the worker has taken an advance on wages. The effective rate of interest has to take into account any wage reduction the worker is accepts by choosing to work for this employer, rather than for one who refuses to give advances. An analysis of rural peoples' need for financial services cannot therefore be divorced from a broader analysis of their involvement in other, interlinked markets. This required the commissioning of a range of South African case studies as well as a number of conceptual papers based on international experience.
- **An overview of rural poverty.** Such a description has to start with an overview of the existence of poverty and its characteristics by gender, race, labour force participation, level of education or training, and location. Further analysis requires a description of the manifestation of poverty in terms of Human Development Indices, levels of income,



wealth and access to social services and infrastructure. Given the particular mobility of the rural population in South Africa, it was, however, also necessary to analyse demographic trends, including the implication of such trends for the existing provision of financial services.

- This analysis therefore included the effects of changing government policy on the rate, composition and direction of migration; on the allocation of government expenditure on physical infrastructure, social and other services; and on the technology of provision of rural financial services. Further, the effects on the rural-urban distribution of the population of the decline in certain resource-based industries, and of changes in government subsidy expenditure, for example on RIDP, border 'security' and GEIS, were studied. The international literature on the links between migration and financial services provision was seen to be a particularly important aspect of the study.

### 3.1.2 The structure of rural industry and the policy environment.

This part of the study focussed on an analysis of rural industry structure and the way that it is changing, especially in agriculture and related industries in the 'agriculture-manufacturing complex'. The terms of reference were drawn widely to include the full range of likely direct and indirect policy influences on the structure of rural industry. This formed the basis for an analysis of the likely effects of reconstruction and development policies on rural areas, and therefore on the rural financial services sector. The following aspects were attended to:

- The descriptive part of the work concentrated on the main features of the agricultural economy as they affect the rural financial services sector. This included the *status quo* and trends in wage employment, consumption, production, domestic and international trade; the agricultural and wider rural asset structure in terms of land and other assets and the policy influences that created and are still supporting this structure; measures of concentration in the farm sector, the agro-manufacturing sector, and the rural (non-agricultural) manufacturing and service sectors; the issue of the 'missing middle' in the spectrum of firm size; the relative absence of agribusiness manufacturing in rural areas; and the limited development of international and domestic tourism resources.
- The second part of the work described the policy environment affecting future rural development, and therefore rural financial services. This involved aspects such as macroeconomic policy; constitutional transformation; fundamental rights and challenges to the existing order (e.g. the first right of the ACB and the Land Bank; the statutory levies of Control Boards); centre/province relationships including the Financial and Fiscal Commission, parastatals and the Local Government Transition Act; the RDP; the Agricultural White Paper; the Department of Trade and Industry and the reorganization of the SMME sector; and changes related to SADC, the CMA and the SACU. Further issues include the impact of GATT agreements on

the ability of and requirement for the government to provide financial and other services in support of exporters based in rural areas and the impact of tariff, exchange rate and monetary policies on relative prices and profitability in different sub-sectors of the rural economy.

- The third part of the work described the political economy of reform in South Africa. Here particular attention was given to the likely effects on power relations in rural areas of the current shifts in the policy environment, and the influence of these new power relations on the provision of rural financial services.

### 3.1.3 Quantifying the needs

Given more time, the Commission would have attempted to translate this knowledge of rural areas and the way in which rural people react to policy changes into a quantified estimate of needs. The purpose here is describe how this would have been done, time permitting. The process starts with the description of the core activities that are expected to dominate in the rural economy in the future, for example the types of farming and agribusiness models that will result from the land reform programme.

The types of enterprise or household selected for detailed needs analysis should be described in terms of the following variables:

- **User characteristics.** This includes characteristics such as gender, geographic location, asset structure and income, enterprise form (whether individual, household, corporate or community/group structure), access to infrastructure and social services and access to other services required to complement financial services.
- **User requirements.** incorporating a description of the precise financial services required by different categories of people and enterprises. This should include a wide range of borrowing and investment instruments such as, for example, for consumption-smoothing and medical emergencies, or for investment in non-agricultural enterprises as well as on farms. It should also include a description of the full range of requirements for reliable and user-friendly savings instruments and money transmission mechanisms.
- **Service requirements.** This entails a description of the precise nature of the instruments used as the vehicles for service delivery. Important aspects include transmission mechanisms, the infrastructure requirements for financial service delivery, transactions costs for the various participants, the scale of loans, grants and savings, interest rates charged and received, collateral requirements, etc.

