Rural Finance Strategy

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Foreword

This document builds on Bank efforts over the past year to define a strategy to carry out the mandates of the Eighth Replenishment related to the development of rural financial markets. The 1994 Agreement for the Eighth Replenishment of the IDB's capital specifically calls for a commitment to reduce poverty and social exclusion through a "wide range of activities ...[including] rural development, job creation, particularly through the microenterprise and business sectors... [and] actions to boost the production capacity of small farmers."

The *rural finance strategy* is the result of an extensive process of background research and external and internal consultation. Civil society organizations, academics, the governments of the region, and institutions active in rural finance reviewed the profile and annotated outlines for the strategy and provided comments. The document was also the subject of consultations with an interdepartmental rural finance strategy group, chaired by SDS/MIC and consisting of representatives from each of the three regional departments, the Multilateral Investment Fund, various central department divisions, and the Office of the Presidency. A paper on the lessons learned in IDB rural lending operations was also prepared to support this strategy.

The *rural finance strategy* is designed as a companion and complement to other technical and strategy documents, including *Sustainable Rural Development* (GN-1909), *Financial Markets* (GN-1948-3), *Microenterprise Development* (GN-1938-3), *Agricultural Development in Latin America and the Caribbean* (GN-2069-2), *Rural Poverty Reduction* (GN-1995-5), and *Renewing the Commitment to Development: Institutional Strategy* (GN-2077-1), all previously considered by the Policy and Evaluation Committee of the Board of Directors .

This document puts forward the rationale, objectives, and areas of action of the Bank's rural finance strategy.

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Executive Summary

Purpose and Objective of the Strategy

The principal purpose of this strategy is to orient the operational staff of the Bank responsible for designing rural finance projects. In so doing, it complements and extends the financial markets strategy. The secondary purposes of the strategy are: to serve as a point of departure for discussions between the Bank and member governments on this topic; to help member governments design their own rural finance strategies; and to assist the Bank management in understanding the issues and institutional implications of adopting and implementing the strategy.

The objective of the Bank's rural finance strategy is to promote the provision of efficient, broadly-based, and sustainable rural financial services. In order to achieve this end, actions are being proposed in three areas: (1) creation of a favorable economic, legal, and financial regulatory environment; (2) creation of sustainable and efficient financial intermediaries dedicated to serving rural areas; and (3) promotion of new financial services, such as insurance, leasing and factoring, in those markets where the first two actions are well advanced.

The document is not specifically focused on agricultural finance but recognizes agricultural production and marketing as the significant part of most rural economies in present-day Latin America and the Caribbean. The rural, nonfarm sector is an increasing by important part of the rural economy, representing a growing share of total rural income and employment. Accordingly, much of the document highlights issues such as the need to develop financial services other than short-term credit (namely medium- and long-term credit, deposits, insurance, leasing, and inventory credit) that will specifically enhance the productivity and expansion possibilities of nonfarm service, processing, and manufacturing enterprises.

This is one of the last strategy documents to be prepared by Management prior to the consolidation and review of all strategies and policies mandated by the Bank's Institutional Strategy (GN-2077-1).

Background

Rural financial markets do not function properly in Latin America and the Caribbean. Rural residents, who account for 30 percent of the region's total population, have limited access to formal financial services, face a small array of financial products, and pay high costs for the financial services that they can access. The underdevelopment of financial markets has a negative effect on productivity enhancing investments, income expansion, and sectoral growth.

Financial markets do not function properly because of a triad of pervasive problems including unmitigated risk, imperfect information, and high transaction costs. In the past, interventions such as credit quotas and subsidized interest rates largely focused on treating symptoms such as lack of access by small- and medium-scale farmers and business operators without an understanding of the underlying factors that shape rural financial markets and make small- and medium-scale producers non-preferred clients. Consequently, the results were unsatisfactory and new efforts are required to address the underlying problems.

Strategy

The *rural finance strategy* addresses the main issues that hamper the growth and development of more complete and efficient rural financial markets and how the Inter-American Bank can best promote and support market-based reforms. The strategy focuses on how to improve access to four specific financial services: credit, deposits, insurance, and payments transfers. It is compatible with and is a logical extension of the Financial Market Strategy (GN 1948-3). The primary, but not exclusive, target group is low- and moderate-income rural entrepreneurs involved in both farm and nonfarm productive and commercial activities. As changes comes to Latin America's rural areas, more of the rural population will depend on nonfarm activities. In many instances, nonfarm activities are and will be more easily bankable than agricultural activities. Nonetheless, improved functioning of rural financial markets is critical to support the modernization of agriculture as called for in the strategy for the agricultural development in Latin America and the Caribbean (GN-2069-2), especially the development of efficient medium-sized farmers and the switch from low-profit, lower yielding crops to more high-profit, higher yielding crops. The improvement of rural financial markets is also important in order to reinforce the growth of the nonfarm economy, a segment of the rural economy that is becoming increasingly important over time in terms of its share of total rural income and employment.

The aim of the Bank's rural finance strategy is to systematically remove the constraints on both the demand for and the supply of financial services in rural areas, thereby allowing profitable intermediation and risk-sharing. Because the Bank has policy-based lending and technical assistance instruments at its disposal, it has a comparative advantage in focusing on the enabling policy environment. The recommended sequence of actions for the Bank (which depends on a suitable macroeconomic environment, overall banking sector strength, a high level of government commitment, and the presence of capable counterparts), is to engage in the following four steps:

1. removing biases in sectoral economic policies that have reduced the profitability and competitiveness of rural economic activities;

2. removing biases in the legal and regulatory framework that have increased the risk and cost of financial intermediation in rural areas;

3. strengthening and improving financial retail capacity for rural financial services; and

4. help to introduce new products and services for rural finance, once the policy environment is favorable and a number of solvent and capable financial intermediaries exist.

Taken together, these four steps help address the problems mentioned earlier: unmitigated risk, imperfect information, and high transactions costs. The more favorable the particular policy and institutional setting is in a country, the greater the possibility for simultaneous action in two or more of these areas.

Implementation

During the period 2000-05, the strategy proposes that each Regional Operational Department should determine which countries could benefit from a more proactive intervention by the Bank in the rural finance sector. The Departments should prepare action plans, on rural finance for those countries to be discussed with the authorities as part of the normal country programming process, with the goal of including operations to implement the plan. The action plans will be based on diagnostic studies and dialogue with significant actors in member borrowing countries. Effective implementation will require a review of operating procedures and changes in the way the Bank does its business because its partners will be primarily private sector entities.

Cost of Strategy Implementation

The Bank can make progress toward implementing the strategy with existing resources. However, full implementation may require the reallocation of staff and budgetary resources because the type of operations being proposed will be labor intensive and therefore high cost.

I. Introduction

Purpose and Objective

The main purpose of this strategy document is to help the operational staff of the Bank design and prepare rural finance projects that reflect the current state of knowledge in development finance. Other purposes are: (1) providing the basis of discussion and dialogue with private sector and public sector counterparts in borrowing member countries interested in promoting rural finance or participating in Bank-sponsored rural finance projects; (2) helping borrowing member governments design their own rural finance strategies; and (3) helping Bank management understand the issues and the budgetary and administrative implications of implementing the proposed strategy. The intended audiences are Bank staff and management, government officials in member countries, and the staff and management of financial intermediaries in borrowing member countries.

The objective of this strategy is to promote the provision of efficient, broadly-based, and sustainable rural financial services. In order to achieve this end, concerted actions will be needed in the following areas: (1) the creation of a favorable policy, legal, and regulatory environment; (2) the creation and strengthening of sustainable financial institutions dedicated to serving rural clients; and (3) in those markets where the first two objectives are well advanced, the promotion of new and innovative financial products and agricultural risk management techniques (deposits, crop insurance, electronic cards, leasing, factoring, warehouse receipts, contract farming, and hedging instruments).

Rural financial markets have not functioned well in Latin America and the Caribbean. The discussion below that follows centers on the historical legacy, the current situation, and why better functioning markets are important.[1]

Historical Legacy

Between 1950 and the early 1990s, the countries of Latin America and the Caribbean relied on a government-driven approach to serve the financial needs of their rural sectors. The norm was of large targeted and subsidized credit programs implemented through state-owned specialized agricultural development banks and private commercial financial entities. The objective was to improve access to credit for small farmers and thereby spur agricultural growth, expand income and reduce poverty. Despite substantial efforts and the best of intentions, evaluations of credit programs sponsored by various international development agencies indicate that results were less than expected. Neither was access to timely credit at reasonable terms by low-income rural customers substantially improved nor were viable financial intermediaries created. Accelerated growth and poverty alleviation goals remained largely unfilled. Development of other important financial services, such as deposits and insurance, were neglected despite demand.

Since the late 1980s and early 1990s, the majority of countries in the region have initiated massive financial sector reforms which include the liberalization of interest rates; the liquidation of insolvent banks and the rehabilitation of others; the liquidation of some insolvent state-owned banks, the reform and conversion of others to second-tier institutions; the improvement of prudential norms and supervision; the reduction of legal reserve requirements; the elimination of targeted credit programs; and the opening of the industry to foreign-owned banks.[2] These changes have re-

1 See Echeverría (2001) for a description of the rural development context in Latin America and the Caribbean, in which the development of rural financial markets is an essential element.

2 The IDB approved 13 financial sector loans and 18 investment sector loans (many of which had finan-

sulted in higher investment efficiency, greater banking competition, and a wider offering of financial products and services. However, these visible improvements have largely benefited urban residents, and further innovation and reform are required to benefit rural residents.

Current Situation: Lack of Depth and Limited Access Persist

Whereas some improvements have been made in urban financial markets, rural financial markets continue to be underdeveloped. For example, despite the general trend of increasing economy-wide financial depth (as measured by M2/GDP) throughout the region in the 1990s, for 5 out 9 countries with available data, the amount of credit to agriculture as a percent of agricultural GDP declined when comparing the pre- or early reform period of 1990-92 to the late-reform period 1994-96 (Wenner and Proenza, 2000).[3] During this same time period, agricultural output growth rates were generally positive, suggesting profitability and alternative sources of financing. Similarly, time deposits and savings as a percent of GDP trended upward for a majority of countries but for three countries with disaggregated urban-rural data in the mid 1990s, the amount of rural deposits as a share of total deposits is minuscule and virtually constant over time (less than 1 percent for Brazil, Chile, and Honduras). Based on recent surveys from seven countries, access rates to formal credit continue to be low (with the exception of Costa Rica). Excluding Costa Rica (40 percent), the average rate was 10.3 percent. The predominant sources of credit continue to be the informal sector, that is, friends, family, traders/suppliers, and moneylenders (Wenner and Proenza, 2000).[4]

The Importance of Financial Sector Development

Historically, financial sector development has been an important underlying element in overall economic growth and development for three reasons. First, financial sector development unleashes the economic potential of increasingly greater proportions of the population and accelerates *economic growth* through efficient intermediation and risk management. Countries with more developed financial markets and greater financial depth (as measured by the ratio of M2 to Gross Domestic Product) have grown faster, other things equal, than countries with less articulated financial markets. People who have not had access to the formal financial sector either because of low income, gender or social discrimination, or because they live in remote locations represent a large and potentially profitable market for financial institutions that can overcome the risk and transaction costs of serving these segments. In the Latin American and Caribbean countries, 30 percent of the total population is rural and a significant proportion is believed to be bankable but underserved.[5] This untapped market represents both a substantial social and private economic loss.

Second, the lack of adequate financial services and deep financial markets hinders the formation of new enterprises and the expansion and modernization of existing ones and contributes to *income inequality*. Those fortunate enough to have access

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cial sector reform components) between 1990 and 1998. Similarly, the World Bank financed 26 financial sector adjustment related operations in Latin America in the period of 1985-1996. See: Wenner, forthcoming and Financial Sector Reform: A Review of World Bank Assistance (1998).

[3] Agricultural credit is a proxy for rural credit due to lack of fully disaggregated data. The decline in the supply of agricultural credit per se is not an accurate measure of rural financial depth because, in the past, some part was believed to have been diverted to nonfarm, urban uses.

[4] Some rural residents may not want to go into debt. However, a fraction of this group may not seek credit due to adverse risk-return tradeoffs (i.e., collateral requirements several times the value of the loan amount) that can be made more favorable with appropriate policy and legal reform.

[5] If the urban microfinance experience can be used as a guide, the expansion of financial services will first benefit the upper poor. Some proportion of the rural poor, simply will not be bankable and other interventions in education, health, and infrastructure will help to increase income-earning potential.

to credit and deposit services can increase their income faster than those that do not.

Third, improved rural financial intermediation could directly *reduce vulnerability* and indirectly alleviate *poverty*. For example, the widespread availability of monetized savings facilities could allow poor households to withdraw savings during cyclical downturns or unexpected idiosyncratic crises and thereby improve household security and smooth consumption. Currently, most rural savings in Latin America are in-kind (livestock, grain reserves, jewelry, inventories, land) and often present divisibility and illiquidity problems during times of crisis.[6] Thus, the greater availability of this financial service would reduce vulnerability to welfare reducing contingencies but not necessarily raise income levels above the poverty threshold.

[6] If the crisis is economy-wide or systemic in nature and results in massive currency devaluation and/or high inflation rates, access to saving services will not necessarily help to maintain consumption levels. The loss of purchasing power could be significant. This threat underlines the need for effective macroeconomic management.

