Rural Credit and Poverty Reduction

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Introduction

Tanzania has undertaken financial sector reforms since 1991. The major objective of the reforms was to enhance efficiency and effectiveness in the functioning of the financial sector. Banks have been allowed more decision making space to operate on commercial basis, free from government interventions. An important component in the financial sector reforms is the market determination of interest rates and credit allocation. In spite of these efforts, the majority of the poor have continued to face limited access to financial services, and where these services are made available, they are often at very high cost.

Recognizing the different needs, capacities and constraints faced by the low-income population, the government developed and adopted a comprehensive micro finance policy that articulates the roles of various institutions and key players in a sustainable micro finance industry. Implementation of this policy is at an early stage and it is too early to assess its effects. Nevertheless, it is useful to review the situation of rural credit on the ground, in relation to poverty reduction. This is important more generally for the ongoing review of the poverty reduction strategy (PRS) and specifically for facilitating implementation of the micro finance policy.

The general objective of this paper is to assess micro finance in relation to rural poverty. Specifically, the paper assesses the poverty situation in the country, the status of micro finance in the rural areas, possible explanations and the challenges facing micro finance in the rural areas.

The Poverty situation

The status of poverty in the country is documented in different publications, the main ones being the annual Poverty and Human Development Reports and PRS progress reports. It is shown that poverty is predominantly concentrated in the rural areas. Based on the 2000/01 Household and Budget Survey, about 38% of the rural population is living below the poverty line, compared to around 22% in the urban areas.

Figure 1: Trend of income poverty and the future targets

Source: Adopted from P&HDR 2003

Figure 1 above shows that rural poverty has declined only marginally between 1990 and 2000. In addition, on the basis of this trend, it is unlikely that the PRS rural poverty target will be met by 2010. Two factors may explain the slow decline in rural income poverty. Firstly, rural GNP has grown slower than is required. Secondly, the gains from economic growth and poverty reduction have not been shared equally among social groups. The rural population has received fewer benefits.

The story on non-income poverty is similar as rural services on education, health, and drinking water are lower in quantity and quality than urban services.

Micro Credit and Poverty Reduction

Experience shows that the poor use micro credit for two purposes. The first is for investment and generation of wealth. This is the more documented purpose and probably the officially accepted and promoted purpose, by many financial institutions. The second is for consumption smoothening. This is less documented and hardly discussed, especially in the context of the rural poor. But the poor face crop failure and need large cash outlays during specific periods of the year to finance education for their children or pay for expensive health services, especially for prolonged sicknesses such as those

related to HIV/AIDS. For this latter purpose, credit is not considered to be an investment, unless it is looked at from the medium or long-term perspective in terms of children education, for example.

Both credits are important for poverty reduction and alleviation for the poor. Credit for investment will reduce income poverty if the project is profitable and grows. But credit for consumption smoothening is unlikely to reduce the poverty level of the borrower. But it will prevent the borrower from falling deeper into poverty levels. In the long run, if the shock (e.g. crop failure) does not repeatedly occur or is not too prolonged, the credit may facilitate poverty reduction by creating opportunities for the borrower to participate more fully in the production process through more healthy and trained population. Therefore, both credits are important for the rural poor. But what is the situation?

Current Micro finance status in rural areas

Historically, rural credit has been provided for financing farm inputs and crop purchases (marketing) through cooperatives and crop authorities/boards. Starting mid 1980s, this practice faced two types of problems. Firstly, partly due to bad governance of these institutions and also as a result of stiff competition from private buyers that had been allowed to buy directly from farmers following a policy change many farmers have opted to sell their crops to private buyers. Secondly, the financial reforms gave banks autonomy to finance those clients that were creditworthy. Many cooperatives did not qualify for funding, that automatically disqualified the rural poor farmers. This situation is revealed in Table 1 showing that commercial banks credit to the agricultural sector has ranged between 3.3 % and 4.8% during 1996-2001. The share rose to 7.2% in 2002. And since these figures include credit to large scale farming, it is safe to assume that a large part of it does not benefit poor farmers.

