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AGRICULTURAL AND RURAL FINANCE : SOME THOUGHTS ON THE ROAD AHEAD

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INTRODUCTION

Much has been written over the past few years about rural finance in South Africa to address inadequacies in the provision of rural financial services. This paper does not attempt to summarize the many different views expressed. Nor does it attempt a detailed review of the Strauss Commission report which came out first as an Interim Report and more recently has been circulating as a much revised draft -- the two versions contain substantially different recommendations, reflecting just how difficult it is to reach consensus on the many apparently intractable issues (some of the comments below may refer to recommendations that have been further modified, since, at the time of writing this paper, the Commission Report had not yet been published). Rather, I think it more useful to pick up on some key issues and on some of the recommendations that have been made by the Strauss Commission and others to examine the advantages and disadvantages of different approaches to addressing the needs of those in rural areas.

THE ROLE OF GOVERNMENT IN DEVELOPING RURAL FINANCIAL MARKETS

Non-interventionist view: Financial markets around the world are characterized by a range of interventions aimed at protecting depositors, ensuring the solvency of financial intermediaries (FIs), promoting competition, and pursuing social and political goals. It is widely accepted that without some of the more indirect interventions (e.g. prudential regulation and supervision of banks), there would be widespread failures in financial markets. However the case for some of the more direct interventions (e.g. targeted credit and state-run FIs) is much more controversial. There are those who say "we've done all there is to do. The deterrents to private banking -- directed, interest rate caps and state development banking -- have largely been eliminated following financial sector reform. Growth is on track and private intermediation may be expected to pick up by itself. Ultimately, some of this growth in intermediation will benefit rural areas -- probably not the poorest, but then again what these areas need is targeted grant programs and not targeted credit"

Interventionist view: But there are others who believe that special measures are needed for the agricultural/rural sectors with a view that "there is a crisis of profitability, we need to offset years of discrimination and hence farmers need to receive (trade) protection and subsidized/affordable credit to encourage the adoption of new technologies and to encourage the investment in new, small farms". The infant industry argument was and is frequently raised to support intervention in financial markets.

Much of the developing world has, at one time or another, opted for heavy intervention in rural financial markets justified on "second best" arguments. These interventions were aimed at supplying affordable credit to small-scale farmers and entrepreneurs, who were perceived as a clientele with no alternative access to formal credit markets. The interventions were also justified on equity grounds -- moneylenders' short-term, high-cost financing was considered something that should not be permitted in a modern society. Frequently, three basic forms of intervention were used: the administrative allocation of funds to agriculture, an imposed interest rate ceiling, and the establishment of and support for specialized credit institutions.

By and large, the performance of state owned credit institutions worldwide has been abysmal. Many of these institutions are now bankrupt. Africa and the rest of the world, is littered with bankrupt parastatals and banks that Governments have eventually had to bail out. Neighboring Zimbabwe shows how difficult it is to take an existing financial institution and convert it into a viable institution serving small farmers and entrepreneurs. Often, the bulk of the "benefit" of Government interventions to support these enterprises has gone to the better off and has ended up as a tax on the poor. In Pakistan for example, concessional lending for farm mechanism resulted in the purchase of large numbers of tractors displacing agricultural laborers and contributing, rather than alleviating rural poverty.

The record over the past 30 years is one in which DFIs have attracted foreign resources (that have to be paid back), they have failed to mobilize domestic resources and have a mixed record in allocating funds. They have also been very costly. In some cases, the subsidies have been enormous (2.2% of GDP in Brazil in 1980 and 1.7% in Mexico in 1986).

While the additionality of directed credit programs for agriculture cannot be quantified, there is little doubt that, in the short term, at least part of the large sums channeled through specialized agricultural credit institutions in different parts of the world have resulted in increased seasonal and investment credit to agriculture. However, in the long run, the poor performance of these FIs has frequently served to reinforce private lenders' concerns regarding the riskiness and profitability of rural credit and has therefore in all likelihood reduced the total volume of credit extended to rural producers.

In Peru for example, there was a dynamic commercial banking sector that was active in the rural areas 20 years ago. Today, the commercial banks are confined solely to the urban areas. The reason: Government refused to allow the commercial banks (CB) to charge market interest rates so they moved out of rural areas where risks were higher. Government then created an Agricultural Bank to fill the vacuum. A few years ago, the Government-sponsored Agricultural bank was wound up with enormous arrears and there is now little formal credit in the rural areas. Government is today trying to re-entice the CBs back into rural lending. This

story is repeated in many or most countries of Latin America. South Africa should avoid these costly errors.