II. Bank Support for Rural Financial Development

The Report on the Eighth General Increase in the Resources of the Inter-American Development Bank states, “The objective...[of the growth strategy]...is to reduce social inequality by incorporating fully the most disadvantaged strata of society into the modern economy...Since social and political stability are indispensable conditions for creating sustainable growth, all parts of society must believe that they have a stake in the system and in the country’s future.”[7] The majority of the economically active rural population consists of small-scale agricultural producers and small, nonfarm entrepreneurs. They tend to experience a high incidence of poverty (54 percent of rural households) and enjoy only limited access to formal financial markets (less than 15 percent in most countries). Access to credit and deposit services by poor persons by itself will not cure poverty, but given auspicious conditions and sustained access to financial services over time, their chances of escaping poverty increases. Therefore, the Bank has a role to play in fostering the development of rural financial markets.

The Bank’s Lending Experience

The Inter-American Development Bank has been one of the leading sources of development assistance to Latin America and the Caribbean. The IDB’s rural finance lending program between 1961 and 1998 can be classified into three categories: (1) targeted, subsidized agricultural credit for medium- and small-scale agricultural producers; (2) sector and regulatory reform; and (3) private enterprise credit and financial intermediary development. In these categories, the IDB approved US$4.4 billion, US$4.2 billion and US$474 million, respectively, for a grand total of US$9.1 billion. In comparison, the World Bank approved US$3.3 billion to be spent on agricultural credit projects between 1961 and 1992 in the Latin American and Caribbean region and USAID invested US$2.3 billion in rural finance between 1961 and 1997 (See Annex 1).[8]

During the period 1961-89, the IDB disbursed over US$4.2 billion for global agricultural credit (GAC) through 131 operations. These credit programs channeled resources, either indirectly through rediscount facilities or directly through loans to state agricultural development banks and other specialized rural lending institutions, for on-lending to rural producers at preferential rates of interest. In addition, the Bank made credit available to rural producers under integrated rural development (IRD) operations which were multifaceted projects attacking problems of rural poverty and underdevelopment in a specific region of a country through simultaneous investments in a number of areas, including, for example, agricultural extension, credit, marketing, infrastructure, and training. During the period 1961-96, 36 IRD operations were approved totaling US$1.3 billion. Of these operations, 18 operations (in the period of 1968-1981) had agricultural credit components totaling US$236 million. Both of these programs were characterized by subsidized interest rates.

In the late 1980s and early 1990s, the Bank’s lending policy changed because of the poor performance of subsidized directed credit schemes. The new focus was on liberalizing markets and improving investment efficiency. Three main instruments—Financial Sector Reform Loans (FSLs), Investment Sector Reform Loans (ISLs), and Agricultural Sector Loans (ASLs)—were used in a coordinated fashion to this end. FSLs helped borrowing member countries to move toward market-based interest rates, increased banking

[7] Pages 2 and 13 of said document. Reference Document No. AB-1683 April 12, 1994.

[7] See World Bank, 1993 and USAID, 1999.

competition, and strengthened prudential and regulatory frameworks. ISLs helped to liberalize trade and investment regulations in order to spur private investment. ASLs removed price distortions that reduced the profitability and competitiveness of agricultural products, thereby making rural producers more bankable. Some of these loans included specific conditionality related to state-owned agricultural development banks and other aspects of rural finance.

In the late 1980s and early 1990s, the Bank also used four other instruments which were targeted specifically to improve access to credit by private entrepreneurs: (1) Small and Microenterprise Global Credit Loans (MicroGlobals); (2) Global Multisectoral Credit Loans; (3) Multilateral Investment Fund Projects (MIF), and (4) Small Projects.[9] Since 1990, the rates of interest charged to final clients have not been subsidized.

MicroGlobals were used to provide liquidity and to reduce funding risk as an incentive for participating financial intermediaries the borrowing countries to serve the small and microenterprise sector. To date, 15 Microenterprise Global Loans have been approved for a total of $594 million, and 13 are in execution. The limited available evidence on these loans suggests that the overwhelming majority of participants in the MicroGlobal programs have been urban-based financial institutions. The amount reaching rural producers is estimated to be about $21 million or approximately 10 percent of the amount disbursed.[10]

Global Multisectoral Credit Loans were used to promote longer term financing and thus stimulate private investment. The programs were open to all types of clients. Some agroindustries and rural enterprises benefited but, again, the majority tended to be urban-based clients involved in manufacturing and services. Out of the $3.6 billion approved, an estimated 9 percent or $323 million went to rural industries and producers. However, the programs played a vital role in strengthening second-tier institutions.

Another instrument that has helped rural clients is Window III (The Small and Microenterprise Facility) of the Multilateral Investment Fund (MIF), which dates back to 1993. The MIF has undertaken few rural finance operations (12) and the amount approved (US$21.6 million) is a modest 5.2 percent of total MIF financing. However, the number of rural finance projects has increased markedly in the last few years, suggesting an upward trend.

Lastly, the Small Projects Program (SPP), dating from 1978 and now renamed into the Social Entrepreneurship Program (SEP) has also benefited rural producers. Fifty-two Small Projects provided financing to rural agricultural producers prior to 1992, but the amount disbursed, $23.7 million, constitutes about 18 percent of cumulative SPP lending. Since the early 1990s, some 80 percent of the resources approved have been directed to microenterprise development, much of it in urban areas but a fair amount rural based. Due to lack of data on client beneficiaries, it is difficult to determine the exact share reaching rural clients. Nonetheless, SPP has been a laboratory in which interesting experiments have been tried. Several financial intermediaries who received Small Project loans have now matured and transformed themselves into regulated financial entities. Some of these transformed financial NGOs are now expanding operations in rural areas.

Since 1985, Bank lending for direct support of rural finance in general, and for agricultural credit in particular, has been declining (Annex 2). The change in credit flow patterns is due to a change in Bank lending policy and the ongoing search for appropriate and effective financial technologies for large scale, rural intermediation that can be promoted in the midst of liberalized policy regimes.

[9] This program was officially revised and renamed Social Entrepreneurship Program in December 1998.

[10] This estimate is based on a review of executing agency reports and conversations with project officers involved in designing and supervising MicroGlobal loans.

Lessons Learned

The lessons discussed in this section are derived from the review of 27 IDB rural finance projects, existing evaluation documents on the topic, and staff interviews (Wenner, forthcoming). The lessons are grouped into four categories, three based on the purpose of the operation and one on implementation experiences. Those categories are targeted credit, sector and regulatory reform, institutional strengthening of financial intermediaries, and program execution.

Targeted Credit

Targeted, subsidized credit programs, such as the Global Agricultural Credit and Integrated Rural Development operations, tended to distort rural financial markets, undermine the viability of many participating financial intermediaries, discourage the mobilization of savings, and disproportionately benefit higher income borrowers. Therefore, these types of projects should not be promoted.

Targeted, nonsubsidized, wholesale credit programs, such as MicroGlobals and Multisectoral Credit operations, played a role in promoting the expansion and deepening of financial services to underserved producers, but their role is limited. Those programs that succeeded in expanding rural producers'access to credit were carried out in countries with large agrarian sectors that had intermediaries already present in rural areas. However, for these wholesale credit projects to avoid unintended negative effects, the interest rates charged to final sub-borrowers should be set on market terms (i.e., should cover operational costs) and rates charged to intermediary institutions should be set at levels that do not undermine their deposit mobilization activity. The Bank's experience has shown that small-scale borrowers are more sensitive to the nonfinancial costs of the transaction (processing fees, travel costs, and income lost due to delays in approval and disbursement) than to the financial costs (interest payments).

The role of second-tier or wholesale institutions has proven to be important in deepening financial markets. However, operations such as Multisectoral Credit Loans that strengthen second-tier institutions and channel resources through them must be carefully designed. Special care should be taken to avoid the negative effects of arbitrary allocation and pricing of long term resources that can undermine savings mobilization efforts and retard the development of secondary markets.

Guaranty funds were often used as a means of reducing the default risk faced by private commercial banks in lending to medium-, small-, and micro entrepreneurs in Latin America and the Caribbean. Typical models included having a third party (i.e. a fund established by donor agencies and national governments) guarantee individual loans made by a financial institution to a client or guarantee a portfolio (i.e. a set of loans made by a financial institution to a particular class of clients who meet certain criteria). These two models, the individual loan guarantee and the portfolio guarantee, proved to be ineffective. They were plagued with high transaction costs, heavy losses, lack of additionality, and moral hazard problems. Most importantly, private banks did not learn how to evaluate risk and thus were not prepared to serve the target population once the guarantee program expired. Since the mid-1980s, a new model of intermediary guarantees, wherein a loan or line of credit from a local bank to a nonbank microfinance institution is backed by an international organization issuing a letter of credit or making cash deposit, has shown more promise. This model has been characterized by low rates of default and losses and has succeeded in increasing access by nonbank microfinance institutions to commercial loans. Though questions of sustainability and the rate at which microfinance institutions are graduating to unguaranteed lending linger, this intermediary model has value and could be used in future operations (Young, et. al., 1997; Levitsky, 1993).[11]

Sector and Regulatory Reform

Experience with sector loans and with technical assistance to promote reforms showed that attention must be paid to the political economy sur-

[11] IDB experience with guaranty funds for rural funds has been limited but the importance of the mechanism warranted inclusion.

rounding their implementation if these types of interventions are to be effective. In the past, vested interests benefited from the status quo. Therefore, new operations must be designed in ways that deal with the threat of opposition to change that is likely to arise. The most telling instances have been attempts to reform state-owned agricultural finance institutions, which have generally failed.

Laws governing the creation, perfection, and enforcement of security interests, moveable property collateral and the attendant regulations and institutions have been shown to be in need of improvement. Small borrowers often lack secure title to land or are unwilling to pledge it in a loan transaction; therefore, other formal collateral substitutes are needed. This element was missing the first wave of reform operations.

The Bank's experience has shown that rural finance reforms have a very low probability of succeeding if included in complicated, multifaceted sector operations. In order to promote change in rural financial markets, reform operations must focus more specifically on rural finance per se.

Institutional Strengthening of Financial Intermediaries

A number of MIF, MicroGlobal, and SPP operations entailed activities to strengthen financial intermediaries. Experience shows that operations that contributed to the creation of sustainable financial intermediaries selected institutions that had certain characteristics. The special characteristics of the institutions include strong leadership, a clear mission to serve the rural small and microenterprise sector, a businesslike approach, and a proven service delivery technology. Therefore, the process of selecting institutions for assistance is crucial to success and the Bank must engage in a rigorous analysis of their actual and potential performance prior to approval, and continue to monitor performance.

Experience shows that innovations are needed in financial service delivery technologies to lower transaction costs and allow financial intermediaries to expand financial services in rural areas. Parallel interventions are needed to reduce the high degree of production and price risk in agriculture. Such parallel efforts include appro-priate investments in physical infrastructure, improved extension services, improved marketing, and an increase in the provision of insurance services.

Building sustainable financial intermediaries capable of providing financial services to rural clients is a slow process that requires a commitment over a long period (5-10 years). Rules or customary norms that prohibit granting of resources to the same group on multiple occasions need to be reevaluated.

Program Execution: Bank Monitoring and Supervision

The Bank's project design and preparation process has generally succeeded in identifying the constraints and developing feasible solutions. However, monitoring and supervision emerged in the review as an area of recurrent weakness. Timely technical interventions by Bank personnel in difficult operations, especially those operations involving complex policy and institutional reforms, was sometimes lacking. Because so many reforms needed in rural finance are of an institutional nature and the period needed to effect change is long, high quality and sustained supervision and monitoring by the IDB has been shown to be important.

III. Problems and Solutions in Rural Finance

To design optimal interventions, problems need to be identified properly and appropriate prescriptions need to be developed. This section explains why rural financial markets are peculiar, what are the main problems, and what are possible solutions.

General Problems in Rural Financial Markets

Rural financial markets do not function efficiently because *production and price risk, imperfect information, and transaction costs* are pervasive, underlying problems. In the past, public sector interventions, such as credit quotas and subsidized interest rates, focused on observable symptoms such as lack of access by small-and medium-scale producers, without an understanding of the underlying factors that shape rural financial markets and make small- and medium-producers non-preferred clients. Consequently, the results were unsatisfactory.

The first root cause for poorly functioning rural credit markets is the combination of high levels of production and price risk and limited mitigation techniques. For example, rural agricultural producers and small-scale entrepreneurs who contract a financial obligation are subject to systematic variability that may result in involuntary default. In the absence of adequate risk mitigation instruments (e.g., collateral, insurance, futures, etc.) financial intermediaries are forced either to withdraw from rural areas or to develop contract design mechanisms that resolve the problems indirectly. Joint liability contracts or group credit is one such alternative. Group credit, however, imposes high transaction costs on group members and seems to work well only when certain conditions are met. Those conditions include regular meetings that provide significant ancillary benefits (market intelligence, business networking, training, etc.), existence of a high degree of social cohesion and loans whose size remains within the mutual insurance capacity of the group. Charging higher rates of interest to compensate for the high risk also has a limit. It can induce adverse selection wherein only the risky clients demand credit.

The second root cause for underdeveloped markets is imperfect or asymmetric information. Information is costly to acquire and transmit, yet it is vital in assessing and managing risk. Good information can serve as a partial substitute for lack of real collateral and a means to prevent moral hazard. However, in rural settings the absence of formal credit histories, the absence of a tradition of record keeping, and the heterogeneity of production conditions complicate creditworthiness evaluations and loan/insurance monitoring activities.

The third root cause is high transaction costs stemming from peculiarities in the physical and institutional setting. Rural areas are characterized by high levels of poverty, spatial dispersion, marked seasonality of income, weak legal and contract enforcement frameworks, poor physical infrastructures, and low levels of schooling. These features increase transaction costs for both intermediaries and clients. Once transaction costs pass a threshold, they stifle intermediation.

