Comments on "Effective Intervention in Rural Finance"

Judith Tendler

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For the Economics and Policy Division of the Agriculture and Rural Development Department of the World Bank

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Costs and interest rates

1.01 Put together, the arguments of this paper seem to be leading toward some policy recommendations about cost, but that never happens, and the reader wonders why. On the one hand, the paper refers to the "high" costs of RFI credit--15% to 30% of the value of loan portfolios--but, on the other hand, recommends a series of changes in RFI operations that would most likely <u>increase</u> costs (e.g., increased monitoring, increased attention to subloan diversion (3.60), increased use of and more sophisticated farm models (3.40), flexible decisionmaking on loan terms, etc.). There are no recommendations as to how costs might be reduced. Yet costs are more within the control of implementing agencies than some of the other variables you spend considerable time on, such as interest-rate levels. (I suggest some approaches to cost problems in the sections entitled "Nongovernmental organizations" and "Farm modeling, costs, and performance.")

1.02 If it is the case that, as you argue, (1) RFI costs are high, (2) certain cost-increasing operational changes in credit programs are needed, and (3) subsidization of interest rates is undesirable--then the reader needs to be told the consequences of your argument: a recommended interest rate of 15%-30% <u>plus</u> (1) additional costs for the administrative improvements you recommend, (2) the cost of capital, (3) a risk premium for bad debt, and (4) an assumed full monetary correction for inflation. (Some paragraphs where this information is needed are 3.54, after first sentence, and 3.15, after last sentence.) It would also help if you worked out an example in nominal terms for a particular country, and then compare your result to prevailing interest rates in that country. A justification for proposing such high real interest rates should be provided.

1.03 It may be that you would be content with an interest rate that, though not covering costs, would be close to other interest rates in the formal financial system. If that is the case--and it is not clear to me what position you would actually take, since the cost discussion is not linked to the interest-rate discussion--then you are in effect agreeing to subsidize cost through the interest rate, something you argue so eloquently against. Please clarify!

Subsidized interest rates

1.04 I cannot agree more fully with much of the argument you make against subsidized interest rates. I think the argument could be improved, especially for such a policy paper, by being a little more specific about what actual real levels of interest rates might result from your no-subsidy recommendations, and whether you consider that acceptable. Also, in your discussions of subsidized interest rates and credit as a vehicle of subsidy, it might be useful to distinguish between cases where (1) the subsidy is in the interest rate and (2) where the interest rate is at a near-market level but there is a subsidy to the lender for start-up costs, including the high early costs of dealing with new borrowers. (You may feel that the latter form is also an interest-rate subsidy, but I'm not sure I would agree.) I believe Dennis Anderson's papers describe such a start-up or "ignorance-reducing" subsidy to the lender, along with interest rates equal to those charged existing borrowers, which sounded quite reasonable to me. This distinction would make it possible for you to distinguish between benign degrees of subsidy and damaging ones.

1.05 The argument against subsidized interest rates has been around for more than ten years, and disseminated in research and conferences funded by the Bank and AID. The fact that the argument is so well known and, in addition, seems to have had little impact on policymakers, requires some comment and some second-best suggestions. Also, conspicuously absent from your discussion of interest rates and the position you take, is the recent literature on the subject, which questions the concept of "market-clearing" interest-rate levels, and the wisdom of trying to charge them. (I discuss this literature below.) The findings of this literature could assist you in making some suggestions that are more compatible with the real-world pervasiveness of subsidized interest rates.

1.06 To refer to almost all agricultural credit projects as having had "bargain rates" (3.23) is, I think, not accurate. If you would run a frequency distribution of <u>real</u> interest rates across Bank projects, I would be surprised if there were not considerable variation. It would be useful for such an exercise to include an attempt to correlate low real rates with high rates of inflation. You might also do a frequency distribution of differences, positive and negative, between project interest rates and rates prevailing in the country. Again, I would expect to see tremendous variation, but would be happy to be proven wrong. This kind of data, and the way the various observations group themselves, would help to provide a map of the difficulties in getting interest rates right, and provide a basis for explaining why some countries do significantly better than others. Though I realize your paper is not a research or evaluation effort, it still should convey an analysis of issues and suggestions that is based on experience--good as well as bad.

1.07 I am not sure that "bargain interest rates" have played as important a role as you attribute to them in causing bad repayment performance. You mention on p. 41, for example, that one incentive for repayment in a particular program was the prospect of access to additional credit through the mobile loan officers. I assume this means that borrowers could not receive new loans until they repaid old ones. I feel that such a policy can be a major contribution to good repayment performance, particularly when interest rates are subsidized--namely, denying new credit until old credit is repaid. And I am sure that the lack of such a policy has been more significant than subsidized interest rates in causing poor repayment performance. Adopting such a policy, moreover, may be politically easier than charging non-subsidized interest rates.

1.08 If low interest rates affect repayment so negatively, how can one explain the cases of high repayment frequently encountered in credit programs with very low interest rates? (The most recent cases I have seen have been UNO in Brazil and FUNDE in Nicaragua. Both organizations will not make new loans until old loans are repaid; and they both lend credit at negative real interest rates and have achieved high repayment rates.) Also, if low interest rates affect repayment adversely, how do you explain the fact that prepayment is not uncommon in small-borrower programs with subsidized rates? The most recent example I have seen is the small-enterprise credit component of the Bank's urban reconstruction project in Nicaragua, where small entrepreneurs were repaying three-to-five-year loans within one year; the loans were made at 12% interest while inflation was 30%.

1.09 Though it seems economically irrational for borrowers to prepay when interest rates are low--as you say in 3.72 (last sentence)--the existence of the phenomenon means that there must be some rationality behind it. Small borrowers usually give two reasons for prepaying: (1) they think it is bad to be "in debt," and they are afraid of "the bank"; and (2) they want to take out new and larger loans (the Nicaraguan case). This gives two possible policy suggestions for increasing the probability of good repayment performance: (1) selecting borrowers who fear the bank (which coincides with much of the Bank's intended target population in "new-style" projects); and (2) requiring that old loans be paid up before new ones are made.

1.10 In making your argument against subsidized interest rates, in sum, I think you are on surer ground if you let the argument rest mainly on the ill effects of economic misallocation, capital erosion, and rationing of credit to better-off borrowers--rather than on adverse repayment effects.

Recent literature on interest rates

1.11 Your argument about interest rates might be enhanced, and some of the contradictions in your paper reduced, if you drew on some of the recent literature on credit rationing and interest rates. Three contributions that come most readily to mind are Stiglitz' & Weiss' article on credit rationing in markets with imperfect information, Akerlof's article on the market for "lemons," and Dennis Anderson's application of some of these concepts to the interest-rate discussion in (I believe) his study of Philippine small-scale enterprise programs.

1.12 The above writings make the following points of relevance to the topic of your paper: (1) in some markets, like that for credit and labor, prices do not equilibrate supply and demand; (2) in markets like that for credit (and used cars), where imperfect information makes it costly or impossible to sort out the good from the bad (dishonest or high-risk borrowers from honest or low-risk ones, defective used cars from good ones), a risk-reflecting interest rate can extinguish the market rather than clear it (at least extinguishing the kinds of borrowers you want as beneficiaries for your projects); (3) a cost- and risk-reflecting interest rate that is high can have the "adverse-selection" effect of attracting dishonest borrowers or those with high-risk projects, as well as discouraging honest borrowers and those with less risky projects from borrowing; and (4) given the preceding, the optimum interest rate for bankers can be theoretically shown to be one that is <u>lower</u> than a market-clearing rate, explaining the empirical fact that bankers tend to ration credit themselves rather than allow the interest rate to do so.

1.13 Credit is a case, in other words, (1) for which a quite respectable argument has been made to show that prices do not necessarily clear markets; and (2), also contrary to what conventional theory assumes, for which the quality of the commodity is affected by its price. The implication of this literature is that lower-than-market-clearing interest rates may not only be a second-best solution, given political constraints, but they may sometimes be <u>first-best</u>. High, "market-clearing" rates, that is, can cause just the kinds of problems that you argue they would avoid.

1.14 I think that the line of reasoning of this literature can provide you with a theoretical basis for some real-world guidance for credit projects, the majority of which will have some degree of "subsidy" in their interest rates. The literature also raises significant questions about the validity of your interest-rate analysis and suggestions, since it shows that a "market-clearing" interest rate (assuming there is such a thing) may contribute just as much to bad borrower selection and delinquency, by being "too high," as excessively low interest rates.

Prevailing rates

1.15 Policymakers and practitioners in third-world countries often argue against increased interest rates by asking "why should we charge more to poor farmers when everybody else gets interest-rate or other subsidies?" I think the argument requires serious treatment because even though it may have no economic legitimacy, it certainly has legitimacy in terms of the logic of justice and political economy. Also, unless governments adopt the interest-rate policy you suggest throughout their financial systems, you do not provide the reader with a logical reason to support the adoption of such an interest rate for one particular project--particularly a project in which beneficiaries are going to get access to subsidies for the first time. Most credit projects do not offer the opportunity to bring about system-wide changes in interest rates, which leaves the Bank in the weak position of having to defend a higher rate for one program than for the others. Also, many policymakers and project managers interpret (perhaps wrongly) the anti-subsidized-interest-rate argument as requiring a rate that is significantly higher than the rate charged to other "normal" borrowers--as, indeed, a real rate reflecting all the costs and risks enumerated above might be.

1.16 I have been impressed in my evaluation work with the political difficulty that all kinds of RFIs have in charging higher interest rates (or charging for other services), even when they want to, because of the characterization of such actions as "socially irresponsible" by the communities where they work and the polity at large. The difficulty is particularly acute when another RFI is charging a significantly lower interest rate--a quite common situation in the institutional environment of Bank credit projects. (Interest rates that are only a few percentage points higher than others usually do not provoke such invidious comparisons.) For all these reasons, policymakers and project designers tend to reject your suggestions about interest rates as unrealistic and unreasonable--and therefore of no interest to them. You could avoid this reaction by offering some project-specific guidance.

