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Zoom microfinance

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Interest rates in the field of microfinance : a technical or political choice ?

Introduction

The debate on interest rates regularly sustains the controversy of rural microfinance world. In the last years, the supporters of an interest rate that would respect market rules have clearly progressed in a field affected by globalization and liberalization. Subsidizing interest rates appears more and more as an archaism supported by some "development experts". Still, this practice existed and still exists in a lesser measure in favour of farmers in developed countries. Therefore, it seemed appropriate to take stock of this question, while at the same time reminding ourselves what an interest rate means and highlighting the arguments used by both the experts and the users.

Just like any other economic activity that wishes to modernize or develop itself, agriculture requires investments. Agricultural stakeholders have two options to ensure the financing of such investments : either the activity generates enough cash flow and the investment can be repaid with capital stock or you have to use credit possibilities.

There is no agriculture in this world that could develop without loans ; moreover, since the second half of the 20th century, the Western agricultural models benefited from important direct and indirect support from the national public authorities in order to ensure their investments.

Agricultural farmers from Southern countries also benefited from some support, even if in a lesser and more variable manner according to their country of origin. Then, with the structural adjustment policies and the withdrawal by the States from the agricultural sectors in the 80's, the logic of the market imposed itself on the Southern countries while Western farmers still can take advantage of an annual 350 billion US$ direct and indirect support.

How do you justify an often high interest rate?

In a decentralized financial system, the interest rate is determined based on various variables :

- The cost of money : the funds generally and essentially come from savings or refinancing with other financial institutions (commercial and development banks, alternative agencies from the North) ;
- The cost of failure-to-pay risks related to the loan : this will be more or less important according to the quality of the guarantees required : material guarantee, joint and several guarantee, endorsement, instalment plans for equipment, warrantage [1],… The guarantees required often have a decisive influence on the level of accessibility to the loan. Moreover, it is not that easy to demonstrate that quality guarantees do have a positive influence on the cost of money.
- The cost of loan management : it includes the expenses related to the structure of the decentralized financial system and can vary according to the “lifestyle” of the institution and its efficiency. It is generally accepted that the competition between financial systems has a positive impact on this factor, which in the end is always benefiting the customer.

The importance of such factors obviously varies according to the situation, but it is quite clear that savings usually give a low return and that, in most rural systems, the risk is well controlled thanks to the combination of different guarantees. The refinancing and managing costs therefore represent the most important expenses in the calculation of the interest applied. This is further true because the donors want to limit subsidies to the DFS (Decentralized Financial Systems), thereby maintaining a relatively high level of average rates (2 to 3% per month).
Hence the debate between the supporters of a sustainable but expensive financial service and the defenders of a reduction of rates, based on the needs and real capabilities for reimbursement, for financing the agricultural activity.

1) Stocks of marketable agricultural products

Access to credit

The theories of the economy teach us that in order to foster macroeconomic growth, the price of money should be reduced. The regular decrease applied by the American and European central banks to the leading rates are seen as incentives to economic recovery. But the CGMF [2] (Community Growth Mutual Funds) in Cameroon share the same opinion: “such an approach is applied in the industrialized countries, focussing efforts on maintaining interest rates at the lowest levels. It is therefore difficult to understand why the poor should accept excessive rates. As far as repayment performance is concerned, little attention is usually paid to the origin of the funds used to reimburse. Customers often have to borrow elsewhere to pay back their loan and keep their dignity”.

What some people might say is not important : for most of the rural people, what counts is the access to credit in a sustainable way and not the price paid for the transaction.

Some surveys carried out among the customers show that the interest rate is rarely seen as a limitation by the borrowers. This appears for instance in a note by the CGAP [3] that tends to demonstrate that, in accordance with the law on decreasing returns, the poor who borrow small amounts are able to live with high interest rates.

This reasoning is probably well founded for some activities that are carried out thanks to microfinance, such as urban micro companies or micro businesses.

For instance, in Latin America, for a micro entrepreneur who pays 3.4% monthly interest rate, the cost of credit generally represents only 6% of his expenses and it therefore has a marginal influence on the result of the activity.

In micro businesses (trade), studies show that the average economic return can go up from 117% to 847% per year, which allows a high rate. Nevertheless, what happens in the case of productive agricultural activities, which are often carried out in a context of uncertainty [4] ?

