CHAPTER-II

RURAL FINANCIAL MARKETS IN DEVELOPING COUNTRIES
2.1. THE PLACE OF CAPITAL IN ECONOMIC PROGRESS

Over the past 30 years ideas about the role of money in the development of an economy have undergone profound changes. The simple view that money is irrelevant to real growth and that accumulation of money retards real growth has been replaced by more complex considerations of the role of finance in general, including monetary and non-monetary financial instruments and functions. This approach has led to the conclusion that finance affects production and that the financial system is a mobilization and allocation mechanism which transforms and distributes risk. ¹

Capital occupies a position so dominant in the economic theory of production and distribution. It should occupy an equally important place in the theory of economic growth. It is the process of capital accumulation that occupies the front of the state of economic growth. The contribution of capital to economic progress is not merely confined to the creation of additional capital assets, similar to those already in existence. It embraces three distinct processes. Firstly, a greater abundance of capital permits the introduction of more round about methods of production or to be more precise, of a more round about pattern of consumption. Secondly, the accumulation of capital is a normal feature of economic expansion. Thirdly, additional capital may be required to allow technical progress to take place. ²
There is a general agreement that, in all countries, the process of economic growth and capital accumulation are closely inter-connected. A high rate of capital formation usually accompanies a rapid growth in productivity and income. The innovation of money and finance tend to increase the size and extent of exchange relationships, or markets, and thus promote the division of labour and lead to increasing returns to scale and technical change.\(^3\)

2.2. CONCEPT OF RURAL FINANCIAL MARKET

A rural financial market consists of relationships between buyers and sellers of financial assets, who are active in rural economies. These relationships are based on transactions that include borrowing, lending and transfer of ownership of financial assets. Financial asset consist of debt claims and ownership claims. Rural financial market includes informal sector intermediaries, formal institutions and private borrowing and lending not involving intermediaries. Financial markets are characterized by intermediaries between savers and borrowers. Finance makes four contributions to commercial economy. It provides efficient means of exchange. It encourages more efficient resource allocation. It provides for the transformation and redistribution of risk among the units. Finance can be used as an important tool in economic stabilization activities.\(^4\)
2.3. RURAL FINANCIAL MARKETS IN DEVELOPING COUNTRIES

The specific objectives that a Government attempts to achieve through ‘rural financial markets’ varies across countries and through time within countries. At least four common objectives are pursued in most rural financial markets. These are: (i) that financial markets should help the poor; (ii) that the operation of financial markets should result in more agricultural output through efficient allocation of resources; (iii) that rural financial market activities should boost Government efforts in other productive sectors; and (iv) that financial intermediaries should evolve into strong and self-sufficient institutions.

Rural financial markets are strongly affected by three sets of policies. They are: (i) those directed at influencing the money supply, the overall monetary system and financial activities in general; (ii) those directed at rural financial markets; (iii) those policies that effect the rates of return that producers in rural areas expect from their investments.5

Until recent times, the use of agricultural credit as a developmental tool seemed clear and straightforward. Negative views about informal credit underlie the emphasis on developing formal lending institutions. The theoretical basis for intervention through the financial system for the sake of development was enhanced by H.T. Patrick in 1966. Patrick suggested the establishment of financial institutions and the provision of loanable
funds as a means of stimulating the pace of investment and economic activity. Attempts to replace informal finance with formal credit institutions have followed the assumption that modern formal lenders are more efficient and socially more desirable. Recent research in low income countries, has shown high transaction cost for both lenders and borrowers in diverse rural financial markets. Transaction costs are elevated because rural financial markets are performing poorly. Evidence shows that interest rates kept low by Government policy discriminate against the poor. Many policy makers have argued that rural people are insensitive to levels and changes in real interest rates. Recently collected evidence, however, shows that the rural people are sensitive to interest rates.6

Rural financial market performance cannot be measured by any single criterion. A well functioning rural financial market should mobilize rural savings as well as disburse credit; it should grow to meet expanding opportunities without continually requiring subsidized inflows of outside funds; it should have an expanding array of vehicles for attracting savings and offer varied and flexible lending terms and conditions.7

2.4. AGRICULTURAL CREDIT IN THE THIRD WORLD

The agricultural economy of the Developing countries is characterized by dualism i.e., the existence of traditional and modern agriculture. This dualism is also reflected in the structure of agricultural
credit. Non-institutional agencies play an important role in the provision of agricultural credit in almost all developing countries due to imperfections in rural capital market, underdevelopment of suitable financial intermediaries and the urban background of the existing financial institutions.

In 9 of the 39 countries studied by the World Bank, loan amount from institutions is less than $5 per rural person while in five countries it is in excess of $100 per capita. On a continental basis, in most countries of Africa and Asia, institutional lending is less than $20 per rural inhabitant, while in a number of Latin American countries, it is in excess of $50 per capita (Appendix-2.1). The percentage of loans made by institutions in Latin America is high while in Africa and Asia, non-institutional lending predominates (Appendix-2.2).

The percentage of farmers receiving institutional credit varies widely in different parts of the Developing world. In certain African countries around one per cent of the total number of farmers used institutional credit, while in Thaiwan, nearly, all farmers have access to it. About 5 per cent of farmers in Africa obtained institutional credit, while the proportion in Latin America and Asia (excluding Thaiwan) is about 15 per cent (Appendix 2.3). In the case of small farmers, coverage by institutions is even more limited. Large farmers have been the main
beneficiaries of institutional credit. It is common to find 70 to 80 per cent of small farmers in a given country with virtually no access to such credit; in Pakistan almost 60 per cent of the farmers received 3 per cent of the institutional credit. In Bangladesh the larger farmers received more than 80 per cent of the loans from the agricultural bank and the co-operative banking system. In the Philippines, 27 per cent of the larger farmers working on 61 per cent of the land, received 98 per cent of the institutional credit.

