BASIS BRIEF
Collaborative Research Support Program

Number 18 November 2003

Meeting the Needs of the Rural Poor through Post-reform Financial Markets

by **Stephen R. Boucher** boucher@primal.ucdavis.edu, **J. Edward Taylor** taylor@primal.ucdavis.edu, **Carolina Trivelli Avila**, trivelli@iep.org.pe, **Antonio Yunez Naude** ayunez@colmex.mx, *and* **Javier Escobal D'Angelo** jescobal@grade.org.pe

The opportunities and risks of liberalization

Because of a fundamental shift in rural development policy in many Latin American countries, smallholders face new opportunities and risks. The elimination of development banks and controls on interest rates drastically curtailed state participation in financial markets, restricting the state instead to a role of augmenting the potential supply of collateral through land titling projects and enforcing the rules of the game through an enhanced regulatory capacity. Liberal reforms implemented throughout the region replaced protectionism with openness. Liberalizing markets for credit and other key factors of production is meant to accelerate growth by enhancing the efficiency of resource allocation, and private markets are seen as the primary mechanism for achieving this.

In this new environment, a smallholder has the chance to draw a loan to buy more land, invest in equipment or labor to make her land more productive, or even provide her children with better education. Yet, these opportunities to increase the household's economic standing might be available only if she puts up title to her land as collateral for the loan, meaning her land and livelihood could be lost completely. This is a very dangerous gamble for most smallholders. Without that collateral, however, the lender would be at risk as well, and it would be difficult to ensure how the loan is used and the probability of repayment.

With the credit market facing such potential constraints to efficiency, it is important to investigate the degree to which the recently liberalized rural financial markets meet the needs of the rural poor. Most countries in Latin America have reduced the state's role in financial markets in the hopes that vibrant private markets for credit, savings, and insurance will emerge. Yet, this creates risk factors that may prevent resource-poor households from participating in the financial marketplace, thereby causing an overall drag to a country's economic growth.

The new BASIS CRSP project, "The Structure and Performance of Rural Financial Markets and the Welfare of the Rural Poor," evaluates the performance of Mexico and Peru's liberalized financial markets. The research will provide informed policy lessons that can enable the rural poor in post-liberalization financial markets throughout the region to better accumulate assets while also using their resources more efficiently.

Liberalization laboratories

Arriving in the 1990s, liberalization came relatively late to Peru, yet it is perhaps the most radical example in the Americas of a dramatic swing of the policy pendulum toward market liberalization. In the agricultural sector, price controls and the state monopoly over inputs were eliminated. The elimination of interest controls was accompanied by the closing of the state-run *Banco Agrario*. A large titling program was carried out in order to reduce tenure insecurity and facilitate the supply of collateral and thereby spur investment demand. A new land law was passed to accompany the titling program. By eliminating farm size ceilings and previous restrictions on both rental and sales transactions, the new law seeks to facilitate the flow of land to those who will use it most efficiently.

The new policies also provided the legal foundation for new rural credit unions (*Cajas Rurales de Ahorro y Crédito*) and strengthened existing municipal banks (*Cajas Municipales de Ahorro y Crédito*). By 1997, it was clear that the formal rural financial market in Peru was experiencing limited success. Commercial banks had begun to increase loan volume to the small class of farmers holding medium-sized farms, while rural credit unions and municipal banks aggressively increased their loan and savings portfolios in the most agriculturally-viable coastal valleys. Credit markets in the highlands, however, languished. In 1998, a macroeconomic crisis in the country and the effects of severe weather dramatically halted the growth of this nascent financial market. The political crisis of 2000-2001 created uncertainties too. The fact that the new Toledo government has revived a state agricultural development bank—*AgroBanco*—suggests that policy in Peru is in a state of flux and in need of sound information on financial market performance.

In Mexico, economic liberalization can be traced to an effort in the mid-1980s to promote recovery from the debt crisis. The key components for the agricultural sector included trade liberalization, removal of most guaranteed prices, elimination of input and output subsidies, and the privatization of input supply and marketing activities. In the early 1990s, an attempt was made to modernize the agricultural sector and incorporate the countryside (especially the traditional, or *ejido*, sector) into economic growth. Similar to Peru, new legislation led to the creation of private property rights and land markets for *ejidos*, which have been granted the power to decide the tenure regime under which they will use their land. Options range from maintaining collective exploitation to the implementation of full, private property rights. This provides a semi-controlled experiment to examine the relationship between different forms of property rights regimes and financial market performance.

