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# ECONOMIC POLICY RESEARCH BULLETIN

## *Credit Accessibility to the Rural Poor in Uganda*

Economic Policy Research Centre
Makerere University Campus
51 Pool Road
P.O. Box 7841,
Kampala-UGANDA

Tel. 256-41-541023
Fax: 256-41-541022
email: eprc@mukla.gn.apc.org

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## Contents

# Credit Accessibility to the Rural Poor in Uganda

*Matovu John and Okumu Luke*
*EPRC*

## I Background

The design of traditional credit markets reflects the concern to policy makers that a shortage of affordable credit constrains growth in the rural sector in Uganda and prevents rural poor's integration into the market economy. This has encouraged Uganda government and other non-government organisations to establish specialised credit institutions to channel credit to the rural poor. For example, the Rural Farmers Credit Scheme of the Uganda Commercial Bank was instituted by Government to provide credit to the rural poor. The results of this scheme, however, were generally unpleasant especially with respect to loan recovery performance from the farmers themselves. During the fiscal year 1995/96, the Government again is to provide an "Entandikwa Credit Scheme" which is implimented through local governments and NGOs.

Although there may be an enormous expansion of formal credit funds from government owned or sponsored rural financial institutions and NGOs, loans have always frequently been skewed in favour of the wealthier and influential individuals. The rural poor have little access to credit from formal institutions. The credit needs of the poor are still served by the informal money lenders who are either rich land owners or traders. The existence of the informal lenders may be attributed to a rich variety of contractual relations that enables them to solve the information problems that are currently beyond the ability of banks and cooperative societies.

There are several factors that may influence an individual's accessibility to credit sources. These include, among other things, contract terms, purpose of the loan, borrowers characteristics, lenders characteristics, relationship between lender and borrower and inter-linkages with other markets.

This study was intended to answer the following questions:

1. What are the factors that determine the choice of source of credit for a low income earner?
2. What are the underlying factors that lead to the better performance of informal credit lenders for loan recovery rates compared to the formal lenders?
3. Is it possible for formal credit institutions to use some of the mechanisms that are used by informal lenders for screening and enforcement of credit contracts?
4. What are the policy conclusions that can be used by the formal credit scheme to channel more credit to the lowest income earners and ensure high loan recovery rates?

## II Performance of credit schemes in Uganda

### *UCB-Rural Farmers' Scheme (RFS)*

The UCB experience with RFS was rather unsatisfactory, especially with respect to loan recover in agricultural sector. This failure appeared to have stemmed from four main sources, namely: loan processing and disbursement, input policy, monitoring, supervision and marketing.

**(a) Loan Processing and Disbursement**

Loan processing and disbursement wever characterised by inordinate delays and a lot of irregularities. There were delays in the appraisal of loans and the many visits one had to make to the bank added to the final real costs of the loans. The high inflation rates also gave rise to the price of inputs, which kept shifting the loan amount required, thereby necessitating progressive and endless re-appraisal by the bank.

**(b) Input Policy**

The disbursement policy of the UCB/RFS was that credit had to be largely by inputs stocked and supplied by the bank itself. This policy no doubt restricted the farmer's choice to burgain for quality and price.

**(c) Monitoring and supervision**

The UCB/RFS seemed to perform without proper guidelines, logistical support and indicators for monitoring and enforcing credit contracts. Thus, once disbursement was approved, there was no sufficient commitment and arrangement on the part of the Branch staff for loan tracking, to ensure that loan was used for the purpose for which it was meant. Thus, the inherent shortcomings allowed the scheme staff laxity and opportunity to impose extortionate demands on borrowers instead of seeing to it as mutual obligation of lender and borrower.

**(d) Marketing**

With regard to marketing, particularly seasonal crops, two salient problems emerged: the first related to direct consumption of the produce by the household and , the second, there was lack of a single market outlet to which a borrower (farmer) could sell the produce. In fact the market was too small to absorb the bumper harvest and this led to the borrowers selling their produce at low prices and hence being unable to pay back the loans.

*The Centenary Rural Development Trust Limited*

The Centenary Rural Development Trust Ltd (CERUDET) is a catholic church-based financial intermediary conducting business as a credit institution under the 1969 Banking Act. Because of the network of Dioceses and Parishes, CERUDET appears to have a remarkable mechanism for vetting loan applications and enforcing recovery. By it's charter, eligible sectors and activities are those undertaken by the relatively disadvantaged people in rural areas. The majority of loans are for trading purposes. These generate adequate income and have a high rate of recovery. Much of the expansion into trade financing is so far in Kampala. However, the loan recovery rates in Kampala area is 52% in contrast with 95% for Kabale area where knowledge of the applicant is much greater. Lending committees utilising church councils, local individuals as well as the branch managers have generally done well for loan recovery in rural areas.

*The Uganda Women's Finance and Credit Trust (UWFCT)*

The main aim of the UWFCT is to facilitate women's access to credit for small scale business undertaking. UWFCT does this by either;

(a) Lending to women funds from UWFCT's own Revolving Loan Fund; or
(b) Helping them prepare bankable projects which they can present to other financial institutions for credit.

The trust has so far provided credit of over 250 projects worth about shs.300 million since its foundation with loan recovery rates of 85%.

*Cooperative Credit Scheme (CCS)*

The CCS was introduced by government in the 1960s, based on the recommendations of J.C. Rayan. He recommended cooperative societies as a chamber of credit to small-scale farmers, which at the time were in an ideal position to recover loans from the sales proceeds of farmer members' crops sold through the societies. After about ten years' operation, the CCS proved a distict success, with a loan recovery performance of about 90%. The reasons for the success are:

(a) careful selection of participating societies and members;
(b) Good record keeping;
(c) Training of staff, committee and members;
(d) Adequate loan supervision.

However, as membership grew larger, the better off members dominated the credit scheme. Also, savings were used to determine the level of loans granted to an individual and this limited the size of loans the poor could get from the scheme. It also led to the loans that the poor could qualify for to be unviable and unattractive. The women beneficiaries of this scheme were also very few.

## III Objectives of the study

There are three basic objectives of this study:

1. To identify the factors that influence an individual's choice of credit source;

2. By examining the existing credit delivery mechanisms (formal and informal), the study is then to suggest an approprite and viable system that will increase credit accessibility to poor; and

3. To determine some policy guidelines which could improve credit advancement to the poor.

## IV Research hypothesis

The probability for the i-th rural individual to choose an informal credit lender is greater than the probability of choosing formal credit lender.

## V Literature review and the conceptual framework

Generally, borrowers in rural areas differ in their likelihood to default and it is costly to determine the extent of that risk for each borrower. This is conventionally known as the screening problem. On the other hand it's costly to ensure that borrowers take the actions which may make repayment most likely (incentive problem). And it's also difficult to compel repayment (enforcement problem).

However, there exists two types of mechanisms for resolving the problems of screening, incentives and enforcement. The direct mechanisms rely on the design of contracts by lenders such that when a borrower responds to these contracts in his own best interests, the lender obtains information about the riskiness of the borrower, and induces him to take actions to reduce the likelihood of default (Stiglitz and Karla 1990). Such mechanisms include interest rates, collateral, duration of payment and form of payment.

Indirect mechanisms include personal relationships between the lenders and borrowers, inter-linkages between markets, reputation of borrower etc. It's the above mechanisms used for solving the three problems outlined above that leads to the sorting of borrowers across lending sources. And some of these mechanisms (especially the indirect mechanisms) may not be easily used by formal institutions.

Several studies including (Stiglitz, 1990; Udry, 1990, Schaefer-Kehnert, 1983; Descamps, 1989; Owusu Kwame, 1982; Adera Adebe, 1987; Chan and Thakor, 1987 and Bell et al., 1990) have focused on particular features of rural credit markets and group lending. In general, the features that have been given particular attention in these studies include credit terms, characteristics of borrowers, characteristics of lenders and the relationships between lenders and borrowers.

*Credit terms*

In many transactions of credit markets, collateral is pledged in exchange for the receipt of a loan (see, for example, Chan and Thakor, 1987; Gangopadhyay and Sengupta, 1987). This reduces the cost to the lender of a loan and it can reduce the moral hazard associated with lending by providing an added incentive for the borrower to repay. It can also alleviate the problem of adverse selection by screening out borrowers most likely to default.

The second credit term is the interest rate. It's generally costly to establish the extent of risk of a particular borrower by a lender, and the pool of applicants for loans at any interest rate may consist of borrowers of different risk categories. However it's been argued that interest rates can take on a dual role of rationing credit and also of regulating the dual composition of the lenders portfolio (Stiglitz,1987). The risky borrowers may be willing to go for higher interest rates given the fact that they don't have expectations to pay. However, it may be a misleading argument that interest rates give the right signal for choice of a credit source by an individual because, there are several other factors of which interest rates is only one of them.

The third factor is the size of loans. This is a factor which has received little attention in the literature of credit markets. Formal institutions generally give bigger loans compared to the informal lenders. This may be due to the fact that the transaction costs by a formal credit lender are lower for a big loan, than many small loans. Yet, the needs of the rural poor are far less than the expectations of formal credit lenders.

The fourth factor is the mode of payment. This factor has also been ignored in the literature of credit markets in developing countries. In this case the lender may provide a loan on condition that the borrower provides some services in kind rather than paying back in cash. Such transactions may be limited under formal credit institutions which normally require payment in cash.

The fifth factor is the purpose of the loan. Choice of source of credit may depend on the use to which that credit is to be allocated. Formal credit institutions require feasibility studies outlining how the client is to utilise the credit and how he expects to pay back with interest. However some of the loans demanded by the rural poor are for smoothening their consumption patterns over periods like during draughts. There appears to be no documented study particularly in Africa focusing on the purpose of the loans demanded by the rural poor.

*Borrowers characteristics*

A lender may use the threat of cutting off credit to induce desired behaviour of an individual (Stiglitz, 1983). More generally, borrowers normally want to avoid defaulting on loans because this tarnishes

their reputation and limits their access to future credit. In Northern Nigeria, it's been found that reputation plays a big role in enforcement of credit contracts especially in the informal sector (Udry, 1990). Formal credit institutions are at a disadvantage in establishing the credibility of a borrower.

*Lenders characteristics*

It's been documented that informal credit institutions have an advantage of being more flexible especially in risk sharing (Udry, 1990). For example, in Northern Nigeria, it was found that repayments owed on a loan appear to depend on the random production and consumption shocks received by the borrower and lender. The rural poor are always confronted with fluctuations in production due to weather changes and this discourages them to use formal credit institutions which are inflexible with conventional interest rates conditions. There are also factors like the number of days it takes for a loan to mature. For the formal credit lenders, loans may be advanced in a day's notice without any written agreement while for banks, a loan may take on average more than a month.

Inter-linked credit contracts may provide means to alleviate the problems of screening and enforcing loan conditions (Stiglitz and Karla, 1990). The most widespread form of inter-linkages is provided by traders who generally require that their clients sell all their crops to or through them (see Bell et al., 1990). This trade credit linkage makes information on size of borrowers operations available only to the creditor.

A surprising result regarding this argument was found by Udry (1990) in Northern Nigeria. Out of 1150 product market transactions that were recorded in his study, 96% were made with traders in markets with whom the household member had no other connection.