This combination of causes explains why formal intermediaries are less likely to be present in rural settings and are at a competitive disadvantage vis-à-vis informal intermediaries, who by virtue of geographic proximity and multi-stranded, economic and social relations enjoy information and transaction cost advantages. Therefore, informal intermediaries tend to be more active than formal ones. It also explains why small-scale producers tend to be non-preferred clients even in competitive formal markets. Higher income, larger-scale producers, those with traditional forms of collateral and established credit histories, tend to be the preferred clients (Wenner and Proenza, 2000).

Specific Problems to be Addressed in Rural Financial Market

For the purposes of this strategy, five major symptomatic problems have been identified that need to be addressed. The major observable problems are (1) limited access to short-term formal credit, (2) market segmentation and lack of competition, (3) limited availability of medium- and long-term credit, (4) paucity of operationally efficient and sustainable financial intermediaries and (5) a limited array of financial services.

Limited access to short term formal credit can be attributed to (1) the low profitability of many rural activities; (2) the lack of traditional forms of collateral, namely titled land; (3) weak and costly formal enforcement mechanisms; and (4) imperfect information. Rural enterprises that do not generate sufficient margin to cover the financial costs of a debt obligation are simply not bankable. In the past, fixed and unvarying prices for agricultural outputs, poor infrastructure that significantly elevated production and marketing costs, and export taxes reduced the profit margin of many rural enterprises. Today, many of the economic policy distortions (e.g., fixed prices and export taxes) have been removed but poor infrastructure, the use of outdated technology, lack of access to overseas product markets, competition with highly subsidized farmers in industrialized countries, lack of awareness on the part of potential clients about financial instruments, and overvalued exchange rates can be complicating factors. The lack of secure title to real estate and the willingness to mortgage it can be another deterrent, even in light of a viable investment project. The high cost of en-forcing credit claims also deters formal intermediaries from being active in the sector. Lastly, the cost of gathering information on dispersed clients without a history of record keeping is still another constraint. This problem affects most small-scale producers and entrepreneurs.

Market segmentation refers to the commonly observed pattern that formal intermediaries tend to serve higher-income, well-collateralized clients while semi-formal and informal intermediaries serve clients with lower incomes and more collateral constraints. The overall small number of financial intermediaries can lead to the exercise of monopoly power. The segmentation and lack of competition results in inefficiency and unnecessarily high rates of interest. Clients with identical loan demand and risk profiles can receive different terms and conditions depending on source of funding. Reasons for the segmentation and weak competition are fourfold: (1) inappropriate regulatory frameworks that limit entry and product innovation; (2) limited availability of risk mitigation techniques; (3) costly and imperfect information; and (4) differential contract enforcement capacity.

The limited availability of medium- and long-term credit is a major constraint to agricultural and industrial diversification, productivity growth, and environmental protection. This is so because many crops are perennial, many soil and water conservation investments have long periods of gestation, and many types of machinery need to be amortized over a longer period. Proven microfinance technologies are short-term in nature and more appropriate for commercial retail activities. Medium-and long-term credit is scarce due to macroeconomic instability and the general absence of effective risk management tools in rural areas. Volatility in interest rates and exchange rates as well as tendencies to tolerate high inflation rates creates uncertainty and risk for long-term investors and lenders. For example, fear of devaluations and high inflation rates discourages domestic savings, further reducing the supply of loanable funds. These factors combined with the higher degree of uncontrollable risk in rural lending and lack of risk mitigation tools (insurance, reinsurance, securizations, commodity price stabilization schemes, vertical integration etc.) result in a tendency for intermediaries in the region to lend short, if at all, to the rural sector. Rural nonfarm industries and medium-sized farmers are particularly affected by the limited availability of medium-and long-term credit. This class of producers is constrained in making fixed investments in plant and equipment, diversifying crop mixes, modernizing technological processes, and exploiting high profit opportunities. As a result, segments that can be a vanguard in generating employment and productivity gains are stymied.

In rural areas there is a *paucity of operationally efficient and sustainable financial intermediaries.*[12] Quite a number of formal and semi-formal intermediaries active in rural areas are subsidy dependent and removed from the efficiency frontier. This state of affairs is due to (1) inappropriate governance and incentive structures; (2) weak business management capacity; (3) excessive reliance on collateral-based lending technologies that increase transaction costs burdens for both the intermediary and the client; (4) vulnerability to covariate risk due to limited portfolio diversification possibilities and small capital bases; and (5) continued donor sponsorship.

Limited supply of other financial services, such as deposits, payment transfers, insurance, and leasing, hamper the ability of rural residents to better manage risk and liquidity. Often, rural clients are forced to use credit as a costly substitute for lack of access to insurance or liquid savings. Other times the dearth of formal financial institutions in the country system complicates the payments clearing and settlement system. The result in either case is welfare-reducing and limits business development. The reasons why these financial products and services have not developed are due to a combination of missing legal, institutional, and economic preconditions and the "free-rider" incentive problem. For example, the limited reach of credit bureaus, the lack of recognition of floating liens on inventories, and the non-deductibility of leasing expenses for income tax purposes hamper the wider use of credit cards, inventory credit, and leasing, respectively. Lastly, because many of the innovations in the financial services industry can be easily copied, innovators are discouraged because the chances of recovering the high cost of experimentation are reduced (free-rider effect).

Proposed Solutions

In order to improve the functioning of rural financial markets, actions are recommended in three broad areas. First, efforts are needed to create a policy environment conducive to rural financial intermediation. More specifically, steps must be taken to improve the profitability of rural activities, reduce macro and sectoral risk for clients, improve information flows, and reduce legal impediments to efficient and low-cost intermediation and contract enforcement. Second, efforts are needed to improve retail capacity, namely by creating new financial institutions, forging links between formal and informal financial institutions, and strengthening existing formal and semi-formal institutions. Third, efforts are required to encourage the introduction and diffusion of financial services other than credit, such as deposits, crop insurance, commodity collateralized finance, hedging instruments, electronic cards, and leasing. These products would serve to better manage risk and liquidity and lower transaction costs. However, these newer services, especially commodity collateralized finance and hedging instruments, must be preceded by strong investments in cash-based agricultural marketing systems and improvements in the legal and regulatory framework.

The enumeration of proposed solutions starts at the general and overarching level and moves to the specific and narrow. Several of the proposed actions are in the domain of the strategies on the development of financial markets and agriculture in Latin America and the Caribbean. However, the intent is to provide a holistic and integrated view of rural finance issues and to set the stage for the presentation of the rural finance strategy in the next chapter.

Creation of a Favorable Policy Environment

Macroeconomic Stability and Policy Consistency. A fair degree of macroeconomic stability and policy consistency are necessary conditions for the promotion of deep, efficient, and competitive rural financial markets. High rates of inflation and exchange rate instability are particularly detrimental to the development of financial markets. Fiscal, monetary, and trade policies affect the risk environment faced by financial intermediaries as well as the cost of funds. The crucial variables for financial markets are the central government=s deficit, the inflation rate, the interest rate, management of terms of trade risk, and the real effective exchange rate. While there are elements be-

[12] See *MicroBanking Bulletin*, July 1999. Few financial institutions with sizeable rural portfolios report and those that do receive mediocre ratings on institutional performance.

yond the control of the government, such as capital movements and terms of trade, central governments can pursue consistency in policies and strengthen their countries' ability to cope with external shocks. Specific areas of action include obtaining contingent access to foreign exchange financing, broadening the tax base, improving tax collection efficiency, setting precautionary fiscal targets, adopting budgetary rules that permit a quick response to external shocks, and adopting the use of medium-term budgeting.

Appropriate Sectoral Economic Policies. Neutral sectoral and investment policies are needed to lower transaction costs in rural financial intermediation (improvements in communications, transport, electricity) and to increase profitability in rural economic activities (absence of economic policies that result in net transfers of income out of rural areas in general and agriculture in particular). The principal areas of concern are public infrastructure investments, market based price incentives for agriculture, and nonfarm incentive policies. Expenditures on rural infrastructure and social services (education and health) can increase rural productivity, lower marketing risk, and reduce financial transaction costs. Unfortunately, rural areas historically have faced a disadvantage in the allocation of infrastructure resources and social spending. Agricultural taxation has diminished with the advent of price and trade liberalization programs in the late 1980s. However, some Latin American and Caribbean agricultural sectors have faced adverse terms of trade due in part to external shocks, weak macroeconomic management, and institutional and infrastructural weaknesses. For example, many of the vital support institutions in rural areas (marketing cooperatives, research institutes (agricultural sciences, plant and livestock breeding, food processing technology, post-harvest handling, etc), and extension services) have withered in recent years. Lastly, incentives for the relocation of industries and start-up of other nonfarm business activities are needed in rural areas to diversify sources of household income and create backward and forward linkages.

Clarification of Property Rights (Titling). Lack of secure land tenure is a major obstacle to the provision of medium-and long-term credit. Less than 50 percent of the privately owned land in LAC is titled and registered. Nonetheless, titling in not a sufficient condition to improve access to credit. Other factors seem to be important, such as larger farm size, higher levels of human capital, and proximity to major consumer markets. Therefore, titling efforts should be cautious and emphasize the use of modern technology (satellite imaging) to reduce cadastral mapping costs, integrate titling and registration procedures, issue universal requirements to register title; and modernize public registries.

A related and important issue is the recognition of women's rights to property acquired while in an official or common-law marriage. Efforts are needed to study the impact of current laws and practices and to determine what can be done to improve equity and fairness in the disposition and pledging of assets.

Effective Legal Environment. An effective and reliable legal system is fundamental to the functioning of financial markets due to the intertemporal, promissory nature of financial transactions. In Latin America and the Caribbean, the secured transaction framework is generally inadequate and public registries are weak. In many instances, the cost of creating, perfecting, and executing guarantees can be prohibitive. For example, in some instances moveable collateral is not readily acceptable due to gaps in the law. In other instances, the lack of adequate enforcement of creditor claims, partly an exogenous historical endowment (French civil law tradition) and partly due to the proliferation of overlapping laws in recent decades, increases the risk and cost of rural financial intermediation. This higher level of risk and cost discourages the entry of formal intermediaries into rural markets or outreach to more low-income, collateral constrained clients. Informal intermediaries remain dominant in rural areas in part due to their willingness to accept a wider variety of collateral and because they have superior enforcement capacity that is based on inter-linked contracts and monopoly power. This market power can be exploited to extract rents in excess of reasonable risk premiums.

Adequate Regulatory Environment. The lack of strong and appropriate prudential regulation and supervision in a liberalized setting increases the chances for banking crises, fails to protect investors and savers, and introduces biases against lending technologies that rely on reputation and small transactions, be it credit or deposit-taking. Thus, systematic actions are needed to correct inappropriate rules and weaknesses in supervision. Particular areas of concern regarding rural financial intermediation are loan documentation, provisioning requirements, loan risk classification, sampling techniques, usury laws, rules on hours of operations, and entry requirements. Also, by promoting the harmonization of accounting standards, and transparency and openness in financial intermediaries through disclosure laws, the government can lower barriers to entry, better safeguard the soundness of the financial sector, and protect the interests of clients and investors from excessive risk taking and poor financial management.

One particularly important issue is the regulation and supervision of deposit-taking institutions. The cost of regulating rural institutions will be high using traditional techniques of supervision, because the total number of financial institutions serving rural areas, at least in the first stage of development, will tend to be large, but each with modest total assets. In the aggregate, rural, deposit-taking, financial institutions may not constitute a systematic threat to the entire financial system but they will demand a disproportionate share of supervisory resources. Therefore, the Bank and other interested parties will have to explore rating agencies, third-party regulation schemes and greater reliance on external audits and delegated supervision in order to avoid overtaxing supervisory authorities and providing for effective protection of small depositors and investors.

Development of Enhanced Information Environments. The use of information is key in all financial transactions and at all levels, macroeconomic, intermediary, and household. However, imperfect information problems are more severe in rural areas than in urban areas and greatly complicate the functioning of rural financial markets. Government can play a pivotal role in improving the quantity and quality of information on rural economic activity and financial intermediation. For example, the government can help promote the creation of credit bureaus by the balancing privacy rights with the need for financial information disclosure laws, national policies that will permit unique client identification, and technology investments in data handling and high speed transmission. The creation of credit bureaus with broad databases could help lower the costs of evaluating credit risk. More indirectly, the government can provide private sector agents with valuable information that will help improve the production and marketing of rural goods through periodic surveys; agricultural censuses; the systematic gathering and dissemination of commodity production, price, trade, transportation, and weather data; and studies of cause and effect relations in agriculture and rural industry. For example, the development of high quality databases could facilitate price and weather forecasting so that private parties could engage in risk transfer activities (forwards, futures, rainfall lottery insurance schemes) and efficient marketing arrangements.

Development of Financial Retail Capacity

The strengthening of financial retail capacity is a clear and fundamental need. Specific areas of concern are governance incentives, quality of business management and technology/contract design in financial institutions. No particular institutional type has been dominant in terms of performance in the development finance literature.[13] Therefore institution-building interventions should be multipronged and guided largely by country context, the quality of available leadership, and the level of institutional commitment to achieving financial self-sustainability. Because of the presence of many state-owned banks in the field, their proper role is discussed separately. Nonetheless, the goal is to extend the frontier of formal finance to incorporate rural areas based on principles of sustainability, efficiency, and significant outreach. Five interventions are possible:

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[13]General institutional types are: (1) private commercial banks; (2) specialized banks (private and state-owned); (3) nonbanks (finance companies, credit unions); (4) credit granting nongovernmental organizations and (5) community or member-owned institutions (village banks, cooperatives, etc.)