1.17 One approach might be to discuss the "acceptable" interest rate as a relative--i.e., relative to prevailing rates for credit provided by private banks, and/or for government credit lines and rediscounting facilities. You might make more progress in interest-rate reform with respect to individual projects if you argued that project beneficiaries be charged the same rate as everyone else--even if, in real-cost terms, the rate was a subsidized one. There is a gray area, in other words, for which the paper could give useful advice.

Inflation

1.18 You might want to mention (for example in 3.53) the role of inflation in causing countries to be bad performers on interest rates. It is much more politically difficult to charge a reasonable real interest rate in a country with high or increasing inflation than in one with low or decreasing inflation. Increasing inflation takes the interest rate out of your hands, and forces you to make a politically conspicuous increase in the nominal interest rate just to keep the real interest rate constant; decreasing inflation is just the opposite, taking care of your politically difficult move for you--all you have to do is maintain the nominal rate, and inflation raises the real rate for you. I am sure that a study of interest rates in Bank projects in various countries would bear this out. (Low real interest rates would be correlated with high- or increasing-inflation countries.)

1.19 Countries with high and/or increasing inflation, in other words, are forced to be poorer performers than those with declining or little inflation. You might want to separate out these two types of cases, if only to remove some of the judgmental opprobrium from the more difficult cases--but hopefully so as also to offer some different policy advice. After the first sentence of 3.53, moreover, you might comment on why the Bank could not solve the problem of creeping decline in real rates by negotiating positive real interest rates, given that it has negotiated, as you say, positive nominal ones.

1.20 It would be helpful to separate out, in sum, the three elements, of the interest-rate problem (for example, in 3.19, after the last sentence): (1) costs not covered, (2) inflation, and (3) the fact that a cost-covering, inflation-covering interest rate might be way above prevailing commercial rates, have "adverse selection" results, or even "extinguish" the market. Costs, in fact, are more within control of any particular lender than inflation and real interest rates. That is why I was confused as to why cost received little attention in your paper.

Trust fund (3.81-3.85)

1.21 Your argument for a trust fund for situations in which it is impossible to raise interest rates is an excellent attempt to offer some second-best advice. The proposal is presented, however, as if it would apply to only a small minority of cases, but I think the prevalence of subsidized interest rates is wider than that. It is not clear to the reader whether you would be willing to propose this mechanism for a majority of cases--or whether you are thinking of a minority of special cases among the larger set of subsidized cases. (It would be helpful if you would specify a minimum real interest rate below which you would place the project in the trust-fund category.)

1.22 Though I am in full sympathy with second-best approaches to the problems you present in the paper, I think the "quarantine" aspect of your proposed trust fund will make the problem worse. The quarantine approach, I feel, capitulates too easily to the problem it is meant to deal with, and offers no way out. It protects management from suffering the penalties of poor performance, and thus removes badly-needed incentives for good performance in the area of borrower selection and loan collection. The administrator earns a service charge but bears no risk from these operations (3.82-3). You say that a staff and trustees without remuneration will cause such a program to have "relatively little vested interest" (3.84); the corollary of this, however, is that there is also relatively little vested interest in making good loans or collecting on them.

1.23 By insulating the trust fund from the pressure to perform, it would seem, one removes any chance that the program will be a learning experience that will help the institution move toward a more healthy credit program in the future. Yet this kind of "externality"--the eventual creation of a healthy financial institution, or the eventual access of a presently excluded target group to formal credit--is the only justification for funding a weak organization or program in the first place.

1.24 The quarantine approach, as used by the Bank for years with autonomous state enterprises in the infrastructure sector, has had a wholesome effect--i.e., a strengthening one. In those cases, however, you attracted and isolated the good performer in the cause of doing the "right" thing--mainly, charging cost-covering prices and engaging in "rational" and "apolitical" decisionmaking about projects. In the trust-fund case, you are quarantining a program so as to let it do the "wrong" thing. You are protecting something inherently weak, in other words, instead of something inherently strong or with the potential to become strong.

1.25 A quarantine of persons for epidemiological purposes has two benefits: it protects the outside population from disease, and it helps the diseased persons to get better (to the extent that they are treated while under quarantine). The trust-fund "quarantine" has no such effects and, indeed, has some of the opposite effects: (1) by serving as a conspicuous justification for interest-rate subsidy to politicians and borrowers in other programs, it "contaminates" that outside population; (2) and by accepting the "inevitability" of delinquency and low interest rates, it withholds "treatment" from the quarantined population.

1.26 In trying to justify Bank support of trust-fund type situations, you argue that Bank participation will "minimize the damage that will occur." If your arguments about the undesirability of subsidized credit are correct, however, then Bank support of the trust-fund mechanism spreads the damage rather than minimizing it--by the signals it sends out to governments that they can continue to receive donor support for subsidized credit and weak institutions. I would remove this particular justification, if you decide to retain this proposal in its current form.

1.27 To me, the trust-fund proposal is like the fungibility discussion in that, in the course of seeing a theoretical argument through to its logical conclusion, one goes to an unreasonable extreme. That is, you can preserve the logic of non-subsidized interest rates and fungibility by isolating the "few" intransigent cases, to which you give separate treatment. I would prefer a version of the trust fund that (1) recognizes that such cases will be more than a few, (2) is more integrated into the existing financial system, and (3) has built-in incentives to performance and built-in provisions or features of the task environment that push the institution in a healthy direction.

1.28 Finally, the trust-fund proposal, as the only new and concrete institutional suggestion of the paper, seems to fly in the face of your convincing arguments that credit is a poor approach to subsidy. Your statements that there are better alternatives than credit to subsidy raise the reader's hopes that you will offer alternative institutional approaches and make corresponding suggestions about how to improve credit institutions--rather than give in to their weaknesses in such a hopeless way.

1.29 One particular danger of the trust-fund mechanism, finally, is that it may produce a spurious improvement in the costs and repayment performance of the <u>non</u>-trust-fund component of a lender's portfolio. When lenders have the choice, they often send the "costlier" (i.e., smaller), the unknown, or the questionable borrowers to their special line of credit--even though that person has the qualifications to borrow from the regular program and may even have been doing so. (This happened frequently with special lines of small-farmer credit administered by the Bank of Brazil in

Northeast Brazil.) Thus the non-trust-fund clientele "improve" (less costly to serve, repay better), while the trust-fund clients are "naturally" selected for their potentially bad effect on the program. The trust fund, then, may represent a bad self-fulfilling prophecy.

Fungibility, rural financial markets, and production-increasing impacts

2.01 Throughout the paper, the reader is confused about the implications of the fungibility argument (e.g., 3.49, 2.05ff). One implication of your discussion of fungibility, subsidized interest rates, and rural financial markets is that it is difficult, except in a few special situations, to bring about increases in production and productivity through credit projects. (I do not fully agree with this implication, and will discuss my reasons later.) You seem to be posing an alternative reason for providing credit--without quite saying it--which is that improvements in rural financial markets (RFMs) are in themselves desirable, for the reasons you discuss mainly in Chapter I.

2.02 You say that "improvement of the performance of rural financial markets is the primary rationale for World Bank activity in these markets" (3.30). Yet your discussion of credit projects in Chapters I and II gives the impression that the main rationale was really the improvement of agricultural production and productivity. If well-functioning rural financial markets are the main rationale, credit projects would not need to be justified in terms of showing impact on production and productivity. (For convenience, I refer subsequently to these two different approaches to justify credit projects as RFM vs. Production-Impact, or PI.)

2.03 If you are concerned mainly with improving the performance of RFMs, in other words, then it would seem that you would be much less concerned with impact on beneficiary production than you are in this paper. Indeed, if RFM improvement _had_ been the Bank's primary rationale, it would have been more concerned with the "impact of the project on the lender'"--a concern you say has been lacking, at least in relation to Bank interest in the impact of the project on the intended beneficiaries.

2.04 Many of your recommendations seem to rest on the PI justification (such as the importance of doing impact analysis), which suggests that you think that the RFM justification is _not_ the main rationale for credit projects. This creates a contradictory and confusing quality throughout the paper (more examples later), and makes it difficult to tie the analysis to the recommendations; some of the discussion of issues, for example, leads the reader to expect a different set of recommendations than those actually proposed, or to be surprised at the recommendations that you make. In this sense, your discussion of fungibility and the perverse effects of past programs is so effective that it undermines the credibility of the recommendations you make. And your arguments about credit as an inferior instrument for achieving PI impacts cause the reader to conclude that you would be _against_ further credit projects with PI objectives.

2.05 Paragraph 2.58 seems to contain most of the elements of the contradiction that runs throughout the paper (paragraph 3.49

also). Your fungibility/substitution argument says that, through credit, you cannot get people to do what they would not otherwise do except in a few unusual cases. (You might devote more attention to specifying what those cases are, and address the reader's uncertainty as to whether you are recommending that credit projects be limited to those exceptions.) The methodology part of your argument says that you cannot measure whether people do things differently. But it is not clear throughout whether you are saying simply that (1) causality is difficult to determine, or that (2) in addition, fungibility makes it difficult to cause borrowers to do what you want them to. The former statement, of course, has less drastic implications for policy than the latter. If you are also saying the latter, then the policy implications you draw do not seem to follow--since you seem to assume continuance of Bank projects aiming at production impacts.

2.06 More specifically, the reader becomes confused as to (1) whether you are indeed saying that fungibility/substitution means that the net impact of credit projects on production is likely to be zero in most cases (together with your arguments about credit as an inferior subsidy instrument); and (2) why you recommend improved methods of project monitoring and evaluation that "take fungibility into account"--when you say one sentence later that "the costs of impact measurement are probably not warranted" because the impact of a credit project "cannot be meaningfully measured."