The above arguments are well summed up by Besley (1994) who says: "In summary, there may be good arguments for intervention, and some may be based on market failure. But as one unpacks each argument, the realization grows that, given the current status of empirical evidence on many related questions, it is impossible to be categorical that an intervention in the credit markets is justified. Empirical work that can speak on these issues is the next challenge if the theoretical progress on the operation of rural credit markets is to be matched by progress in the policy sphere."

New Paradigm: The truth probably lies in between these two extreme views but there is no proven or fully accepted view on the appropriate level of Government intervention to foster development of rural financial markets. The new paradigm is market oriented and points to a case for Government intervention only if there is an identified market failure that Governments are in a position to address. Because of lack of information, enforcement and social barriers to trade, financial markets are typically not Pareto efficient. That is, they are likely to be characterized by market failures that may justify interventions. However, direct measurement of departures from second-best efficiency is difficult and indeed uncommon. The appropriate role for governments in addressing market failure is far from obvious. This is because the socially optimal level of provision is hard to assess, governments may not have the requisite financial or skilled human resources for a given intervention, and interventions are themselves subject to failure. The lessons that emerge from experience elsewhere are:

(i) get the framework right, that is, remove trade and marketing bottlenecks, remove legal and other regulatory constraints,

(ii) consider interventions that promote intermediation by private FIs and, only then,

(iii) consider direct interventions to tackle specific market failures.

Because of past failures, the scope and degree of direct interventions by Governments remains hotly debated. Two criteria, however, need to be considered. First, over the long-term, the experience of most countries would suggest that education, health, and infrastructure are more important than formal credit to improve the livelihoods of the less well off. Moreover, the track record of public expenditures on schools, roads etc., in helping the rural poor is immensely better than the track record of government support to financial institutions.

The practical conclusion would seem straightforward: funds aimed primarily at poverty alleviation ought to be spent mainly on development approaches with a proven track record. Second, financial-institution approaches to rural poverty alleviation are still largely in the experimental stages and should be funded accordingly, that is to say cautiously. Blanket prescriptions should be avoided unless they are based on proven successes. This note examines the Strauss recommendations in this context.

STRAUSS COMMISSION REPORT: GENERAL COMMENTS

The bulk of the Interim Report was well argued and provided relevant lessons for application to the rural financial sector in South Africa (and indeed elsewhere). In particular, the section on international experience and some of the background sections were excellent. The report stressed the importance of savings, the need to allow market interest rates to prevail, the merits of transaction cost-type subsidies rather than interest rates subsidies, and the need to build up a demand driven financial services, However, there was a serious disjoint in the Interim Report between the analysis and the recommendations. The more recent draft report attempts to remedy this. It has some 70 recommendations (actually more if one adds recommendations that do not see their way into the summary recommendations). While this is testament to the recent work that has gone into the report, at times it is difficult to isolate priority areas from those of lesser importance.

CREDIT AS THE CRUCIAL CONSTRAINT TO DEVELOPMENT?

The Interim Report argued correctly that credit should not be overemphasized as the poor can least afford to be caught in a debt trap. Yet, the report appears to imply that credit is one of the major constraints to rural development. The fact that half of all households in South Africa have some debt would suggest that lack of credit may well not be the binding constraint that the report implies (but even if it is, it is far from clear that the answers exist as to how to provide credit to rural areas on a sustainable basis). Most important is the need to create the environment for the establishment of a system of rural finance based on the private sector rather than crowding it out. The Commission report probably overly focuses on the provision of credit and gives insufficient attention to getting the incentives right to attract the private sector, and access to credit. It needs to set priorities between what is essential, for example, means to finance the land reform and what would be desirable.

Role of Commercial Banks (CBs): The revised Commission Report recommends a massive reorientation of the Land Bank into a Government-sponsored bank to support small farmers. The LB has little experience in this area and most international experience shows how difficult it is to reorientate an existing institution or to establish a parastatal-type bank. The Interim Report noted that the Government should support the market rather than replace it, yet the market (as measured by the active participation of the commercial banks) is unlikely to expand if Government-sponsored institutions are active in the area (to the contrary, the CBs have a perfect justification not to be involved since the "rural finance problem" will then be catered for by Government).