In Tunisia, 90 per cent of the farmers received 34 per cent of the loans. Studies on Thailand, Bolivia, Chile, Columbia, Ethiopia and Honduras indicated that the larger farmers were the main beneficiaries of institutional credit. According to the survey of rural indebtedness conducted by the Central Bank of Sri Lanka in 1991, non-institutional sources provided 84.2 per cent of the total credit requirement in Sri Lanka. Friends, relatives, shop-keepers and moneylenders provided 65 per cent of the total credit and the remaining was met by institutional agencies in Vietnam during the year 1992.

Agricultural credit under these conditions has been static in the vast majority of Developing countries. The main problem is to convert static into dynamic credit. This involves the development of a sound agricultural credit system in the ‘Third World’ countries.
The World Bank has also recognized long ago, the problem of agricultural credit in the Developing countries. Its contribution to research, extension and finance relating to agricultural credit in the 'Third World' is commendable. The special problems of lending to small farmers have caused the World Bank to lay down certain principles concerning the development of credit programmes for small farmers. The World Bank has consistently encouraged credit agencies to lend on the basis of the productive capacity of the farmer and on the quality of the technology package. In several countries, the Bank has also encouraged attempts to do away with the requirements for collateral while lending to small groups of farmers, the group being jointly responsible for the debts of its individual members. In other cases, it has encouraged the merger of credit and marketing arrangements. The bankers are giving renewed attention to the organization of extension services to popularize the technology package in agriculture. The banks have also provided technical assistance to institutions at the national level to assist them in developing their policies and procedures.

Regarding the dimension of credit, by the middle of 1983, the banks had lent about 4,650 million. The World Bank has to constantly search for the most effective ways of using the funds available for agricultural credit to promote more rapid economic development in the 'Third World'.

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2.5. BANKS AS AGENTS OF DEVELOPMENT

The financial institutions can influence the capital stock for development purposes in three ways. Firstly, they can encourage a more efficient allocation of a given total amount of tangible wealth or capital by bringing about changes in its ownership and composition through intermediation among different types of asset holders. Secondly, by intermediation between savers and entrepreneurial investors, the financial institutions can encourage a more efficient allocation of new investment additions to capital stock from relatively less to relatively more productive uses. Thirdly, they can induce an increase in the rate of accumulation of capital by providing increased incentives to save and invest.

In Developing countries this banking function i.e., creating, accumulating and efficient allocation of capital assumes great importance. The way in which banks function will determine the degree of success of the development effort. Financial intermediaries can advance rural development by means of (a) savings promotion, (b) investment effort and (c) sectoral and regional distribution of investment.

If any scarce factor associated with underdevelopment of rural sector is singled out, it would be capital. The supply of funds in areas is small and limited because of low rate of savings, prevalence of barter system, lack of financial assets and lack of proper storage facilities.
Increasing supply of funds is more important than simply the reduction of rates to advance rural development. The plentitude of funds enables the promising entrepreneur to assume a greater debt that he could otherwise have and consequently provides him the wider horizons of conceivable opportunities of productive investments.

Regional and sectoral distribution of investment is more relevant for rural development. Investment funds should be deployed in those sectors which have linkages with rural economy. To this end, banks can modestly help by maintaining a balance between credit advanced in different regions and to different sectors. To achieve this, they have to abandon the role of market-followers and assume the responsibility of market-setters. If this can be achieved, credit to agriculture and small scale and cottage industries would increase, thereby giving a fillip to rural development.

A review of the trends of Banking development in India reveals the evolution of innovative banking to facilitate the achievement of economic and social objectives of planned development. The saving promotion function of banks not only helps the cause of capital formation but contains impending inflationary dangers, since money when not saved is spent as wasteful expenditure, particularly by the poor people. The yeoman service of banks in spreading the banking habits now encompasses not only the cities or urban areas but also the rural, semi-urban, backward and
unbanked areas. By financing the farmers, village industries and a bulk of the self-employed, who are otherwise dependents on moneylenders, the banks serve the welfare of the rural masses. They are financing, smiths, cobblers, taxi-drivers, carpenters, goldsmiths, vegetable sellers, fisherwomen and a host of other people with small means. No security is insisted on as the banks consider the welfare of the people of paramount importance and faith in the integrity of the people has to be respected.

Banks are now undertaking useful social service activities. They help to start and run schools, award scholarships to poor but brilliant young people to pursue their studies, to start hospitals or health centres in rural areas; to provide medical relief to the poor at a cheaper rate; to construct houses both for rural and the semi-urban poor at a reasonably low rate of interest and easy instalments of repayments; to give financial support to install drainage system and drinking water facilities in slum-areas and villages. Indeed, banks have widened and deepened their activities promoting mass banking to serve people.

Thus banks have assumed a catalytic role in the promotion of social welfare and the advancement of economic development. They have now accepted the precept that development should follow banks rather than banks follow development, and the bankers are considered not only ‘dealers in money’ but ‘leaders in development’. They are today playing a
development inducing and development sustaining role in the process of
economic development, not only in India but also in many Developing
countries of the world and acting as an instrument for establishment of an
egalitarian society.
References


5. Ibid.

6. Ibid.