- Upgrade semiformal financial institutions to regulated financial intermediaries;
- Assist commercial banks interested in serving low- and moderate-income clients;
- Link formal and informal financial intermediaries;
- Restructure and reform existing financial institutions; and
- Create new financial institutions.

Each type of intervention has its advantages and disadvantages. The choices, however, are not mutually exclusive but depend on context. For example, several semiformal, credit-granting, nongovernmental organizations (NGOs) have successfully transformed themselves into regulated, formal financial entities (Prodem to BancoSol in Bolivia; AMPES to Financiera Calpia in El Salvador; Ademi to BancoAdemi in the Dominican Republic; etc.) and now serve rural areas. However, the transformation process is expensive and requires very strong and capable leadership, competent and committed staff, and sustained donor support. Commercial banks interested in serving low-income segments of the market (downscaling) have significant advantages such as economies of scale and scope, good management information systems, a staff that is well trained in finance, accounting, etc. However, downscaling is not likely to be successful without a strong strategic commitment to the sector, a willingness to open branches in low-income, rural areas, and an ability to change corporate culture, staff recruitment practices, and technology in an effective manner. Linking formal to informal institutions such as private banks and credit-granting NGOs or banks and agricultural input suppliers/food processors/export-ers is a promising avenue but the layering of costs, agency problems, effective coordination, and monopoly power can be issues. Existing financial institutions such as state-owned agricultural development banks, *cajas rurales*, and credit unions have a checkered past. Their attempts to address market failures have not always been successful. Thus, care must be exercised in determining whether reform, consolidation, or liquidation is the best course of action. Lastly, the creation of new financial institutions, such as narrow or specialized banks, again is promising. Nevertheless, the charter laws must be well designed to create proper governance incentives, clear ownership rights, and appropriate capital structures. This route, while attractive because one can begin anew, can be costly and take time to bear results. It may also conflict with current macrofinancial views that favor a consolidation of banks and the promotion of a few strong, universal banks in Latin America. The issue ultimately will have to be resolved at the country level through dialogue and consensus building. In the short term, governments can use temporary incentives to encourage commercial banks to enter rural markets either directly through the opening of branches or indirectly via linkages to local financial institutions or local agents. However, these incentives should not be substitutes for actions that address underlying risk and information problems (improving rural infrastructure, policies that spur nonfarm businesses and increased rates to farming, reforms of legal systems, etc.) that when resolved will make rural banking more attractive and sustainable in the long run.

The role of state-owned and managed financial institutions has diminished somewhat in recent years, yet they continue to be dominant suppliers of credit to rural producers in several countries. These types of institutions have historically been justified based on claims of market failure; that is, the inability or unwillingness of the private owned financial entities to act in a socially desirable manner. However, the history of direct government interventions in financial markets, especially through state-owned banks, has not been successful in terms of attaining institutional sustainability and targeting efficiency. The combination of conflicts of interest in governance, moral hazard, and inefficient operations have led to significant problems. Common problems included tolerance of high delinquency rates, high administrative cost structures, frequent turnover in leadership, political interference in the loan approval process, pricing policies that contributed to decapitalization, cumbersome operating procedures that increased transactions costs for borrowers, and disproportionate concentration of the benefits in higher income households, despite publicly stated intentions to the contrary.

While government interventions cannot be ruled out categorically and market failures cannot be dismissed, safeguards should exist to prevent the substitution of a market failure with a government failure. Governments should be able to defend their actions, including the continuance of first-tier institutions by proving that the market failure can be removed in a cost-effective manner. First, if there are information asymmetries, the government (state bank or state run credit programs) must demonstrate that it has better access to information at lower cost than the private sector. Second, if there are externalities, the government should be able to quantify them and propose a solution that internalizes the costs. Third, if the private sector is unwilling to serve the financial demands of a specific sector (rural), then the government should solve the underlying root causes of the problem and not treat the symptoms. These conditions rarely hold and therefore, member governments should not view first-tier lending operations as a solution. They should instead focus on setting appropriate policies, ensuring proper oversight, creating a favorable legal environment, and play a temporary role in helping to foster longer term financial markets through second-tier institutions that allocate the resources at market rates (see Vives and Staking, 1997). While these longer term principles are being pursued in accordance with the Bank's Financial Market Strategy (GN- 1948-3), in some exceptional areas such as the rural sector, the IDB may channel resources to those first-tier state-owned financial institutions that are able to meet certain criteria.[14]

As a practical solution to the politically unpopular proposal to dismantle state agricultural banks without alternatives, member governments may want to focus on developing linkages with formal urban financial intermediaries and semiformal and informal intermediaries and providing technical assistance and funding to mutualist-owned, savings-led financial institutions in the short term. In the medium term, member governments may seek to encourage the formation of new, privately owned and managed equity-based, financial institutions dedicated to rural finance and microfinance. In the long term, member governments may attempt to attract commercial banks to extend out and penetrate rural areas when profitability has been clearly demonstrated and competitive forces lead commercial banks to explore new niches. Temporary subsidies to defray the costs of establishing branch networks may be provided. They should make every effort, however, not to distort the functioning of the market.

Promotion of Other Financial Services and Innovation

The promotion of other financial services would more efficiently transfer risk and allow rural clients to better manage liquidity. The principal impediments to the expansion of these services are mostly legal and institutional ones. Thus, the development of new products will lag behind and depend on the degree of success in strengthening the enabling policy environment and developing financial institutional retail capacity.

Deposit Services. Several impediments need to be overcome to promote the voluntary mobilization of deposits. First, if the country has weak macroeconomic management then the regime imposes taxes on savers via high legal reserve requirements and inflation. These policies result in low positive and even negative real rates of return on savings instruments thereby discouraging savings mobilization. Second, ineffective supervision of deposit taking institutions or, in its absence, full and independent disclosure of risk jeopardizes the savings of low-income, unsophisticated clients. Third, inadequate regulatory frameworks that, for example, do not permit flexible hours of operation to suit the density of prospective clients and their work schedules (e.g., requirements to be open a fixed number of days and hours, prohibitions on mobile banking units, etc.) make the capture of

[14] Where private banks are unable to adequately support the government's rural development goals, the Bank may support state-owned first-tier financial institutions on a transitional and exceptional basis. Such support must be shown to be cost effective and must include explicit mechanisms to develop private market financing sources. Eligible state-owned exceptions must have technical justifications and sound management and efficient operations marked by transparency. They must be operating in the context of an agreed plan to phase out any subsides or at least shift them to on-budget operations that can function with private banks. They must have had regular and transparent audits and a solid track record of financing mid- and long-term projects.

savings from low- and moderate-income rural clients difficult because the costs may be too great to justify an extensive branch network in rural areas. Fourth, the lack of explicit deposit insurance as a last resort form of protection for small savers may influence the decisions of risk averse savers. Fifth, the transaction cost of mobilizing small savings are high and there is concern with the volatility of sight deposits, which is the preference of low-income individuals. At present service delivery technologies are not well developed and market research and product testing are needed. In certain countries, however, the large flow of remittances to rural areas represents a potentially attractive business opportunity for intermediaries. If they can capture some of these flows as savings, a valuable service would be provided and funding problems diminished. Well-managed and eventually well-supervised deposit-taking financial institutions have inherent advantages over credit-only financial institutions. In the past, probably too much emphasis has been placed on building credit only institutions.

Insurance and Hedging Instruments. Property and liability insurance are important in reducing risks in rural financial intermediation. For farm households and small business entrepreneurs, the availability of formal insurance can protect against unexpected output losses and damage to equipment and buildings. For financial intermediaries, clients with access to insurance can reduce credit risk, especially crop insurance for farmers. In the past, most crop insurance schemes have been publicly funded. They have generally not worked and private crop insurers have either been deterred by the publicly subsidized schemes or catered only to large, commercial farmers. The majority of medium- and small-scale farmers remain excluded because there are high administrative costs in serving them. Given this state of affairs, new schemes will likely have to be single-peril (drought, windstorm, hail, etc.) to avoid moral hazard and adverse selection problems and keep premiums affordable. Geographic coverage would have to be sufficiently wide so that the insured threat is negatively correlated.

In addition, other risk reducing instruments, such as forwards, futures, options, and swaps, need to be cautiously promoted. These other instruments help to manage price and exchange rate uncertainty. In order for them to be more widely used in internal markets by small- and medium-sized agricultural producers, legal enforcement and communications infrastructure will have to be improved and more commodity exchanges developed. The challenge of thin or illiquid markets will have to be overcome.

Commodity Collateralized Credit: Warehouse Receipts, Inventory Credit, and Accounts Receivables. Input suppliers, feedlot operators, abattoirs, grain silo operators, processing plants, exporters, and manufacturing factories could play an even more significant role in granting credit to small agricultural producers and small businesses if they could better leverage their assets. Currently, many of these operators receive loans from commercial banks to finance working capital needs, but the amount is limited by the value of real estate collateral that can be pledged. If these operators could collateralize their inventories or account receivables, they could obtain more financing that could then be used to on-lend to smaller suppliers and subcontractors, hitherto largely excluded from formal credit markets. Likewise, small businesses could pledge accounts receivable and directly receive financing from formal intermediaries.

At present licensed warehouses exist in several countries and issue negotiable receipts for agricultural commodities that can be endorsed, thus providing the endorsee the collateral of underlying inventory deposits in the warehouse and the possibility of financing. Current warehousing systems, however, are limited in scope and face little competition. They are plagued with uneven grading, inefficient storage procedures, high capitalization costs, and documentation that can be altered or counterfeited without severe penalties.

The main impediments to more widespread use of inventories and accounts receivable, are problems in establishing a security interest at reasonable cost and gaps in the law. For example, accounts receivable in many systems do not have legal standing unless the underlying claim is reduced to a promissory note (*pagaré*), which is cumbersome and not appropriate for trade finance (Flesig and de la Peña, 1996 and 1998).

Leasing. In rural areas where medium- and long-term financing is particularly scarce, leasing of equipment could became an attractive alternative. Unfortunately, it is still largely an urban phenomenon. In the last 30 years, leasing has grown rapidly in the developing world, particularly in Asia. In Latin America, slower growth is attributable to more volatile macroeconomic conditions, weak regulatory frameworks, and tax disincentives. In rural areas, leasing of farm and nonfarm machinery and vehicles could represent a means to enhance productivity and lower marketing costs. Since the asset remains in the name of the lessor, repossession in the case of nonpayment is easier, reducing the expenses normally associated with delinquency control. Common obstacles, however, are difficulties in calculating cash flow of rural businesses, the requirement to have legal orders to enter the property of delinquent leasees, the lack of insurance for leased property that creates high degrees of risk, and the inability of the leasee to deduct the leasing interest expense from pre-tax income.

Electronic Cards. The use of debit, credit, and smart cards promises to reduce transaction costs for rural clients significantly. The obstacles that check the widespread adoption of electronic cards in rural areas are the following: (1) difficulties in calculating cash flows for the self-employed; (2) nonexistent credit bureaus or bureaus that contain only negative information on mostly large firms and urban wage earners of limited duration; (3) postal services that are unreliable, complicating billing and payment processes; (4) low levels of educational attainment in the rural areas of certain countries that complicate adoption and use; (5) unreliable electric and telecommunication service; (6) and the use of competing and incompatible networks and proprietary standards that limit client access only to the machines of the issuing institution.

Payment Transfers. Cash is the most commonly used payment instrument in the rural areas of less developed economies. In contrast, checks and electronic payments (debit, credit card, GIROs, and wire transfers) are most in developed economies. In rural areas of Latin America, the present dearth of formal financial institutions and underdeveloped infrastructures, makes the use of debit and credit transfer payment instruments difficult. Large amounts of noninterest earning cash must be held on balance for transaction purposes. While the situation is acceptable for small valued transactions, it has disadvantages in large value transactions. In order to improve the efficiency of the payments system, greater attention must be paid to linking banks, using national postal systems, and promoting the use of more checks and other payments instruments. The situation should improve with time and as a natural by-product of expanding the presence of formal banking institutions and telecommunications, innovations in rural areas.

IV. The Bank's Objective, Roles, and Strategy

This section explains the objective, roles, and the strategy for rural finance that the Bank should adopt based on generalized country settings. It also discusses how the Bank could use various instruments to achieve its strategic goals.

Objective

The objective of the Bank's rural finance strategy is to promote efficient and sustainable rural financial intermediation. The Bank can achieve this by adopting a systematic approach: (1) creating a favorable policy and legal environment; (2) developing financial retail capacity; and (3) promoting other financial services (warehouse receipts, credit cards, leasing, insurance, etc.) in those markets where the first two elements of the approach are well advanced.

Consistency with Related Strategies

The rural finance strategy is consistent with and closely related to the financial market strategy (GN-1948-3) and the agricultural development strategy (GN-2069-2).

The rural finance strategy extends the financial market strategy to a subsystem which shares some common characteristics with the general financial system but also has distinctive ones. Although the strategies share common goals (such as the orderly development of financial market systems, the strengthening of banks, the consolidation of reforms started in the 1990s, and continued rationalization of state intervention) there are slight differences in emphasis due to settings. Because rural areas have distinctive characteristics such as low population density, poorer infrastructure, and lower incomes, the rural finance strategy emphasizes risk transfer mechanisms (such as crop insurance and hedging instruments), the introduction of transaction cost-cutting innovations (such as electronic cards), and financial contracts that do not require large pre-established amounts of collateral or proven credit histories (leasing, commodity collateralized lending, factoring, and contract farming). Another area of differing emphasis is the role of commercial banks in the provision of financial services. In the short term, the rural finance strategy sees commercial banks as playing a more indirect role, for example, financing large agroprocessors who in turn engage in contract farming with small- and medium-sized producers. Commercial banks in the medium-to long-term may become more active in the direct provision of rural financial services as banking competition grows, as investments in infrastructure lower transaction costs and as information capital is developed. Thus, the financial market strategy places emphasis on strengthening existing banks and supervisory authorities, while the rural finance strategy recognizes the need to create institutional space for more types of financial institutions that will be dedicated to micro and rural finance and to better adapt supervisory practices to the challenges of rural finance without jeopardizing the soundness of the entire financial system.