Probably the first question that the Commission should have asked was could the CBs meet some or all of the needs of the rural sector? Instead, the Interim Commission Report tended to write off the CBs saying they were unlikely to do the job unless certain constraints were removed and incentives provided. Yet the Commission did not spell out these conditions in

more detail or recommend steps to address them. In this context, it may be worthwhile to re-examine the **methodology** used by the Commission. I understand that questionnaires were sent out to the CBs who were not very forthcoming in responding. Given the time and resources available to the Commission, it might have been better to have carried out intensive interviews with the CBs in rural areas to really clarify constraints to lending. Once identified, the Commission should have tried to address each constraint as a matter of priority, for example, the measures needed to stop CBs being discriminated against vis-à-vis the Government/ parastatal banking sector. Thus all statutory advantages to Government banks should be eliminated immediately, for example, elimination of the statutory advantage of the Land Bank in securing senior claims on debtors and allowing CBs to compete on an equal footing in financing the cooperative movement.

If externalities exist and Government is willing to assume part of the risk associated with lending through, for example, guarantees (paras 33 and 34), CBs should be eligible for them in the same way as other institutions. I understand that the latest version of the Commission Report recommends that CBs receive the same treatment. In sum, it may be better and much cheaper for the Government to subsidize the private sector to provide credit than to build up a Government sponsored financial institution[1]. After all, the Interim Report notes that there are over 3300 CB branches in the country and that the CBs have a visible presence in all but the remotest rural areas (the revised draft seems to take issue with this, noting that, if spatial aspects are taken into account, the coverage is weak). Government cannot afford not to build on the existing network of branches and the expertise that exists in the CBs.

THE LEGAL AND REGULATORY FRAMEWORK FOR RURAL FINANCIAL MARKETS

In many countries , shortcomings in laws, regulations, and institutions prevent formal sector institutions from delivering credit to farmers and rural businesses. They also make it difficult for the formal sector to lend to the informal sector and for banks and other financial institutions to lend to non-bank creditors such as traders who have many advantages in reaching rural borrowers especially the poor. Lenders need a system where claims against property can be created, publicly established and enforced. The more uncertain and expensive this process, the less willing are lenders to lend. Problems can also arise in the creation of a mortgage or a claim on movable property as a result of un-titled land, high administration costs, and the absence of legal provisions for future interests in continuation in the framework for secured transactions.

Secured Collateral with immovable assets: Experience in many countries suggests that formal financial institutions will only lend against the value of real estate using a mortgage, for which a title property is needed. In South Africa today, many small farmers have only recently received their land. Based on experience in other countries, credit institutions may have little faith in their ability to recover bad debts through sale of a property. In some countries, even though it is legally possible, it becomes very difficult (with loan officers getting threatened), costly, and time consuming taking up to two years to repossess. I am not sure of the reality here, but I would suspect that the perception by the CBs might be that it would be politically very difficult to recover land that has only recently been given to black farmers. If so, those institutions requiring a mortgage will be reluctant to lend. My impression is that the Commission Report gives attention to the protection of rights of the small farmers but does insufficient to create the environment to facilitate lending by the CBs.

Secured Collateral with movable assets: Mortgage lending will not, over the long-term, serve the needs of the small farmer. Ideally, FIs should lend against warehouse receipts, stored production, livestock and equipment (moveable property), and to small traders who can, in turn, extend credit to small producers. It is not clear to what extent formal lenders in South Africa legally can or will accept any of the above as collateral. Few countries have provision for future interest so a farmer cannot get a loan against a newly planted crop because the output does not yet exist. Movable capital - such as livestock, farm equipment, accounts receivable - represent about half of the non-residential private capital stock in industrial countries. Banks in industrial countries refinance small loans made by countless shops, wholesalers, fertilizer dealers, and other enterprises that routinely extend small amounts of unsecured credit to small borrowers (demonstrating also the link between agricultural production and rural micro-enterprises). They perform the same function in refinancing the loans extended by finance companies and pawnshops. Commercial banks should be encouraged to lend on a basis other than the mortgage and passbook system.

