IFPRI

RURAL FINANCIAL POLICIES for FOOD SECURITY of the POOR

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The Demand for Financial Services by the Rural Poor

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RESEARCH PROGRAM MISSION

The research program titled Rural Financial Policies for Food Security of the Poor seeks to identify policies and institutional arrangements that help the poor integrate themselves into sustainable savings and credit systems in order to increase capacity to invest, bear risk, and preserve livelihoods.

FOCUS COUNTRIES

- Bangladesh
- Cameroon
- China
- Egypt
- Ghana
- Madagascar
- Malawi
- Nepal
- Pakistan

ABOUT THE AUTHORS

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This policy brief summarizes lessons learned from IFPRI´s multicountry program on rural finance and household food security with regard to the poors' demand for financial services. The lessons are derived from detailed household surveys conducted in nine countries of Asia and Africa: Bangladesh, Cameroon, China, Egypt, Ghana, Madagascar, Malawi, Nepal, and Pakistan.

The Myth and Reality

At first glance, many might be tempted to say that the poor earning less than $1 per day are not creditworthy, able to save, or able to afford insurance against the risks they face. That this myth is wholly unfounded has been demonstrated time and again by empirical research on informal financial markets and risk-coping behavior of households. Poor households are indeed willing to pay market rates for reliable and continued access to different types of financial services, including insurance. Credit and savings facilities can help poor rural households manage—and often augment—their otherwise meager resources and acquire adequate food and other basic necessities. Credit facilities enable the poor to tap financial resources beyond their own and take advantage of profitable investment opportunities. Well-managed savings facilities provide incentives for households to build up funds for investment or future consumption. Credit and savings facilities enable farmers to invest in land improvements or agricultural technology such as high-yielding seeds and fertilizers that increase incomes (while sustaining the natural resource base). For landless rural households, credit and savings facilities can help establish or expand family enterprises, potentially making the difference between grinding poverty and an economically secure life. Short-term borrowing or savings are often used to maintain consumption of basic necessities when household incomes decline temporarily, e.g., after a bad harvest or between agricultural seasons.

The myth of the unserviceable poor should also have been laid to rest by the recognition of an increasing number of successful institutional innovations that provide savings, credit, and insurance services to poor people in developing countries.

The Myth Has Led to Wrong Policies

Faulty perceptions about the poor have led to faulty policy strategies and financial products. Much of financial policy at the end of the 1980s and even today has been based on the unserviceable myth, leading to well-meant, but inefficient and costly policies for the development of financial institutions with negligible outreach to and impact on the poor. Either the poor were thought uncreditworthy or unable to pay market interest rates. The former myth led to policy inaction, whereas the latter led to massive interest rate subsidies. The myth that the poor were unable to save or to insure induced past policy to neglect altogether the savings and insurance services that are particularly relevant to the poor.

Patterns of Demand for Financial Services by the Poor

To satisfy the demand for financial services by the poor through institutional and product innovation is not possible without a thorough appreciation of the issue of food insecurity. In the nine countries of the IFPRI research program, households belonging to

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the lowest income quartile spend as much as 91 percent of their consumption budget on food. On average for all households in the nine countries, 60–70 percent of expenditures in incurred for food. No wonder then that much of the demand for loans, savings, and insurance services by the poor is driven by their motivation to avoid food insecurity.

The average cumulative yearly amount borrowed by poor households from the formal and informal sectors ranges from about US$4 in Malawi to $80 in Bangladesh to $133 in Cameroon. Informal lenders—friends, relatives, neighbors, informal groups, or moneylenders—provide the bulk of loans. In Pakistan and Cameroon, less than 5 percent of the amount borrowed by poor rural households was obtained from formal lenders such as state and agricultural development banks and microfinance institutions (e.g., credit unions, cooperatives, and group-based programs run by government, nongovernmental organizations, and village banks). The IFPRI program shows that several member-based microfinance institutions successfully reach the poorest income quartiles in Bangladesh and Malawi.

Overall, however, the formal sector lends disproportionately more to upper income groups. The poor obtain a smaller share of their loans from the formal sector than the nonpoor in six countries (China, Egypt, Madagascar, Malawi, Nepal, and Pakistan). Even in a country like Egypt, with a relatively dense coverage of formal financial institutions, the role of informal lenders remains important.

Many loans obtained by poor households are used for consumption, mainly of food. About 50–90 percent of loans obtained from the formal and informal sectors combined went to consumption-related purchases. In Pakistan, more than 80 percent were spent on consumption. Moreover, in six out of eight countries, loans for consumption are more important for the poorest quartile than for the nonpoor. In every country, the share of loans used for consumption was higher for informal loans than for formal loans.

In poor households, the spheres of consumption, production, and investment are inseparable in the sense that consumption and nutrition are important to a household's ability to earn income. If a laborer does not have enough to eat, he may be too weak to work productively. In general, family labor is by far the most important production factor, and the maintenance and enhancement of labor productivity is central for securing and increasing income. Bankers in particular frequently argue against consumption loans on the grounds that loans should finance activities that generate income for repaying the loan. The reality, however, is that consumption loans have to be considered as working capital loans for maintaining and enhancing the production factor labor. While the wealthy may invest in land and capital assets, the poor invest in their labor. Both types of investment have economic returns that can generate cash income for loan repayment.

Policy Conclusions

The truth is that the poor are creditworthy, can save, and pay for insurance—they have done it all along as the myriad of informal savings, credit, and insurance arrangements between friends, relatives, and other networks daily demonstrate. But it is also true that financial institutions (and related knowledge and technology) as well as an enabling policy environment were not in place in the past (and still are not in many countries). Because the two gaps were not given due consideration in central and commercial, as well as parastatal, banks, the poor were simply deemed to be unbankable. To put it positively, the microfinance revolution taught that institutional innovations—not just technological ones—and related changes in the legal and regulatory policy framework could extend the feasibility frontier of sustainable finance to reaching the poor. While increasing numbers of people living around or somewhat below the poverty line are reached by innovations in financial institutions, outreach to the poorest, especially in rural and disadvantaged areas, remains low.

Research by IFPRI on the demand for financial services points out that product innovation that responds to the food security motives of rural households can lead to higher outreach and higher impact on the poor. However, policy also needs to recognize that while the poor are creditworthy and able to save and insure, financial institutions may still fail to cover their costs, even with improved products. Many of the poor, particularly in remote areas having high transaction costs, still cannot be served by financially sustainable institutions. The primary role of policy should therefore be to foster institutional innovations, such as the development of new information technologies, which can allow this to occur. ■

Selected References

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ABOUT IFPRI

IFPRI's mission is to identify and analyze strategies for meeting food needs of the developing world, with particular emphasis on low-income countries and the poor.

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