On the same question, Marc Labie [5] underlines that for the micro entrepreneur the most important cost to get access to the credit is not the interest rate but more often than not the cost of transaction : the time spend travelling, waiting, filling in papers… For micro credits, this very often represents an important factor, even sometimes a deterrent. In this field as well, competition between microfinance agencies often has a positive effect : it means they will improve the speed of transactions.

A rate that complies with the market ?

According to the CGAP, the experiences with subsidized rates have affected few customers during short periods of time. They created distortions on the market. The programmes with high subsidies have shown the lower payment levels : the customers saw credit as disguised donations.

However, how do you define a rate that complies with the market ? To what kind of cost can we compare the interest rate applied by a decentralized

2) Zoom microfinance n°6
3) CGAP – Consultative Group to Assist the Poorest – Donor brief n°6 – September 2002.
4) Rainfall, illness, lack of regulated markets,…
5) M.Labie – La microfinance en questions. Limites et choix organisationnels. Editions Luc Pire (Bruxelles)/ Fondation pour les générations futures, 1999, 116 pages.

financial system ? They are often compared to those of the informal sector (usurers), usually between 10 and 20% per month. Such a comparison is of course favourable to the DFS and puts an end to any discussion, except if we refuse to consider the informal rate as an acceptable reference.

The comparison with formal bank rates on the other hand is often unfavourable. But the banks are not interested in the same customers as those of the DFS. So there's no real competition between the former and the latter for a same target-group of customers.

Another reference can be applied: the interest rate should rather be seen in the perspective of the return obtained from the operation. It is considered that the average financial cost represents 10% of the return. However, this estimation is no systematically valid. Indeed, what can we say about a family that grows millet in Senegal ? In such situations, couldn't we say that the good reimbursement rates observed tally with decapitalization (sale of cattle for instance)? Isn't such a situation the one we frequently observe in the case of the MC² in Cameroon when people try to preserve their dignity ?

Let us put an end to a vain debate

It is however possible to highlight some points to put a end to a vain debate between development experts defending low rates without taking into account financing mechanisms and microfinance experts essentially motivated by performance and sustainability related to bank criteria.

It should also be noted that the discussion on rate levels has also progressed within the world of microfinance between those who favour real rates and others who think that the DFS should benefit from structural subsidies because of their specific role in the fight against poverty.

1. Transparency

Most DFS give an unchanging rate to the customer (i.e. a monthly percentage applied to the initial loan). Such a practice is very often contrary to the classical rules applied to the loan cost calculation that recommend an interest rate calculated on the basis of a diminishing balance and related to the amounts already reimbursed and the remaining capital.

The option of unchanging rate makes it possible to indicate right away the total amount to be paid back, which according to some people would facilitate a better understanding of loan mechanisms for the borrowers. For others, such a practice means that customers are considered as more stupid than they are. It also complicates the comparison between rates applied by rival DFS that use different methods.

Illustration n°1 : a 70% variation of the real cost of money according to the calculation method.

The difference between both methods gives us significantly different results. For instance, a customer receiving a € 1,000 loan presented with a monthly interest of 3% will pay an effective rate that will vary very much if he pays back one time or on a monthly basis : if he pays back once after one year, he will pay € 1,360 (effective rate of 36% per year). But if he pays monthly an amount of € 133.33, that is for the same total of € 1,360, he will have paid an effective monthly rate of 5% (60% per year). In case he pays on a weekly basis, this percentage will be of 64%!

The calculation is even more complex when a fixed amount has to be paid for management expenses and/or if the customer is required to block a previously opened savings account that bears no interests.

Illustration n° 2 : farmers' leaders reacting to DFS competition.

A farmers' association in Peru (Espinar Federation in the district of Cuzco) decided to transfer the capital created for granting loans to its members to a specialized institution : Micro Crédito para el Desarrollo (MIDE).[6] Initially, MIDE was "benefiting" from a monopoly in the region. Loans were granted in national currency with a 4.2% monthly rate (decreasing, on the remaining capital) and MIDE was offering a 0.85% monthly interest rate on the funds of the federation. The level of recovery was excellent (close to 99%). The appearance of a competitive agency [7] promoted by the Peruvian state and offering a better rate to the producers (3% per month) implied in a first phase that the loans diminished and in a second phase that the terms of reference were renegotiated with MIDE [8].
This example clearly shows that farmers' leaders are able to compare access conditions to credit and to draw the relevant conclusions.