Credit policy also shifted substantially during this time. The volume of state credit channeled to farmers via the agricultural development bank—BANRURAL—declined sharply after 1989. Commercial banks, in part, made up for this by increasing their supply of agricultural credit. These loans, however, are concentrated among large private farmers. The decline in formal credit to smallfarmers was offset partially by government support for credit unions as well as several state programs. The project will address to what degree smallfarmers have effective access to these formal institutions and whether or not sound alternatives exist.

What liberalization lacks

Hernando de Soto argues that poor households stand to gain most from the types of property rights reforms and market liberalization policies implemented in Peru and Mexico. Market-oriented reforms should allow poor households to realize the previously unfulfilled potential of their assets. De Soto points out that in developed countries entrepreneurs are able to leverage residential assets in capital markets. By defining and granting property rights over land, and strengthening property registration and legal institutions, the recent policy reforms should spur investment demand—and thus the demand for finance—among poor households. Replacing inefficient state-run banks with forward-looking private financial institutions allows this increased demand to be met, thereby generating a "win-win" scenario of equality, enhanced efficiency, and less poverty.

Yet, there are causes for concern regarding the outcome of liberalization policies. Enhancing efficiency in rural financial markets may be prevented by "information asymmetries" inherent in credit transactions. The lack of well-established credit bureaus makes it difficult for a lender to use past performance to evaluate the quality of a new loan applicant. Even after granting a loan, information problems are especially troublesome in rural areas, where it is difficult and costly to monitor borrower use of funds and thus minimize the probability of default. Requiring collateral—and thereby instilling the borrower with a strong motivation to avoid default—is the conventional means by which lenders overcome information problems. By granting secure and tradable private property rights to land, government titling programs increase the potential supply of collateral, which policymakers hope will allow smallholders access to formal credit markets.

While more flexible land markets and increased collateralization may be necessary steps, they are unlikely to represent a "cure" for infirm financial markets. Indeed, unless commensurate attention is paid to redressing failures in insurance markets, credit and land liberalization policies may not only fail to enhance efficiency, they may in fact cause additional ailments such as greater inequality. For example, since placing land at risk as collateral is potentially devastating for smallfarmers who rely on that land for their livelihood, land titling programs may have little positive impact for these households. In addition, the inability to insure against weather, crop, or health risks is likely to have more serious impacts on the production patterns of poor farmers. Overall, information-based failures in liberalized markets tend to be more harmful to low-wealth households.

In the foreground of the liberalization picture one sees many benefits. Yet, liberalization polices may disproportionately increase wealth for those who have forms of collateral that cause them less risk to post, and for those who have easier access to the various credit markets. Effective policy must draw from a complete picture that shows the impacts liberalized financial markets have on resource allocation, especially the ability of poor households to accumulate assets. The BASIS CRSP project helps fill in the picture by revealing what leads to credit market failures in post-reform Latin America and the extent of credit constraints on household welfare and production. This deeper focus will enable policy to be more informed and effective.

A foundation for policies that equalize benefits…

Why do households that could obtain a loan, choose not to? What are the regional and household characteristics that contribute to keeping households from the financial marketplace altogether? The research project is creating a unique household-level panel data set containing information on production, income, expenditures, asset accumulation, and participation in financial and other factor markets. Approximately 800 households will be interviewed in each country at twelve-month intervals over a three-year period. The breadth and depth of the information combined with the longitudinal component make this data set unique in Latin America. Analysis of the data will develop the picture of why certain families are not in the financial marketplace, and it will show how well credit markets are performing in different areas.

The research will track the performance of credit markets for different types of households over time. Econometric analysis will allow for an assessment of the impact of financial market access on household welfare, production decisions, and the ability to accumulate assets. Analysis of these data will lead to an identification of the factors that cause the benefits of liberalized policies to be unequal and therefore overall economic performance. Also, BASIS CRSP will be able to evaluate the impact of policy changes that occur in the middle of the panel, such as migration policy, titling of communal land, or establishment of a new financial institution.

Many farmers simply do not have wide access to different types of lenders in the credit market and cannot afford the interests rates available to them. Even farmers who could afford the interest rates might be unable to undertake a productive investment project if they do not have sufficient collateral assets. By granting freehold titles, the property rights reforms introduced in Peru and Mexico partially redress this problem. Recent research suggests, however, that increasing collateral assets may be a necessary but not sufficient step in overcoming credit market imperfections. Risk averse households may be unwilling to offer their assets as collateral even if the loan contract would raise their expected income.

…and minimize risk

Collateral is not just a means for lenders to compensate for default risk—since that could be accomplished by raising the interest rate. Collateral also indirectly controls the composition of the applicant pool: high-risk individuals will be less willing to post collateral. And it influences borrower behavior: a borrower who stands to lose collateral is less likely to divert the investment funds to consumption.