Similarly, the rural finance strategy is integrally related to the agricultural development strategy. Rural finance will not thrive if the actions called for in the agricultural development strategy are not realized. That strategy seeks to consolidate sectoral economic policy reforms; modernize public and private agencies that provide agricultural support services; improve the functioning of land markets through the promotion of titling and leaseholds; and increased investments in education, social services, and physical infrastructure. All the actions in the agricultural development strategy serve to increase productivity, lower transaction costs, reduce investment uncertainty, and improve the profitability of rural productive activities. Conversely, if rural financial markets are not better developed in the near term, much of the modernization and product diversification envisioned in the agricultural development strategy are much less likely to occur.

Roles

To achieve the stated objective, the IDB will have to play the roles of catalyst and financier. It will also have to collaborate with the public and private sectors in member countries. As a catalyst, the IDB may directly assist borrowing member governments by initiating dialogues to convince them of the importance either of consolidating or starting policy reforms that would lower the cost of rural financial intermediation. As a financier, the IDB can directly help borrowing governments to finance reform projects and financial intermediaries who seek to improve retail capacity and to introduce new financial products and services. Assistance can take the forms of knowledge sharing or the provision of financial resources.

The other two parties in the process of financial market development, the public and private sectors in specific countries, will have important roles too. In the future, the proper and rational role for the public sector will be to focus on creating a favorable policy environment for rural intermediation. The role of the private sector is in assuming more risk and providing the financial services directly. Until recently, the public sectors of borrowing member governments have been heavily involved in the direct provision of rural financial services.

Strategy

The strategy of the Bank will be to systematically remove the obstacles to efficient rural financial intermediation. As constraints on both the demand for and supply of financial services are lessened, new products and new types of institutional arrangements will appear to exploit profit-making opportunities. The Bank's orientation should be to constantly support and encourage private sector initiatives, especially in the areas of retail delivery of services and product innovation, and not to displace or to stifle such initiatives. Because the number of constraints is high and detailed knowledge is lacking in many specific areas, the approach will have to be cautious and iterative. In essence, the Bank should adopt a "learning by doing" approach: initiating a number of pilot operations, monitoring progress regularly, applying lessons learned in larger scale projects, transferring knowledge from one country to another, and modifying strategies and guidelines as necessary.

In order to maximize the impact of the Bank's limited resources by attaining the rapid transformation of the largest number of rural financial markets possible in the region, the Bank's approach should be to work in an integrated and phased manner in those countries with auspicious settings and to be selective in the types of interventions pursued in countries with less favorable settings. Accordingly, the Bank should concentrate its resources in high potential countries that meet most, if not all, of the following conditions: (1) a stable macroeconomic environment defined as low inflation, a low fiscal deficit, a sustainable current account deficit, and a real effective exchange rate that is not appreciating; (2) existence of a banking sector with adequate liquidity, acceptable asset quality, and competition; (3) a political leadership that is committed to reforming rural financial markets; and (4) the existence of a willingness and technical capacity on the part of the public and private sectors to implement the reform program and to penetrate rural areas.

Countries will vary on these indicators, some indicators will be above average and others will be lower. Some the indicators, such as the macroeconomic ones, could also change quickly due to exogenous shocks. Other indicators may change due to endogenous factors, such as a change in political leadership during the course of project preparation. Nonetheless, the strategy recommends following a logical and sequential order. First, if the prerequisites are met, Bank staff should focus first on helping the borrowing member government remove biases in sectoral economic policies that reduce the profitability and competitiveness of rural economic activities. Second, Bank staff should attempt to strengthen the legal and regulatory framework to reduce the risk and cost of rural financial intermediation and increase opportunities for profitable intermediation and competition. Third, once the policy, legal, and regulatory environment is fairly favorable, the staff should focus on identifying and helping financial intermediaries committed to the rapid attainment of financial and economic sustainability and the expansion of rural financial services. Fourth and last, as the legal/regulatory framework and institutional setting permit, the Bank should help financial intermediaries introduce new financial products. The higher the degree of macroeconomic stability and lower the degree of bias in sectoral and regulatory policies the greater the scope for simultaneous actions on a number of fronts. Conversely, the lesser the degree of macroeconomic stability and the higher the degree of bias in sectoral and regulatory policies the greater the likelihood that Bank interventions, especially in support of financial intermediaries, may not succeed in the long run in creating sustainable and viable entities. In these less than ideal situations, the Bank may focus on assisting promising financial intermediaries, demonstrating viability, and building momentum for appropriate policy changes that would permit more widespread replication or scaling up of the successful institutional model. Nonetheless, working in such settings will be high risk.

Because countries differ, specific Bank actions will have to be based on careful country diagnoses of the constraints present and the structure and performance of rural financial markets. In order to tailor the interventions to country settings, the strategy is recommending the development of country specific actions plans on rural finance.

Actions to Remedy Specific Problems and Relevant Instruments

In this section, detailed actions will be recommended to remedy the major problems already identified and the appropriate instrument(s) to achieve the desired end. Annex 3 contains a summary in matrix form. The discussion below will be divided into three sections that correspond to (1) creating a favorable policy environment; (2) developing private financial retail capacity; and (3) introducing new financial services and innovations. The actions proposed below are intended to serve as an aid for operational staff in providing a set of possible solutions when designing specific rural finance intervention programs. The typical country will be beset by several, if not all, of the mentioned problems. Thus, responsible staff will have to exercise judgement in determining priorities and the feasibility of chosen interventions.

Action Area: Creation of Favorable Policy Environment

Problem 1: Lack of Access to Formal Short-Term Credit

Specific Actions: In order to improve access to formal credit, the Bank should prepare operations that (1) change the legal framework so that a greater variety of moveable collateral can be used to secure credit transactions; (2) reduce the degree of risk creditors face by improving the ease with which credit claims can be legally enforced; (3) remove biases in sectoral policies so that the profitability and competitiveness of rural productive activities are improved; (4) increase land titling and registration efforts; and (5) improve the flow and quality of information on rural households, firms, and rural productive activities through investments in surveys, information dissemination services, and the creation of credit bureaus. This enhancement in the availability of information will serve to improve decision making and reduce risk.[15]

Instruments: Three different types of instruments can be used—sector loans, sector facilities, and technical cooperation programs—depending on the country context, the availability of resources, the degree of borrower country commitment, and the quality of management talent involved in the project.

Sector Loans: If the macroeconomic setting is favorable, member government interest is high, and the key counterpart agencies are competent and well managed, the Bank may attempt a single, large-scale loan that addresses most of the constraints identified in a diagnostic exercise. For

[15] Note that the last three actions recommended fall largely within the purview of other strategies, e.g. Agricultural Development in Latin America and the Caribbean and Rural Poverty Reduction. Nonetheless, we strongly urge that staff involved in designing rural fi;nance operations become aware of the relationships among Financial Market and Environment Divisions and coordinate with them.

example, a modified investment or financial sector loan, called a *rural finance adjustment program*, could be proposed that sets disbursement conditions such as increased government spending on rural infrastructure, social services, and technology transfer; an improved legal framework for the creation, perfection, and execution of security interests; the strengthening the judicial system to allow for the rapid arbitration or settlement of credit claims; and the creation of credit bureaus among other interventions. Obviously these operations will likely be prepared for very few countries. However, caution should be exercised. Because the time needed to effect long lasting and complex institutional change does not match the incentives implicit in the quick disbursing nature of the loans, the loan may be difficult to execute. Also, the Bank may not be able to approve many of these types of operations given the established lending limits for sector loans.

Sector Facilities:[16] Sector facilities are similar to the sector loans but less ambitious in scope (up to US$5 million per operation), and designed to take advantage of particular windows of opportunities or dynamic situations in member countries, where the traditional project preparation cycle may be too long to exploit certain benefits. In such circumstances, the Bank may opt to use this instrument to provide fast-track support to address problems of a cross-sectoral nature. Emphasis will be placed on activities that are low risk, have high impact, can be implemented rapidly, and are not overly complicated to prepare.

Technical Cooperation Programs: If the macroeconomic, political, and institutional setting are less favorable, the Bank may attempt to use individual stand alone Technical Cooperation (TC) operations or Multilateral Investment Fund (MIF) operations in a surgical fashion. These individual, smaller operations will have to be coordinated and sequenced so that over time, they can have a net significant impact. Correspondingly, the Bank must be constantly engaged in a policy dialogue with the member government and key stakeholders in civil society, seeking to galvanize support for redress of remaining obstacles.

Problem 2: Financial Market Segmentation, Inefficiency, and Limited Competition

Specific Actions: In order to reduce financial market segmentation and inefficiency, the Bank should prepare operations that (1) revise banking and financial regulatory frameworks so that barriers to entry, transactions costs, and constraints to technological innovation are reduced to a reasonable minimum that still serves to protect the soundness and safety of the entire financial system; (2) promote linkages, mergers, and acquisitions between urban and rural financial institutions to better diversify risk, and attain economies of scale and scope; and (3) improve the variety of risk mitigation techniques available for the client (such as insurance, hedging instruments) and for the intermediary (such as portfolio securization, intermediary guarantees, and emergency funds) so that more intermediaries will be encouraged to enter rural finance profitably. Many of these risk mitigation instruments are underdeveloped due to legal and policy impediments.

Instruments: The preferred instrument would be a series of *Innovation Loans (ILs)* and *Technical Cooperation (TC)* operations that help the member government identify anti-rural finance biases in the legal and financial regulatory framework; that help to formulate new laws and regulations to remove the identified weaknesses; that strengthen the institutions responsible for enforcement; that broker activities between interested urban-rural financial institutions and that introduce other risk management techniques.

Problem 3: Limited Availability of Medium- and Long-Term Credit

Specific Actions: In order to improve the availability of long-term finance, the Bank should prepare operations that (1) provide temporary access to external funds through second-tier banks to compensate for the lack of funding sources; (2) promote pension funds and the insurance industry as a means of increasing longer term sources of

[16] Note: Parameters have been proposed for Education, Health, and Trade sectors in document GN-2085 “Proposal for New Lending Instruments”. Parameters for rural finance subsector would have to be developed.

funds; and (3) promote the introduction of variable interest rate contracts in countries that have attained macroeconomic stability so as to reduce risk for lenders.

Instruments: Two instruments can be used to improve the supply of medium- and long-term credit: MIF and multisector credit operations.

MIF Debt Instrument Purchases and Intermediary Guarantees: One instrument would be a MIF purchase (or partial intermediary guarantee) of debt instruments (bonds or commercial paper) issued by one or more banks in a particular country committed to long term rural lending as a signal to large scale institutional investors such as pension funds and insurance companies. These actions would be consistent with the Bank's attempts to spur the development of secondary and capital markets.

Multisector Credit Loan: Another instrument would be a Multisector Credit Loan (MCL) that provides a line of credit to a second-tier bank that then allocates funds to first-tier banks for medium- and long-term lending on the condition that the cost of the line of credit is equal to the cost of mobilizing deposits in the system. One caveat is that the use of an auction allocation mechanism in the case of small countries may lead to collusion. Another caveat is that a sense of dependency could be created on the second-tier, especially if the pricing and allocation mechanism is arbitrary and implies subsidies. For example, the external line of credit may distract efforts at improving rates of domestic savings and developing security markets, that in the long term, would allow firms to access capital. Because agricultural lending, especially over the medium and long term, is quite risky, efforts to create insurance products, hedging instruments, and emergency standby funds should accompany these interventions.

Action Area:
Improve Private Financial Retail Capacity

Problem: Paucity of Operationally Efficient and Sustainable Private Intermediaries Serving Rural Clients

Specific Actions: In order to increase the number and size of viable intermediaries, the Bank should prepare operations that seek to improve institutional retail capacity in private financial intermediaries dedicated to serving rural clients. Specific operations may consist of (1) equity investments, intermediary guarantees, and loans to financial institutions in order to increase the supply of loanable funds; and (2) grants to financial intermediaries entering the rural sector to allow the acquisition of equipment, the training of staff and management, market research, transfer of technology, upgrading of management information systems, and the design of new governance structures and drafting of laws to allow for the creation of new types of financial intermediaries; and (3) the establishment of emergency funds to help with the recapitalization of well-managed institutions adversely affected by external shocks.

The Bank can pursue several intervention options: (1) help semi-formal, financial institutions (i.e., NGOs) upgrade to formal, regulated financial institutions; (2) help commercial banks reach smaller scale clients "downscale;" (3) link formal financial intermediaries with informal financial intermediaries reaching medium and small rural clients; (4) reform existing institutions such as credit union movements, village banks, *cajas rurales*, and state-owned agricultural development banks; and (5) create new institutions. The selected approach depends on country conditions. However, previous experiences suggest that it is preferable for the Bank to encourage successful, credit-granting NGOs based in urban areas to expand to rural areas and to promote the linking of formal institutions, such as commercial banks, to informal and semi-formal intermediaries, such as financial NGOs, credit unions, and suppliers/traders active in rural areas, who can then on-lend to clients. Another preferred option would be to create new specialized institutions with proper governance incentives and smaller minimum capital requirements. The least preferred options are to encourage commercial bank downscaling and to reform existing institutions. Commercial banks have been quite reluctant to enter rural markets and attempts to reform state-owned banks and other existing entities have largely failed due to serious management weaknesses, governance problems, and political interference. An important associated issue is one of regulation and supervision of deposit-taking institutions. The cost of regulating rural institutions will be high using traditional techniques of supervision, because the total number of financial institutions serving rural areas, at least in the first stage of development, will tend to be large but each with modest total assets. In the aggregate, rural, deposit-taking, financial institutions may not constitute a systemic threat to the entire financial system but they will demand a disproportionate share of supervisory resources. Therefore, the Bank and other interested parties will have to explore rating agencies, third-party regulation schemes and greater reliance on external audits and delegated supervision in order to avoid overtaxing supervisory resources and providing for effective protection of small depositor and investor interests.