The relationship between lenders and borrowers is expected to play an important role in enforcement of contracts. The same phenomenon was found in Northern Nigeria where 97% of the informal sector loans are made between individuals of the same village or between relatives (Udry, 1990).

*Integration of the Formal Financial Institutions with Rural Credit Societies and Groups*

Lending groups and credit cooperatives have the potential to reach small farmers with affordable credit (Bratton, 1986). Despite their apparent advantages, credit cooperatives have had mixed results as far as their performance is concerned (Deschamps, 1989). The performance of credit cooperatives in Uganda have generally been characterised by high delinquency rates. In many cases farmers' cooperatives have been organised at the government's initiative. But rather than starting out with a single purpose cooperative, such as credit unions, officials have frequently launched multipurpose cooperatives providing inputs as well as marketing and financial services. These ambitious arrangements frequently involve a top-down approach, with top-down decision making and little participation of members. Given the fact that most of these organisations are always subsidised by government, this also affects the sense of joint ownership that could serve as a driving force behind loan repayments. This has also stunted the mobilisation of savings and increased the cooperatives financial dependence on external sources (Adera, 1987).

With the above record of cooperatives, this study is aimed at finding ways of integrating formal credit schemes with the poor through group lending. The performance of group lending has been proved to be effective in different countries including Cameroon, Malawi and Bangladesh. The Grameen Bank in Bangladesh while lending to some of the poorest people has had one of the lowest default rates ever, i.e. less than 2%, and a very high participation rate.

One of the basic advantages with group lending is that they give more information about the riskiness of the borrowers. The bulk of a lenders transaction costs is related to the assessment of credit worthiness and the viability of loan recovery. However under group lending, since members have some social and economic ties, they can easily enhance their projects by providing external lenders with vital information about the members. Joint liability can also improve repayment as the risk of default diminishes with increased membership unless all members' activities are highly correlated. However there are some disadvantages with group lending of which the moral hazard problem is one of them. Under a system of joint liability, all members are highly liable for the costs of default by any member. This implies that the risks are born by the group while the benefits are reaped by the individual member. The second problem with group lending is that the liquidity and income of individuals who live near each other and engage in similar economic activities are often highly correlated and hence their loan portfolio is likely to suffer from inadequate diversification.

The crucial factors that will be focused on as regards group lending are; size of the group and it's homogeneity since studies have shown that this highly affects the performance of group lending. For example, in Ghana the performance of large groups with close to 100 members was worse than that of groups with 10-20 members (Owussu and Tetteh, 1982). In Zimbabwe groups with more than twenty members proved to be more susceptible to default than smaller groups (Bratton, 1986). In Malawi where group lending has performed exceptionally well, loans are made only to relatively homogeneous groups. Group members are always from the same village and often affiliated through kinship (Schaefer-Kehnert, 1983).

## VI The methodology

The survey was undertaken in four districts namely; Lira, Mbale, Rakai and Rukungiri. One county was chosen in each district from which a sample of four parishes were selected using simple random sampling procedures. In order to get a representative number of borrowers compared to the lenders, stratified random sampling was used. The total number of borrowers who were interviewed were 903 of which 231 were from Lira, 238 from Mbale, 188 from Rakai and 246 from Rukungiri.

The data were captured using two structured questionnaires to get information on the borrowing/lending patterns of individuals. One of the questionnaires was for the borrowers and the other was for the lenders. The two questionnaires were administered by interviewers. The data were extracted using the EPINFO package and then exported to SAS for more comprehensive analysis.

*The model*

Assuming an individual decision maker i, chooses to use creditor lender j. Depending on his individual attributes, $S_i$, he/she will have alternatives from a set of choice attributes, $X_j$. These attributes include collateral, kinship and reputation of borrower.

By an individual using a particular credit source, it's assumed that he will derive some utility by using a particular source and the utility function can be formalised as follows:

$$U_{ij} = \beta Z_{ij} + e_i \quad \text{----------} \quad \text{----------} \quad (1)$$

where $Z_{ij} = [X_j : S_i]$, that is, $Z_{ij}$ a vector of functions of characteristics $X_j$ and attribute $S_i$, ß is a vector of coefficients of alternative specific parameters, and $e_i$ is a random variable representing the random behaviour, unobserved factors and measurement error(See, for example, Jude et al,1980 and Fombay et al, 1984).

Assuming that the explanatory variables vary by the alternatives of credit sources available, McFadden (1974a) showed that the general random utility function (1) can be expressed as a conditional categorical model. The disturbances $e_i$ are assumed to be independent and identically distributed with a Weibul distribution. Thus the probability is given by th following;

$$\text{Probability } (i, j) = \exp(\beta_j Z_{ij}) / \exp(\beta_j Z_{ij}) \text{----------(2)}$$

## VII Presentation and discussion on the empirical findings

*Credit Sources*

According to the survey results, four distinct credit sources were identified, that is,

(a) informal individual lenders (INFINDSO);
(b) informal group lenders (INFGROSO);
(c) formal traditional lenders e.g banks and registered cooperative societies (FORTRASO); and
(d) formal non-traditional lenders e.g. registered NGOs (FORNTRSO).

In a broader sense, these four sources can be reduced to two categories: formal and informal. But because there is a distinct difference between borrowing from a group and from an individual, it makes more sense to split this into individual and group sources. Also formal sources had to be split into traditional and non-traditional lenders because of the lending conditions which are significantly different.

As Table 1 shows, 52.2% of the respondents interviewed were getting their credit from INFINDSO while 24.8 percent get their credit from INFGROSO, 12.8 percent from formal traditional lenders (FORTRASO) and 10.8 percent get their credit from formal non-traditional lenders (FORNTRSO).

**Table 1: Sources of Credit**

| Credit source | frequency | percentage |
|---|---|---|
| INFINDSO | 472 | 52.2 |
| INFGROSO | 224 | 24.8 |
| FORTRASO | 56 | 12.2 |
| FORNTRSO | 109 | 10.8 |

Given that group lending is one of the ideal method of allocating credit to the poor, respondents were asked whether they belonged to any groups meant for credit allocation. Out of the total sample interviewed, 45.8 percent responded that they belonged to credit groups (either formal or informal), with Rukungiri district having the biggest percentage of those belonging to credit groups **(Table 2)**.

**Table 2: Borrowers belonging to credit groups**

| DISTRICT | FREQUENCY | PERCENTAGE* |
|---|---|---|
| Lira | 98 | 42.42 |
| Mbale | 90 | 37.82 |
| Rakai | 65 | 34.17 |
| Rukungiri | 161 | 65.45 |

*The percentange represents the fraction of the number of people interviewed in the district who belong to credit groups.

Of the respondents belonging to credit groups, 39.2 percent recommended that credit should be channelled through these groups and the reasons given are that groups can stand as surity in case a borrower lacks collateral and they can also easily provide the necessary information about group members to the lenders which is not the case with informal individual borrowers.

*Credit Accessibility and factors affecting it*

Credit accessibility and factors affecting it were other aspects which this study focused on. In particular, factors that were considered include: Credit terms, chracteristics of borrowers, characteristics of lenders and the relationship between lenders and borrowers.

(a) Collateral

Providing collateral is a very common practice in most credit markets. This is normally done to reduce the risks of default by the borrower and also it's a method of screening borrowers. In the four districts surveyed, the most commonly used collateral is land title.

In this study, out of the total population interviewed, 89.4 percent owned land. Of these, 42.1 percent owned more than four acres, 23.8 percent had two to four acres and 23.5 percent owned less than two acres (Table 3). Since the majority of those interviewed own more than four acres, land shortage in the first place does not seem to be crucial and therefore its use in acquiring credit may not be an obstacle. This leads us to ask what perhaps could make the land unusable as collatoral.

Table 3: Size of Land Ownership

| SIZE LAND | Frequency | Percent |
|---|---|---|
| Below two acres | 212 | 23.5 |
| From two to four | 215 | 23.8 |
| Over four acres | 380 | 42.1 |
| Non response | 11 | 1.2 |
| Not applicable | 85 | 9.4 |

Table 4: Limitations of using Land for Credit Transactions

| LIMLAND | Frequency | Percent |
|---|---|---|
| Communal ownership | 43 | 4.8 |
| Title | 236 | 26.1 |
| Unproductive land | 6 | 0.7 |
| Small size of land | 29 | 3.2 |
| Non response | 40 | 4.4 |
| Not applicable | 549 | 60.8 |

Table 4, gives a summary of limitations to the use of land for credit transactions. Out of the 89.4 percent of the respondents who owned land, 35 percent could not easily use it for credit transactions. The main reason was lack of title. 26.1 percent of the respondents said lack of title was an hinderance to using their land for credit transactions. Other reasons were communal ownership of land, unproductiveness and small land size. This is not surprising given that the conventional approach of getting loans has been a demand for land titles.

Investigating further whether land and lack of title are significant factors in obtaining credit from different sources, models 1,2,3 and 4 given in the appendix were fitted. The dependent variables

were the four different sources of credit and these had two response levels (i.e whether someone was borrowing from a particular source or not). The sources of credit were modeled against different independent variables using the CATMOD procedure of the SAS package.

A close look at the weighted least squares estimates of the four models, the limitation of using land titles in credit transactions hinder the borrowers accessibility to credit from the four sources given that the parameter had only negative signs in the four models.
Lastly, it was also found that among the respondents who provide collateral, only a very small percentage (2.8 percent) lost their collateral as a result of failure to pay back, an indication that people normally pay back their loans.

**(b) Interest rates**

Interest rates take on a dual role of rationing credit and regulating the dual composition of the lenders protfolio. As a result, most lenders charge an interest on the loans they give to their clients. But this is more pronounced in the formal sector than informal sector.
From the survey findings, out of the total population interviewed, 58.4 percent were charged interest on the loans they borrowed, and of these the majority were clients of the formal traditional lenders as shown in Table 5.

**Table 5: Credit Sources and Borrowers Paying Interest**

| SOURCES | FREQUENCY | PERCENTAGE* |
|---|---|---|
| INFINDSO | 170 | 36.02 |
| INFGROSO | 172 | 76.79 |
| FORTRASO | 51 | 91.07 |
| FORNTRSO | 99 | 90.83 |

*The percentage represents the number of people who pay interest and borrow from the respective sources.

**Table 6: Credit Sources and Interest Charged**

| | 0 - 10% | | 11-20% | | 21-30% | | 31-40% | | 41-50% | | 51% Above | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Freq | % | Freq | % | Freq | % | Freq | % | Freq | % | Freq | % |
| INFINDSO | 38 | 8.1 | 49 | 10.4 | 18 | 3.8 | 9 | 1.9 | 4 | 0.9 | 39 | 8.1 |
| INFGROSO | 74 | 33.0 | 63 | 28.1 | 18 | 8.0 | 1 | 0.5 | 3 | 0.3 | 2 | 0.9 |
| FORTRASO | 8 | 14.3 | 5 | 8.9 | 24 | 42.9 | 61 | 0.7 | 0 | 0.0 | 2 | 3.6 |
| FORNTRSO | 49 | 45.0 | 28 | 25.7 | 6 | 5.5 | 6 | 5.5 | 5 | 4.6 | 2 | 1.8 |

Percentages represent the number of people who are charged interest in the respective ranges by their respective sources.