2.07 When this paragraph is clarified, I think it might be better to place the paper's earlier discussion of fungibility here, rather than on pp. 28-29; the earlier discussion leaves the reader hanging without this kind of logical conclusion, and the brief reference to fungibility here in one short paragraph comes somewhat out of the blue--for someone who has not read or who has read and forgotten the earlier few pages on fungibility.

<u>Credit as bad for subsidy</u>

2.08 Some of the confusion of the paper might be reduced if you could clarify, early on, the implications of your position for policy. You argue in paragraph 2.23, for example, that efforts to lower the costs of innovation and to provide incentives that deal directly with production constraints may be more effective than credit. Credit is therefore a poor vehicle for subsidy, you say, because of its higher probability of misapplication or diversion than direct subsidies. (You might, by the way, want to say here or elsewhere whether you think <u>un</u>subsidized credit is equally undesirable, and under what conditions it might be the preferred instrument.)

2.09 Again in 2.21 (fourth sentence), you say that where "the degree of commercialization is low," credit "is most easily accomplished through input suppliers or produce buyers." The reader wants to know the implication of this finding for Bank policy. Should Bank projects stay away completely from such low-commercialization areas? Or would you support projects that increase the supply of credit channeled through input suppliers or produce buyers?

2.10 After reading these statements about credit as a poor vehicle for subsidy, the reader is expecting you to discuss some better <u>non-credit</u> ways of providing subsidies, and to recommend a reduction of Bank credit projects or credit components, except under certain conditions. Because this does not happen, one is left confused; paragraphs such as these make the paper seem as if, in subsequent discussions of how to improve the administration of credit programs, it is ignoring the implications of its own analysis.

2.11 Though I agree with your discussion of the disadvantages of credit as subsidy, I think it is also important to discuss credit not only as a form of subsidizing production (a not very desirable one, you say), but also as a way of extending RFMs to those who now have no access to them. This would be consistent with your earlier discussion of the advantages for development of assisting the evolution of rural financial markets. Paragraph 3.28 (penultimate sentence) is another instance in which credit is stated to be a "poor channel for subsidy" but there is no indication of what is better, and why, and whether credit projects should therefore be abandoned.

2.12 <u>Input dealers</u>. You do indicate a preference for subsidizing credit through input suppliers (2.46-7) rather than directly, but the suggestion needs some clarification. I am not sure that the reader will understand as to whether you are talking about opening up lines of credit to private input-suppliers (at subsidized or non-subsidized rates?), or whether you are talking about subsidizing the price of inputs purchased at private suppliers by farmers who are directly receiving non-subsidized project credit. I assume, from Bank projects like those in Nigeria, that you are talking about the latter case--providing credit to farmers at non-subsidized rates to buy inputs from private suppliers sold at subsidized prices.

2.13 If the latter case is what you are expressing a preference for, then one misses any reference to the misallocational problems of this approach--namely, the stimulation of an agriculture that (1) is intensive in petroleum-based products and purchased inputs in general, and (2) may simply revert to its pre-project form when the subsidy is withdrawn. It seems that the Bank itself has participated actively in pointing out these misallocational results. It does not seem to go without saying, in other words, that credit would have greater misallocational effects than fertilizer and other input subsidies. But if this is so, the reader should be told why.

2.14 In general, your discussion of fungibility (e.g., 2.05) seems more like a methodological discussion (how to measure impact) than the "financial issue" that it is called. (The same is true of the section on "the optimum amount of finance"--2.09ff). I see fungibility (and "the optimum amount of finance") as issues of interest mainly to us economists, and not to policymakers and project designers. Clearly, the outcome of our discussions has tremendous relevance for policy and project design. But in and of themselves, these subjects may appear as irrelevant and confusing to the policymaker and designer of projects--the audience to whom the paper seems to be addressed. I would prefer to see these two sections deleted and their arguments drawn upon, where necessary, in the more policy-oriented sections (e.g., fungibility can be called upon to explain why subsidized interest rates cause problems).

Impact analysis

2.15 The last sentence of paragraph 2.58, if you want to stand by it, deserves more emphasis--i.e., that impact measurement is not worth the money. It has important implications for Bank policy with respect to its own evaluation and that required of lenders. A little more should be said about what the statement means for Bank project justification and monitoring, and for lender evaluation and monitoring practices--namely, I assume, a giving up on attempts to measure impact. Also, the recommendation is a bold enough one to require its receiving more emphasis, and repetition in the Summary & Conclusions. As I discuss later, I would feel more comfortable with a less puristic approach to evidence of impact; and I think that impact measurement should be the task of Bank units specialized in research and/or evaluation, and cannot be routinely done on each project--because of the need for a skilled approach to it, and for cross-project results.

2.16 The pessimistic statement about impact measurement, together with your recommendations about monitoring, is confusing. On the one hand, you argue that fungibility makes it difficult to monitor the impact of credit programs and make valid statements about causality. On the other hand, you recommend elsewhere in the report that better monitoring of impact should be required of lenders. Two possible approaches to resolving the contradiction come to my mind. The first is to give up on impact monitoring, given the difficulty of making the diagnosis. The second is to take a somewhat different approach to determining impact, which I outline below.

2.17 You might want to give up on requiring impact analysis by lenders for the following reasons. One is that it is costly, and you argue that (1) the costs of agricultural lending are already a high percentage of loan value (15%-30%), and (2) that impact measurement is not worth the money. A second and more important reason is that lenders usually have little interest in impact monitoring, seeing it as a nuisance requirement of the Bank and delegating it to low-level or low-prestige divisions of their organization. To the extent that lenders <u>do</u> accord importance to impact analysis, it is often because they hope it will show that their program is successful--bringing a built-in bias to the exercise of determining impact.

2.18 The lender's lack of expertise in sophisticated impact analysis often causes the Bank to end up having to help the lender with methodology, haggling with the lender over the quality of the results, and attempting to patch up the results and make them better--all involving considerable expenditure of time and resources by both sides, and often hard feelings. If impact is so difficult to diagnose, then its diagnosis should best be kept within the purview of those who specialize in it, and who have no vested interest in having it turn out in a particular way--in this case, the appropriate research or evaluation department of the Bank.

2.19 In trying to look for impact, I think we tend to be overwhelmed by the requirements of the economics discipline for proving causation. The harder we try and the more sophisticated we get, the dimmer are the hopes for being able to establish, statistically, the case for cause and effect. Given the underdeveloped state of the art, however, I believe that one must settle for more rustic approaches to doing research and evaluation on this topic, in order to learn anything at all. It is possible to gain a certain sense of impact, for example, from careful interviewing of credit beneficiaries about what they thought they "did differently" as a result of participating in the program, and from interviewing project staff. I am sure that others at the Bank have found the same, and that this approach could be used in some cross-project evaluation work. I think our gloom about assessing impact, in sum, is in part a result of putting our efforts and faith too exclusively into the econometric approach, given what we know about the difficulties it poses.

Beyond fungibility

2.20 The fungibility argument against impact is a powerful one because it makes such eminent sense from the point of view of economic analysis. In my interviews with peasant farmers and microentrepreneurs who borrow from special credit programs, however, I have found that the taking of credit often represents a distinct event in their lives--both in terms of the actions leading up to the securing of credit, and the activity that the credit is meant to finance. The contacts of borrowers with extension and other agents around the credit experience contributes to this quality of a special occasion for change.

2.21 The poorer people are, or the less experience they have had with formal credit institutions or extension agencies, the more they tend to see the credit as tied to a change that they are embarking upon in their productive lives--a change that they feel is enabled by the credit and the "moral support" they receive from the contact with technical-assistance agents. The credit and the institutional setting in which credit comes, in other words, provide a kind of pacing, a discipline, and a courage for the borrowers to make changes in the way they produce--even if the change is only in the scale of production. In these senses, credit can be seen as having "caused" the change. (I suspect that the "moral support" of technical assistance may be at least as significant a contribution to change caused by such assistance in many cases as the actual new inputs or new techniques promoted by the assistance agents.) It is difficult to explain this kind of credit-caused change within the bounds of fungibility analysis.

2.22 People who have little experience with the banking system live in great fear of formal credit. The fear will operate as strongly as "economic rationality" in determining how they respond to investment opportunities facilitated by credit, and in causing them to invest the credit the way they are "supposed to." Your discussion of fungibility (and diversion of credit) does not seem to have any room for this fear. The fungibility analysis assumes a credit-taker who is comfortable with formal institutions, can shift his capital easily from one investment to another, and is mobile enough and has the information to do so. Many of the intended beneficiaries of the credit projects--or, at least, the new-style ones--do not fit into this category. Fungibility will not be in operation for them--or at least its perverse manifestations in the form of diversion and investment outside agriculture--because of their fear of doing something of which the bank disapproves, their lack of information and assets, and their immobility.

2.23 At the least, then, I think you might want to distinguish between different types of borrowers, in tracking the damage wrought by fungibility and in making a judgment about the prospects for achieving impact with credit. I, for example, would suspect that fungibility was no more important in explaining why Bank credit projects did not achieve their desired production impact than was the inappropriateness of the "technical package," or the inability of lenders to reach the "fearful" class of borrowers--i.e., those without previous access to formal credit. (More comments below on the need for a distinction in the paper between poorer and better-off borrowers.)