Instruments: The primary instruments that can be used are Technical Cooperation (reimbursable and nonreimbursable), Multi-phased Program Loans (MPL), Multilateral Investment Fund (MIF), Global Microenterprise Loans (MicroGlobals), and Social Entrepreneurship Programs (SEP).

Technical Cooperation. TC operations can be used for basic institutional strengthening activities.

Multi-Phase Program Loan. MPLs could be a useful instrument because support for one or a set of relevant support and intermediary institutions could be sequenced and phased in over time based on attainment of performance indicators such successful policy and legal reform, adoption of new technologies, institutional restructuring, etc. With a long-range plan in place, the advantage of this instrument is the promise of greater continuity and predictability of support over time based on transparent and hithero agreed upon performance standards. Oftentimes, institutional reform is slow and painstaking and this instrument would allow flexibility in the pacing without resorting “stop and go” measures that may rob the project of forward momentum.

Multilateral Investment Fund. MIF projects (loans, guarantees, equity investments, microfinance line of activity) have a wide applicability and should be targeted to the more mature institutions that are interested in scaling-up activities and are close to attaining financial sustainability.

MicroGlobals can have a positive impact on rural finance if the participating regulated institutions are already present in rural areas and have a strong commitment to the sector. In general, MicroGlobals should not be expected to play a major role in transforming rural financial markets due to its broad targeting feature and the fact that the vast majority of participating regulated entities are urban-based.

Social Entrepreneurship Program. The SEP also has a limited role to play due to scarce of funding. Given this reality, funds should be directed to those institutions that can become sustainable within a short time horizon and disbursements should be made based on attainment of performance benchmarks. The niche for SEP would be to help promising, nascent rural intermediaries, who are not quite mature enough for MIF financing.

**Action Area:
Promote New Financial Services
and Innovations**

Problem: Limited Array of Financial Products and Services

Specific Actions: To increase the number of available financial products and services, operations should remove the legal and institutional weaknesses that hamper the introduction and spread of new services and innovations. While action in this area should be cautious and in the context of relatively well developed financial systems and rural marketing production structures, some specific actions would include (1) grants and loans to member governments to help public sector authorities remove impediments in existing commercial, tax, banking and insurance codes to permit the wider use of warehouse receipts, accounts receivable, inventory credit, and hedging instruments; (2) grants to intermediaries to assist them in the transfer of technology, staff training, market research, and pilot testing of new products; and (3) equity investments, loans, lines of credit, and guarantees to intermediaries needing capital to expand new services to rural clients. The Inter-American Investment Corporation (IIC) recently approved three innovative projects along these lines. One project in Mexico promises to finance 10,000 mostly small corn producers through warehouse receipts and grain repurchase agreements. This project introduces financing plus modern risk management techniques such as hedging and insurance for a clientele hitherto excluded. Another project is an agency line of credit through the Latin American Agribusiness Development Corporation (LAAD) to help finance export-oriented, small and medium agribusinesses. The virtue of this arrangement is that the agricultural lending expertise of a corporation that knows the sector is captured and its impact scaled up. Lastly, a multisectoral line of credit operation helps banks with a presence in rural areas enter into medium-term lending and leasing arrangements.

Instruments: The preferred instruments are stand alone Technical Cooperation operations, Innovation Loans, MIF microfinance line of activity operations, and multifaceted MIF operations that combine technical assistance grants with financing to allow for the introduction and expansion of the new financial services.

V. Implementation

Priorities

The Bank's number one priority, in collaboration with member governments, is to create an enabling economic, legal and regulatory environment. The Bank has a comparative advantage in this area because it can use conditionality lending instruments to achieve desired changes and it can bring to bear knowledge acquired throughout the region. For relatively modest investments the probability is increased for achieving rapid and dramatic change.

The Bank's second priority is to build financial retail capacity in rural areas. The Bank needs to transfer appropriate service delivery technology and help innovators and pioneers, because the private banking sector in the region perceives rural finance as particularly high risk and is averse to enter this segment of the market. To change this perception, the principal challenge is to demonstrate that rural financial intermediation is indeed profitable.

The number three and lowest priority is to introduce new financial products and services, once progress has been made on improving the legal and policy frameworks and some financial intermediaries dedicated to serving rural credit demands have developed and attained operational and financial sustainability.[17]

Proposed Action Plans

In order to implement the strategy, each Regional Operational Department should determine which countries could benefit from a more proactive intervention by the Bank in rural finance. For those countries, over the period 2000-2005, the Departments should prepare action plans on rural finance to be discussed with the authorities of borrowing member countries as part of the normal country programming process. The goal is to include operations to implement the plan. The reason is that the Bank must respect the prerogatives of and recognize the heterogeneity in levels of rural financial market development across borrowing member countries. The action plans should consist of the following: (1) a diagnosis of country specific rural financial market constraints; (2) a long-term plan to address these problems systematically; (3) a prioritized list of project interventions, including pilot operations; and (4) a provision for monitoring and evaluation of, at least, the pilot operations. Furthermore, each Regional Operational Department should then be responsible for implementing two action plans during the same period. Because of the complexity and uncertainty of the undertaking, pilot operations should be closely monitored in order to determine what practices are viable, to inform the design of projects in other countries, to estimate the cost of product roll-out or scaling up of operations if the pilot is successful, and to help reformulate country specific and Bank strategies. Because of the nature of the rural economy and the low levels of institutional infrastructure in many places, the time frames needed to assess the performance of the pilot operations may be in the 5-10 year vicinity.

Target Countries and Sequencing of Interventions

The strategy recommends that the Bank target its project activities in countries with large rural populations, both in absolute and relative terms, and sizeable agrarian economies. In addition, Bank staff could initiate "new financial product" pilot projects in countries with smaller rural economies but relatively higher degrees of macro-

[17] See Annex 4 for a detailed list of priorities under the broad priority action areas. Bank operational staff should attempt, where possible, to follow the sequence, making adjustments for country specific conditions.

economic stability and more developed financial markets. In order to contribute to improving rural financial markets as rapidly as possible, the Bank should focus on countries with relatively stable macroeconomic indicators and relatively stable banking systems. The Bank should then screen countries according to levels of government commitment to reform initiatives and the number of competent and willing collaborating institutions both in the public and private sectors. The higher the commitment and capacity, the greater the scope for Bank action in that country. If conditions are fair to favorable, the Bank may be able to work simultaneously on three fronts: (1) policy environment; (2) retail capacity, and (3) new products. If conditions are less favorable, the bank may have to work in a sequential manner, focusing on removing gross distortions and weaknesses at the policy and institutional levels.

Bank staff will have to exercise judgement in determining the sequencing of interventions and making the required trade-offs between the logical order espoused in the strategy and the practical realities of varying degrees of country development, counterpart commitment, and technical capacity. Some general guidelines follow. If levels of bias in the sectoral economic policies are high enough to reduce the profitability and competitiveness of a large number of rural economic activities, staff should develop a comprehensive program of policy reform contingent on a high level of member government commitment to change and the existence of able counterpart agencies.[18] If the level of bias and distortion is moderate to low and a large number of rural activities are indeed profitable, Bank staff should engage in a simultaneous program of policy reform to remove lingering policy biases and to develop institutional retail capacity. If favorable macroeconomic and sectoral conditions exist or reforms are underway, Bank staff should focus on removing biases in the legal and financial regulatory framework that increase transactions costs and risk for intermediaries attempting to serve low- and moderate-income clients. If the legal and regulatory framework is inadequate but improving, Bank staff may attempt to strengthen promising financial intermediaries that meet the following conditions: (1) operate in an area with a density of potential clients with viable investment opportunities, especially with access to productive inputs and output markets; (2) face unmet demand for financial services; (3) face no civil unrest in area of operation; (4) possess a leadership and staff dedicated to achieving financial self-sufficiency and operational efficiency; and (5) possess knowledge of a proven service delivery technology or exhibit a willingness to adapt an appropriate one. Once a number of strong financial intermediaries exist and the corresponding legal and institutional conditions generally prevail (see Annex 5), Bank staff should promote the introduction of new products.

[18] Some summary measures are nominal and effective rates of protection, domestic resource costs, and producer subsidy equivalents.

Organizational Implications and Recommendations

The implementation of this *strategy* implies a number of changes, most of which are applicable to other types of operations and sector strategies as well. However, this section attempts to underscore the significance of the recommended action for the full and effective the implementation of the rural finance strategy. The first four items are particularly relevant to the implementation of this strategy and the latter two are more general.

Improve Coordination. The Central and Regional Operational Departments will have to improve communication and coordination with each other as well as with other multilateral and bilateral development institutions, and with private and public sector entities in member countries, in order to avoid duplication of efforts, to share information and knowledge, and to better exploit staff competencies. The work program will entail activities in five broad areas: (1) research/dissemination; (2) dialogue/brokering; (3) project preparation; (4) training; and (5) project monitoring and evaluation. Economies can be realized with effective planning and coordination. For example, the Bank could establish a Network on Rural Development and Rural Finance comprised of Regional Operational Departments, Central Departments, and Country

Offices staff. The primary role of the Operational staff would be to identify, prepare, and negotiate projects. The primary role of the Central Department staff would be to evaluate, serve as a clearinghouse for information, and provide technical support. The primary role of the Country Office would be to broker relationships with the private sector, forge alliances, and supervise projects. Steps to improve incentives for cooperation among the three parts of the Bank should be adopted.

Build a Critical Mass of Technical Staff. The Bank should develop a critical mass of technical staff knowledgeable about a wide range of legal, economic policy, agriculture, business development, and financial issues in order to design, prepare, and monitor rural finance projects. Some of the topics include: adequacy of civil and commercial codes, adequacy of banking supervision and regulation frameworks, impact of sectoral and macroeconomic policies on agriculture, hedging instruments, insurance, leasing, organizational restructuring, strategic planning, governance incentives, liability diversification, etc. Because many of the operations that will be proposed may involve much more collaboration with the private sector than in the past, prior experience of working in that sector would help to enhance understanding and facilitate the building of partnerships. Therefore, the Bank should inventory the skill sets of existing staff, upgrade these skill sets where possible, and depending on the availability of resources either recruit new staff or hire consultants in order to fill critical skill gaps and constitute a core cadre.

Institutionalize Learning and Managing Knowledge. The Bank has to develop a more systematic way to learn from previous experiences and rapidly incorporate those lessons into new operations under preparation because a wide variety of rural finance operations, especially pilot projects, are being recommended to suit varying country conditions. The better organization, sharing, and use of project evaluation information will serve to enhance project quality. In addition, an up-to-date roster of consultants and identification of existing technical expertise within the Bank can help to economize costs and speed the transfer of knowledge. A database on rural finance projects that incorporates information on project impact and results, not primarily process indicators, as well as reference information should be developed and maintained by a Central Department.

Generate Country "Ownership" of Rural Finance Reform Program. Borrowing member country governments will have to take "ownership" of any intervention program and to commit to a process of sustained implementation. In the case of rural finance, this commitment is particularly important due to the cross-cutting nature of the issues. Multiple actors and agencies are involved and setbacks in execution will have to be overcome by a number of champions in different sectors. Bank staff can help the process by helping government policymakers develop a clear vision, by sharing knowledge gained outside the country, by presenting viable alternatives, and by identifying strong and capable advocates of reform and innovation in both the public and private sectors. The process of taking ownership and building consensus can occur either through the normal programming cycle or through a more elaborate sequence of events that begin with diagnostic studies, include consulting key stakeholders, and end with the formulation of a country specific rural finance strategy.

Brokering Relationships with the Private Sector and Reducing Transaction Costs. The Bank has to develop the capacity to react faster to regulatory challenges and emerging crises in financial intermediaries, and to reduce the transaction costs imposed on clients that result from project approval. Given the diminishing role of the state in directly providing financial services and the strategy's emphasis on private initiatives, it is logical to assume that the private sector will play an even more dominant role in the provision of rural financial services in the future. Thus, the Bank should change its operational procedures and develop a client-focused, entrepreneurial approach to doing business. Otherwise, the Bank's ability to forge successful partnerships and leverage more investment funds from the private sector will be undermined. Therefore, approval procedures should be reviewed and the usefulness of each procedure questioned. The current hierarchical system and multiple layers of oversight inhibit rapid negotiation, information sharing, and deal making.

Improve Quality of Project Supervision and Monitoring. The Bank has to improve the quality of project supervision and monitoring across the board in order to obtain more positive impacts and replicable projects. Much of the Bank's current incentive structure favors a routine monitoring of disbursements and compliance with established contracting and reporting procedures. Engineering institutional change and policy reform is a labor-intensive effort wherein timely interventions can make a difference between successful transformation, mediocre muddling, or failed results. Monitoring indicators should be developed that are impact and results oriented, not just process-oriented. In the case of rural finance projects, the inherently high degrees of complexity and riskiness underscore the need for consistent and high quality supervision in order to improve the chances for success.

Resources Needed for Strategy Implementation. The Bank can make progress on implementing the strategy with existing resources. However, full implementation may require reallocation of staff and budgetary resources. The reason is that the operations being proposed will be labor intensive and therefore high cost.