It was found that the majority of lenders in the informal sector were charging low interest rates (11-20 percent) as compared to the formal traditional sources who were charging
21-30 percent (Table 6). However, it was also found that there is a considerable percentage of informal lenders (8 percent) who charge an interest rate greater than 50 percent.

Observing this from the four models, the factor of paying interest rate was only significant in the ANOVA table for informal individual lenders. Nevertheless, it was found that in all the four models,

high interest rates had negative signs and hence hinder borrowers accessibility to credit. The negative coefficients were most prevalent for the ranges 30-40%,40-50% and 50% and above. This is consistent with the concept that high interest rates relates negatively with ability to acquire loans. A big percentage of 23.3 respondents also revealed from the general question that the interest rates charged by most formal lenders were very high.

### (c) Mode of Payment

In some credit transactions, lenders (especially in the informal sector) are flexible with the mode of credit repayment. This influences an individuals choice of a credit source. The practice with most formal lenders is the cash repayment requirement. In the informal sector, both individuals and groups, mode of repayment is flexible hence perhaps the preference of these sources compared, in particular, to the traditional formal sources. As seen in **Table 7**, nearly 50 percent of those interviewed responded that they could pay back in other forms rather than cash. Secondly, the majority of those who could pay back in other forms were in the informal sector and non-traditional formal sector. This is particularly important for policy makers because it gives a clear signal on policy choices.

**Table 7: Sources of Credit and Non-cash Payment**

| SOURCES | FREQUENCY | PERCENTAGE* |
|---|---|---|
| INFINDSO | 240 | 50.85 |
| INFGROSO | 107 | 47.77 |
| FORTRASO | 11 | 19.64 |
| FORNTRSO | 47 | 43.12 |

*The percentage represents the number of people who pay in noncash form from the respective sources.

**Table 8: Sources of Credit and other Forms of Payment**

| SOURCE | KIND PAYMENT | | REDUCING SHARES | | CONFISCATE COLLATERAL | |
|---|---|---|---|---|---|---|
| | Freq | % | Freq | % | Freq | % |
| INFINDSO2 | 40 | 50.6 | 3 | 0.6 | 0 | 0.0 |
| INFGROSO | 101 | 45.1 | 2 | 0.9 | 1 | 0.5 |
| FORTRASO | 10 | 17.9 | 0 | 0.0 | 1 | 1.8 |
| FORNTRSO | 44 | 40.4 | 0 | 0.0 | 2 | 1.8 |

Percentages represent the number of people who are charged interest in the respective ranges by their respective sources.

**Table 8** shows sources of credit and other forms of payment other than cash. The majority of borrowers who were borrowing from the informal sector could pay back in kind either by providing labour services to their lenders or selling their produce through the lenders. Two things are pertinent here: first, is the provision of labour services and second, selling produce through lenders. These two practices give the borrowers opportunity to market their labour services and output. In this way the poor are able to improve their quality of life.

Besides, the problems of the rural people are marketing and finding productive activities to engage in. Therefore, payment of credit by other forms other than cash is an innovation although it would

be argued that the lenders may in the end exploit these borrowers as is the case in Mbale with coffee farmers.

### (d) Feasibility Studies

This is normally a requirement for most traditional banks if an individual is to obtain credit from these institutions and indeed nearly all those who were required to provide feasiblility studies, were clients of traditional credit sources. Out of the 17.7 percent respondents who were required to provide feasibility studies, only 9.1 percent knew how to write a feasibility study. These two factors (requirement of feasibility study and knowing how to write a feasibility study) were found insignificant in models 1 and 2 due to the fact that the informal lenders do not require feasibility studies. In models 3 and 4 for the formal sector, the two factors were quite significant. In model 3, the probability of an individual getting credit from a traditional lending institution without a feasibility study was found to be very small (0.0356).

In this regard, 12.1 percent of the respondents recommended that before formal lenders institute credit schemes, people should be sensitized about the feasible projects that they can be undertaken to enable them pay back the loans and also get trained how to write simple feasibility studies.

### (e) Purpose of the Loan

Choice of a credit source also depends on the purpose for which the loan is being borrowed. 57% of the respondents were borrowing for capital. The rest borrowed mainly for payment of school fees, medical expenses and consumption.

**Table 9: Reasons for Borrowing**

| REASBORR | Frequency | Percent |
|---|---|---|
| Consumption | 97 | 10.7 |
| Paying other debts | 34 | 3.8 |
| Capital | 515 | 57.0 |
| School/medical fees | 108 | 12.0 |
| Payment of taxes | 5 | 0.6 |
| Non response | 144 | 15.9 |

**Table 10: Sources of Credit and Reasons for Borrowing**

| | CONSUMPTION | | PAY DEBT | | CAPITAL | | FEES/MED | | TAXES | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Freq | % | Freq | % | Freq | % | Freq | % | Freq | % |
| INFINDSO | 73 | 15.5 | 23 | 4.9 | 256 | 54.2 | 60 | 12.7 | 5 | 1.1 |
| INFGROSO | 19 | 8.5 | 4 | 1.8 | 112 | 50.0 | 42 | 18.8 | 0 | 0.0 |
| FORTRASO | 2 | 3.6 | 4 | 7.1 | 39 | 69.6 | 2 | 3.6 | 0 | 0.0 |
| FORNTRSO | 1 | 0.9 | 1 | 0.9 | 77 | 70.6 | 2 | 1.8 | 0 | 0.0 |

Percentages represent the number of people who borrow for reasons given above and their respective sources.

Given the fact that the majority of the borrowers may not necessarily reveal the purpose for which they are borrowing, this may imply that a big percentage of the loans borrowed may not be utilised for productive activities.

Analyzing it from the four models, reasons for borrowing (REASBORR) were insignificant in models 1 and 2 for the informal sector and very significant in models 3 and 4 for the formal sector. It is also revealed in the four models that if an individual is borrowing to cover school and medical fees, the probabilities of not getting a loan from the traditional and non traditional formal lenders were 0.7574 and 0.7016 respectively, implying that chances of getting credit for school and medical fees are very minimal. On the other hand, in model 1, the probability of not getting a loan from informal individual sources was found to be very high (0.9492) which indicated that loans borrowed from the informal individual lenders are not for capital productive activities.

### (f) Sharing Risks and Uncertainities

Risk sharing between borrowers and lenders may take different forms including postponement of payment period in case of failure to repay the loan due to unforeseen misfortunes. From **Table 11**, the total respondents who renegotiated their credit with their respective lenders constituted 71.3 percent. Of this, 61.3 percent postponed their repayment period.

Table 11: Renegotiation Changes

| RENECHAN | Frequency | Percent |
|---|---|---|
| POSTPONING PAYMENT | 553 | 61.2 |
| REVISE INTEREST | 40 | 4.4 |
| INKIND PAYMENT | 73 | 8.1 |
| NON RESPONSE | 12 | 1.3 |
| NOT APPLICABLE | 225 | 24.9 |

Table 12: Credit Sources by Renegotiation Changes

| SOURCE | POSTPONE PAYMENT | | REVISE INTEREST | | INKIND PAYMENT | |
|---|---|---|---|---|---|---|
| | Freq | % | Freq | % | Freq | % |
| INFINDSO | 321 | 68.0 | 12 | 2.54 | 43 | 9.1 |
| INFGROSO | 117 | 52.2 | 14 | 6.3 | 15 | 6.7 |
| FORTRASO | 31 | 55.4 | 8 | 14.4 | 1 | 1.8 |
| FORNTRSO | 55 | 50.5 | 7 | 6.4 | 7 | 6.4 |

The postponement of payment period is generally more common among borrowers who borrow from informal individual lenders while revision of interest rates was more common in formal traditional lenders. However looking at the four models in the appendix, this variable was not a significant factor in determining an individual's accessibility to credit.

### (g) Relationship between Borrowers and Lenders

relationship plays a very significant role in the choice of credit source and in the enforcement of credit contracts. As shown in **Table 13**, the study revealed that the majority of borrowers getting credit from informal individual lenders were either friends or relatives of the lenders and those borrowing from formal traditional lenders were either members or clients of the institutions. From the four models that were fitted, the relationship between borrowers and lenders in models 1,2 and 3 was found to be very significant.

**Table 13: Sources and Relationship to Borrowers**

| RELATIONSHIP | ININDREL | | INGROREL | | FOTRAREL | | FONTRREL | |
|---|---|---|---|---|---|---|---|---|
| | Freq | % | Freq | % | Freq | % | Freq | % |
| Friends | 197 | 21.8 | 11 | 1.2 | 0 | 0.0 | 0 | 0.0 |
| Relatives | 241 | 26.7 | 8 | 0.9 | 0 | 0.0 | 0 | 0.0 |
| Member/Clients | 37 | 4.1 | 221 | 24.5 | 56 | 6.2 | 71 | 7.9 |
| No relationships | 56 | 6.2 | 15 | 1.7 | 23 | 2.5 | 45 | 4.9 |
| Non response | 11 | 1.2 | 10 | 1.1 | 19 | 2.1 | 24 | 2.7 |

**(g) Duration of getting a Loan**

The formalities involved in getting a loan from a particular source and the duration it takes to get these loans is also another factor that determines an individual's choice of a credit source. From the Table 14, the borrowers were asked how long it takes them to get a loan from their clients from the date of request.

**Table 14: Sources and Duration of Getting Loans:**

| DURATION | ININDDUR | | INGRODUR | | FOTRADUR | | FONTRDUR | |
|---|---|---|---|---|---|---|---|---|
| | Freq | % | Freq | % | Freq | % | Preq | % |
| Immediately | 95 | 10.5 | 25 | 2.8 | 0 | 0.0 | 3 | 0.3 |
| One day | 81 | 9.0 | 33 | 3.7 | 1 | 0.1 | 2 | 0.2 |
| One week | 191 | 21.2 | 56 | 6.2 | 5 | 0.6 | 10 | 1.1 |
| Two weeks | 41 | 4.5 | 26 | 2.9 | 9 | 1.0 | 10 | 1.1 |
| One month | 40 | 4.4 | 28 | 3.1 | 12 | 1.3 | 13 | 1.4 |
| Over a month | 20 | 2.2 | 20 | 2.2 | 39 | 4.3 | 54 | 6.0 |
| Non response | 99 | 11.0 | 103 | 11.4 | 94 | 10.0 | 118 | 13.1 |

It can be seen from the Table 14 that the majority of borrowers using informal individual lenders get their loans from lenders with in a week from the date of request while 11% get the loans instantly. However, when compared to the formal lenders, a considerable percentage was getting their loans after a month from the date of request. This strongly discourages borrowers who would prefer to get loans instantly without going through bureacratic procedures.

**(h) Other Requirements Impossed on Borrowers**

In addition to conditions like providing collateral, charging interest rates e.t.c., borrowers were asked whether there are other conditions imposed on the loans that they contract. A number of conditions emerged out of this question and these included; writting an agreement, providing a witness, being a member of the group, paying back in time, being a permanent resident, selling produce through the lender, group expulsion in case of failure to pay, and being trust worthy.