In Peru, for example, the inability of banks to play this role does not arise from the small size of the ultimate loan. Rather, it emerges from the difficulties in using small accounts as collateral, registering claims against them, and regulating loans made against such collateral. The issue of collateral has emerged as a major constraint to lending in Latin America. The traditional response was to establish a Government-sponsored bank, but after years of failure, the more appropriate response is to have an in depth examination of related issues to strengthen the framework for secured collateral. The Commission recommends that consideration should be given to the introduction of a Pledge Registration Office, where pledges of movable objects could be registered, noting that registration of such a pledge must be simple and cheap. This is definitely a step forward but this issue probably needs greater examination and experimentation to be sure to identify the full range of collateral constraints.

There are substantial restrictions on the use of movable collateral, removal of which would greatly facilitate access to credit. In countries that provide for an appropriate secured transaction framework, secured loans carry a significantly lower rate of interest than unsecured loans. Moreover, as regulatory and legal constraints are removed, the supply curve for credit will shift to the right resulting in lower rates of interest and an increased flow of credit. Indeed the combination of lower interest rates and more credit from well designed programs to reform the laws of secured transactions produce gains have been estimated as high as several percentage points of rural GDP. This could well apply to South Africa.

Savings mobilization. Many specialized agricultural

credit institutions have suffered from deficiencies inherent in their design. They frequently were not expected to function as true financial intermediaries which mobilize deposits to make loans. Instead, these institutions have merely channeled Government-supplied funds to rural borrowers. Moreover, the continuous availability of external funds at below market rates has not obliged rural financial institutions to operated under financial viability constraints. Together with lack of competition and limited accountability, this has led to bad loans, inefficient operations, patronage and irregularities. International experience shows that performance incentives of specialized agricultural credit institutions have often been based on quick loan approval and disbursement; this has led to rapid growth in lending volume, mounting arrears, and high overhead costs.

Again, international experience shows that of the few specialized financial institutions that have succeeded (a) savings mobilization and (b) diversified portfolios have been critical factors. The former is sometimes referred to as the forgotten half of rural savings. Self-sustainability of rural financial institutions is based on the ability to mobilize resources and attain financial viability. Experience shows that rural financial institutions can generate a significant amount of funds from deposits (para 41). The poor performance of many RFIs worldwide in mobilizing deposits has frequently been because of narrow targeting which has limited deposit taking to farmers. Unless the scope of RFIs is broadened to include all segments of the rural population, the objectives of resource mobilization will be difficult to attain.

The revised draft Commission Report recommends an expanded role for the Post Office as a facility to collect rural savings. It also suggest some form of agency agreement between the Post Office and CBs and/or other institutions to provide rural populations increased facilities in which to place their savings. I do not believe that there is much encouraging experience with such arrangements elsewhere but most importantly it separates the saving mobilization and credit functions of the proposed "new" Land Bank. As noted, one of the lessons of international experience is that the two appear to need to go hand in glove to ensure the development of a successful rural finance institution.

Diversification of risk: Rural finance institutions with narrowly targeted clientele have had high risk portfolios. There is evidence in many countries that farm investment is not always a farmer's priority enterprise but rather non-farm investments which are expected to yield additional sources of income. Agricultural banks need to diversify their portfolios to improve risk management which calls for diversification of lending from agricultural production to the broader objective of financing the full range of the rural sector's needs. There is now ample evidence to show that diversification enhances the financial stability of financial institutions.

The recent draft Commission Report, noting that (a) KHULA intends to finance micro-enterprises and (b) South Africa is favoring sectoral financial institutions, accepts that the future role of the Land Bank should continue to focus on land and agriculturally related finance. It recommends that there be little overlap and registers its concern that KHULA is thinking of getting involved in agricultural lending. This recommendation would appear to contradict international experience which point to the success of multi-sectoral financial institutions. By failing to diversify risk, I believe that the chances of success are much reduced. If a single micro-enterprise fails, it is hoped that others will succeed thereby spreading risks. It is more difficult to diversify risk in agriculture -- a drought in a certain part of a country will affect most farmers so that there is little scope for a FI that is required to restrict its lending to agriculture to diversify.

THE PROPOSED "NEW" LAND BANK (LB)

The Commission Report revolves around a number of assumptions -- that there is inadequate finance available in the rural areas, that the CBs are unlikely to become involved in providing such finance, and the best way to fill the financing "gap" will be through a commercially oriented parastatal. The Commission recommends that the existing Land Bank be revamped and reoriented to provide loans to small farmers. It would also continue to provide access to its existing clientele. As I read the report, the LB would have three major functions as discussed below.