The second stage would be to quantify the number of people or enterprises that fit into each of the major 'types' identified in the first stage. The third stage would involve quantifying the requirements of each type of user for different financial services, i.e., for savings and money transmission facilities etc. This would allow a crude projection of the possible future size of the market for a range of financial services.



### 3.2 The institutional analysis

The first objective with the institutional analysis was to assess the efficiency of the current institutional structure tasked with the provision of financial services. The expectation was that this would guide the Commission in its recommendations in its proposals on future structures. Efficiency in this context was measured in terms of two primary variables, namely the sustainability of institutions and the outreach or client coverage of the institution.

Due to the short life span of the inquiry it was not possible to do an in-depth analysis of the complete institutional structure that currently provides financial services in rural areas. As a first step, therefore, a relatively superficial analysis was made of all existing institutions. This was followed by a more in-depth analysis of a selection of these. Institutions were categorised in four broad groups, namely commercial institutions, development finance institutions, cooperative institutions and non-government institutions.

#### 3.2.1 Sustainability

The demise of numerous agricultural development banks and other specialised credit institutions in other parts of the world over the last 40 years necessitated a relook at the criteria with which institutional performance is measured. The measure most frequently used to evaluate this performance in the past was the number of clients reached, rather than the ability of institutions to both reach their clients and at the same time survive as a financial intermediary. The emphasis has therefore shifted from a narrow view of financial services as consisting of the supply of credit to poor rural entrepreneurs, to one that views the task of building financial systems in under serviced areas as being one of incentive-orientated financial institution-building. (Krahn and Schmidt, 1995). This was seen to be in line with the Terms of Reference of the Commission, namely to make recommendations on sustainable institutions that can service diverse sectors and provide diverse services (thus not only credit).

Conventional analysis of financial profitability proves to be quite inadequate when the object of analysis is a non-profit organisation. The normal financial statements of these institutions rarely, if ever, provide information on implicit or explicit subsidies received. In conventional accounting practice, the cost of funds are measured as accounting cost. The opportunity cost of borrowed funds is not taken into account at all. No routine standardised methodology existed until very recently to assess the financial situation of development finance institutions which also measures subsidy flows at the same time. In 1992 a methodology was proposed that provided a measurement of both financial and economic variables within the same approach (Yaron, 1992). The objective of analysis therefore shifted to providing a comprehensive method of assessing and measuring the overall financial costs involved in operating development finance institutions and quantifying this in an easily understood measure.

#### 3.2.2 The subsidy dependence index (SDI)<sup>1</sup>

The SDI is a method that provides a public interest analysis of the dependence on subsidies and financial

performance of development finance institutions. It accounts for the full social cost applied in the operating of these institutions and therefore indicates the full value of a variety of subsidies received by the institution. It explicitly reveals the extent of subsidy required to keep the institution afloat, information not readily available through the normal financial statements of the organisation.

The SDI, as a methodology is instrumental in:

- Placing the total subsidy allocated to a DFI in the context of its activity level (Yaron, 1995) represented by the subsidy received measured against the interest earned on its loan portfolio extended to its targeted clientele in the market place. This is similar to calculations of effective protection, domestic resource cost or job creation cost;
- Tracking a development finance institutions' subsidy dependence over time, thereby applying the SDI as a planning and monitoring analytical tool; and
- Comparing the subsidy dependence of development finance institutions that provide similar services to a similar clientele.

The calculation of the SDI involves aggregating all the subsidies received by the institution. The total amount of the subsidy is then measured against the on-lending interest rate, multiplied by the average annual loan portfolio. This measures annual subsidies as a percentage of interest income and shows the percentage increase in average interest rates charged by the institution that will be necessary to eliminate all subsidies.