**Table 15: Other Conditions Imposed by Lenders**

| Conditions | INFINDSO | | INFGROSO | | FORTRASO | | FORNTRSO | |
|---|---|---|---|---|---|---|---|---|
| | Freq | % | Freq | % | Freq | % | Freq | % |
| Written agreement | 61 | 6.8 | 51 | 5.6 | 4 | 0.4 | 3 | 0.3 |
| Providing witness | 9 | 1.0 | 29 | 3.2 | 15 | 1.7 | 5 | 0.6 |
| Member of group | 3 | 0.3 | 16 | 1.8 | 7 | 0.8 | 8 | 0.9 |
| Time limit | 96 | 10.6 | 49 | 5.4 | 10 | 1.1 | 4 | 0.4 |
| Customer/account | 3 | 0.3 | 0 | 0.0 | 22 | 2.4 | 31 | 3.4 |
| Payment in kind | 4 | 0.4 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| No condition | 225 | 24.9 | 30 | 3.3 | 11 | 1.2 | 14 | 1.6 |
| Permanent reside | 3 | 0.3 | 1 | 0.1 | 1 | 0.1 | 12 | 1.3 |
| Trust worthness | 15 | 1.7 | 8 | 0.9 | 1 | 0.1 | 0 | 0.0 |
| Selling produce | 3 | 0.3 | 8 | 0.9 | 1 | 0.1 | 44 | 4.9 |
| Group expel | 0 | 0.0 | 4 | 0.4 | 0 | 0.0 | 0 | 0.0 |
| Non response | 98 | 10.9 | 75 | 8.3 | 61 | 6.8 | 57 | 6.3 |

## VIII Main policy implications

The findings and conclusions of this study indicate that formal lending institutions should be more creative in dealing with the the rural community. What the formal and/or informal lending institutions should do are the followings:

*Rationalisation of the collateral requirement*

Collateral, especially where land titles are required, hinders people's accessibility to credit from the formal sector although factors such as communal ownership, small size of land and unproductivity may also hinder the use of land as collateral. In view of this problem, the strategies that could be adopted include (i) formal lending institutions substituting the use of land as collateral for recommendations from village elders and RCs - the character loan system; and (ii) To encourage group lending because this provides information about the riskiness of the borrowers and it can also guarantee the credit worthiness and the viability of loan recovery more than an individual providing collateral. This will not only minimize the problem of land titles but the use of land as collateral. Joint liability of a loan also improves repayment as the risk of default diminishes with increased membership.

*Rationalisation of the interest rates*

According to the survey results, interest rates charged by formal institutions are generally higher than those of the informal credit lenders. This makes accessing loans from formal institutions more expensive and in addition to other factors, therefore drives potential borrowers to informal sources which generally have little to lend. Formal institutions should as a result charge competitive interest rates if they are to target to the rural poor who may resort to getting credit from informal institutions at lower interest rates.

Alternatively, formal institutions should adopt a flexible interest rate regime and charge customer-specific interest rates. This would depend on the type collateral being offered by the borrower or the level of risks involved.

*Simplifying loan application procedures*

The formalities involved in getting loans from formal institutions are also a hinderance to the rural poor's accessibility to credit. Formal institutions should therefore simplify on the modalities of getting loans to suit the rural poor, reduce the number of days a loan takes to be obtained by the borrower from the date of request, and also improvising other acceptable forms of feasibility studies that can be easily prepared by the rural poor. Awareness campaigns could also be done to make people know about feasibility studies and their significance and also establishing a transparent system for loan applications.

*Sharing risks and uncertainties with borrowers*

The borrowers generally experience risks and uncertainties after getting the loans. However, as it has been revealed from the study, informal lenders are more flexible in sharing risks with borrowers in case of unforeseen misfortunes, like wars, inflation, droughts, floods etc. Hence given that Uganda is vulnerable to macroeconomic fluctuations, formal institutions should also adjust their loan terms accordingly. This could be achieved by establishing insurance schemes to protect both the lenders and borrowers.

*Supervising and monitoring projects*

There should be frequent supervision and monitoring of projects being undertaken by the credit beneficiaries given the fact that a considerable proportion of the borrowers do not utilize loans for productive activities and hence leading to higher default rates. In this case, the RCs in conjunction with the lenders should be utilised in monitoring of the proposed projects.

*Allowing non-cash payment*

Formal institutions should accept other forms of payment which may be in noncash form eg. borrowers paying back in form of harvest.

*Contract lending*

This is similar to the arrangement between the BAT and tobacco farmers in West Nile. The lender is to supply the borrower with the necessary inputs but the marketing of the product is done by the lender. In that way the lender will first recover his/her capital plus interest from the proceeds of the sale and the surplus is then given to the borrower.

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# Appendix I

**Accrynoms**

| | |
|---|---|
| INFINDSO : | Informal individual sources |
| INFGROSO : | Informal group sources |
| FORTRASO : | Formal traditional sources |
| FORNTRSO : | Formal non-traditional sources |
| CREGRO : | Belonging to credit group |
| LANDOWN : | Type of land ownership |
| SIZELAND : | Size of land |
| LANDCRED : | Using land for credit transactions |
| LIMLAND : | Limitations of using land for credit |
| PROVCOL : | Providing collateral for credit |
| ININDINT : | Interest rate charged by informal individual lenders |
| INGROINT : | Interest rate charged by informal group lenders |
| FOTRAINT : | Interest rate charged by formal traditional lenders |
| FONTRINT : | Interest rate charged by formal non-traditional lenders |
| NONCASH : | Paying in non cash form |
| FORMSPAY : | Other forms of payment |
| FEASTUD : | Providing feasibility study |
| WRITEFEA : | Writting feasibility study |
| RENECRED : | Renegotiation of credit |
| RENECHAN : | Renegotiation changes |
| ININDDUR : | Duration of getting a loan from informal individual lenders |
| INGRODUR : | Duration of getting a loan from informal group lenders |
| FOTRADUR : | Duration of getting a loan from formal traditional lenders |
| FONTRDUR : | Duration of getting a loan from formal traditional lenders |
| REASBORR : | Reasons for borrowing |
| ININDREL : | Relationship to informal individual lenders |
| INGROREL : | Relationship to informal group lenders |
| FOTRAREL : | Relationship to formal traditional lenders |
| FONTRREL : | Relationship to formal non-traditional lenders |
| ININDCON : | Other conditions imposed on loans by informal individual lenders |
| INGROCON : | Other conditions imposed on loans by informal group lenders |
| FOTRACON : | Other conditions imposed on loans by formal traditional lenders |
| FONTRCON : | Other conditions imposed on loans by formal non-traditional lenders |

# Appendix II

**Definition of categorical variables in the four models**

1 : Intercept
2 : Borrower owning land
3 : Borrower no owning land
4 : Land owned communally
5 : Lack of land title
6 : Unproductive land
7 : Small size of land owned
8 : Fragmented land
9 : Providing collateral to lenders
10 : Not providing collateral to lenders
11 : Non-response
12 : Paying interest rate on loans borrowed
13 : Not paying interest on loans borrowed
14 : Zero to ten percent interest rate
15 : Eleven to twenty percent interest rate
16 : Twenty one thirty percent interest rate
17 : Thirty one to forty percent interest rate
18 : Forty one to fifty percent interest rate
19 : Fifty and above interest rate
20 : Non response
21 : Required to provide feasibility study
22 : Feasibility study not required
23 : Know how to write fesibility study
24 : Not knowing how to write feasibility study
25 : Non response
26 : Renegotiation of credit
27 : No renegotiation of credit
28 : Borrowing for consumption
29 : Borrowing to pay other debts
30 : Borrowing to get capital
31 : Borrowing to pay school fees/medical expenses
32 : Borrowing to pay taxes
33 : Related to lenders as a friend
34 : Related to lenders as a relative
35 : Related to lender as client/member
36 : Not related to lender
37 : Non response
38 : Writting agreement
39 : Providing witness
40 : Being member of group
41 : Time limit of paying back loan
42 : Having account/customer to the lender
43 : Paying in kind
44 : Expulsion from group
45 : No other condition
46 : Permanent resident
47 : Being trust worthy
48 : Non response

## Model 1: Informal individual sources

| Effect | Parameter | Estimate | Standard Error | Chi-Square | Prob |
|---|---|---|---|---|---|
| INTERCEPT | 1 | 0.3414 | 0.7530 | 0.21 | 0.6503 |
| LAND | 2 | 0.2942 | 0.4676 | 0.40 | 0.5292 |
| | 3 | 0.3742 | 0.4839 | 0.60 | 0.4394 |
| LIMLAND | 4 | 0.0960 | 0.2793 | 0.12 | 0.7312 |
| | 5 | -0.0832 | 0.1981 | 0.18 | 0.6747 |
| | 6 | 0.0333 | 0.6293 | 0.00 | 0.9578 |
| | 7 | -0.0290 | 0.3346 | 0.01 | 0.9309 |
| | 8 | 0.0761 | 0.2919 | 0.07 | 0.7944 |
| PROVCOLL | 9 | 0.0335 | 0.4944 | 0.00 | 0.9459 |
| | 10 | 0.0654 | 0.4810 | 0.02 | 0.8918 |
| | 11 | 0.1065 | 0.7062 | 0.02 | 0.8801 |
| INTEREST | 12 | -0.4767 | 0.4201 | 1.29 | 0.2565 |
| | 13 | 0.1539 | 0.4354 | 0.12 | 0.7237 |
| ININDINT | 14 | 0.0366 | 0.3034 | 0.01 | 0.9039 |
| | 15 | 0.3277 | 0.3044 | 1.16 | 0.2817 |
| | 16 | 0.2633 | 0.4154 | 0.40 | 0.5262 |
| | 17 | -0.2358 | 0.4949 | 0.23 | 0.6337 |
| | 18 | -0.0176 | 0.7900 | 0.00 | 0.9823 |
| | 19 | 0.3634 | 0.3584 | 1.03 | 0.3106 |
| | 20 | -0.4253 | 0.5888 | 0.52 | 0.4701 |
| FEASTUD | 21 | -0.1320 | 0.2062 | 0.41 | 0.5221 |
| | 22 | -0.0243 | 0.1755 | 0.02 | 0.8897 |
| WRITEFEA | 23 | -0.0497 | 0.2324 | 0.05 | 0.8308 |
| | 24 | 0.0324 | 0.1487 | 0.05 | 0.8274 |
| | 25 | -0.1220 | 0.1514 | 0.65 | 0.4206 |
| RENECRED | 26 | -0.0441 | 0.3865 | 0.01 | 0.9091 |
| | 27 | -0.0347 | 0.3904 | 0.01 | 0.9291 |
| REASBORR | 28 | 0.1252 | 0.2358 | 0.28 | 0.5956 |
| | 29 | 0.1591 | 0.3112 | 0.26 | 0.6092 |
| | 30 | -0.0115 | 0.1808 | 0.0 | 0.9492 |
| | 31 | 0.0579 | 0.2234 | 0.07 | 0.7955 |
| | 32 | -0.1477 | 0.6649 | 0.05 | 0.8242 |
| ININDREL | 33 | 0.2235 | 0.1783 | 1.57 | 0.2101 |
| | 34 | 0.1909 | 0.1724 | 1.23 | 0.2681 |
| | 35 | 0.1098 | 0.3026 | 0.13 | 0.7166 |
| | 36 | 0.3972 | 0.2957 | 1.80 | 0.1792 |
| | 37 | -0.4355 | 0.4860 | 0.80 | 0.3702 |
| ININDCON | 38 | 0.2522 | 0.3282 | 0.59 | 0.4422 |
| | 39 | -0.0969 | 0.5806 | 0.03 | 0.8674 |
| | 40 | 0.2254 | 0.9498 | 0.06 | 0.8124 |
| | 41 | 0.2345 | 0.2825 | 0.69 | 0.4065 |
| | 42 | -0.3454 | 0.9735 | 0.13 | 0.7228 |
| | 43 | 0.3743 | 0.9249 | 0.16 | 0.6857 |
| | 44 | 0.3288 | 0.2481 | 1.76 | 0.1852 |
| | 45 | -0.2686 | 0.9502 | 0.08 | 0.7774 |
| | 46 | 0.3138 | 0.5045 | 0.39 | 0.5339 |
| | 47 | -0.7456 | 1.0030 | 0.55 | 0.4573 |
| | 48 | 0.2168 | 0.2753 | 0.62 | 0.4310 |