2.24 For the above reasons, I would have a somewhat more sanguine view of the prospects for influencing the way people produce than is implied in your analysis of fungibility, subsidized interest rates, and the results of past projects. (Again, this same more sanguine view seems to lie between the lines of other parts of your paper, particularly in the more policy-oriented and practice-oriented parts, but you do not come out and state or justify this view in analytical terms.) In general, I think one tends to get swept away by the clean elegance of the fungibility argument and, because of the force of its logic, to carry it further than one would really like to do, given one's knowledge of how things work on the ground. Your paper conveys a sense of that quality of being inadvertently "swept away," as seen in the greater belief in impact revealed in your recommendation discussion than in your analysis.

Fungibility and diversion

2.25 Another example of confusion arising from the fungibility analysis is your discussion of diversion of loan funds and your recommendations for more sanctions and supervision (3.28-3.29). According to the logic of your general analysis and recommendations (only implied sometimes), diversion of credit should not be a problem in future projects because (1) the Bank should be supporting only those projects with "realistic" interest rates (with the exception of the trust-fund cases), which will keep the "diverters" away; (2) the Bank should stay away from PI programs since there are better and more direct ways of achieving PI objectives ("credit is a poor vehicle for subsidy"); and (3) in the cases where interest rates are subsidized (the "trust-fund" projects) the incentives to divert will be so great, as you argue, that it will be difficult to prevent diversion; even if one can, the monitoring system required to do so will be quite costly.

2.26 Fungibility analysis, moreover, says that even the person who invests his credit in the intended activity may have been meaning to do so anyway, so that the net result of the loan is to free up his own resources to invest elsewhere--presumably in an activity more profitable than the intended one. (Your corollary conclusion is that credit is therefore not the best way to subsidize an activity like agriculture, or to promote increases in its production and productivity.) What about this borrower who borrows for something he was going to do anyway, and takes the freed funds and invests in urban real estate? According to your fungibility analysis, is he any less a diverter than the one who does not invest in the intended activity at all? If not, then why sanction one and not the other?

2.27 According to your own analysis, the increased supervision and sanctions you recommend to prevent diversion would not seem to be required or to be effective, and would certainly add to already-high costs. If one is concerned about diversion, I think a more effective and less costly approach is to identify policies and organizational characteristics that "repel" the would-be diverters from borrowing in the first place--e.g., the less subsidized interest rates you recommend, peer pressure systems, "fearful" target borrowers, a highly visible presence of lending agency personnel (examples are dispersed location of branches in small communities, such as credit unions systems, and hiring of people from the community to visit businesses or plots on a regular basis--a less costly approach because it does not require vehicles and urban professional salaries).

Conclusion

2.28 You point out that much rural investment and innovation has been financed out of farmers' own capital, out of suppliers' credit, or out of well-functioning RFMs--and that trying to increase production and productivity through credit does not work very well. If these statements are true, then the conclusion of your logic would seem to be that these other "superior" instruments should be allowed to take over: production projects, according to your logic, should be carried out only in regions already endowed with financial infrastructure, or credit projects should create the financial infrastructure themselves or make what already exists operate better. In this latter "RFM approach," credit is used as an end rather than as a means to attack production problems. Perhaps this is a radical approach--stripping production programs of their credit components, or divorcing credit components from the production-increasing objectives--but it seems to be where the logic of your own argument leads.

Delinquency and RFI performance

3.01 Your discussion of delinquency and its prevention (3.59-3.62, 3.64) might benefit from a brief description of the success-causing characteristics of programs that have had good repayment performance, and a linking of suggestions to these characteristics. As it is, your discussion gives the impression that high delinquency is so much the norm that you can only rely on hypothesis or textbook recommendations for advice. We now know a lot more about what causes good performance and what causes repayment problems. We also know how intractable such problems are to the usual recommendations of "better monitoring," etc. Finally, it is very hard to deal with such problems, or to withhold funds because of them, once a project gets going. One would like to know some of the lessons learned from the Bank's experience, and how they would inform suggestions.

3.02 I was surprised at your bleak characterization of the repayment experience with RFI credit programs. There is a numerous minority of cases where repayment was managed adequately, or where agencies learned to overcome delinquency problems. In their study of SSE programs in the Philippines, for example, Anderson & Khambata found certain clear differences between high-performing and low-performing loans: the poor performers received loans for (1) new activities, as opposed to ongoing businesses, (2) large expansions of existing activities (in relation to the current size of the business), and a few other factors that I do not remember.

3.03 In my own evaluations of SSE programs in Brazil and Nicaragua, I found additional factors that could be significant in causing high repayment: (1) a strict policy of not giving second loans until the first are paid off (I think that should be one of the most salient of your procedural recommendations in 3.14, and 3.60, first sentence); (2) a clientele with fears of the bank or of a bad credit record (usually found among poorer clients and/or those without access to any other source of formal credit); (3) a physical environment, or type of clientele, that minimizes the costs of collection (town vs. farmer credit, giving people credit at places where they regularly gather, like marketplaces); (4) peer pressure that arises in a group-credit situation, or around a locally-based credit institution like a credit union, where borrowers have a stake through savings in making sure others repay. (I was surprised that you did not make this latter argument in favor of your plea to emphasize savings. I do not have any particular attachment to the above-listed characteristics, nor are they exhaustive.

3.04 What is common to the above characteristics is that they provide simple criteria for the Bank in choosing credit projects to support, for designing these projects, and for monitoring them. The criteria do not rely on increased organizational complexity, increased staff and costs, increased honesty, or an unrealistic hope for decreased pressures on lenders by influential and delinquent borrowers. In this sense, these characteristics are like "market influences" which on their own bring about the desired effect, without having to rely completely on an "administered" solution. Some of your suggestions to deal with delinquency and other problems seem to depend too much on such administered solutions, which are difficult to put into place effectively; the incentives all run in the opposite direction and, partly for this reason, they (the solutions) tend to be costly.

3.05 Institutional procedures that reduce delinquency, of course, may also conflict with the production-increasing (PI) objectives of a credit program. For example, restricting loans to an applicant's existing business in order to increase the likelihood of repayment may be in conflict with a project's goal of increasing production in certain "dynamic" sectors. Likewise, limiting credit to people with fear of banks may leave one with a clientele that does not have enough capital and income to make the kinds of investments desired under the program. Though one may ultimately decide in favor of the PI-objective--lending for the more delinquency-prone project or clientele--it should at least be recognized that one is giving up certain aspects of organizational design and of the task environment that would help to make high repayment more likely.

3.06 With the examples of the above paragraph, we are back again at the implicit conflict in your paper between PI programs and RFM programs. If we retreat somewhat from our PI objectives--choosing our clientele, our institutions, and our environments according to their repayment potential--then we are following more of an RFM justification for the projects we fund.

Bank experience

3.07 As in the case of delinquency, the paper in general needs some reference to cases where problems did not exist or were overcome, as a basis for making recommendations about how to improve RFIs. Section 3.14-3.29 on "weaknesses" is a section particularly needing this kind of help. (Granted, the preceding section is on "accomplishments," but it is about accomplishments in impact and RFM development, and not with respect to the problems discussed in 3.14-3.29.) Without this basis in past experience, the recommendations tend to be perceived by the reader as "the same old thing," or the "boilerplate" of appraisal reports and texts on organizations. In 3.22 in particular, one would like to hear about some cases where credit allocation was appropriate, or became less inappropriate. How were these cases different, and what lessons might you draw about policy and project design for the future?

3.08 In general, the paper provides no accounting of or explanation for the partial successes that have been achieved by the Bank. One example is the providing of small borrowers with credit for the first time; perhaps these farmers were not as low in the income distribution as was hoped, but they were lower than the status quo ante. I stress the successful aspects of the projects because when one tackles a new problem, as the Bank did with the new-style projects of the 1970s, one is bound to be successful only intermittently at the beginning; further success will be dependent on learning why the good cases worked and the bad ones did not. My concern is that your argument can be used as a basis for throwing out the whole attempt (even though you yourself do not) because, when judged on your own economic-theoretic grounds, it has been a failure. To not describe the success and draw the lessons seems to be an abdication of part of the responsibility involved in doing something new.

3.09 If you try to characterize some of the more successful cases, with respect to the problems you list in section 3.14-3.29, then this may weaken your arguments about the damaging effects of low interest rates, etc., on institutional performance, because you will have to explain why the damage did not occur in these particular cases. Also, examination of such cases helps one to learn how problems like low interest rates are overcome. One often discovers, for example, that organizations make progress in certain areas--not the ones most important to us--and only at a subsequent stage are they able to attack and overcome other problems that are more difficult. If this is the case, with respect to some of the problems discussed here, then it is important that we discover what the signs of a "good start" are, and try to support projects of this nature--never forgetting, of course, the things we think are weaknesses, and giving support for the organization's overcoming them.

3.10 Without this kind of approach, a donor like the Bank gets stuck with the worst of both worlds: you either turn your back on applicant organizations with the "bad" qualities (the less common response), or you "give in" unhappily because of political pressures and the need to move funds (e.g., Brazil). An alternate response would be to gain a sense, from one's own projects, of the characteristics of the implementing agencies, weak or strong--or of their environments--that tend to make for rapid learning and evolution toward strength. And of the kinds of Bank interventions along the way, or choices at the beginning, that would help this process of growth. Without knowing the characteristics of the projects that were successful, it is difficult to take this course. It is this sense that the paper lacks.

Poor and better-off borrowers

4.01 My puzzlement over your characterization of RFI credit programs as generally delinquent is based on my own experience in evaluating credit programs with clients who had almost no previous access to bank credit--and on the oft-heard statement from rural bankers, as also found in the literature, that the poorer borrowers are the better repayers because of their fear of the bank, of losing their land, and of losing their only chance for further loans. Poorer borrowers are also distinct from larger borrowers, as you yourself say, in that they may not have the resources to carry out the PI investments that are central to many credit projects. Though you state at one point that borrowers with a minimum level of investment capacity are a more desirable clientele for PI-promoting projects, you do not seem to draw any other comparisons between these two classes of borrowers. This leaves the reader with the implication that you think that "the rural poor" are beyond the pale of credit projects, as you actually state in 2.24.