Table 1: Commercial Banks Credit to the Agricultural Sector, 1996-2002

	1996	1997	1998	1999	2000	2001	2002
Agricultural Production	1,044.6	11,037.2	12,218.0	16,668.3	19,157.5	27,035.1	54,055.6
%	0.3	2.9	2.7	2.7	2.8	4.0	7.2
Crop Marketing	7,289.7	5,232.6	3,518.1	5,502.8	2,948.8	1,241.5	0.0
%	2.0	1.4	0.8	0.9	0.4	0.2	0.0
Export	3,541.7	2,277.9	2,960.7	1,875.6	2,187.1	0.0	0.0
%	1.0	0.6	0.7	0.3	0.3	0.0	0.0
Total (Agriculture)	11,876.0	18,547.7	18,696.8	24,046.7	24,293.4	28,276.6	54,055.6
%	3.3	4.8	4.2	4.0	3.5	4.2	7.2
Grand Total	360,419.9	386,212.6	448,463.1	607,561.3	691,609.6	678,921.8	749,066.8

Source: The Economic Survey, 2002.

More recently, banks have taken advantage of the rapid growth of micro finance institutions, collective savings and credit associations and other informal financial institutions to extend their financial services to the poor. And since in theory many of these target both rural and urban poor, these services should reach the rural poor. However, the actual situation is different as can be seen from the example of the small industries development organization (SIDO) in the table below.

Table 2: Distribution of credits between urban and rural (1994-2003)

Location	*Loan given*		*Value of loan given our*	
	Number	*%*	*Tshs ('000)*	*%*
Urban	13,588	87.4	4,711,433	88.4
Rural	1,951	12.6	620,350	11.6
Total	***15,539***	***100.0***	***5,331,783***	***100.0***

Source: SIDO, 2003

The distribution of credit shows that 87.4% of the total number of credit from SIDO goes to the urban areas, whose value constitutes 88.4% of the total credit given out. But even

for the limited amount that goes to the rural areas, we can safely assume that the bulk is not allocated to small scale or peasant agriculture.

It is interesting to note the significance of consumer loans in the credit allocation as shown by the example from the National Micro Finance Bank (NMB) for the month of January 2004, depicted in Table 3. Most of this allocation is for consumption smoothening although some of it is invested in residential houses and consumer durables.

Table 3: Allocation of credits by Sector (January 2004)

Sector	% of loan taken
Manufacturing	1.5
Services	3.3
Trade/commerce	15.2
Small scale/peasant agriculture	0.2
Others	0.5
Consumer loans	79.3
Micro finance Institutions	0.1
Total	100.0

Source: NMB, 2004

Explanations to the Current Rural Micro Finance Status

The evidence provided above shows that for the banks, credit is business; although some people have argued that it is bad business for banks lend only 6 billion out of a trillion. They will give credit where profitability is high and the risk is low. Rural Tanzania is too risky for a number of reasons.

Firstly, agriculture, its economic mainstay is characterized by high uncertainties. Its high dependence on rain and traditional farming systems as well as an externally determined pricing system make output and income from this sector low and unpredictable. The results are low consumption/savings/assets that are key in attracting banks credits.

Secondly, the set up for many rural institutions is not appropriate for facilitating credit. Traditional institutions are still opposed to borrowing. In addition, the experience with

new institutions such as cooperatives did not leave behind a positive image to push the rural poor to organize themselves around that system. But worst of all, these new institutions discouraged loan repayment.

Thirdly, rural infrastructure is very poor. Until very recently with the popularity and spread of mobile telephones, communication in the rural areas was very bad. But even now the costs are very high. The rural road network is still very seasonal in many areas. But perhaps of highest importance is the security of the banks. Many rural areas do not yet have police service. It takes too long for the police to arrive at the scene of crime. By the time they arrive the operation is no longer useful.