VI. Conclusions

The Bank is justified in being involved in helping to develop and restructure rural financial markets in Latin America and the Caribbean due to their underlying importance in the process of economic development. Economies with well-articulated financial markets tend to exhibit higher rates of economic growth than economies with less developed financial markets. While substantial progress has been made in improving the functioning of urban financial markets in the region in the last decade and a half, rural financial markets remain shallow, segmented, and noncompetitive. Rural entrepreneurs, especially small- and medium-scale farmers and small business operators, face more acute problems in gaining access to formal financial services than their urban counterparts. Because 30 percent of the region's population resides in rural areas and 54 percent of the rural households are poor, the social and economic consequences of the urban-rural financial market dualism are non-trivial—constrained economic growth and limited poverty reduction potential.

The reasons that rural financial markets function poorly can be attributed to a triad of problems—asymmetric information, high levels of production and price risk, and high transaction costs. The Bank's strategy will be to systematically attack and resolve these problems so that profitable, market driven intermediation can occur. Actions are recommended in three broad areas: (1) creation of a favorable policy environment; (2) development of institutional retail capacity; and (3) promotion of other financial services and innovation. The Bank has a comparative advantage in focusing on the enabling policy environment. In addition, the Bank can and should promote intermediary institution building. Because no particular institutional type or service delivery technology has yet proven to be dominant, except for the largely unsatisfactory experience of state-owed agricultural development banks, a wide variety of experimentation is suggested. In the case of state-owned financial institutions, given their checkered past, the option of reforming them as first-tier institutions is not recommended. Support for these institutions should be based on their conversion to second-tier entities or a move to operate according to market criteria.[19] Much effort will have to be dedicated to building a new rural financial infrastructure and linking urban-based financial institutions to rural based semi-formal and informal intermediaries. The process will take time and require sustained investment of resources. Lastly, the Bank should help intermediaries introduce new financial services and products such as savings and insurance as institutional maturity, regulatory oversight capacity, and the legal environment permit.

In designing a set of optimal interventions, the Bank should proceed cautiously and build a consensus for action within member countries, tailor interventions according to the level of development and the degree of commitment, and seek at all times to build safe and sound, market driven financial systems. A cardinal premise is that rural finance will only thrive when the set of profitable and viable investment opportunities expands. The Bank's actions in the rural finance area should be compatible and complementary to the actions proposed in the financial market, rural poverty reduction, and agricultural development in strategies. The aim is to expand the frontier of formal finance to serve hitherto unreachable clients in an

[19] Where private banks are unable to adequately support the Government's rural development goals, the Bank may support state-owned first-tier financial institutions on a transitional and exceptional basis. Such support must be shown to be cost effective and must include explicit mechanisms to develop private market financing sources. Eligible state-owned exceptions must have technical justifications and sound management and efficient operations marked by transparency. They must be operating in the context of an agreed plan to phase out any subsides or at least shift them to on-budget operations that can function with private banks. They must have had regular and transparent audits and a solid track record of financing mid- and long-term projects.

efficient and sustainable manner. Large entrepreneurs in rural areas already enjoy access to financial services but small and medium-sized entrepreneurs do not enjoy great degrees of access. Improved functioning of rural financial markets would stand to benefit all classes but especially the latter two. Small-scale entrepreneurs desire access to short-term credit and savings deposits in order to expand output, smooth consumption over time, and prepare for future expenses and investments. The more dynamic small- and medium-sized firms will benefit tremendously from more efficient risk transfer mechanisms (insurance and hedging), access to longer term finance that would permit modernization and diversification, and from product innovations such as leasing, commodity-collateralized finance, and electronic cards.

The Bank has a number of instruments that have to be effectively coordinated in order to reduce transactions costs and to improve monitoring and supervision. Four instruments are particularly relevant to the task at hand: (1) the Multilateral Investment Fund because of its flexibility; (2) Technical Cooperation grants and loans due to the importance of technology transfer and knowledge creation; (3) flexible lending instruments (Innovation loans, Multi-phase Program loans, and Sector Facilities) due to their ability to support experiments, address cross-cutting issues, and provide support over more than one project cycle, and (4) Multisectoral Credit Loans as a means to expand the availability of medium- and long-term credit, which currently is a critical constraint in rural areas.

To effect positive change, the strategy recommends the combination of these and other instruments in country-specific action plans, that include a diagnosis of the particular rural financial market setting, proposed solutions, and a list of prioritized projects. A program of implementation of action plans in the period 2002-2005 is being proposed for those countries that would benefit the most from such a program.

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Annexes

Annex 1.
Estimated Allocation of Agricultural Credit, Rural Enterprise Credit, and Financial Market Reform Loans: 1961-1998

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Annex 1

Estimated Allocation of Agricultural Credit, Rural Enterprise Credit and Financial Market Reform Loans: 1961-1998

Type of Operation	Number of Operations	Total Amount Approved (US$ millions)
TARGETED AGRICULTURAL CREDIT		
Agricultural Credit Loans	131	4,205
Integrated Rural Development Loans (Credit Components Only)	18	236
SUBTOTAL	**149**	**4,441**
SECTOR AND REGULATORY REFORM		
Financial and Investment Sector Reform Loans	31	3,637
Agricultural Sector Loans	8	602
Multilateral Investment Fund(Regulatory and Legal Reform)	13	13
SUBTOTAL	**52**	**4,252**
RURAL PRIVATE ENTERPRISE CREDIT AND INTERMEDIARY DEVELOPMENT		
Small Projects (Agricultural Credit)	52	24
Small Projects (Microenterprise and Other Credit)[1]	182	84
Multilateral Investment Fund (Rural Finance Projects)[2]	12	22
Multisectoral Credit[3]	10	323
Microenterprise Global Credit (Rural Lending)[4]	6	21
SUBTOTAL	**262**	**474**

Source: Inter-American Development Bank Operational Departments Database.

[1] The values represented are the sums of projects classified as Microenterprise, and Global Credits, Programs, Multisector, and Fishing. This sum is an overestimation of rural credit because the classifications include client groups that are wholly urban-focused, wholly rural groups, and as well as urban-based groups that on-lend for rural purposes. Due to limited information on the composition and of portfolios, a rural-urban disaggregation is difficult.

[2] Six of twelve projects involve institutions with an exclusively rural focus. The total value of these six projects is $14.3 million.

[3] Nine percent or so of the total value of Multisectorial credit loans ($3.5 b) is estimated to have gone to support rural based industries and producers. However, the loans helped to strengthen many second-tier institutions and develop medium and long-term credit, contributing to overall financial market development.

[4]An estimated 10% of the total amount disbursed as of December 1998 (US$206 million). Of the 15 Small and MicroGlobals approved, only 6 had intermediaries with rural loan portfolios.

Annex 2

Rural Finance Operations:
Estimated Allocations of Direct and Indirect Support
by Year and Type of Operation
(US$ millions)

Type of Operation/Year	1961-1965	1966-1970	1971-1975	1976-1980	1981-1985	1986-1990	1991-1995	1996-1998	Total
DIRECT SUPPORT									
Global Agricultural Credit	122	151	248	459	1,625	1,600	0	0	4,205
Integrated Rural Development (Agric. Credit)		17	37	161	22	0	0	0	237
Small Projects (Agricultural Credit)				6	9	7	2	0	24
Small Projects (Est. Rural Microenterprise)							10	6	16
MicroGlobals (Est. Rural Allocation)							20	1	21
MIF (Rural Intermediary Support)							15	7	22
Total Direct	122	168	285	626	1,656	1,607	47	14	4,549
INDIRECT SUPPORT*									
Sector Loans						410	2,880	950	4,240
Multisectoral Credit					39	106	1,587	1,853	3,585
MIF (Regulatory Reform)							4	9	13
Total Indirect					39	516	4471	2812	7,838
GRAND TOTAL	122	168	285	626	1,696	2,123	4,517	2,826	12,387

Sources: Inter-American Development Bank, Operational Database and Author's Calculations

Notes:

**Indirect Support*: These operations help to create conditions favorable for rural intermediation in general. Sector loans and MIF regulatory operations help to strengthen prudential and supervisory framework. Multisectoral Credit operations help to strengthen second-tier institutions and extend medium and long-term credit. Although a small percentage of rural clients are believed to have benefited from direct access to medium and long-term credit under Multisector Credit operations, these operations were valuable in strengthening second-tier institutions. Therefore, the total sum is credited as indirect support.

Rounding errors exist.

Annex 3a

Rural Finance Strategy:
Guidelines for the Preparation of Action Plans

Action Area 1*: *Create a Favorable Policy Environment			
Problems	**Causes**	**Areas of Intervention**	**Actions**
Lack of Access to Formal Financial Services	Lack of collateral.	1. Support reform laws that aim to strengthen and improve the legal framework for secured transactions that would permit the wider use of moveable collateral. 2. Continue to support land titling and registration efforts that would increase the number of persons who can pledge real estate as collateral.	Use stand-alone TC and MIF operations to reform secured transaction's framework and improve enforcement capacity. Coordinate and support efforts to include titling, reform of secured transaction frameworks, and enhancement of information environment in larger Bank agricultural, financial sector, and modernization of the state operations.
	Prohibitive Cost of Enforcing Credit Claims	Simplify procedures and strengthen the institutions (i.e., public registries and courts) responsible for verifying and enforcing credit claims. Engage in reform of judiciary system and promote use of alternative dispute resolution to lower costs of contract enforcement.	
	Difficulties in obtaining complete and accurate information in a cost-effective and timely manner.	Improve the supply, quality, and exchange of data on rural households, entrepreneurial activity, and production conditions. Encourage member governments to invest in rural censuses, household surveys, and routine gathering and publication of agricultural price and production data.	Use TCs and MIF operations to create and strengthen credit bureaus and promote private sector gathering and dissemination of market information.
	Low profitability of many rural activities	1. Encourage member governments to increase investments in rural infrastructure, social services, technology transfer, and marketing services to lower cost of production, transport, and marketing. 2. Encourage member governments to remove remaining price and incentive biases that lower profitability and competitiveness. Maintain vigilance to ensure that these biases do not reappear.	1. Use policy-based Sector Loans with multiple components: (1) reform of sectoral economic policies, (2) reform of secured transaction's framework and property rights (titling, public registries, contract enforcement); (3) reform of financial regulatory frameworks; and (4) enhancing the collection and dissemination of information on rural production, prices, trade volumes, and household/firm characteristics. (If conditions do not permit, use stand alone TCs and MIFs).

Annex 3a (cont.):

Rural Finance Strategy:
Guidelines for the Preparation of Action Plans

Action Area 1 (cont.): Create a Favorable Policy Environment			
Problems	**Causes**	**Areas of Intervention**	**Actions**
Financial Market Segmentation and Limited Competition	Inadequate legal and financial regulatory framework that limit entry and innovation and increase cost of rural financial intermediation.	1. Identify and remove biases in the banking laws that limit competition. Promote the creation of narrow banks.	1. Use stand-alone TCs and MIF operations to improve regulatory frameworks.
	Limited availability of risk mitigation techniques at both the firm and financial intermediary levels that make intermediation more costly.	1. Support private sector led efforts to introduce crop insurance and expand access to property and casualty insurance in general. 2. Support the linkage of urban and rural formal intermediaries, including mergers and acquisitions, in order to diversify risk better.	Use RTC or MIF operations to train staff of rural institutions how to manage operational risk better and to experiment with linking formal and informal intermediaries.
	Differential enforcement capabilities. Informal intermediaries have advantages over formal ones. Thus, they are more active in rural areas.	1. Promote formal-informal intermediary linkages(bank-supplier-farmer)to better exploit complementary advantages (formal intermediaries have larger capital bases than informal intermediaries but the latter have better information and enforcement capacity). 2. Encourage formal intermediaries to mimic products offered by informal suppliers such as Rotating Savings and Credit Associations (ROSCAs).	Use MIF resources to experiment with linking, for example, a private commercial bank with a financial NGO or a bank with an agroprocessor/trader who on-lend to smaller borrowers.
Limited Availability of Medium and Long term Credit	Low domestic savings rates, macroeconomic instability, limited risk management tools, and lack of funds.	1. Provide temporary access to external funds to relieve the constraint. 2. Underwrite bond issues of banks interested in lending long to rural areas so that they can attract investments from Pension Funds.	Use Multisectoral Credit Loans to second-tier institutions who allocate funds to first-tier institutions in a transparent manner and use market-based pricing. Also, use MIF Guarantee operations to underwrite investments in banks willing to lend long.

Annex 3a (cont.):

Rural Finance Strategy:
Guidelines for the Preparation of Action Plans

Action Area 2:
Improve Retail Institutional Capacity

Problems	Causes	Areas of Intervention	Actions
Paucity of Operationally Efficient and Sustainable Financial Intermediaries in Rural Areas	Inappropriate governance and incentive structures. Tradition of direct government intervention.	1. Help member governments and financial intermediaries design governance and capital structures that promote solvency yet a social commitment. 2. Help national governments to rationalize the role of state-owned institutions and to aggressively encourage the entry of privately owned intermediaries into rural areas. Options include, privatizing first tier state-owned banks, offering temporary operational subsidies to private banks and successful urban microfinance intermediaries willing to expand services in rural areas, promoting linkages between formal and informal intermediares. 3. Invest in the training of managers, board of directors, and staff of rural finance institutions and expand lending capacity.	1. Use TCs and MIF operations to help member governments revise existing charters to correct weaknesses (i.e., credit unions) and to formulate new limited charters and regulations that will improve incentives for financial NGOs and allow narrow banks. 2. Use loans to help member government privatize or liquidate first-tier state agricultural banks. Use MIF operations to explore private management contracts. 3. Use TC grants either as a stand alone or parallel to MIF financing operations (loans, equity, guarantees) to train staff, reengineer organizations, and expand the lending capacity of promising intermediaries committed to sustainability and that serve all productive units in rural areas, not just agriculture. 4. Also use TC and/or administrative budget funds to conduct best practice research and disseminate results in order to spur adoption of proven industry practices.
	Weak business management capacity.	Support training and improved educational opportunities especially in accounting, finance, banking, and business administration.	Use TC grants to transfer technology, train staff, and upgrade management information systems.
	Excessive reliance on collateral-based lending technologies.	Fund the transfer of appropriate technologies especially for agricultural lending and microfinance.	Use TC grants either as a stand-alone or with parallel financing.
	Vulnerability to systematic shocks such as bad weather.	Support the creation of emergency funds for disaster loans that can protect well-functioning rural intermediaries from uncontrollable threats.	Use a Standby Loan Facility to establish emergency fund to help intermediaries adversely affected by natural disasters.