4.02 I think that the paper should be more explicit in drawing distinctions between poorer and better-off borrowers--not only in the discussion of delinquency, but with respect to your generally pessimistic judgments about PI programs. Are you talking about excluding the bottom 5% or 40%? the completely landless vs. the semi-landless? the fixed businesses vs. hawkers? And so on. The income-increasing and RFM-improving arguments for assisting poorer borrowers should also be dealt with--even if only for the purpose of rejecting those arguments. For example: poor farmers who borrow for annual operating costs often increase the land under cultivation according to traditional techniques (one of the findings of the OED study of Sub-Saharan African projects, I believe). This means increased production, increased income, the employment effects of increased hiring of labor, and the increased agricultural wage that will sometimes result from the withdrawal from the labor market of the borrowers' own part-time labor, previously hired out to larger farmers. (This latter effect was visible in the Northeast Brazil projects.)

Credit and the poor

4.03 I am not sure I agree that credit has relatively little potential for reaching the rural poor. The experience of some NGOs with credit to informal-sector hawkers and vendors is a case in point, as well as some of the attempts of these and public-sector RFIs to reach poorer farmers. I agree that it is difficult for the poor to be reached by formal lending institutions, because of the "psychological distance" and other factors you mention; but some NGOs and even public-sector programs have made considerable progress in overcoming that distance. It is this kind of progress one would like to hear more of, and the lessons it holds for policy and project design. And if the PI objective is the only strong justification for supporting medium as opposed to small borrowers, finally, then it is somewhat of a weak justification--according to your own negative findings about the ability of credit projects to achieve PI objectives.

4.04 Collateral and the poor (3.45). Collateral requirements have been one of the major obstacles to getting formal lenders to provide credit to small farmers and merchants. The World Bank has invested considerable time and effort with lenders in various projects, trying to get them to reduce collateral requirements. Many projects that have suspended collateral requirements, moreover, have had successful repayment rates--substituting co-signature or other types of pressures to repay for collateral. Your recommendation of increased recourse by lenders to collateral (in 3.45) therefore causes some confusion for the reader, given that collateral requirements have been pointed to for so long as an undesirable barrier to extending the services of RFIs to small borrowers. You might want to specify that you are talking about a better-off class of borrowers (if, indeed, you are), but in that case collateral is usually required of these borrowers anyway, isn't it? At the least, the reader should be told that there is a conflict between the goals of good banking and expanding RFM services to a broader population. Also, how might you lessen the conflict?

4.05 Transactions costs and the poor (2.52). Shouldn't transactions costs include costs of travel to towns where banks are located, and lodging and meals? In Latin America, these costs have been constantly mentioned to me by small farmers as significant. Your omission of these costs, along with your inclusion of the costs of "entertaining credit agency representatives," confuses me as to whether you are assuming a better-off borrower than the ones, for example, that were the intended beneficiaries of the Bank's rural development projects in Northeast Brazil. This, together with your previous statement that credit cannot really reach the rural poor, makes me wonder if you have drawn a cutoff point for typical beneficiaries without telling the reader exactly what it is and why you do so. At other points, you do seem to be including poorer borrowers in your target groups (e.g., when you talk about psychological distance between bankers and borrowers). Please clarify!

Agricultural vs. non-agricultural rural credit

5.01 Throughout the paper, I had the impression that you were talking about agricultural credit--as opposed to credit to rural merchants, artisan manufacturers, and service establishments. (I will refer to the latter type of credit as "NAR" credit--"non-agricultural rural.") At a few points, however, you do refer to NAR credit in your discussions, creating some confusion in my mind as to what the paper covers.

5.02 There are significant differences between NAR and agricultural credit, so that the problems of, or recommendations for, one are not necessarily relevant to the other. The important differences between the performance of credit institutions servicing NAR clientele as opposed to a farmer clientele are related, in part, to the different characteristics of the task, which cause NAR credit to be "easier." Credit-union organizations, for example, have frequently done perfectly well at NAR credit, and then failed miserably when they extended their program to agricultural credit. (I have discussed these differences at length in a recent paper for the IAF on a credit program in Nicaragua.)

5.03 Some of the major problems you describe for RFM credit do not afflict NAR credit, or at least, not to the same extent--particularly repayment problems--because of the physical concentration of NAR borrowers (in towns), their nearness to the bank, the peer pressure that can easily be applied in the case of group or credit-union lending, the low cost of collection as a result of physical concentration of the borrowers, and the lack of extreme seasonal cycles in NAR borrowers' incomes and expenditures. Despite this greater easiness of NAR lending, NAR credit has received much less attention and resources than agricultural credit, because it has lacked the kind of production- and productivity-increasing justification that has attracted so much funding for agriculture. Development planners have never looked at small retail, manufacturing, and service establishments as a sector through which one could achieve significant increases in a country's production, productivity, and employment--and hence this sector was never endowed with the kind of powerful justification for credit projects that agriculture was.

5.04 The lack of development interest in the NAR sector turns out to explain another reason for the greater "ease" of NAR credit: the organization dispensing the credit is usually not encumbered with the costly and organizationally complicating processes of selection and monitoring of, and technical assistance for, borrowers that supervised agricultural-credit programs are. Many of the problems you identify in past credit projects are in part a result of these attempts to select the "right" borrower, from the production-increasing point of view, and to make sure he applies the new techniques and inputs. (NAR credit, for example, is not burdened with the problem of what to do about agricultural extensionists who prefer to stay in the office rather than visit faraway plots, or who prefer to visit large farmers rather than smaller ones.) For all these reasons, you might want to include some discussions of NAR credit and its differences from farmer credit, or make it clear that your discussion relates only to farmer credit.

5.05 My point about NAR credit relates back to my concern about separating out the RFM argument for supporting credit programs from the production-increasing (PI) argument. If you decide, based on your negative conclusions about credit as a vehicle to subsidize increased production, that an RFM approach to credit is better for justifying and designing credit projects--which seems to be behind your lines in various places--then NAR credit is no less justifiable than agricultural credit. But if a PI approach is behind your justification and design of credit projects, then NAR credit <u>is</u> less justifiable than agricultural credit. That's one reason why I think it is important to distinguish the two positions, and indicate early on in the paper where you stand. At the least, you need to explain why your negative findings on PI objectives and institutional performance do not lead you to a more RFM-oriented approach.

<u>Informal moneylenders</u>

5.06 Dennis Anderson, I believe, made a point about NAR credit that represents an argument in its favor, if one indeed were to rely principally on an RFM justification for credit projects. Small retail merchants sell much of their goods on credit, and the amount of credit they offer is directly affected by the amount of credit to which they have access. An increase in credit to small merchants therefore reverberates in increased credit to clients, including farmers. If agricultural innovations are being introduced in a region simultaneously, then this increased merchant credit may represent a more efficient and effective way of enabling farmers to adopt the new inputs and techniques. Or, at the least, the logic of your own arguments on informal credit, on the problems of PI projects, and on the undesirability of credit as an instrument of PI subsidy, would seem to suggest this to be the case.

5.07 I actually assumed that your early complimentary discussion of the informal credit system was heading toward the Anderson type of tie-in to project strategy and design. In 3.42 (last sentence), in light of your earlier portrayal of informal moneylenders, it <u>seems</u> as if you are about to recommend that credit projects direct some credit through merchants. But you do not do that, so the reader is left hanging somewhat as to the implications of your discussion of the virtues of informal moneylenders, and their complementarity with formal lenders. Though I have no particular allegiance to the small-merchant-credit idea, one does need to see some examples of the implication for policy of your discussion of informal moneylending. If there are no policy or design implications, then perhaps that particular discussion is not necessary in a policy-oriented paper, particularly because of the misleading expectation it creates.

5.08 Your discussion of informal-vs.-formal lenders of Chapter I could, I believe, be better brought in at 2.33-4 in a more condensed form. Also, paragraph 3.57 is one of the few places at which the discussion of informal lending in Chapters I and II is brought to bear on a subsequent argument. As the Chapter-I discussion of informal lending now stands, it has a kind of diffuse quality, and the reader does not know what policy-relevant point it will lead to, and why so much time is being spent on it. Also, too much space <u>is</u> devoted to the discussion of informal markets and their virtues--though I agree completely with what you say--in relation to the very few number of subsequent points on policy and project design that are related to this subject.

5.09 Sentence three of 3.57 talks about the desirability of increased interest rates as an incentive for formal lenders to compete with informal lenders. I do not quite understand what is meant. Formal lenders, it seems to me, have absolutely no desire to attract the clientele that informal lenders serve. Much of the work behind the Bank's credit projects has been involved in trying to convince formal lenders to serve that clientele--regardless of the interest rate. What one wants is to get formal lenders to <u>want</u> to compete with informal lenders, and I do not understand why high interest rates in themselves would do that. Indeed, formal lenders could compete better, if they wanted to, with <u>lower</u> interest rates. Please explain!

Nongovernmental organizations

6.01 I wondered why you did not say anything about nongovernmental organizations (NGOs). In some cases, they have structures and task environments that are more conducive to the successful administration of credit to small borrowers, particularly those without access to formal financial institutions. You seem to dismiss the NGO option when you mention, in passing, that the Bank can lend only to governments. Though this is true, NGOs can receive Bank funds channeled through government programs, or local counterpart funds of a Bank project. For example, UNO is a small-enterprise credit NGO in Brazil that now receives the majority of its funds through two World Bank projects; FEDESAL (?) in El Salvador is (or was) another example. In Nicaragua, Bank project officers tried to include FUNDE, an NGO association of credit unions, in an urban reconstruction project. (FUNDE was not included because of problems between it and the government, not because of any problem on the Bank's side in having it included.) In Bangladesh, the Bank has expressed interest in providing support to the highly successful Grameen Bank, also an NGO.