Risk creates a strong potential for credit market outcomes to be biased against low-wealth households. The poorest cannot post sufficient collateral, while many households that are able to post collateral, and thus have access to the credit market, prefer instead to undertake low-risk, low-return activities. What factors cause this? An important innovation of this research project is to incorporate the potential for "risk rationing" into the investigation of credit market performance.

Land titling programs will not benefit the smallholder that is at risk of potentially losing his or her land as a consequence of applying for credit. Without policies that help reduce risk, normally risk-averse households will not enter the credit market. Production decisions depend not only on a household's attitude and preference towards risk, but also on the degree of risk it must bear. In particular, households that are able to smooth consumption through consumption credit, formal insurance, or informal risk-sharing networks will be more willing to engage in high-risk, high-return activities. Households facing poorly-developed financial markets will sacrifice

BASIS
Briefs

Authors

Stephen R. Boucher
J. Edward Taylor
University of California-Davis, USA

Carolina Trivelli Avila
Instituto de Estudios Peruanos, Peru

Antonio Yunez Naude
El Colegio de Mexico, Mexico

Javier Escobal D'Angelo
Grupo de Analises Para el Desarrollo, Peru

Publication made possible by support in part from the US Agency for International Development (USAID) Grant No. LAG-A-00-96-90016-00 through BASIS CRSP.

Edited and layout by
BASIS CRSP
Comments encouraged:
Department of Agricultural and Applied Economics, University of Wisconsin, Madison, WI 53706 USA
basis-me@facstaff.wisc.edu
tel: +608-262-5538
fax: +608-262-4376
http://www.basis.wisc.edu

expected income and instead choose to remain in low-risk but low-return activities.

This relationship between financial market failure and a household's choice of activities has policy implications regarding efficiency and equity. If low-wealth households face greater financial market constraints, they will "choose" activities that perpetuate their poverty. Households for whom credit or insurance markets perform poorly will be caught in a vicious circle whereby they "voluntarily" abstain from high-return activities and therefore cannot accumulate the very assets that would allow them better access to financial markets.

Recent research suggests rethinking the role of the informal sector as well. It once was thought that the informal loan market with its high interest rates was the sector of last resort, and any borrower who had an informal loan must have been unable to get into the formal sector. Instead of simply receiving the spillover demand from the formal sector, however, the informal sector, due to greater information and lower transactions costs, may in fact offer the lowest-cost loans. If informal lenders indeed have greater information (or better means of contract enforcement), they will be able to offer a greater variety of contracts, including higher-interest rate/lower-collateral contracts that banks may be unable to offer.

The nature of risk creates problems for the performance of a country's economy overall. Groups aversely affected by risk act as a drag on the economy and reduce the benefits that can come from liberalization. It is therefore of fundamental importance to discover how affected groups can avoid being trapped in a position of using only low-risk, low-return strategies, and instead can begin accessing credit in such a way as to engage in more profitable production.

Building capacity in the region

The lessons learned from this research project will have almost immediate effect in the two countries. *Programa de Estudios del Cambio Economico y Sustentabilidad en el Agro Mexicano* (PRECESAM) was founded by two of the project's researchers in order to facilitate local research capacity in studying the rapid economic changes occurring in rural Mexico. Local PRECESAM researchers will participate in the implementation of this BASIS CRSP project and facilitate rapid dissemination of results.

In Peru, the research will be supported by the *Instituto de Estudios Peruanos* (IAP) and *Grupo de Analisis para el Desarrollo* (GRADE)—the two leading social science research institutions of the country. These institutions' close ties with policymakers will make dissemination of results rapid and policy effective. The Office of Agricultural Information in the Ministry of Agriculture also is involved in research design and dissemination.

BASIS

Suggested reading

Aurbach, N. N. 2001. *States, Banks, and Markets: Mexico's Path to Financial Liberalization in Comparative Perspective*. Boulder: Westview.

Boucher, S. R. and M. Carter. 2001. "Risk Rationing and Activity Choice in Moral Hazard Constrained Credit Markets." Agricultural and Applied Economics Staff Paper 445. Madison: University of Wisconsin.

de Janvry, A., G. Gordillo, and E. Sadoulet. 1997. *Mexico's Second Agrarian Reform: Household and Community Response*. Center for U.S.-Mexican Studies. San Diego: University of California.

de Janvry, A., G. Gordillo, J.P. Platteau, and E. Sadoulet. 2001. *Access to Land, Rural Poverty, and Public Action*. New York: Oxford University Press.

de Soto, H. 2000. *The Mystery of Capitalism: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books.

Trivelli, C. and J. Larson. 2001. "Titulación de tierras en el Perú: Se está cumpliendo la promesa?" *Debate Agrario* 32:49-88.