Yaron (1992) defines the annual subsidy received by a development finance institution as:

$$S = A(m-c) + \{(E \times m) - P\} + K$$

where:

- |   |   |                                                                                                                                                                                                                                                                                                         |
|---|---|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| S | = | the annual subsidy received by the institution;                                                                                                                                                                                                                                                         |
| A | = | the concessional borrowed funds outstanding (annual average);                                                                                                                                                                                                                                           |
| m | = | interest rate the institution would be assumed to pay for borrowed funds if access to borrowed concessional funds were eliminated (generally market reference deposit interest rates (MRDIR), adjusted to reserve requirements and the administrative cost of mobilising and servicing these deposits); |
| c | = | weighted average annual concessional rate of interest actually paid by the institution on its average concessional borrowed funds outstanding;                                                                                                                                                          |
| E | = | average annual equity;                                                                                                                                                                                                                                                                                  |
| P | = | reported annual profit before tax (adjusted, when necessary, for loan loss provisions, inflation, etc.); and                                                                                                                                                                                            |
| K | = | the sum of all other annual subsidies received by the institution (such as partial                                                                                                                                                                                                                      |



Outreach indicators	Productivity indicators	Profitability indicators (%)
Number of branches	% loans in arrears (volume)	Return on assets
First year of operation	Loans/staff	Interest earned/aver. portfolio
Non-financial services	Volume lent/staff	Gross financial margin
Deposit accounts	Loans/loan officer	Non-int. expenses/ave. portfolio
Average deposit size	Volume lent/loan officer	Accounting profit index
Number loans outstanding		Typical deposit rate
Average loan size		Typical loan rate
Agricultural loans outstand.		SDI
Average agric. loan size		Implied average loan rate

Source: Based on the work of Douglas Graham, Ohio State University, 1995.

or complete coverage of the institutions' operational costs by the state).

The subsidy dependence index is then calculated as follows:

$$SDI = S/(LP \times I)$$

where:

- SDI = subsidy dependence index of the institution;  
 LP = average annual outstanding loan portfolio of the DFI;  
 I = weighted average on-lending interest earned on the DFI's loan portfolio.

This ratio indicates the percentage increase in the average on-lending interest rate required to compensate a development finance institution for the full and immediate elimination of subsidies in a given year, while keeping its return on equity equal to the market reference deposit rate. Note that this method for subsidy reduction is only one possible measure. Other measures may include stricter loan approval procedures, more aggressive loan collection, expanding services to include deposit taking facilities and decreasing administration costs through several measures.

An SDI of zero means that the institution has achieved financial self-sustainability. An SDI of 100 per cent indicates that a doubling of the prevailing average on-lending interest rate is required if subsidies are to be eliminated. A negative SDI indicates that a DFI has not only achieved financial sustainability, but that its annual profits exceeded the total annual value of the subsidies. It also implies that the DFI could have lowered its average on-lending interest rate while simultaneously eliminating any subsidies received in the same year.

The SDI does not judge subsidies. It provides a measurement of subsidies which is essential in assessing the social cost of the institution to society. This calculation also provides no indication of how the subsidy was used, it only shows what level of subsidies flowed into the institution. The calculation of the SDI does not require additional information other than that contained in standard audited financial statements. Where it is not possible to obtain the information required from the financial statements, little further effort is normally required. The need for further calculation is also usually an indication of inadequate financial reporting.

The calculation of the SDI is not the final objective, but the means to a standardised calculation of subsidy flows through an institution. The next step is to analyse whether the impact of the subsidy justifies the extent of the subsidy. Measures of the outreach of the institution are required to address this issue.

### 3.3.3 Outreach

The Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand reached 2.6 million borrowers (1988-1989) or 52 per cent of the targeted small farmers (Yaron, 1994). This is a good illustration of efficiency in terms of outreach. The challenge is to increase the outreach and decrease subsidy dependence at the same time. Few institutions in the world have succeeded in achieving these joint objectives.

Yaron (1994) cites the following measures for outreach:

- The value and number of loans extended;
- The value and number of savings accounts;
- The type of financial services offered;
- The number of branches and village sub-branches;
- The percentage of the total rural population served;
- The real annual growth of the financial institution's assets over recent years;
- The participation of women as clients;

The Commission has attempted to calculate most of these measures of outreach for South African institutions. In this analysis productivity can also be expressed in terms of the number of loans and the volume of loans per staff member and per loan officer. Analysis of the outreach and sustainability of institutions provides information on the current situation. As with most such investigations, the results of such an analysis need to be placed in the right context. A financial institution that has been operating for only one year may not be at a break-even point yet. Thus a high unit cost of transactions may decrease over time as client coverage improves and volumes increase. In the analysis other aspects like years of operation, whether non-financial services are provided, etc., were also considered. The following table provides a more comprehensive indication of the aspects covered in the analysis. Information on these aspects is also essential



for the monitoring of policy impact and institutional change over time.