6.02 AID, also a government-to-government donor, has included NGO credit organizations in its projects to a greater extent than the Bank. Unlike the Bank, AID can negotiate some funding agreements directly with NGOs, and also is under political pressure to do so. Still, a significant share of AID's support to NGOs has been channeled through governments--either directly, as the Bank did with UNO in Brazil, or indirectly, when AID has played an important role in facilitating NGO borrowing in the domestic financial system.

6.03 I am not a fan of NGOs, and I think their alleged superiority to public-sector or for-profit institutions is often non-existent or exaggerated. Nor do I think that the Bank should be involved in creating NGOs to meet credit needs. But NGOs, where they already exist and have done well, have some characteristics that make it easier for them to surmount the obstacles to rural credit that you describe in your paper. And these characteristics, which I outline below, make it possible for NGOs to take a less "administered" and costly approach to the problems of small-borrower credit. I think that the Bank should therefore keep its eye out for successful NGOs in the countries where it works, and do its best to link some credit programs to them when the occasion presents itself. In such cases, the Bank might sometimes use the NGO to pave the way for more formal institutions to ultimately service certain clients that are presently outside the system. Or the Bank might want to channel credit through the NGO and the larger public-sector institution; this will create some competitive pressures on the latter institution to do well, as well as some occasions for transfer of learning from the NGO to the formal institution.

6.04 NGOs are often better suited than other credit institutions to make small loans and serve a clientele without access to formal credit--whether the NGO is a bank in itself, or whether it simply administers funds channeled through, and collected by, the banking system (as in the UNO case). The main reason that NGOs have an easier time of serving "the little guy" is that they tenaciously believe that this is their mission. They and their staffs do not "suffer," as the bank manager does, from having a portfolio of high-cost small loans. And they get funding from their donors and praise from their constituents for providing credit to the "poor people" that are "treated so badly" by the banks. Private and government-owned banks, along with extension staffs, do not rely on an NGO-type constituency. If anything, their constituency is the "big guys," not the little ones.

6.05 NGOs <u>have</u> to provide credit to those without access in order to maintain their image of being different and "better than" government and banks. As part of their mythology about being better than government and banks, NGOs like to describe themselves as invulnerable to political influence in making lending and collection decisions. Though they may not always be so, at least they have the mystique to give them moral support for this endeavor. Government institutions and banks do not usually have this mystique to reinforce their attempts to work with small borrowers.

6.06 For NGO staff, then, working with poor clients does not entail the status deprivation and the unpleasantness that it often does for government personnel and bank officers. NGOs therefore have more of an incentive to grapple with and solve the problems of making many small loans to those untutored in formal credit. When FUNDE started its credit unions for market women in Nicaragua, for example, they (the credit unions) did not work very well; the women were not that interested and those who borrowed did not repay. So FUNDE hired as consultants two moneylenders who worked the markets; their advice was to "get rid of the air conditioning," locate the credit union right in the marketplace and make it a more humble affair, and collect savings and repayments on a daily basis--just as the moneylenders were used to doing. FUNDE adopted this advice, and the program became a success. One cannot imagine most banks or government institutions being willing or able to seek this kind of advice, or act on it.

6.07 NGO managers and staffs are usually long on commitment and short on skills and financial-management experience. They are therefore forced to use a more rustic approach to selecting borrowers and getting them to repay. They do not have the skills or the resources to engage in informed project analysis, farm modeling, technical assistance, or supervision; nor can they make frequent recourse to the legal system for enforcing debt contracts. They are therefore forced into borrower selection and collection procedures that depend on community norms of peer pressure or fear--which work quite well.

6.08 NGOs have been among the first RFIs to combine credit with savings--as you so strongly recommend--in a way that other formal credit institutions usually do not. Though borrowers may often save in formal credit institutions, savings are not so intimately linked to borrowing as they are in the credit-union type NGO. The advantages of this link are not only that the borrower's saving can be used as partial collateral for the loan, but that the savings deposits cause borrowers to be interested in the management of the local credit union, and to be indignant about those who do not repay. Formal credit institutions rarely experience this kind of community or borrower pressure for collecting from delinquent borrowers and for good management. In short, the pressure for good management and collection comes from the task environment, rather than from an administered system of formal selection processes and monitoring. The latter adds to cost, and often does not work because of perverse incentives and political pressures.

6.09 NGOs of the credit-union variety run on less skilled and less costly labor than formal credit institutions. In addition to their underpaid and committed staffs, credit-union networks avail themselves of the managerial abilities and leadership power of community leaders for free. Formal credit institutions, moreover, usually cannot be so decentralized and have as many small "branches" as credit-union networks do. And it is this decentralized location, near where "small people" work, that lowers transactions costs for both the borrower and the lender; the borrower has less distance to travel to apply for the loan, receive disbursements, and make repayments--and it is feasible for the lender to make more frequent collection visits to the borrower and to require frequent amortization payments from the borrower. The more neighborly setting of the small credit-union town, and the nature of the credit union as a community institution, make for strong pressures for repayment. (The location of credit unions in marketplaces, or other places where people gather regularly to work or trade, is the ideal setting from the point of view of minimizing collection costs, and maintaining a collection presence in a place where the borrower is constantly taking in money.)

6.10 Credit unions and other credit NGOs often lend in smaller amounts than formal institutions, though often at more frequent intervals. The small loans result from (1) the constraint of the savings mechanism (members can borrow only two to three times savings), (2) a fear of not being repaid (lack of repayment to large formal institutions by small borrowers who represent a small part of a large portfolio is less troubling to management), and (3) the conspicuousness of unusually large loans in a community institution in a small town. All this serves to endow the credit union with a financial conservatism that helps keep repayment high, partly by discouraging those who want to borrow larger amounts (they, in disgust, go to the bank). Again, these factors represent a "structural" or environmental approach to overcoming the kinds of problems you discuss.

6.11 NGOs often leave much to be desired. Their costs may not be as low as the rhetoric goes (almost no empirical research has been done); they often reach a plateau of saving and lending at a fairly low level, seeming to prefer the "quiet life"; and they usually do not aggressively pursue savings deposits beyond those required to take a loan. Thus the "rustic" approach, in some cases, may not be compatible with dynamic growth, or the high levels of lending that would be required under a Bank project. At the least, however, it is important to recognize that NGOs can have some comparative advantages at doing the kind of lending--small loans, savings-based systems, reaching people with no previous access to banks--that expands rural financial markets. And whether or not NGOs are actually chosen to participate in Bank credit projects, it is important to recognize the structural factors that contribute to their repayment performance, and try to transfer some of these lessons to the design of non-NGO projects.

Shorter observations

Savings (2.46, 3.31)

7.01 I commend you for the emphasis on savings as complementary to lending, and think that this is an area where it would be useful to elaborate more. Can you explain why savings instruments, if so desirable on both private and social grounds, have received so little attention from lenders (2.50)? Possible reasons are (1) legal restrictions, (2) perverse incentives to get loan capital from outside the branch or the system--from headquarters, central banks, donors, (3) a preference for "the quiet life," (4) the difficult-to-inspire confidence required for depositors to entrust longer-term deposits with an institution, (5) the risk to the lender of relying on withdrawable deposits as a source of capital, and (6) the resulting more sophisticated financial management required. How might projects be conceived so as to make savings more desirable to lenders?

7.02 You might also want to point out another implication of financial institutions' obtaining a greater amount of their loan capital from savings deposits. Namely, to the extent that savings allow those institutions (or branches) to rely more on their own capital, they will be less dependent on and less responsive to central banks or other outside funders (and branches will be less dependent on headquarters). The shift in these power balances may have some undesirable aspects for those who set financial policy; as long as outside capital is available, it may be less costly for central institutions _not_ to encourage the introduction of savings facilities in the system.

7.03 In this sense, the donors themselves create a disincentive to savings facilities by making so much savings-free credit available. Or, at the least, they have kept down the relative cost of _not_ introducing savings. Might you be willing, therefore, to consider a policy recommendation that would change these 'perverse incentives' and undesirable relative costs by sometimes making donor capital available to RFIs on the basis of a matching formula with respect to savings? Given your appeal for an emphasis on savings, and your critique of the disincentives, such a recommendation would seem to flow logically from your arguments.

7.04 In your discussions of savings, you might include the caveat that credit-_and_-savings is a more complex and demanding task of financial management than credit only--as J.D. himself pointed out to me (and as you allude to in 3.32). After citing this difficulty, you might make some suggestions--based on experience--about how the transition to the more difficult dual role might be made. Or, perhaps the increased risks and costs of introducing withdrawable deposits are too great to merit making this move. What structural and organizational characteristics of an existing institution augur success at handling the credit-_cum_-savings task? Again, you might mention here that credit unions succeed at combining credit and savings. (In some cases, however, "permissive" donor funding for agricultural credit has undermined the savings discipline built up by credit unions.)

7.05 Also with respect to savings, you say that SFCIs (specialized farm credit institutions) do not provide opportunities for farmers to save, and this is one of their disadvantages. Yet is this a problem only of SFCIs? I often see farmers not saving at a bank because of the inadequate return on savings paid by nearby and accessible banks. Could you elaborate a little on whether you actually think it is desirable or feasible (in both organizational and legal terms) for SFCIs to offer savings instruments?

7.06 In 3.31 (last sentence), I do not quite understand whether you mean that project funds should not be disbursed until savings performance is verified, or if a project should not be even appraised or approved until such performance is verified. I do not have much faith in placing such conditions on disbursement <u>after</u> project appraisal, because somehow the conditions are always gotten around; or the implementing agency always comes up with a good excuse as to why the conditions could not be met; or the conditions evoke a "cosmetic" or makeshift response from the applicant agency, which is not solid enough to hold through project implementation. Appraisal and approval, as you know, create tremendous pressures within the Bank and the applicant country to go ahead, at no matter what compromise. Given that savings is not as easy to do as credit alone, one would <u>not</u> want to create an incentive for lenders to initiate a savings program in a slapdash way, just to get Bank approval for appraisal or funding.