2. What are the conditions for the funding of the agricultural sector? Innovations are needed

An objective analysis of the history of agricultural development in industrialized countries shows that agricultural loans played a major role in the modernization process of the rural world. The level of interest rates applied, quite often higher as compared to the bank rates on the market, was an important factor in the transformation of agriculture in the North. This was a very clear political choice based on the specific risks of the agricultural sector and the need to invest with a differed profitability. Of course, interest rate subsidies are today less frequent in industrialized countries; on the one hand, farming systems are now more competitive and less risky ; and on the other, public funding is currently applied through direct income support mechanisms.

In developing countries, public development banks have largely funded agriculture during the 1960's and 1970's thanks to special rates proposed by the States. However, most of these banks went bankrupt because of serious management problems. In more concrete terms, this implies that in many rural areas, microfinance represents the only financial offer for most households.

Today, many consider that liberal orthodoxy as well as the lack of resources in the Southern States explain the rejection of any interest rate subsidy for the agricultural sector. However, how can we seriously think that farming systems in the South can be modernized and that food security is fostered when States lack the necessary means ? The development of new transfer mechanisms between the North and the South should be allowed outside the classical development aid context : regulation and taxation of international economic and commercial activity, debt conversion,…

6) Cfr. Zoom n°8
7) RED RURAL
8) Debate still in progress in January 2003

3. Specificity of agriculture and livestock farming

The debate on interest rates is difficult for two reasons : with the exception of decentralized financial systems working in profitable areas, loans are usually focussing on activities that can accept high interest rates on short periods and the need for medium-term and long-term capital investment loans is far from being met; this doesn't make it possible for an agricultural system able to develop in a largely unstable and hostile environment to exist.

The other problem is due to the fact that agriculture is more and more often seen as any other activity, that has to be analysed with pure economic classical criteria. Nevertheless, due to the risks inherent to the activity and the characteristics of land property, this specific sector cannot be ruled by market laws because it could lead to large-scale bankruptcies. However, microfinance is typically regulated by "general" financial and economic rules and hardly ever takes into account the specificity of agriculture in its analysis. If the customers pay back and go on asking for loans, everything is fine! But this means that the ripple effect of high cost loans is ignored : it contributes to underpaying the producers and reduces the appeal of the agricultural sector as a source of incomes to households, thereby leading to further urban migration. We should add to this the subsequent effect of an even more precarious food security.

Political interest rate or interest rates policy?

The dispute over the level of interest rates is eventually linked to two approaches.

Either an interest rate policy is developed and is essentially based on the sustainability of financial institutions. There are strong arguments here (permanence and quality of services), but the long-term impact of funding on the agricultural sector is ignored.

Or a political interest rate is fixed. The importance of financial transfers needed to launch agricultural activities highlights the need to apply lighter rates to fund investments. History shows that agricultural matters often had a political nature. The choices (or lack of choices) appeared as decisive in the fields of employment, land use, contribution of agriculture to the national economy and food sovereignty. All things considered, they determined a model of society.

Still, the debate becomes a dialogue of the deaf. For microfinance institutions, a high rate is a question of survival. However, for farmers' and producers' organizations as well as for their members, it is also a question of survival !

The technical and political levels become intricate and the technique is predominant while real choices should be made on a political level.

A few actions, essentially technical ones, can be mentioned although they do include some political dimension or impact.

- As far as the decentralized financial systems are concerned, scale economies, technical innovations and more professionalism can contribute to the reduction of rates. High rates should in no case foster a less efficient management of DFS. The CGAP gives the example of Banco Sol in Bolivia : by doubling its efficiency, this institution could reduce its rate, from 50% to 24%.