## Model 2: Informal group sources

| Effect | Parameter | Estimate | Standard Error | Chi-Square | Prob |
|---|---|---|---|---|---|
| INTERCEPT | 1 | 0.7916 | 0.8066 | 0.96 | 0.3264 |
| LAND | 2 | 0.0628 | 0.4777 | 0.02 | 0.8954 |
| LIMLAND | 3 | 0.4341 | 0.5000 | 0.75 | 0.3853 |
| | 4 | 0.0150 | 0.2784 | 0.00 | 0.9571 |
| | 5 | -0.1898 | 0.2037 | 0.87 | 0.3514 |
| | 6 | 0.2805 | 0.6273 | 0.20 | 0.6547 |
| | 7 | 0.1127 | 0.3290 | 0.12 | 0.7319 |
| PROVCOLL | 8 | 0.0900 | 0.2858 | 0.10 | 0.7528 |
| | 9 | -0.3983 | 0.4956 | 0.65 | 0.4217 |
| | 10 | -0.4586 | 0.4857 | 0.89 | 0.3450 |
| INTEREST | 11 | 0.3053 | 0.7142 | 0.18 | 0.6690 |
| | 12 | 0.3470 | 0.4253 | 0.67 | 0.4146 |
| INGROINT | 13 | 0.3632 | 0.4481 | 0.66 | 0.4177 |
| | 14 | -0.1523 | 0.3805 | 0.16 | 0.6890 |
| | 15 | -0.1192 | 0.3901 | 0.09 | 0.7599 |
| | 16 | -0.0996 | 0.4794 | 0.04 | 0.8354 |
| | 17 | 0.2810 | 1.1614 | 0.06 | 0.8089 |
| | 18 | 0.2713 | 1.0130 | 0.07 | 0.7888 |
| | 19 | -0.0556 | 1.1591 | 0.00 | 0.9617 |
| | 20 | -0.0867 | 1.6780 | 0.00 | 0.9588 |
| FEASTUD | 21 | 0.1706 | 0.7016 | 0.06 | 0.8079 |
| | 22 | -0.0095 | 0.2071 | 0.00 | 0.9632 |
| WRITEFEA | 23 | -0.1864 | 0.1767 | 1.11 | 0.2913 |
| | 24 | -0.00184 | 0.2423 | 0.00 | 0.9939 |
| | 25 | -0.1916 | 0.1589 | 1.45 | 0.2279 |
| RENECRED | 26 | -0.0106 | 0.1579 | 0.00 | 0.9466 |
| | 27 | -0.2008 | 0.3788 | 0.28 | 0.5961 |
| REASBORR | 28 | 0.0239 | 0.3864 | 0.00 | 0.9506 |
| | 29 | -0.0915 | 0.2593 | 0.12 | 0.7241 |
| | 30 | 0.00692 | 0.3436 | 0.00 | 0.9839 |
| | 31 | -0.2400 | 0.1973 | 1.48 | 0.2238 |
| | 32 | 0.0095 | 0.2467 | 0.00 | 0.9692 |
| INGROREL | 33 | 0.4649 | 0.7164 | 0.42 | 0.5164 |
| | 34 | 0.4479 | 0.5091 | 0.77 | 0.3790 |
| | 35 | 0.1698 | 0.5590 | 0.09 | 0.7613 |
| | 36 | 0.5020 | 0.2528 | 3.94 | 0.0470 |
| | 37 | 0.2232 | 0.5200 | 0.18 | 0.6678 |
| INGROCON | 38 | -0.4041 | 0.5876 | 0.47 | 0.4917 |
| | 39 | 0.3753 | 0.3273 | 1.32 | 0.2515 |
| | 40 | 0.1292 | 0.3929 | 0.11 | 0.7424 |
| | 41 | -0.1240 | 0.4758 | 0.07 | 0.7943 |
| | 42 | 0.1843 | 0.3368 | 0.30 | 0.5842 |
| | 43 | -0.00689 | 0.8520 | 0.00 | 0.9935 |
| | 44 | 0.1755 | 0.4079 | 0.19 | 0.6670 |
| | 45 | 0.8395 | 1.6116 | 0.27 | 0.6024 |
| | 46 | -0.5862 | 0.6400 | 0.84 | 0.3596 |
| | 47 | -0.7239 | 0.6503 | 1.24 | 0.2656 |
| | 48 | 0.0428 | 0.3184 | 0.02 | 0.8930 |

## Model 3: Formal traditional sources

| Effect | Parameter | Estimate | Standard Error | Chi-Square | Prob |
|---|---|---|---|---|---|
| INTERCEPT | 1 | 1.2220 | 0.8790 | 1.93 | 0.1645 |
| LAND | 2 | -0.0270 | 0.4704 | 0.00 | 0.9543 |
| | 3 | 0.2511 | 0.4964 | 0.26 | 0.6129 |
| LIMLAND | 4 | 0.1853 | 0.3001 | 0.38 | 0.5370 |
| | 5 | -0.3674 | 0.2224 | 2.73 | 0.0985 |
| | 6 | 0.2293 | 0.6774 | 0.11 | 0.7350 |
| | 7 | 0.1939 | 0.3530 | 0.30 | 0.5827 |
| | 8 | 0.2252 | 0.3039 | 0.55 | 0.4586 |
| PROVCOLL | 9 | -0.4925 | 0.4978 | 0.98 | 0.3224 |
| | 10 | -0.4810 | 0.4864 | 0.98 | 0.3227 |
| | 11 | 0.2257 | 0.7028 | 0.10 | 0.7481 |
| INTEREST | 12 | 0.0897 | 0.4080 | 0.05 | 0.8260 |
| | 13 | 0.0847 | 0.4185 | 0.04 | 0.8395 |
| FOTRAINT | 14 | 0.2640 | 0.6837 | 0.15 | 0.6994 |
| | 15 | 0.3776 | 0.5833 | 0.42 | 0.5174 |
| | 16 | 0.3381 | 0.4358 | 0.60 | 0.4379 |
| | 17 | 0.2762 | 0.6233 | 0.20 | 0.6577 |
| | 18 | -0.5422 | 1.1679 | 0.22 | 0.6425 |
| | 19 | -0.1503 | 1.6398 | 0.01 | 0.9270 |
| | 20 | -0.3567 | 0.6380 | 0.31 | 0.5761 |
| FEASTUD | 21 | 0.0253 | 0.2152 | 0.01 | 0.9063 |
| | 22 | -0.3824 | 0.1820 | 4.42 | 0.0356 |
| WRITEFEA | 23 | -0.0569 | 0.2503 | 0.05 | 0.8202 |
| | 24 | -0.1787 | 0.1604 | 1.24 | 0.2652 |
| | 25 | -0.1817 | 0.1699 | 1.14 | 0.2848 |
| RENECRED | 26 | -0.1318 | 0.3788 | 0.12 | 0.7279 |
| | 27 | 0.1159 | 0.3840 | 0.09 | 0.7629 |
| REASBORR | 28 | 0.1069 | 0.2621 | 0.17 | 0.6835 |
| | 29 | 0.1635 | 0.3544 | 0.21 | 0.6446 |
| | 30 | -0.3598 | 0.2068 | 3.03 | 0.0819 |
| | 31 | -0.0807 | 0.2611 | 0.10 | 0.7574 |
| | 32 | 0.6238 | 0.7168 | 0.76 | 0.3842 |
| FOTRAREL | 33 | 0.0224 | 2.0392 | 0.00 | 0.9912 |
| | 34 | 0.1058 | 0.5862 | 0.03 | 0.8568 |
| | 35 | 0.6359 | 0.6786 | 0.88 | 0.3487 |
| | 36 | -0.1852 | 0.6763 | 0.07 | 0.7842 |
| FOTRACON | 37 | 0.0224 | 0.8745 | 0.00 | 0.9796 |
| | 38 | 0.0522 | 0.5654 | 0.01 | 0.9264 |
| | 39 | 0.2000 | 0.7007 | 0.08 | 0.7753 |
| | 40 | -0.4675 | 0.6122 | 0.58 | 0.4451 |
| | 41 | 0.2834 | 0.5763 | 0.24 | 0.6229 |
| | 42 | -0.1602 | 0.6839 | 0.05 | 0.8148 |
| | 43 | 0.1990 | 1.6435 | 0.01 | 0.9036 |
| | 44 | 0.0320 | 1.6672 | 0.00 | 0.9847 |
| | 45 | 0.2731 | 1.7232 | 0.03 | 0.8741 |
| | 46 | 0.0807 | 0.4712 | 0.03 | 0.8640 |