7.07 (3.33, fifth sentence). Formal RFIs, as well as informal moneylenders, also do not solicit savings deposits. In many cases, this is because they are receiving their loan capital from a headquarters institution or from public-sector lines of credit--which is usually easier and less costly than instituting and running a program of withdrawable deposits. Formal institutions also are faced with the same problem that you cite for informal lenders--i.e., of having depositors want to withdraw their loans at the same time when borrowers are least able to repay (during planting and before the harvest, before Christmas and other holidays). I think it is more important and accurate to draw attention to these problems as reasons why formal institutions do not have savings programs in rural areas, than to characterize the informal system in this way. It is with respect to the formal institution, moreover, that the Bank can suggest how these problems and the disincentives might be overcome.

Farm modeling, costs, and performance (e.g., 3.12)

7.08 One of the main burdens on the costs of agricultural programs results from the agricultural-production-increasing goals (PI) that are added onto the goals of improving rural financial markets--namely, (1) selecting a borrower who will not only repay but will invest the credit in farming and be amenable to adopting new techniques; (2) devising an agronomic and financial plan for that farmer (involving costly calculation time and visits to the plot);

(3) monitoring the farmer's use of the credit after he receives it (more costly visits); and (4) making sure he learns to use the credit the way you want him to (costly technical assistance). (The same things can be said of similar models applied to credit programs for small-scale rural enterprise.)

7.09 My experience with the use of the farm and other credit-investment models you discuss to assist in borrower selection and loan-size determination is that they also serve a ritualistic function, which may be more significant than their intended purpose--at least in small-borrower programs. The ritual consists of the lender and borrower getting to know each other, through the interviews required to get the information necessary for application of the model, the natural weeding-out of those applicants who feel annoyed and intruded upon by the questioning of lender staff and time spent doing so, and the gaining of "courage" by applicants fearful of a first exposure to formal credit or new production techniques. The ritual is also useful in keeping applicants from borrowing more than they can handle, in the cases where the model comes up with a recommended loan amount that is less than what the applicant wanted.

7.10 In helping the lender to make wise decisions about whom to lend to and how much, in contrast to the ritual functions, the farm model process is quite costly and cumbersome--for reasons explained below. Also, if impact on production is so difficult to achieve through credit, as you argue, it seems a contradiction in terms to recommend a process of borrower analysis that is so linked to a desired and particular type of impact on production. The ritualistic contribution of the credit-investment model is in itself not undesirable. The problem lies in the fact that the resources spent on the ritual are quite costly--especially when visits must be made to the applicant's place of business or farm. (Often, it is not possible to obtain adequate income and expenditure data from the applicant without going to his place of business.) Also, the information gained by extension agents from credit applicants is not very good--or not good enough to warrant the use of a sophisticated model, or to be that useful in determining loan size, loan terms, whether the loan should be made at all, and whether the borrower is likely to repay.

7.11 Lender and extension staff often take a perfunctory approach to filling out the income and expense forms for the credit-investment model, since staff performance is judged not by the performance of borrowers but by the number of loans made and number of clients visited. The employees who gather the information and fill out the model forms are usually not that expert in how to acquire information about income and expenditures, particularly with respect to small farmers and businessmen, who have multi-enterprise households and transact significant shares of their incomes and expenditures in kind. Even if staff do know how to gather this information, it is time-consuming for them to get the information right. In order to be feasible for standardized use, in sum, the credit investment model has to be generalized and applied by generalists to the point that it often cannot capture the crucial things one needs to know about any particular enterprise, nor is the information fed into the model up to its (the model's) quality.

7.12 Other approaches to achieving a healthy portfolio of loans and high repayment rates are less costly--and require less of a complicated, sophisticated, and large organization--than the credit-investment modeling you discuss. Some of the approaches I have seen working well are: (1) a policy that second loans cannot be granted until first loans are paid off; (2) a policy that requires that first loans be conservatively sized, or for less ambitious undertakings than the clients want, so that the client can establish a track record; (3) a peer mechanism for choosing borrowers and for enforcing repayment (such as solidarity groups, or credit unions); (4) caution about financing new businesses, or large expansions of existing businesses--at least for the first few loans; (5) choice of borrower and determination of loan size on the basis of the applicant's savings-deposit behavior in the institution (this is something you yourself cite as a reason for the desirability of combining savings with credit). Though these approaches might seem crude in comparison to the investment-model approach, the model approach also produces a quite crude version of the information and analysis it is meant to process. Here is a place where an inclusion of something about NGO experience with credit might widen the range of alternatives you have to choose from.

7.13 The model approach is difficult to criticize, or to change, because it endows organizations with greater power because of the need it imposes on them for a trained and large staff. Larger organizations, with more educated staffs, are more powerful and prestigious than smaller ones with little staff or less skilled staff. That is why the disadvantages of the model cannot be overemphasized, since the abandonment of the model would go so much against the self interest of the organization involved. It may be that the disadvantages of the model approach are greater for small-enterprise credit than for farmer credit; farm investment may be more amenable to standardization, because of the fairly uniform way in which crops are produced in certain regions, and the widespread production of two or three crops. Nevertheless, I think the problems of the model approach and its costs are significant for either type of credit, and need to be noted--even if one is basically in favor of the approach.

Saturation (2.26-2.28)

7.14 I have a little difficulty, here and subsequently, with the concept that "too much credit is outstanding" and that financial markets are "saturated." I would agree that the small percentage of rural borrowers who gain access to formal credit have themselves been saturated, but this leaves the large unattended group of potential borrowers completely "<u>un</u>saturated"--i.e., without formal credit. And the reason that existing borrowers are "saturated" is not only that there is too much credit in the system, but that the system does not get the credit out to many borrowers--for all the reasons you discuss. The point, it would seem to me, is not that too much credit is being provided, but that effective RFIs are not being created in the process of providing credit--which is your point about the impact of credit on the lending institution, as opposed to the borrower. As you say, the problem is that the Bank supports projects where borrowers "are not punished (for nonpayment) by denial of borrowing privileges" (2.27). I would expect this factor to be more significant than "overloading of financial systems" (2.27) in explaining "poor loan repayment performance." (Poor loan repayment performance can exist in "unsaturated" systems, either because of disaster or because of policies like allowing borrowers new loans before they repay old ones.)

7.15 I understand and agree with the more general point you are making in this section--that project managers cannot simply assume that "more credit funding is always wanted," and that this is not an acceptable justification for a credit project. But it is difficult for the project manager to give up his traditional justification unless you supply him with an alternative one. The brunt of this section's argument, however, is that it is almost impossible to determine whether credit constraints exist.

7.16 I think you might get out of this bind by taking an "RFM approach" to the question of whether a credit project is justified: namely, is this a region where a substantial portion of your target population (defined in any way you want) has access to formal credit? If not, I would consider this a sufficient criterion for providing credit in a way that permanently extends RFMs to that population. This criterion frees you from making a judgment on the difficult question of whether credit markets for already-served borrowers are constrained or saturated.

7.17 Finally, I think it is possible to get an idea of whether lack of credit is a constraint through skillful interviewing of farmers in the region--asking questions about what services are most lacking in the area, how they would like to improve their production, what the government should do that it is not doing now. I have been surprised at the number of times credit was low on the list and how the lack of interest in credit and greater concern about other things could be explained in terms of the agro-economy of the area. I would not be quite so gloomy as you, in sum, about the possibilities of ascertaining whether credit is a constraint and what it might accomplish.

Optimum amount of financing (2.09ff)

7.18 Because the point of this section seems to be that there is no methodology for identifying situations where credit is a constraint, there seem to be no policy implications to be drawn from the point--except to tell project managers that they are going to have to come up with more sophisticated-sounding justifications for why they want credit projects. The section seems mainly, therefore, to be a discussion of the state of the methodological art--how to do proper justification of World Bank credit projects. Perhaps this section might be eliminated completely--and some of the points from it folded into subsequent sections of the paper where they can be used in support of other arguments. Or, you might tell the reader right at the start about the link you plan to make between these problems and policy or project design. For example, you might take the first sentences of 2.14 and introduce this section with them. Then the reader has more of a sense of why he should bear with the methodological discussion.

7.19 I am not sure that a "typology" is needed in a paper like this to indicate "the comparative importance of credit in removing relevant constraints." If, as you say, no methodology exists to identify the financial constraints to rural development (2.13), then how can a typology help one to make decisions?

7.20 It is not clear to the reader whether the examples you suggest--irrigation being constrained by the lack of credit at one extreme and changes in input use or husbandry practices not constrained at the other--are based on conjecture or Bank experience. Whereas the examples at the ends of your continuum seem plausible in terms of economic logic, I have often seen changes in input use and husbandry practices brought about through the vehicle of a supervised credit program. And one cannot say that farmers would have adopted such new methods, or listened to extensionists, if the tremendous incentive of obtaining credit had not been held out to them. According to these cases, credit would be as powerful as irrigation in bringing about changes in input use. Your two extremes should therefore be more carefully explained.

Long-term credit (3.10)

7.21 The paper should say a few things about the negative aspects of long-term credit. In countries with low or negative real interest rates, the borrower gains more by borrowing and repaying long rather than short; for the lender, capital erosion is greater with long-term lending. This induces borrowers to (1) borrow long for short-term needs, (2) undertake uneconomic long-term investment projects, and (3) postpone repayment as long as possible. Under such conditions, repayment problems will therefore be greater with long-term credit, the availability of long-term credit will provide inducements for economically undesirable substitution of capital for labor, uneconomic investment projects will be encouraged more with long than short credit, and lenders will perform less well than they would with only short-term lending. If you assume that the Bank will fund only projects with nonsubsidized interest rates and with indexing clauses, then these considerations are irrelevant. But I think the assumption is not accurate, and one needs some second-best discussion of this issue.