### 3.3.4 Monitoring and evaluation

A number of studies are under way in South Africa to investigate the provision of financial services for a wide range of sectors, including housing, agriculture, small business, fisheries, tourism and land reform. It is therefore extremely important, for the purposes of monitoring the institutional change that will result from the implementation of these proposals, to execute a baseline survey as a matter of urgency. Part of this exercise would be to plan for the long term monitoring and evaluation of the ensuing changes, that will build on such a baseline survey. An assignment, partly funded from the budget of the Commission, has been approved to ensure that such a baseline study is done for the rural areas of South Africa.

The assignment aims to monitor institutional changes in rural financial markets. In order to do this a few areas of emphasis have been identified that will help to track changes that occur. These areas refer both to geographical areas and specific variables that need to be identified with which change could be monitored on an efficient basis. It is not possible or desirable to cover the total South African geographical area as a result of capacity constraints, cost and declining marginal returns on the assessment effort. Specific geographic areas and specific variables need to be selected to ensure that the most cost efficient monitoring is accomplished.

The analysis will concentrate on three levels. The first level relates to a brief description of the South African financial market, the second to institutions in rural financial markets and the third at the clients in rural financial markets. The emphasis in the study is to approach the exercise with as few preconceived notions about monitoring institutional change as possible. The study both will monitor and will build monitoring technology and capacity as it goes along. Conventional approaches to research are based on detailed *a priori* planning. Here the emphasis is on a strong objective, certain policy guidelines based on best practise and extremely flexible implementation.

## 4. Lessons learned

Most policy processes that agricultural economists get involved in will be similar to the example given above. Agricultural economists have to learn to understand that the best advice will always be too late. Policy makers cannot wait for perfect answers, and have to learn to make decisions based on imperfect information. To minimise the risk that decisions are made on the basis of incorrect information, agricultural economists have to keep the following advice:

- The past is a more imperfect source of lessons for the future than is often assumed. Unfortunately, many of the analytical tools used by agricultural economists are based on some degree of extrapolation from the past. This is often exacerbated by the paucity of fresh data, a problem familiar to many agricultural economists in South Africa.
- One way out of this situation is to develop the ability to see into the future. This presents the analyst with two problems. First, it is impossible,

and second, the most successful methods of prediction are again based on some view of the continuity of events over time.

- For the optimist, however, there are a number of different ways in which this dependence on assumptions about continuity can be overcome. The best place to start is to recognise the difficulties faced by decision makers, and to recognise that these will not go away. It is therefore best to be prepared for perpetual emergencies. This has at least four important implications for agricultural economists.

⇒ Recognising the importance of timely information and lobbying for the creation and maintenance of data bases that are user friendly, compatible and conducive to professional use.

⇒ Building capacity in the arts and skills of policy analysis. South Africa has a scarcity of such skills relative to the demand in South and Southern Africa, and agricultural economists have a comparative advantage born from the skills in which they have been trained. The challenges faced by those involved in tertiary education are large, and cannot consist only of formal training. Agricultural economists who are involved in these policy processes have a responsibility to teach, nurture and mentor new talents continuously.

⇒ Recognising the shortcomings of their disciplinary skills in the face of complexity, and getting used to working in interdisciplinary teams, to teaching and learning while they do so and the same time maintaining their disciplinary excellence.

⇒ Learning to devise and improvise on methodologies as they go along. Here South African agricultural economists have much to learn from international best practice techniques and from international comparative studies, including the experience of our colleagues in other parts of Southern Africa.

⇒ Learning to live with flexibility in implementation, to work towards finding a strong objective and a firm policy framework, with decentralised and flexible implementation, rather than to seek useless, outdated blueprints.

- Finally, agricultural economists also have to ensure that the institutional support for policy work helps rather than hinders their efforts. The existing policy capacity in South Africa has been balkanised and cut off from the heart of decision making for too long. We face the challenge of lobbying for strong, integrated policy capacities in our country. If it is inevitable that the decision makers in the Departments of Agriculture and Land Affairs, or those in the provinces and at central government level will be in conflict, this

is part of the reality we have to deal with. However, we have a duty to ensure that this does not spill over and affect the quality of advice that decision makers receive. We need to support the creation of strong and independent capacities for policy analysis that can prepare for a future that will be as uncertain as it is today.

**Notes:**

1. This section draws on the work of Yaron (1992; 1995).

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