## Model 4: Formal non-traditional sources

| Effect | Parameter | Estimate | Standard Error | Chi-Square | Prob |
|---|---|---|---|---|---|
| INTERCEPT | 1 | 1.1837 | 0.7830 | 2.29 | 0.1306 |
| LAND | 2 | -0.0565 | 0.4721 | 0.01 | 0.9047 |
| | 3 | 0.1717 | 0.4923 | 0.12 | 0.7273 |
| LIMLAND | 4 | 0.2058 | 0.3005 | 0.47 | 0.4936 |
| | 5 | -0.2541 | 0.2216 | 1.31 | 0.2515 |
| | 6 | -0.1004 | 0.6895 | 0.02 | 0.8843 |
| | 7 | 0.2704 | 0.3564 | 0.58 | 0.4481 |
| | 8 | 0.2224 | 0.2990 | 0.55 | 0.4570 |
| PROVCOLL | 9 | -0.4533 | 0.4990 | 0.83 | 0.3637 |
| | 10 | -0.4899 | 0.4866 | 1.01 | 0.3140 |
| | 11 | 0.1669 | 0.7083 | 0.06 | 0.8137 |
| INTEREST | 12 | 0.3386 | 0.4347 | 0.61 | 0.4360 |
| | 13 | 0.3169 | 0.4463 | 0.50 | 0.4776 |
| FONTRINT | 14 | 0.2396 | 0.4563 | 0.28 | 0.5995 |
| | 15 | 0.0301 | 0.5057 | 0.00 | 0.9525 |
| | 16 | 0.0455 | 0.6461 | 0.00 | 0.9438 |
| | 17 | 0.1683 | 0.7559 | 0.05 | 0.8238 |
| | 18 | 0.2780 | 0.7920 | 0.12 | 0.7256 |
| | 19 | -0.0123 | 0.9533 | 0.00 | 0.9897 |
| | 20 | -0.3091 | 0.6694 | 0.21 | 0.6442 |
| FEASTUD | 21 | 0.1481 | 0.2145 | 0.48 | 0.4898 |
| | 22 | -0.3064 | 0.1776 | 2.98 | 0.0845 |
| WRITEFEA | 23 | -0.1089 | 0.2488 | 0.19 | 0.6616 |
| | 24 | -0.2150 | 0.1606 | 1.79 | 0.1806 |
| | 25 | -0.1236 | 0.1668 | 0.55 | 0.4586 |
| RENECRED | 26 | -0.2814 | 0.3831 | 0.54 | 0.4626 |
| | 27 | -0.0198 | 0.3868 | 0.00 | 0.9593 |
| REASBORR | 28 | 0.0625 | 0.2643 | 0.06 | 0.8130 |
| | 29 | 0.1807 | 0.3445 | 0.28 | 0.5999 |
| | 30 | -0.3952 | 0.2099 | 3.54 | 0.0598 |
| | 31 | -0.0995 | 0.2596 | 0.15 | 0.7016 |
| | 32 | 0.5864 | 0.7169 | 0.67 | 0.4133 |
| FONTRREL | 33 | 0.5908 | 1.2413 | 0.23 | 0.6341 |
| | 34 | -1.0413 | 1.0994 | 0.90 | 0.3435 |
| | 35 | 0.1856 | 0.4584 | 0.16 | 0.6855 |
| | 36 | 0.3509 | 0.5648 | 0.39 | 0.5344 |
| | 37 | 0.1414 | 0.5087 | 0.08 | 0.7811 |
| FONTRCON | 38 | -0.1408 | 0.9716 | 0.02 | 0.8847 |
| | 39 | 0.3705 | 0.7735 | 0.23 | 0.6319 |
| | 40 | -0.3398 | 0.6620 | 0.26 | 0.6078 |
| | 41 | -0.6340 | 0.9016 | 0.49 | 0.4819 |
| | 42 | 0.3118 | 0.6592 | 0.22 | 0.6362 |
| | 43 | 0.1534 | 0.5338 | 0.08 | 0.7738 |
| | 44 | 0.5983 | 0.5538 | 1.17 | 0.2800 |
| | 45 | 0.7973 | 0.4991 | 2.55 | 0.1102 |
| | 46 | -0.3226 | 0.5012 | 0.41 | 0.5198 |

# The interest policy for rural finance

*Dr. Willie O. Odwongo*
*Agricultural Secretariat*

## I Introduction

There is a growing concern among the farming community and policy makers that the present liberalized interest rate regime adopted by Government discriminates against the agricultural sector and consequently constraints investment and growth in the sector. The general complaints in regard to the interest rate for agricultural credit are centered mainly around the following:

(a) Interest charged by the banks on agricultural loans are very high and unreasonable compared to rates of return to investment in agriculture, particularly in the context of generally low producer prices of most of the export crops as well as declining food crop prices.

(b) The current commercial banks' margins are exorbitantly high as the interest spreads between the deposit rates and advances or loans are too wide. Most of these differences may be attributed to inefficiencies within the banking system. Further, the banks prefer to invest in Treasury Bills (TBs) or lend to trading and commercial sectors rather than the real sectors.

(c) Some commercial banks compound interest for agricultural advances on monthly or quarterly basis whereas in the case of deposits, clients including farmers get payment of interest compounded only, on half-yearly basis. Instead of compound interest, the farmers want simple interest rate charged for agricultural advances.

(d) Besides interest rates, the commercial banks charge commitment fees, service charges, and penalty fees on late repayments. These charges are besides being very high, charged over and above interest rates.

(e) Banks charge interest rates on the entire loan amount sanctioned from the date of sanction instead of, on the amount disbursed and from date of disbursement.

(f) Disbursement and repayment of interest as well as repayment of loans are not synchronized with production season and/or harvesting/marketing of crops or livestock products.

The issue of interest rate for agricultural credit has therefore become a major concern to policy makers in Government, the BOU and most of the donors who fund agricultural credit projects. In this presentation, an attempt has, therefore, been made to address the issues involved in the interest rate policy for agricultural lending with a view to presenting suitable and workable recommendations for the sector.

## II Factors determining interest rates

Interest rate is price for money and an important instrument for mobilization of funds from the "savers" and allocating them to the "users". One of the basic functions of the banks is to facilitate

the channelling of funds from the savers to the users. This intermediation between supply and demand by the banks has, therefore, necessarily to aim at providing the best possible returns to the "depositors" who are the savers at the lowest possible cost to the "borrowers who are users of the funds.

The structure of the financial system thus comprises savers (depositors), the users (the borrowers), and the banks (the intermediaries). The process has three sometimes conflicting objectives, namely, (a) maximum return to savers (b) minimum cost to the borrowers and (c) adequate margin to the intermediaries to meet intermediation cost and make adequate profit. In a perfect market oriented economy, the interest offered to the farmers is attractive enough to make them have preference for bank deposits as compared with alternative avenues of investment available to savers. The resources so deposited in the banks are lent to the borrowers for viable projects which guarantee adequate returns to repay the loan with interest sufficient for the banks to meet the operational costs and make adequate profit. Thus, in general, interest rate is an important instrument for mobilizing resources and allocating them to various sectors to achieve development objectives of the national economic policy.

In theory interest rate for deposits is determined by opportunity cost of the money and that for lending is a function of the opportunity cost of credit. In an inflationary situation, the primary policy consideration is to maintain the value of money and provide incentives to save. The resource mobilization objective cannot be achieved unless the depositors are assured about the money value and positive returns to be earned.

## III Present policy and interest rate structure

The present Government policy is to pursue monetary and credit policies conducive to maintaining steady and low inflation and thereby promote macro-economic stability to lay the foundation for sustainable economic growth. To achieve this goal, an efficient financial sector with an effective banking system is considered absolutely essential. Government, therefore, with the financial assistance from IDA initiated, in 1992, a financial sector reform program the Financial Sector Adjustment Program (FSAP) with the main objective of at deepening the financial system and establishing over the medium term, an efficient system of resource mobilization and allocation. It was conceived that with this program, the system would become increasingly more liberal and market oriented and offer a greater variety of instruments to both savers and borrowers. Such a system is expected to stimulate savings and mobilize resources for the promotion of longer term growth and development of Uganda.

With the above policy objective in perspective, the Government is thus committed to moving towards a more market determined interest rate structure. For instance, in the Budget Speech of 1990, the Minister of Finance reiterated that "The principle basis of our interest rate policy is to encourage savings . The saver must receive positive rate of returns so as to maintain the real value of his savings and to compensate him for abstaining from consumption".

FSAP was launched in 1992, when inflation was still very high, and it envisaged to reform interest rates in the following manner:

(a) In the first phase during the period of high inflation, key interest rates would be aligned to the average preceding months' TB rates determined in an auction market. The Government would, however, ensure that positive rates are maintained for time deposits. This phase has already been accomplished.

(b) In the second phase, as inflation declines and stabilizes, the functioning of credit markets are improved and a larger set of financial instruments become available in the market, greater flexibility would be given to the bankers in the determination of interest rates. This phase has also been accomplished.

(c) In the third and final phase, the BOU would fully liberalize interest rates and manage them through indirect monetary instruments.

In pursuance of the above objectives under FSAP, the BOU began liberalizing interest rates in November 1992 and by July 1994, all interest rates were fully liberalized. To-date the banks are free to fix their own deposit and lending rates. The Bank of Uganda announces only indicative rates based on TBs auction market rates.

The BOU Research Department in association with Bank Supervision Department is expected to monitor closely the interest rates charged by the banks to ensure that the spread between the deposits and lending rates does not act as a disincentive to some parties in the financial system.

Trends in the interest rate structure between 1989 and June 1995 are given in Table 1. Following the liberalization of interest rates in November 1992, there has been a gradual but steady decline in the commercial bank lending rates from over 40% to about 19.5% in June 1995. This decline in the lending rate of over 50% during a 2 1/2 year period may be attributed largely to the decline in inflation and the relative macro-economic stability that has prevailed over the period.

**Table 1: Structure of Interest Rate**

| Category | March 1989 | Jan 1990 | Feb 1991 | Aug 1991 | March 1992 | Nov 1992 | Jan 1993 | June 1993 | Dec 1993 | March 1994 | Jun 1994 | Dec 1994 | March 1995 | June 1995 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank of Uganda | | | | | | | | | | | | | | |
| Way & Means | 15 | 14 | 14 | 14 | 14 | 14 | 14 | 14 | 18 | 22 | 9.27 | 6.86 | 8.05 | 6.27 |
| Rediscount Rate | 48 | 43 | 38 | 40 | 41 | 40 | 40 | 25 | 23 | 23 | 16.50 | 14.00 | 14.00 | 10.39 |
| Bank Rate to CB | 55 | 50 | 44 | 46 | 47 | 41 | 41 | 26 | 24 | 24 | 17.50 | 15.00 | 15.00 | 12.00 |
| Treasury Bills | | | | | | | | | | | | | | |
| 35 Days | 38 | 34 | 29 | 35 | 36 | 36 | - | - | - | - | - | - | - | - |
| 63 Days | 40 | 36 | 30 | 36 | 37 | 37 | - | - | - | - | - | - | - | - |
| 91 Days | 43 | 39 | 31 | 37 | 38 | 38 | 19 | 24 | 18 | 22 | 9.27 | 6.86 | 8.05 | 6.27 |
| Government Stocks | | | | | | | | | | | | | | |
| 5 Years | 45 | 40 | 40 | 40 | 40 | 42 | 42 | 42 | - | - | | - | - | - |
| 10 Years | 47 | 42 | 42 | 42 | 42 | 44 | 44 | 44 | - | - | - | - | - | - |
| 15 Years | 50 | 45 | 45 | 45 | 45 | 47 | 47 | 47 | - | - | - | - | - | - |
| Commercial Banks | | | | | | | | | | | | | | |
| Deposit Rates | | | | | | | | | | | | | | |
| Demand deposits | 20 | 18 | 12 | 13 | 8 | 8 | - | - | - | - | opt | opt | opt | opt |
| Saving deposits | 33 | 30 | 28 | 32 | 33 | 29 | 10 | 15 | 8 | 13 | 4.10 | 2.67 | 2.78 | 2.73 |
| Time deposits (min.) | | | | | | | | | | | | | | |
| 3 - 6 months | 33 | 30 | 29 | 34 | 35 | 32 | 13 | 18 | 11 | 16 | 4.10 | n.a | n.a | n.a. |
| 7 - 12 months | 35 | 32 | 30 | 35 | 36 | 33 | 14 | 19 | 12 | 17 | 7.85 | 7.03 | 7.07 | 7.96 |
| Min. one year | 37 | 33 | 31 | 36 | 37 | 33 | 14 | neg | neg | neg | - | - | - | - |
| Lending Rates | | | | | | | | | | | | | | |
| Agriculture | 25 | 25 | 32 | 37 | 38 | 41 | 22 | 25 | 20 | 25 | 20.49 | 22.25 | 21.71 | 19.53 |
| Export/Manufacture | 25 | 25 | 32 | 37 | 38 | 41 | 22 | 25 | 20 | 25 | 20.49 | 22.25 | 21.71 | 19.53 |
| Commerce/Unsecured | 30 | 30 | 39 | 41 | 42 | 44 | 22 | 25 | 20 | 25 | 20.49 | 22.25 | 21.71 | 19.53 |

**Source:** **Bank of Uganda**

## IV Interest rate issues for Agricultural lending

The interest rate issues for agricultural lending are mainly centered around the following:

(1) High interest rate for agriculture

The argument for high interest rate for agriculture is based on higher transaction costs to banks due to:

(a) Under developed and segmented market arising out of poor communication, small farmers scattered in distant areas and imperfect knowledge of rural borrowers.