LB as retailer to commercial farms: The first function will be to continue serving its existing clientele, that is to function as a retail bank to the (largely white) commercial farming sector. This seems to have two major drawbacks. As in Zimbabwe, it has proven extremely difficult to reorientate a bank from one major objective to another and, secondly, it may be difficult for the LB to establish itself as a "friend" of the rural population if white farmers can go to a bank branch and get a loan but black farmers (other than those who form Common Property Associations) will largely be required to go to a retail institution.

This leads to the next point. If the Commission is making a distinction between the large and small farm populations, why not carry the argument to its logical conclusion and privatize the large farm functions of the Land Bank, that is, the present day functions of the bank? Government has stressed the role of the private sector. Why keep the Land Bank as a Government bank if it is as strong as the Commission report implies? I believe that this option should have been considered seriously before other recommendations were made for additional activities of the LB. The expansion of the Government sector in the financial arena when the demands on Government's limited resources are so high in areas where there are no other investors seems to be counter intuitive and contrary to experience elsewhere in the world. Privatization (of the retail function) would leave the two tasks identified below to be addressed (that is, the wholesaling function and providing grant support and technical assistance to rural financial institutions).

LB as Wholesaler: The second, and very different role of the LB will be to act as wholesaler geared to "fostering, nurturing, supporting and coordinating local and provincial level rural financial institutions". It is not clear, but I assume that in addition to a capacity building function (para 36ff), this would include the refinance of loans made by smaller rural financial institutions. Which Government institutions, including development banks, will be eligible? Will a parastatal be able to resist strong political pressure to provide

finance to a provincial institution and what will be the extent of Government's liability? This is precisely where much international experience suggests that a public wholesaler may end up bearing the credit risk that retailers should have and, in turn, if loans go sour, central Government ends up bailing out the wholesaler. In short, a rural (wholesale) bank is a contingent liability that frequently has, in the long run, to be funded from the budget. It raises a number of moral hazard issues.

If the LB is to be a wholesaler (first tier/apex institution), one of the main issues is whether it would support new rural financial institutions, such as NGOs, on a pilot basis to get them started -- an infant industry argument -- in which case the financing provided should be small or whether the LB would provide significant amounts of funding to a range of institutions. If the former, the funding should be from the budget. If the latter, there is a strong possibility that Government would incur a large contingent liability as has been the experience in so many other countries. In short, this aspect of the LB's business should be treated as that of a pilot operation. The argument for large-scale wholesaling seems to be weak especially if the financing of large white commercial farmers could be handled by CBs.

One way to limit unfunded liabilities is for the Government to guarantee selected loans and include the cost of the guarantee in the budget (for example loans related to land reform). The cost of this is then fully funded and transparent. The Commission recommends that the state finance a risk sharing agreement. The aim is to encourage both parastatal financial institutions and the private sector to lend to groups of rural entrepreneurs who have pooled there assets and therefore do not fulfill the normal criteria applied by financial institutions. It is not clear if a risk sharing arrangement would be available for the individual farmer and, if not, whether financial institutions, be they CBs or NGOs would be willing to lend for medium or long term investment. If guarantees are to be considered, they would need to be explicitly provided for in the budget. The drawback is that credit guarantees tend to become permanent and can eventually lead to a heavy drain on the budget.

The Commission treats the CBs as retailers while the LB would generally be a wholesaler. My understanding is that the CBs will receive the same level of support proposed for other institutions (e.g. risk sharing). However, there may be an inherent bias by the LB not to support the CBs, either through its refinance capacity, or through grants for, say, opening additional branches. Ultimately, the CBs will be, and they certainly should be, competing with the LB in its business with large farmers and entrepreneurs. All measures possible should be taken to support the CBs who have the staff and branches to play an immediate role.

The real issue is evaluation of consumer risk at the household level. The incentive to do this correctly will only exist if the threat of bankruptcy exists and there is no wholesale bank to prop up the system. Government could do this by avoiding a wholesale bank while addressing its distributional objectives and externalities through direct grants.

Grants and TA by LB to local level institutions: Earmarking of credit per se involves a subsidy in the sense that it increases credit allocations above market-determined levels. But, in addition, many types of explicit subsidies are typically provided to favored lines. Once again, the case for subsidies needs to be carefully established, and the best form of the subsidy, if any, should be determined. An important case in point is the subsidization of credit to the rural poor: the best intervention is frequently not a general line subsidy credit but rather help to institutions to develop substitutes for the screening and enforcement mechanisms used by informal lenders.