Annex 3a (cont.):

Rural Finance Strategy:
Guidelines for the Preparation of Action Plans

Action Area 3: Promote New Financial Services			
Problems	**Causes**	**Areas of Intervention**	**Actions**
Limited Array of Non-Loan Financial Services (i.e., deposits, insurance, hedging, electronic cards, leasing, warehouse receipts, payments transfers, etc.)	Missing legal, institutional, and economic preconditions prevent the development of new services.	1.Address weaknesses in legal, tax, regulatory, and institutional frameworks that make new products uneconomical to introduce. Simultaneously ensure that there are sufficient risk control devices. 2. Place heavy emphasis on improved regulation or rating of deposit-taking institutions. For larger sized institutions, some form of implicit or explicit deposit insurance aimed at protecting small savers may be advisable. 3. Promote the financial rating of non-regulated institutions and the passage of disclosure laws, and accounting harmonization rules that would serve to improve transparency in financial transactions. 4. Attempt to link existing financial institutions and post offices in rural areas to improve payment system efficiency and explore the use of electronic cards and radio technology as solutions to payment transfer problems.	1. Use MIF operations to make appropriate reforms in civil, banking, commercial, and tax codes. 2. Use MIF operations to support market research, pilot testing, and scaling up of new products and services as well as improvements in payment systems. 3. Use TC grants and administrative budget to design and implement with strategic partners an information database that would allow for the monitoring and evaluation of results with aim of replication in other countries.
	Incentive problems exist because of the non-exclusionary nature of the innovations. Innovators bear high cost and imitators can reap benefits without making the initial high outlays. Therefore, the amount of innovation is suboptimal.	Help financial intermediaries who are experimenting with new products in rural areas through subsidies.	Use TC grants to fund feasibility studies, market research, transfer technology, and engage in product pilot testing. Use MIF equity operations to help scale up new product operations.

Annex 3b:

Rural Finance Strategy:
Guidelines for Strategy Implementation Plan

Implementation Issues	Action	How to Achieve
Developing an integrated, phased approach to resolving the interrelated problems encountered in underdeveloped rural financial markets.	Undertake country level diagnostic studies of rural financial markets and develop country specific strategies with the active participation of key national level and community stakeholders.	Assemble joint Bank and borrowing country teams to undertake the assignment when feasible. Otherwise hire consultants to complete the tasks.
Developing a consensus on a course of action and a high degree of borrowing country of “ownership”.	Identify champions both in the public and private sector within borrowing member countries who will be strong and able advocates of reform and innovation.	Charge Regional Department and Field Office Bank staff with cultivating contacts and engaging prospective “champions” in an on going dialogue.
Improving coordination between Central Departments and Regional Departments, with other multilateral and bilateral development institutions, and with the private-public sector entities in member borrowing countries.	Develop a pipeline of operations and research/dissemination/training activities. The project activity focus should be in order of decreasing importance: (1) legal, regulatory, and policy reform; (2) development of retail institutional capacity; and (3) promotion of new financial products.	Establish a Network on Rural Finance that includes Central Department, Regional Department, and Field Office staff should be formed to share experiences and inform each other of respective projects under consideration. Representative of the Group should be tasked with coordinating on a regular basis with other international development organizations and private sector interest groups.
Building a critical mass of technical expertise on the topic	Hire or contract more persons well versed in rural finance, especially the new style of financial intermediation that is beginning to appear (subcontracting, bank-NGO-client linked lending, contract farming).	Concentrate the additional expertise in Regional Departments and Country Fields Office and charge staff with developing new projects and monitoring execution.
Brokering relationships with the private sector and reducing transactions costs imposed on prospective clients of the Bank and staff of Bank attempting novel approaches.	Simplify Bank procedures governing the approval of Technical Cooperations, MIF projects, and Loans. As private sector partners become more important in the process, the ability to forge successful alliances will be diminished if the Bank is not more responsive to client-partner needs and learns to play a catalytic role in matching parties with complementary needs, facilitating the exchange of information, and leveraging financial resources.	First, canvass the opinions of operational staff and clients to determine bottlenecks and to quantify full processing costs, then attempt to streamline approval procedures. Second, emphasize a change in client focus by delegating more power to the operational specialists in Regional Departments and Country Field Office and encourage the staff to engage in and cultivate relationships with potential private sector partners.
Emphasizing quality in execution of operations instead of number and total value of approved operations.	Change the incentives in place that favor routine monitoring and disbursement compliance to a set that favor active involvement and partnership with clients in search of high impact results. Engineering institutional change and policy reform in rural finance is a labor-intensive effort	Provide proper incentives and discretion for operational staff to follow-up and monitor projects. For example, tie merit pay to results of projects in portfolio, given special awards, provide training, and allocate more time to these

	in which timely interventions can make a difference between successful goal achievement and mediocre or failed results.	activities in staff workplans. Charge a Central Department with monitoring the implementation and evaluation of the approved action plans.
Institutionalizing Learning and Managing Knowledge	Develop a systematic way to learn from experiences and rapidly incorporate those lessons into new operations under preparation. Projects that are likely to be prepared will be of an experimental or pilot nature and the Bank can enhance the quality of latter operations through timely evaluation and application of learning.	Design projects with more clearly verifiable performance indicators and technical staff along with consultants should engage in monitoring and evaluation exercises. The information should be entered into a simple database that would allow ready access to other potential users.

Annex 4:
Implementation Priorities
(Descending Order of Importance)

Priority 1: Legal, Regulatory, and Policy Environment	
Subpriority 1:	Remove biases in sectoral economic policies that reduce profitability and competitiveness of rural productive activities.
Subpriority 2:	Reform the secured transaction=s framework to allow for a wider variety of acceptable forms of collateral that can be pledged as surety. Continue with land titling and registration programs.
Subpriority 3:	Improve the effectiveness of the contract enforcement apparatus.
Subpriority 4:	Remove biases in the financial regulatory and supervisory framework against character and reputation based lending, operational platform flexibility, and usury restrictions. While secured lending is essential for the safety of any banking system, prudential norms should allow some flexibility for the use of sound lending techniques that rely on information and social capital, such as credit scoring and group credit.
Subpriority 5:	Improve supervisory capacity by introducing new on-site sampling techniques, third and self-regulation schemes for institutions of a small asset size, and use of rating agencies for non-depository institutions.
Subpriority 6:	Reform banking and financial institution laws to allow for new types of limited charter and small capitalization rural financial intermediaries.
Priority 2: Institutional Retail Capacity	
Subpriority 1:	Reform governance and incentives within organizations with the aim of instilling a drive for operational efficiency and financial self-sufficiency combined with a social commitment. Focus on private and member-owned institutions.
Subpriority 2:	Improve management quality in financial intermediaries with sizeable rural portfolios.
Subpriority 3:	Assist in the transfer of new service delivery technologies appropriate for a rural setting and a generally moderate- to low-income clientele.
Subpriority 4:	Promote linkages between formal and informal intermediaries in rural areas and between urban and rural based financial intermediaries.
Subpriority 5:	Provide financing to expand operations of high potential organizations.
Priority 3: Product Innovation	
Subpriority 1:	Deposit Mobilization
Subpriority 2:	Commodity Collateralized Finance (warehouse receipts, accounts receivable etc.)
Subpriority 3:	Electronic cards
Subpriority 4:	Leasing
Subpriority 5:	Insurance
Subpriority 6:	Hedging Instruments
Subpriority 7:	Payment Transfers

Annex 5:
Highly Desirable Conditions for Product Innovation

Selected Financial Products	**Policy, Legal, and Institutional Requirements**
Voluntary Saving Deposits	• Liberalized financial sector (no interest rate ceilings). • Institution licensed, subject to reserve requirements, and regulated. *Note*: Member-owned institutions may be exempted but emphasis should be placed on solvency and informal supervision or ratings.
Negotiable Warehouse Receipts	• Warehouse Law (must provide legal protection for depositors and allows the co-mingling of various deposits in order to lower transaction costs). • Bonding and/or Insurance Fund Established to Protect Depositors against Financial Failure of Warehouse. • Uniform grades and standards exist (essential for impersonal a "paper trading" based on solely on commodity description). • Adequate physical infrastructure(transport, drying, storage).
Electronic Cards(Debit, Credit, Smart)	• Efficient and reliable communications infrastructure. • Functioning credit bureaus (case of credit cards). • Effective contract enforcement mechanisms. • Compatible networks and standardized equipment.
Leasing	• Ability for leasor to quickly and inexpensively reclaim property from leasee in case of delinquency. • Availability and affordability of property and liability insurance. • Allowance for deduction of leasing interest expenses from pre-tax income. • Allowance of depreciation to leasor.
Insurance (crop)	• Licensed and regulated insurance carriers. • Availability of reliable, low-cost information on specific perils and yield loss correlations. • Availability of international reinsurance.
Hedging	• Country creditworthiness. • Liberalized Financial Sector (no exchange rate controls). • Financial, Civil, Commercial Codes that recognize hedging contracts. • Absence of government actions that hamper development of private sector risk management techniques, i.e., domestic price stabilization schemes. • Commodity Exchanges and Clearinghouses for transactions • Uniform Grades and Standards. • Adequate data processing and communications infrastructures. • Adequate transport and storage facilities. • Knowledge of how to analyze and quantify risk exposure and use the instruments on the part of market participants, brokers, and financial analysts.

Annex 6:
Results of Public Consultation Process

Person Making Comment	Institutional Affiliation	Country	Summary of Principal Points Raised	Resolution of Issues Raised	Relevant section or page reflecting incorporation of comment
Francisco Javier Delgado	Banco de México-Fideicomisos Instituídos en Relación con la Agricultura (FIRA)	Mexico	1. Fundamental issue in lack of medium and long- term credit is not lack of institutional supply, but presence of risk. 2. Make more explicit the role of commercial banks. 3. Can work simultaneously in three areas: policy, retail capacity, and new products.	1. Rephrased to give equal weight to lack of domestic savings, macroeconomic stability, and risk issues. 2. Partially accepted. 3. Accepted.	1. Paragraph 3.10 rewritten. 2. Paragraph 3.24 modified slightly. 3. See last paragraph on pg. iii of executive summary and paragraph 5.5. Was never an impossibility. Language clarified.
Roque Miranda	Instituto de Desarrollo Social y Promoción Humana (INDES)	Argentina	Recommends incentives for urban based financial intermediaries to extent to rural areas.	Partially Accepted.	See end of paragraph 3.24.
Francisco Rhon	Centro Andino de Acción Popular	Ecuador	1. Too much emphasis on agriculture. 2. Emphasize role for cooperatives and credit unions.	1. Partially Accepted. 2. Not Accepted.	1. See third paragraph of executive summary. 2. Paragraphs 3.24 and 4.20 provided a balanced treatment. Thrust of comment, generally not supported by empirical evidence. There may be individual country exceptions.
Dale Adams	Retired Ohio State University Professor	USA	1. Historical discussion lacking. 2. Emphasize saving deposits. 3. Emphasize Transactions Costs	1. Not Accepted. 2. Accepted. 3. Not Accepted.	1. See background paper entitled "Lessons Learned." Has extensive discussion of history of rural lending. Strategy document is not the appropriate place for long historical treatment. 2. Paragraph 3.29 rewritten. 3. Paragraphs 3.2-3.5 provide a balanced assessment.

J.D. von Pischke	President, Frontier Finance	USA	1. Remove the word: "credit needs". It connotes entitlement. 2. Chapter III is too optimistic. 3. Make clear that donors should focus on "policy environment" and let private sector handle "downstream" retail capacity.	1. Partially Accepted. 2. Partially Accepted. 3. Accepted.	1. Removed in most places. 2. The changes proposed are ambitious but the whole document is caveated and no pancreas are purported, just rational, systematic actions. 3. Paragraph 4.8 has been modified to emphasis the point.
Mark Schreiner	Washington University in St. Louis	USA	Extremely supportive.	NA	NA
Doug Pearce	Natural Resources Institute	UK	Extremely supportive	NA	NA

Consultation Process:

The document was distributed by email to 23 prominent persons in the field of rural finance in both English and Spanish, representing a cross-section of academia, finance, government, international development organizations, and consulting firms. In addition, ACDI/VOCA, a U.S. based non-governmental organization, emailed the document to over 50 private and civil society organizations in Latin America and the Caribbean. Both language versions of the document were also placed on the IDB website in April 2000 and availability was announced via DEVFINANCE, an internet user group with over 600 members dedicated to sharing information related to and discussing microfinance issues. A reminder notice was sent to the list of prominent persons and civil society organization on June12, 2000. The official comment period was 45 days long, starting on May 12 and ending on June 26, 2000.