

# Synopsis

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This *Synopsis* introduces the first in a new series of publications from IFPRI. The FOOD POLICY REVIEW series provides a forum for scholarly reviews of the literature on key topics relevant to food and agricultural policy. These works are substantive syntheses of research on major food policy issues and may include original research to supplement the discussion. They provide considered judgments on policy options in light of current knowledge on issues that reflect the underlying processes that contribute to the reduction of poverty, hunger, and malnutrition in the world.

## Institutional Finance for Agricultural Development: An Analytical Survey of Critical Issues

Bhupat M. Desai and John W. Mellor

In reviewing the literature for Institutional Finance for Agricultural Development: An Analytical Survey of Critical Issues, Bhupat M. Desai and John W. Mellor look at how rural financial institutions (RFIs) are organized, how they can improve their financial viability, and how real interest rates affect the demand for rural loans, the supply of rural deposits, and rural savings. Their purpose is to make the findings of the extensive literature on agricultural credit policy accessible to developing-country policymakers.

The review addresses six major questions: Why promote formal RFIs? How should RFIs be organized? What are the transaction costs of RFIs and how should they be measured? What effects do real interest rates and other factors have on rural loans, deposits, and savings? What determines whether an RFI system is a net contributor to or a drain on public resources? And, what policy conclusions can be drawn from this analysis? To answer these questions, Desai and Mellor look at the literature on RFIs in high-, middle-, and low-income countries, both developed and developing. They include countries in four developing regions—Sub-Saharan Africa, Asia, the Near East and Mediterranean Basin, and Latin Amer-

ica and the Caribbean—as well as Western Europe and North America.

Drawing from a wealth of descriptive, cross-national material, the review includes detailed case studies of successful RFIs in several Asian countries: the Grameen Bank and the Sonali Bank in Bangladesh; cooperatives, nationalized commercial banks, and to some extent regional rural banks in India; the Bank for Agriculture and Agricultural Cooperatives and lower-level cooperatives in Thailand; two branches of the Agricultural Bank of Sudan in Sudan; and county and township cooperatives in the Republic of Korea.

### Organization of RFIs

As economies grow, informal traditional sources of credit, such as relatives and moneylenders, give way to formal, often publicly supported, financial institutions, such as banks, credit societies, and cooperatives. How these institutions are organized is crucial to their success. To develop effective RFIs, this report proposes that policymakers take the following steps:

- promote multiple RFIs in a given area;
- encourage a variety of forms of organization;
- promote the vertical structure of RFIs from local to regional to national;
- encourage high density of field-level offices;
- ensure that a large share of rural clients have access; and
- encourage RFIs to undertake a diversity of functions that help integrate the financial aspects of agricultural production, input distribution, processing, and marketing.

In most countries, RFIs can be found in a variety of organizational forms, including public-sector banks, cooperatives, private commercial banks, and government loan departments. Desai and Mellor find, however, that RFIs in many developing countries lack adequate vertical organization and fail to provide broad enough coverage of the rural population and many of the functions needed to promote agricultural growth. Systems that meet these criteria are better able to realize rural growth with equity, integration of rural financial markets, and economies of scale. They are more likely to be financially viable because their transaction costs are lower. Banks or cooperatives that have many branches and offer a wide range of services can realize unit cost savings because their volume of business is larger.

### Interest Rate Levels

Much of the literature holds that if RFIs set high enough interest rates, they will make a profit on loans and attract an adequate number of depositors to ensure that the institution is profitable. Desai and Mellor refute that contention for two reasons. First, in developing countries the demand for rural loans expands or contracts depending on the interest rate, but the amount of savings and deposits do not. Farmers' total costs of production are affected by changes in the interest rates they pay on loans. If the interest rate is too high, farmers will borrow less, which will adversely affect agricultural productivity. But farmers prefer to keep their assets in physical form anyhow—in seed, equipment, livestock, and so forth—so a change in the rate paid on savings and deposits is unlikely to have a profound effect on the level of farmers' deposits. For a financial institution to remain viable, however, interest rates must cover transaction costs. If an in-

crease in interest rates decreases the volume of business, it cuts back on the savings the institution can accrue from economies of scale, negatively affecting its profitability.

Second, in developing countries, accessibility, liquidity, and safety affect rural borrowing, savings, and deposits more than the interest rate. A high density of local-level offices over a wide geographic area is critical. Coverage of farmers ranges from only 7 percent in Africa to 24 percent in Asia. In the developed countries, coverage is almost universal. In the short run, rapid expansion may mean that administrative costs are high, but in the long run, high density is essential for continued viability.

They conclude that three barometers should be consulted in setting interest rates: expected rate of return on investment in agriculture, the potential for realizing economies of scale in transaction and other costs of RFIs, and the normal inflation rate. Thus, the higher the expected rate of return on investment in agriculture and inflation, the higher the interest rate should be. But as economies of scale are achieved, the interest rate should be reduced.

### Findings and Policy Implications

Much of the literature reviewed holds that rural financing follows demand; it is not led by the supply of credit. Desai and Mellor argue that the availability of new technology, which spawns an increased need for financial services, and the emergence of rural financial institutions should be simultaneous. Integrated rural financial markets emerge as the result of deliberate public policy in both developed and developing countries, not unguided market forces. In the process of economic development, private informal lenders decline in importance as publicly supported financial institutions grow. In four countries with successful development of rural financial institutions—Japan, Taiwan, the Republic of Korea, and the United States—all have publicly supported RFIs. Although many governments support RFIs through measures such as contributions to capital, administered interest rates, and credit and deposit insurance guarantees, the attention paid to promotion of RFIs has seldom been sustained.

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Please send me a copy of Food Policy Review 1, *Institutional Finance for Agricultural Development: An Analytical Survey of Critical Issues*, by Bhupat M. Desai and John W. Mellor.

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