It is proposed that the LB would foster and nurture a whole range of financial institutions, such as NGOs, local level financial institutions, DFIs, commercial bank branches, local authorities and other kinds of institution seeking to render financial services in the rural areas. The report notes that the main support would be to build human and financial capacity through training, monitoring and support programs. The LB would receive and manage grants for specific expenditures on personnel and travel to compensate for the higher transaction costs of financial delivery to low volume areas, presumably also when volumes are low during startup. I believe that the form of these grants, which will be funded from the budget, are overly restrictive. Given that there is so little consensus on what to do and how to do it, the answer surely lies in testing and experimentation using different pilots in different parts of the country -- let the flowers bloom. Without extensive local experimentation, it is difficult to know what products are needed or how best to supply them. This learning process could be facilitated through access to a variety of grants: transaction cost grants, grants for establishing branches, grants for personnel, guarantees for loans in "new" areas etc. This type of support can play a crucial role in helping to build up NGOs and other institutions. The support is transparent and can be time-bound.

SUCCESSFUL RURAL FINANCIAL SCHEMES

Autonomy/Independence. Internationally, one of the fundamental problems for specialized rural financial institutions has proven to be the lack of autonomy to adhere to sound credit practices and respond to market signals. In many instances, this lack of autonomy has led to financially unviable lending in compliance with a government's mandate to meet development objectives. Specialized rural finance institutions generally face difficulties in attaining a satisfactory level of financial performance. The major reason for this being that these institutions are government-owned and controlled. Many, probably half of such institutions worldwide are not in a position to determine their lending rates. They also depend on Government as a source of finance - directly or indirectly.

Lessons from Success Stories: Despite the plethora of failures internationally, there are a number of successes. Three often cited successful RFIs are: the Grameen Bank (GB) in Bangladesh, the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, and the Village Banks (Unit Desas)(BUD) of Bank Rakyat Indonesia (BRI). All three share the following features:

- conducive macro-economic, agricultural and rural policies, and relatively stable political environment;
- adequate investment in rural infrastructure;
- high degree of management autonomy;
- staff policies that stress training and monetary incentives (but not for lending volume);
- innovative low-cost distribution systems and mobile banking;
- innovative and flexible (but market) lending rates;
- close monitoring of loan performance with high collection rates and low arrears;
- domestic savings mobilization as a growing source of funds, resulting in a diminishing need for donor-type funds;
- strong controls to limit expenditures and administrative costs; and
- advanced MIS systems which facilitate effective planning, control and timely monitoring of loan repayment.

BAAC operates as a state-owned bank under the auspices of the Ministry of Finance. It has enjoyed a great deal of autonomy. BAAC lent initially through agricultural cooperatives, but repayment problems led it to start lending directly to farmers. BAAC enjoys certain privileges aimed at stimulating agriculture. In addition, the Bank of Thailand requires that commercial banks invest at least 20% of their deposits in agriculture, either directly or through BAAC (most have opted of the latter providing BAAC with a large and consistent source of funds albeit that this is, of course, a tax on the rest of the banking system).

The founding objectives of BUD were to: replace existing (largely failed) directed agricultural credit with broad-based credit to the rural population involved in **any** type of economic activity; provide a full range of financial services including savings; and replace subsidized credit with positive on-lending rates. BUD's phenomenal success in savings mobilization has become its main distinguishing achievement. The focus of Grameen Bank has been somewhat different with its main goal to improve the living conditions of the rural poor by providing them access to credit, savings facilities and certain non-financial social services. Lending is exclusively through joint liability groups tied to compulsory savings.

The three institutions have experienced tremendous growth in assets and deposits over the past decade. In the case of BUD, by 1993, the volume of deposits was more than double that of its outstanding loan portfolio disproving the long outdated myths that the poor cannot save and that they require subsidized credit. All three have attained high levels of market penetration in their target markets. They all deploy a system of mobile banks. While BUD requires full collateral, it makes use of character references by village chiefs and has highly flexible loan terms and various savings instruments. BAAC and BD both use joint liability. BAAC has various savings instruments available, while savings in GB are compulsory and tied to loans and membership.