Fourthly, the rural poor have limited skills that are required to manage credit. Small and inexperienced business people often do not separate between family and business transactions, either because they lack the simple book keeping skills or do not appreciate the need to do so. Sometimes finances of several businesses are managed together without a clear system of separating the performance of each, making it difficult to distinguish between profit and loss making ventures. In addition due to lack of financial management capacity, the rural poor is also likely to face entrepreneurial as well as project management constraints. Some good performers of small enterprises have failed to perform with the growth of business.

All these factors taken together have led to either limited credit accessibility as seen above or high cost of the credit provided. Currently many micro finance institutions charge around 30% interest on the credit they give. This is a very high lending rate, by many standards, since the rate of inflation is slightly less than 5%. An argument has been put forward that the issue of high lending rate is less important than accessibility. This may be partly correct since there is evidence of high repayment rate for many micro borrowers. But it is hard to believe that profitability is as high or higher than 30% for many micro enterprises. It is more likely that only a few activities earn such high profits. Therefore, two things must be happening. First, the distribution of credit is very skewed. This can be observed in Table 3 where, excluding consumer loans, 79% of the credit goes

to trade/commerce. Second, debt burden is increasing for those in areas that do not earn such high profits. It should be remembered that credit is both capital and debt. When profitability is low, the debt burden rises and the concept of capital disappears. The issue of increasing debt burden may not yet have surfaced in the micro finance world because lending institutions have been targeting highly profitable and secure areas. Alternatively, borrowers have used other sources (including support from relatives and friends) to pay debts to avoid harassment and social pressure.

The Challenges to be addressed

The challenges relate to the problems/constraints identified above. We have noted that banks prefer to work through intermediary institutions not only as a risk minimizing strategy but also in order to enhance cost effectiveness and efficiency. Banks that are currently working through cooperatives and micro finance institutions have become more successful in their outreach programmes. Two challenges have to be addressed simultaneously in this context. First, banks should develop smart partnership with cooperatives and MFI. Second, the management capacity of cooperatives and MFI must be strengthened. If properly done, this will enhance accessibility to credit, reduce risk and lower costs.

Banks also prefer group to individual lending. Group lending has been done through cooperatives, employers, and economic and social groups. This is partly to avoid dealing with small volumes that raise costs but also in order to reduce the risks of dealing with individuals whose ability and credibility would not be known to the banks. Two challenges may have to be addressed simultaneously in this context. First, efforts have to be made to encourage the formation of these groups and build their entrepreneurial and management capacity as mentioned earlier. Second, efforts must be made to encourage savings. Unfortunately this is an area that has received very little attention from banks. Yet in order to raise viability of rural credit the savings culture must be developed. Banks should consider this hypothesis: successful savers are likely to be successful borrowers. In this way, groups of individual savers will emerge. Here banks need to play a more pro-

active role than has so far been the case. Perhaps a review of the interest rate structure may need to be addressed.

We have seen that credit has been used either as working capital to smoothen consumption or as investment to generate more wealth. We have also seen that the current structure of credit favours credit for smoothening consumption. But this facility is mainly available in the urban areas and for employees (such as teachers) in the rural areas. In the rural areas it is also likely to be extended to estate farmers and their related out-growers but not to small individual farmers. In the past, cooperatives played a positive role in managing the working capital on behalf of small individual farmers. This useful role was cut off between mid 1970s and mid 1980s when cooperatives ceased to exist. The challenge is to facilitate formation of cooperatives and SACCOS in the rural areas and develop their capacity to play that role.

However, as we have seen, not all the constraints relate to the financial system, banks and micro finance institutions. Nor do they necessarily relate to the borrowers and savers in the form of borrowing and savings culture and limited organizational capacity. Poor governance and infrastructure reduce credit accessibility and raise the cost to borrowers. These are areas currently being addressed via the ongoing reforms in the central government and local authorities. But given limited resources it may take long before tangible results can be seen, especially in remote rural areas. In the meantime, some more innovative strategies (such as mobile banking) may have to be developed to facilitate credit accessibility in these areas. Development and implementation of such strategies would require collaboration between the banks, MFI and the government.