- Differentiated interest rates should be applied based on the use of the loan: short-term activities (shops, crop year,…) can normally sustain higher rates as compared to medium-term or long-term investment loans. A lower interest rate for medium-term loans is also justified in economical terms : management expenses are usually lower and there can be material guarantees, for instance through the promotion of instalment plans.
- To find ways to better align farmers' logic and bankers' logic : the bankers counts his time. For him, time is money ! There is a contract with a deadline and any late payment implies interests on arrears. The farmer does not count his time. He draws the fruits of his crop and tries to sell them at the best moment that is not necessarily the moment he has to pays back his loan.
- In savings and loans networks, reasoning based on differentials is essential : farmers who are members of a savings and credit bank or cooperative very often decide to have a low return for their own savings. This usually allows them to grant loans at a lower cost, particularly when the "savings" service is quite heavy in a decentralized financial service (obligation to have regular hours)
- To favour alliances between decentralized financial services and farmers' and producers' organizations : such alliances could develop in two ways : mobilization of higher and better regulated agricultural prices and promotion of agricultural insurance systems that reduce the risk inherent to production.

Don't get mixed up in the debate

The points mentioned above timely remind us that even if the permanence of decentralized financial tools should be an objective, this same objective should at the same time be seen in the perspective of more global development contexts, aims and stakes that are specific to the agricultural systems in the Southern countries.

For instance, on the microeconomic level, if a differentiation policy of financial products appear as being wise to adapt to the different target activity sectors, such a policy will also imply additional costs for the DFS that will not necessarily be paid off with the usually low volumes of the concerned funding.

In more general terms, we cannot avoid the question of principle : is it justified to ensure the intrinsic sustainability of funding tools in Southern agriculture ? Contrary to what happens with the Western economies, should agriculture in the South modernize and develop itself based on its own productivity while at the same time this same productivity already suffers from a differential that is often close to a factor 500 as compared to the most performing agricultural systems?

SOS Faim and microfinance

SOS Faim has been working for many years in the field of microfinance and gives its support to the activities of its partners working in this sector in Africa and Latin America.
Among them : Kajo-Jiginew in Mali ; DECSI and SFPI in Ethiopia ; Edpyme Proempresa, Edpymes Confianza, MIDE and Fondesurco in Peru ; Sointral in Chili, FADES in Bolivia and CGMF in Cameroon.

Just like any other development tool, microfinance must be questioned as far as its objectives, modalities and implementation conditions are concerned. It is with this idea in mind that SOS Faim publishes, among others, “Zoom Microfinance”. Eight other issues have already examined initiatives taken in Africa and Latin America.

This issues as well as the present one can be downloaded in French, English and Spanish on the website of SOS Faim Belgium : www.sosfaim.be.

Other publications by SOS Faim

Crédit et développement rural en Amérique Latine (in French and Spanish). FADES-SOS FAIM, éditions Action pour le développement, 1995.

Pour de nouvelles approches de l’aide au développement. Quels outils financiers pour une coopération équitable ? SOS FAIM-COTA, actes du colloque, 1994.

Edition spéciale Défis-Sud, **Le financement alternatif**, October 1996.

Edition spéciale Défis-Sud, **La microfinance lutte-t-elle contre la pauvreté ?**, October 2000 - Index available on www.sosfaim.be/Defis-Sud

La réglementation de la microfinance en Éthiopie, Nicole Hogger, communication during the SOS Faim seminar in La Paz, October 2001.

ONG Financieras : Fondos Financieros Privados: la experiencia boliviana. Hugo Rivas Guerra, Rafael E. Rojas L. Edición SOS Faim, 2002.

We should also mention here an audiovisual documentary on the experience of Kajo-Jiginew, “The attics of money” by Jean-Michel Rodrigo, Mecanos Production, 2001. Copy available at SOS Faim Belgium by paying dispatching costs.

If you want to contribute to the debate launched by SOS Faim on microfinance, please do not hesitate to send us your comments and questions by mail or e-mail.

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• INTER-RESEAUX – Développement rural – Financement des exploitations agricoles dans les pays en développement - fiche n° 1 actualisée avril 2002 – Des taux d’intérêt exorbitants ? - Denis PESCHE et Dominique LESAFFRE.
• "Le taux d’intérêt en question". Cécile LAPENU (CERISE). Fiche n° 4 d’approfondissement du séminaire de Dakar : le financement de l’agriculture familiale dans le contexte de la libéralisation : quelle contribution de la microfinance ? 2002.

Zoom Microfinance N°8 dealt with impact studies focusing essentially on the example of MIDE in Peru. It is based on research funded by the W.P. Schmitz-Stiftung Foundation and the DED of German cooperation and published with the support of the Dutch Association CORDAID.

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