7.22 The client who borrows short for working capital (or even for investments) will have to borrow again after or within a year, and therefore has a strong inducement to repay in order to continue running his business (assuming the lender does not allow new financing before the old is repaid). In that the longer-term borrower has to come back for more credit less frequently, or not at all, he has less inducement to repay and suffers less for not repaying.

7.23 Many of the small borrowers I have interviewed seem more interested in gaining access to working-capital credit than long-term credit--partly because of the distaste for debt and large projects. Or, small borrowers will undertake what we consider long-term investments with short-term credit and do perfectly well at it; a striking case is the Bank's urban reconstruction project in Nicaragua, where informal-sector merchants and manufacturers paid off their three-to-five-year investment credits way ahead of time (the credit was for reconstruction of war-destroyed buildings and inventories). They did so partly so as to qualify for more credit.

7.24 Long-term credit involves somewhat of a distributional bias in favor of better-off borrowers, who usually already have access to formal institutional credit. Poorer borrowers will not take longer-term credit, either because they cannot afford it, do not have the collateral for it, or are afraid of it. A program that supplies only short-term credit, then, has somewhat of a natural mechanism for excluding larger borrowers who already have access to formal credit. Finally, the availability of long-term credit often tends to feed the propensities of some service agencies to push overly ambitious investment projects on their clients.

7.25 For all these reasons, the introduction of long-term credit is not necessarily an unmitigated achievement of credit projects.

Flexibility (3.68-3.80)

7.26 Though I agree that flexibility is desirable for all the reasons you state, I believe it has certain disadvantages that should be pointed out: (1) "flexibility" is responsible for one of the main problems in agricultural credit portfolios--excessive refinancing (it is important to make some suggestions as to how one could bring about the desirable result of flexibility without introducing a cover for increased delinquency concealed as refinancing); (2) by allowing so much discretion on individual loans, flexibility opens up more space for the exertion of political pressure by influential borrowers in the determination of loan terms; (3) flexibility, as you propose it, makes more complex demands on management, who must now decide on loan terms, in addition to whether or not to lend, and for what amount (it seems that one would want to reduce, rather than increase, the demands made on RFI management); and (4) the literature referred to above, particularly the Stiglitz/Weiss article, suggests that rationing of credit at a fixed interest rate, perhaps lower than what would seem to be a market-clearing rate, is an economically rational and optimal way for bank managers to make decisions about credit.

Specialized farm credit institutions (2.46-7)

7.27 From these last two paragraphs, you leave the reader with a negative impression of SFCIs as opposed to traditional financial institutions. Does this mean that you recommend not supporting SFCIs? On the positive side, I think it is worth mentioning that these institutions have sometimes been better able to achieve some of the difficult goals of credit programs--reaching a clientele with no previous access, innovating in the relaxing of certain collateral requirements and in the reduction of bureaucratic red tape, and more empathetic relationships with the target group. It is precisely because SFCIs have <u>only</u> this task to do and not all the others (and other clienteles) that a traditional financial institution must attend to, that SFCIs are sometimes better able to engage in the organizational risk-taking that is necessary to carry out such programs effectively.

7.28 Finally, the problems you describe SFCIs as having (e.g. in 3.19) also seem characteristic to me of <u>non</u>-SCFI credit projects I have looked at. Most of the criticisms you make of SFCIs, for example, sound very much like the Bank of Brazil.

<u>Participation (2.47)</u>

7.29 You say that the choice of financial institutions for the Bank to support should be influenced, among other things, by "possibilities for expanded participation of rural people in credit decisions." I wondered if you might elaborate on that, since it is the only item in this list that you have said nothing about previously--nor say anything subsequently. Also, "participation" is generally not characteristic of formal financial institutions, nor have financial institutions been the focus of attention of those concerned about participation. It is not clear, therefore, what you have in mind. The only thing that comes to my mind is the credit-union model, but I'm not sure that is what you mean.

Performance policy (3.65, second sentence)

7.30 Again, my concern about the political difficulty of making disbursement contingent on performance once the project is approved, after which the Bank loses much of its bargaining power. I think the Bank can "emit" strong performance incentives by making it known in countries where it lends that it will support institutions that have certain kinds of performance indicators. Credit is an area where one can specify the indicators very clearly--level of repayments, level of savings, etc. A policy paper, it would seem to me, would be an excellent vehicle for making such incentives known.

Debunking

7.31 In general, I am wholeheartedly in favor of the "debunking" you do of certain inaccurate arguments--that credit is a constraint, that credit has impact, that impact can be measured, that people always want more credit, that moneylenders are exploitative, etc. And I admire your being so honest about the fact that it will be very difficult to determine certain relationships. Readers who are project designers and policymakers, however, will want to know what justification or what action they should put in place of the ones you are "taking away" from them. Otherwise, I am afraid they will not accept your arguments. That is why I think these "debunking" points would do better as integral parts of policy-suggesting sections. Or, you might run through a certain series of points, telling the reader your purpose of showing the fallacies of prevailing ways of thinking. At the end of each debunked argument, you might explain how the debunking relates to how people should change the way they set policy for credit and how they design credit projects. This would make the organization and purpose of much of your paper clearer.

<u>Example windows (e.g., p. 34)</u>

7.32 I like this example, and the others that follow. Having more examples in the earlier part of the paper (and subsequently) would help the reader to relate your arguments to their practical implications.

7.33 It is not clear, by the end of this particular example, whether you think the artificial insemination (AI) approach was better and whether you would recommend it for future Bank livestock projects over the approach actually used. Your "but" introducing the third sentence in the second paragraph makes it sound like there is no role for a credit institution if one uses the AI alternative of this example, and makes it sound like this is not the most favorable approach. The implication of this example <u>seems</u> to be that not only was credit not necessary, but the non-credit approach was more desirable. But you don't draw the implication and the reader is not really sure whether you would agree with it. It is this kind of example which causes my puzzlement later on in the paper at your not suggesting alternatives at the various points where you refer to credit as producing no impact or, as in this case, a less desirable one.

Chapter III

7.34 This chapter is the best-written, most interesting, and clearest of the three, and I am tempted to suggest that it go first--not only for these reasons, but because it gives the more general discussions of Chapter I and II more reason for being, and helps them to make more sense. Otherwise, I am afraid the reader may not have the patience or understanding to see it through to Chapter III. I would, where possible, try to fold in the more general arguments of previous chapters into this one, using them only to the extent that they can be placed in service of the more concrete arguments being made here.

Miscellaneous points

7.35 (2.54, fifth sentence). What does "lending under projects" mean?

7.36 (3.01). The two different dollar figures in the first sentence are confusing. One does not know what the difference is between the \$7 million and the \$4 million.

7.37 (3.02(d)). Could you explain what "systematic institutional decisionmaking" is, and in what sense it is an accomplishment?

7.38 (3.02(e)). When you say "assistance to progressive farmers," do you mean credit, or agricultural extension (without credit), or both together?

7.39 (3.04). Sentence two is unclear. Do you mean that though Bank credit projects might, on their own, have caused upward pressure on prices, other non-Bank projects (donor and domestic) were simultaneously being carried out that relieved the supply shortages that would have caused these upward pressures? If so, the argument (of this and the preceding paragraph) seems a little tautological and perhaps somewhat defensive, since you present no empirical evidence. You might want to dispense with the point completely, or condense it to a sentence or two.

7.40 (3.04, last sentence). You might want to eliminate this Brazil example. Given that the Bank continued to lend to Brazil for credit projects or credit components for many years after it recognized the high level of rural credit relative to value added in that country, it is not the best example of the tough-minded carrying out of a policy preference. Also, my impression of the Bank's objections to the Brazilians about the "policy environment" surrounding credit projects was that they had to do with the highly subsidized interest rates, rather than the level of credit in relation to agricultural product. The example may therefore not really fit here. Finally, your reference to Brazil's "policy environment" as causing Bank displeasure is inadvertently mysterious; it sounds as if there was something undesirable about Brazil's policy that you are keeping from the reader--which, of course, is not true. Why not just say, "Because of Brazil's inflationary credit levels..."?

7.41 (3.06, last sentence). You might add as an employment effect the withdrawing of hired-out labor from the market by farmers receiving credit for the first time, and the resulting possible increase in the agricultural wage in the area as a result of the leftward shift in the supply curve for agricultural labor.

7.42 Early adopters (3.13, last sentence). None of these suggestions you make for early adopters includes credit, which goes together with your previous statements that credit is an inferior instrument of subsidy. Am I wrong in this interpretation? In either case, it would make things clearer if you would mention whether or not credit fits in this picture. If it does, how? If not, is there any reason to include this section at all? If your recommendations for early adopters include credit, then I am again somewhat confused about your earlier discussions of the difficulty of obtaining impact with credit, given fungibility, and other constraints.

7.43 Debt capacity (3.36). I think the previous discussion of this issue would be better brought in here, in service of the arguments you are making here. The previous discussion could be reduced, eliminating parts that do not relate to the argument here.

7.44 Debt service and cost (3.40). The kind of emphasis you propose costs more money, as well as being subject to the caveats I mentioned before about the "model approach" to choosing and monitoring borrowers.

7.45 Subsidy/incentive (3.54). The last part of the last sentence is a very important part. I think most people do not know how to provide credit subsidies in a way that maintains an incentive for the institution to perform well. There is a real need for some concrete advice here. As noted elsewhere, the trust fund mechanism seems to provide a disincentive to performance.