(b) Lack of collateral/security as farmers are too poor to have assets that could be collateralized mainly because land markets and property rights in rural areas ar still poorly developed. Consequently the risks associated with rural lending are very high.

(c) Covariance risk due to weather and price risks and as a result default rates are very high.

(2) Lower or preferential interest rate for agriculture

The arguments put forward for lower or preferential interest rate for agriculture are:

(a) Lower interest rates induce farmers to adopt new technologies and invest on the farm to stimulate agricultural growth.

(b) The rate of return to capital in agriculture compared to other sectors is low and hence the interest rate for the agricultural sector should be lower to attract investment.

(c) Most farmers are small farmers whose risk bearing capacity is very low. Unless the interest rate is low they cannot be induced to invest to help make them more productive.

(d) Low interest rate for agriculture helps to fulfil the social objective of equity. Interest rate policy can be used as an instrument to help re-distribute income in favor of agriculture and low income groups of farmers.

(e) Low interest rates are advocated as a means of offsetting adverse terms of trade.

(3) Application and modus operandi for charging of interest for agriculture should be different.

The arguments put forward in this regard are:

(a) Interest rates for agricultural advances should not be compounded and should be charged on annual basis in order to minimize the farmers' costs..

(b) Payment of interest should be synchronized with harvesting/marketing of agricultural produce as farmers do not have any reliable source of income during the intervening production period.

All the above arguments have merits and demerits in economic terms. For example, high interest rate has adverse impact in the following ways:-

(a) Curtails demand for production and investment loans thereby adversely affecting investment in agriculture.

(b) Constrains growth and supply response as farmers think it is costly to adopt new technologies;

(c) Deters farmers from moving into cash economy by inhibiting them from borrowing the resources needed to increase production. It constrains monetization of the agricultural economy;

(d) Increases default rate as the rate of return generated is not adequate to pay interest charged.

On the other hand, low interest rate particularly below the real cost of capital and/or negative real interest rate amounts to subsidization of credit which distorts resource use and can lead to:

(a) Erosion of customer incentive to save in the banking system as it becomes obvious that deposits with the banks will not fetch adequate returns.

(b) Considerable abuse and leakages - subsidized or concessional interest is open to corruption or political abuse and instead of small scale farmers benefiting, large scale farmers benefit most because of their credit worthiness and influence. Thus in most cases the actual beneficiaries are quite different from the target group.

(c) Weakening of the financial system - low cost credit if not subsidized by Government or donors means ultimately loss to financial institutions, resulting in depletion of resources and weakening of financial viability.

There is thus no simple or unique answer to the question of what is an appropriate interest rate for agriculture especially for small scale farmers. However, the following interest rate strategies have been adopted by various countries and they have produced diverse results over the years as discussed below:-

(i) **Administered or fixed rates** - that are not adjusted periodically to inflation resulting having negative interest rates and adverse effects on the financial systems of countries who have adopted this system.

(ii) **Positive rates based on points over and above inflation.** Uganda in the early 1990s adopted 4 points above inflation rate to determine positive rate of interest rate. Even the present policy is based on maintaining positive, but market determined real interest rate.

(iii) **Cost related Interest Rates** - Cost related interest rates are worked out based on real costs of funds and a spread above this cost, say 2 to 3 percent to cover operational cost of administration. This strategy is mostly adopted in the case of project credits.

(iv) **Preferential Interest Rates** - A preferential interest rate is normally lower than the market interest rate by a certain margin pre-set with an intention of promoting investment in the preferred

sector, say agriculture. This strategy may also imply differential interest rates based on cross - subsidy to cover the full intermediation costs. In the past, most of the developing countries adopted this strategy. Although Uganda, prior to liberalization had similar interest rate structure, it was not effective in targeting flow of credit to the real sectors particularly the agricultural sector.

(v) **Market Interest Rates** - The market rates are based on opportunity cost of the money or determined by market forces. In some developing countries including Uganda, it has recently been linked to TB market rates.

In the highly inflationary situation such as was faced by Uganda in the 1980s and early 1990s, it was very difficult to devise an appropriate interest rate policy because of the contradictions inherent in the policy options available at the time. For instance, to encourage savings, interest rates had to be positive in real terms so that the depositors could earn real positive returns on their financial investments. At the same time, the tight money control needed to control inflation also necessitated high real interest rate to curtail demand for credit to match the supply contraction. On the other hand, to encourage growth in the economy, resources had to flow to the real sectors. If the real interest rates were kept highly positive, then given the low return on capital in productive sectors, the interest burden on these sectors would be unreasonable. In such a situation, credits would be increasingly allocated for speculative purposes or would be linked to distress borrowing. This would constrain growth in the real sectors.

During the 1970s and the early 1980s, interest rate was not adjusted to inflation rate and was kept artificially low. Consequently interest rate was negative and the total bank deposit which was 9 to 12 percent of the GDP dropped to about 3-4% in the 1980s and time deposits declined to 28-35 percent of the total deposits. It is only in recent years when inflation was stabilized and interest rate was reduced, that the time deposit ratio has improved significantly. There is also no evidence to show that in Uganda the share of currency in circulation declined with the introduction of positive real interest rate policy in the 1990s. Thus, in the Ugandan context the high positive interest rate policy has not contributed to increase in deposit mobilization and contraction of money supply. Similar observations have been made in other countries such as Argentina and Brazil where high inflation prevailed and the high interest rate policy has not contributed to control of inflation and increase in savings. Moreover, it appears that once the high nominal interest rate policy is adopted the commercial banks usually resist subsequent reductions in interest rate when inflation is brought down to desirable levels. This is evidently what is happening in Uganda at present.

The fundamental issue in the interest rate policy in Uganda should, therefore not be centered around the present policy of positive interest rate for deposits only, but also on the current high interest rate for lending to productive sectors, particularly agriculture, which in turn is due to the high interest spread resulting from inefficient transaction costs.

Table 2 contains interest rates for deposit and agricultural lending and interest rate margins between 1981 and September 1994.

**Table 2: Nominal Interest Margins (1981 - 1994 Sept)**

| Year | Saving Deposit Rate | Weighted Average Deposit Rate | Agricultural Lending Rate | Interest Rate Margins | |
|---|---|---|---|---|---|
| | | | | 4-2 | 4-3 |
| 1 | 2 | 3 | 4 | 5 | 6 |
| 1981 | 8 | 2 | 13 | 5 | 11 |
| 1985 | 18 | 4 | 24 | 6 | 20 |
| 1986 | 28 | 15 | 38 | 10 | 23 |
| 1987 | 18 | 9 | 25 | 7 | 16 |
| 1988 | 28 | 17 | 35 | 7 | 18 |
| 1989 | 33 | 23 | 40 | 7 | 17 |
| 1990 | 30 | 21 | 36 | 6 | 15 |
| 1991 | 32 | 18 | 37 | 5 | 19 |
| 1992 | 25 | 13 | 37 | 12 | 24 |
| 1993 | 8 | 3 | 33 | 25 | 30 |
| 1994(Sept) | 3 | 6 | 18 | 16 | 15 |

Note: Weighted average deposit rate is based on deposit composition
Deposit rate varies from bank to bank from 3 to 12 percent.

**Source: Bank of Uganda.**

Since liberalization and freeing of interest rates in 1992, large interest rate margins have emerged in spite of significant reductions in inflation. The spread between the saving deposit rate and lending rate for agricultural advances has been up to 30 percent. The difference between the average deposit rate and agricultural lending rate is thus very wide and Uganda has one of the widest interest rate margins in the world. Banks in developed countries usually register spreads of 2 to 3 percent. Most of the developing countries record spreads between 7 and 13 percent and Uganda is among the few with over 15 percent interest margin.

In spite of this, the agricultural sector receives very little credit from the banking sector. Since the banks are now free to determine the interest rates for other advances they have no incentive to lend to the agricultural sector. The interest rate profiles of the individual banks even do not mention interest rate for agricultural credit.

In the Ugandan context, it is also important to take into consideration interest rate as a cost which has bearing on profitability of new technologies and viability of various agricultural enterprises. In appendix 1 an analysis is made on the impact of different interest rate scenarios on the farmers' income and the results of this analysis are summarized in Table 3. This analysis shows that at current levels of low input usage, interest charges constitute only a small proportion of total production costs so that even at 30% interest rate, there is no significant impact on the profitability of most crops.

As regards the argument of high transaction costs for agricultural lending, other country experiences show that some of the problems of agricultural credit such as lack of collateral, imperfect knowledge, high loan delinquency etc. can be overcome through group lending, linking informal agencies with formal agencies, improved technical back-up services from the Government and other innovative instruments for rural financial intermediation. With an appropriate credit delivery mechanism there is good scope for minimizing the transaction costs for agricultural loans. A study by the Agricultural Secretariat in 1994 shows that some of the primary cooperative societies have

successfully operated agricultural credit programs under the Cooperative Credit Scheme (CCS) while receiving only 3 percent interest margin.