BUD is self-sustainable, while BAAC is marginally subsidy-dependent. The GB, while still heavily subsidy dependent, has markedly reduced its subsidy dependence over recent years. BUD's loan portfolio is very diversified with agriculture accounting for only 20% of the portfolio.

As noted, all institutions have a significant degree of management autonomy and employ well qualified staff on whom they invest heavily on intensive training. Spending on training amounts to almost 6% of BUD's total operating costs. Incentives are tied to both group and individual performance. In BUD, staff can receive 10% of a branch's profits with a maximum of 1.5 months' salary in bonuses. The loan collection performance of all three institutions is good ranging from 90% to 98% for the GB.

WHERE TO IN THE FUTURE?

As noted at the outset, there is no magic bullet that is going to resolve dilemmas on which there is relatively little agreement internationally. Probably the most important lessons from other countries are to get the macro, financial and agricultural frameworks right, allow interest rates to be set freely, and proceed with caution with Government interventions to avoid crowding out the private sector. In this context, it is probably best not to apply blanket solutions; rather, there needs to be support for extensive experimentation to identify what products are needed and how best to apply them.

Evidence suggests that traditionally disadvantaged groups of the rural population may be trapped in a low risk/low return investment strategies that in the long run will widen income disparities. The lack of access to rural financial markets may be contributing to this state of affairs and, as such, some form of government intervention may be desirable. In the first instance, the crucial issue is to address only the one or two issues that are real impediments to development such as access to financial resources for the new black farmers, while government endeavors to arrive at a better understanding of the issues at hand and formulates implementable strategies for dealing with them.

The debate internationally and around the Strauss Commission shows that it is very difficult to get broad consensus about how best to proceed. Certainly there is little proven track record based on local experience. The short-term objective should therefore be to: build on existing successes and test new mechanisms and policies that could be pursued; augment the participation of rural entrepreneurs in rural financial markets (including but not limited to agriculture); overcome the segmentation of these markets; and increase the competition in the sector.

What is needed is to test on a pilot basis, in the South African setting, key policies suggested by the specialized literature on financial markets in rural areas and on successes in SA and elsewhere in the world. This experimentation is essential because mistakes in the design and implementation of any kind of blanket approach will be extremely costly. These pilots could take many forms from state run interventions, albeit on a

small scale, to the fostering of NGOs, and incentives to commercial banks to establish very small branches to gain a better understanding of what is standing in the way of their getting involved (they may be surprised at the potential for generating savings). The Commission goes a long way in this direction but suggests a tone more of blanket solutions rather than one of caution and experimentation.

For example, an expanded role for the Post Office to provide the rural population a safe haven for their savings might be tried on an experimental basis rather than across the country, especially since international experience would suggest the importance that rural FIs mobilize their own savings. Similarly, allow full competition in the rural sector without restricting an institution only to agricultural lending; thereby denying it the ability to diversify its loan portfolio. Experiment with modest guarantees, different support to NGOs, different policies, for example the complete liberalization of interest rates, the provision of integrated financial services or with changes in collateral requirements to screening of borrowers on the basis of character and reputation. Try different forms of incentives for loan officers. Try to do whatever is possible to bring in the CBs.

In Mexico for example, after years of attempts to build up a viable and sustainable system or rural finance, there are still few clear-cut answers. As a result, Government is adopting a formal program of experimentation including support to some commercial banks to (a) adopt and test different technologies for financial intermediation in rural areas, and (b) explore on a pilot basis the market opportunities in those rural communities with no financial intermediaries. Grants will be provided to CBs to enable this experimentation. Costs of experimentation may be high, not least in the delay in adopting any across-the-board solution but the cost of large scale failure is much higher.

In short, there has been a great deal of analysis and debate in SA on the delivery of financial services to the rural population. The Commission Report is a significant step in the right direction although I believe there are major concerns on the savings and diversification fronts. This paper argues that there is also a danger of over prescriptive solutions which could, based on experiences elsewhere, require Government to step in and bail out the system at considerable cost in the longer term. While one could argue that after years of discrimination this would not be overly serious, it could undermine the financial system and would further delay the build up of a viable/sustainable system. A more modest experimental/pilot oriented approach may be warranted.

NOTES:

1. An alternative would be to provide fiscal transfers directly to the rural households so that they can pledge it into the banking system and attract private capital. Such an arrangement would leave the business of credit in the hands of the private sector whild the Government could concentrate on equity and efficiency through non-distorting fiscal transfers.