**Table 3: Impact of Interest Rates on Farm Income (shillings per Hectare)**

| Crop | Non - Borrower | | Borrower | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Gross Margins (GM) | Returns to family Labour RFL | 12% pa | | 18% pa | | 30 % pa | |
| | | | GM | RFL | GM | RFL | GM | RFL |
| Robusta Coffee | 536,073 | 4,358 | 2,283,666 | 19,353 | 2,270,210 | 19,239 | 2,243,298 | 19,011 |
| Arabica Coffee | 726,026 | 5,418 | 1,576,032 | 11,421 | 1,566,112 | 11,349 | 1,546,272 | 11,205 |
| Tea | 145,121 | 768 | 363,023 | 1,745 | 352,312 | 1,694 | 330,892 | 1,591 |
| Cotton - Hoe | 40,907 | 333 | – | – | – | – | – | – |
| Cotton - Oxen | – | – | 100,731 | 1,449 | 95,615 | 1,347 | 85,383 | 1,203 |
| Cotton - Tractor | – | – | 147,489 | 1,799 | 140,377 | 1,712 | 126,153 | 1,538 |
| Maize | 31,070 | 222 | 103,350 | 1,694 | 94,176 | 1,544 | 75,828 | 1,243 |
| Beans | 69,255 | 533 | 201,438 | 2,962 | 191,338 | 2,814 | 171,138 | 2,517 |
| Simsim | 96,352 | 853 | 48,817 | 751 | 39,949 | 615 | 22,211 | 342 |
| Groundnut | 93,927 | 626 | 155,226 | 1,826 | 140,554 | 1,654 | 111,210 | 1,308 |

Note: All figures are based on 1994 prices.
**Source: Agricultural Secretariat.**

In regard to the application of interest rate, it is the universal banking practice to apply interest rate on deposits on half yearly basis and for loans on quarterly basis. In the case of agricultural loans, most of the developing countries, however, adopt the policy of compounding interest on half yearly basis. There is no justification for charging simple interest rate (on annual basis) as it is contrary to the normal banking business practice. The banks pay interest rate on half-yearly basis for the resources given to them by depositors. Hence they cannot accept simple interest for loaning their funds. This will result in loss and will adversely affect the viability of financial institutions. Since the long term objective is to develop sustainable viable rural financial markets, any deviation from the usual banking practice may not serve the purpose and hence should not be accepted.

Even in the case of donor funds, there is no justification for adopting a practice which is contrary to the banking norms as the objective should be to develop sound banking practices in rural areas.

As regards the time and mode of payment of interest, the mode of agricultural production and nature of cash flows should be looked into in determining the terms of payment for interest. Since most of the crops and enterprises are within the half-year production cycle, the interest could be made payable on half yearly basis instead of quarterly.

## VI Recommended interest rate policy framework for Agricultural lending

FSAP has rightly emphasized the gradual and phased manner of liberalization of interest rate regime in Uganda. It has also emphasized the need to strengthen the capability of the BOU Research and Supervision Departments to regularly review interest rate structures to ensure that the spread between deposit and lending rates does not act as disincentive to effective financial intermediation for achieving the medium and long term development objectives. The BOU is also expected to manage the interest rate through indirect monetary instruments.

Within the above policy framework, the regulatory function of the BOU should take into consideration the following:

(a) With the high demand for loans, low saving rate, market determined interest rates will continue to remain very high. With discontinuation of mandatory minimum rates for time deposits, rates have fallen in the case of some banks to as low as 3 percent which is below the present inflation rate. The present high interest spread acts as a disincentive for lending to the real sector whose rate of return in the present stage of economy is very low due to distortions in costs. Consequently, the present high interest rate stifles investment in the agricultural sector.

(b) The only way the agricultural sector receives credit is through targeted credit program funded from external sources. With liberalization, the banks are now free to determine their own interest rates for advances and thus have a crowding out effect or rationing effect on real sector lending. More than 70 percent of the banks credit resources are now allocated to the trading sector. The only way the agricultural sector receives credit is through targeted credit programs from external sources.

Under the present market based regime of interest rate policy, it is clear that the importance of real sectors and need for flow of adequate credit to these sectors for growth and supply response are not well catered for and hence the real sectors are discriminated against. Thus the cardinal crucial objective of the financial system to allocate resources to maximize growth is probably being compromised.

It is therefore recommended that all efforts should be made to encourage commercial banks to participate in agricultural lending. The recommendation of the Rapid Appraisal of Rural Finance Study commissioned by Government in 1994 is that since at present direct intermediation by commercial banks at the grassroots level would not be viable and sustainable, the banks may operate through Rural Financial Intermediaries (RFIs)e.g. primary co-operative societies, farmer groups, Non-Governmental Organizations (NGOs), ginneries, etc. who have comparative advantage for financial intermediation in rural areas. The study further recommended a capacity building program for RFIs to make them attractive to commercial banks as the media for financial intermediation in rural areas. It is envisaged that the operation through RFIs would not only reduce the intermediation costs for the commercial banks, but would also act as an instrument for bringing down interest rates for agricultural lending particularly if adequate competition could be generated through encouraging participation of many commercial banks in rural lending. To increase the stock of loanable funds, of the commercial banks, the study also recommended that donor funds available for agricultural lending be channelled by the Development Finance Department (DFD) in Bank of Uganda for on-lending on favorable terms to commercial banks participating in agricultural lending in rural areas. Further, in order to make it attractive for commercial banks to participate in agricultural lending the study also recommended the establishment of a private sector based Credit Guarantee company to be run on insurance principles and to provide insurance cover for commercial banks participating in agricultural lending. The above recommendations have already been accepted by Government and are currently being tried with funds available for agricultural lending under the Cotton sub-sector Development Project (CSDP) as well as Livestock Services Project (LSP). It is anticipated that these programs will provide the basis for medium and long term interest rate policy for agricultural lending.

Based on experiences of the banking industry in Uganda and other countries, the following should also be considered as integral parts of the interest rate policy.

(a) Interest rate for agricultural advances should be applied on half-yearly basis and not on quarterly basis and payment of interest should synchronize with harvesting/marketing of crop produce or livestock products.

(b) Interest rate should be applied not on the loan amount sanctioned from the date of sanction but on the amount disbursed and outstanding and effective date as and when disbursed.

(c) Banks should be allowed to charge:

- Service charges not exceeding 1 percent of the loan amount sanctioned once and for all and it should not be linked to interest rate.

- Penalty rate of 2 percent on defaulted amount which could be linked to interest rate. Wherever repayment is deferred or rescheduled for drought, natural calamities or situations beyond control of the borrower, penalty rate should not be levied.

# Making the poor less impoverished through credit finance: A case of the Uganda Commercial Bank's Rural Farmers' Scheme (RFS)

*Luggya-Sempebwa*
*UCB Research Division*

## I Background

Uganda Commercial Bank in establishing the Rural Farmers Scheme was aware of the existence of a big portion of the population that was poor yet could not be availed credit through the normal banking avenues. It knew that these people's operative units are very small with production dependent on vagaries of seasons and often their produce is of perishable nature which makes storage almost impossible.

It was also aware that their contacts with markets for raw materials and for output were limited which reduced their bargaining power considerably. Furthermore, it was aware that this body of rural producers harbours the largest number of poor households with few assets to talk of, with labour of its members being the main productive asset. Food and cash received is hardly sufficient even in good times. Their access to new information for example, a new process, inputs and market preference is very limited.

Because of these reasons many credit institutions found dealing with such people administratively cumbersome, less remunerative and more risky. Yet if a more equal distribution of income is indeed a development objective to be pursued, the rural strategies have to specifically be designed to implement this and giving the rural people credit is definitely one of them.

It is with this background that UCB established RFS with the intention of providing credit, increase production and productivity, enhance incomes, savings and assets and generally improve the living standards of the rural people.

## II Objectives of Rural Farmers' Scheme

Rural Farmers' Scheme was started by UCB in 1987 and aimed at assisting small rural farmers engaged in growing various annual crops, rehabilitation of perennial crops and keeping livestock such as poultry, piggery, cattle, and fishing.

## III Nature and Operations of Rural Farmers Scheme

The scheme was designed to finance 28 different enterprises involved in agricultural production, for example, production of crop, vegetables, oils traditional export crops, poultry, livestock, fishing etc. Out of 61 UCB branches that existed in 1987, 25 branches spread all over the country participated in this scheme initially. By 1992 the participating branches had increased to 52 branches.

## IV Scheme Organization and Administration

RFS was to be managed through UCB branch network. For purposes of planning, design and implementation a Task force consisting of twelve senior staff under the chairmanship of the UCB Chairman/Managing Director was established.

Specialised officers were attached at branch level while the technical supervision and implementation was the responsibility of the credit analysts based at the regional offices.

At Head Office there was the Chief Co-ordinator and a deputy Chief Co-ordinator with staff to handle the overall co-ordination, control, supervision and monitoring of the scheme.

## V Scheme Method

### 1 Participants selection criteria

All farmers whose enterprises were falling under the defined target groups were eligible provided they fulfilled the following criteria:-

(a) be a full-time farmer.
(b) be a recognised resident in the area.
(c) be a regular tax payer or show unquestionable evidence of exemption from tax (e.g married women).
(d) be a holder of land under any locally recognised tenure system or show evidence of availability for renting or borrowing of such land.
(e) hold or have access to basic infrastructure e.g housing.

However, priority was to be given to farmers with past experience in a particular enterprise. Women farmers and women groups were also given precedence over male farmers.

### 2 Sources of Scheme Funds

The initial funding of the scheme of Shs. 6 billion was to be out of bank funds. At a later stage, donors and government injected in more funds. By 1995 the scheme had received over Shs. 1 billion from government and over Shs. 18 billion from donors.

### 3 Interest Rates Charge

Interest rates charged were lower than the market rates by specified percentages depending on whether collaterals were offered or not.

### 4 Insurance

A commercial fee of 1% of the total loan was charged once at disbursement.

## VI Assessment of the Scheme

### 1 Success of the Scheme

Quite a number of successes were registered under the scheme. These included the following:

(a) Participation in the scheme meant direct access to loanable funds by the farmers enabling them to increase production output from land and labour resources. It also meant widening the scope and horizon of operation which led to increased productivity and yields hence increased

incomes. Credit provided also allowed for the purchase of additional land, animals and other assets. These assets provided not only higher incomes but also by-products and other services.

(b) The farmer was introduced to banking which helped him to learn about financial matters. Many farmers were exposed to bookkeeping and records-keeping which enlightened their knowledge and assisted them to perform better.

(c) There was easy access to technical assistance since the technical staff were dealing directly with the farmer. The farmers were at will to get into contact with the officers who were always available at the branches. The officers also made it a point to visit the farmers regularly.

(d) Many farmers' groups were formed which were observed to be of higher managerial capabilities than individuals especially when it came to following up borrowers.

(e) There was increased monetization of the rural areas as more and more farmers produced for the market rather than for subsistence. Many farmers acquired assets from the sales of their produce.

(f) There was increased food security in almost all areas where the scheme served. The country was able to supply food items to neighbouring countries which were suffering from food shortage due to draught and wars.

(g) There were numerous linkages associated with increased agricultural production which accrued to the rural areas. Many artisans set up businesses as a result of increased income in the rural areas.

(h) The economy as a whole benefited from the increased production which contributed significantly to the high GDP growth experienced since 1987.

**2 Failure of the Scheme**

While there were successes of the scheme as mentioned above, there were failures that hindered the successes to take precedence. These included the following:-

**(a) The rural nature of the scheme**

Rural is often erroneously perceived as synonymous with agriculture. Rural Farmers' Scheme was no exception. The scheme considered people in the rural areas only and the emphasis was mainly on agricultural production which is a highly risky sector. This meant that viable micro enterprises in urban areas and rural areas which were not directly dealing in agricultural production were not financed.

It was also to be a pilot project covering a few districts and a specified number of categories of project for a period of three years after which period a study was to be carried to judge its successes and limitations.

This study was however never done and the scheme was expanded to cover the entire country. This meant that the resources that had been earmarked to manage the pilot scheme were overstressed leading to loopholes, inefficiencies and failures in implementation, monitoring and eventually recoveries.

Lending was mainly for agricultural production which definitely led to increased production of almost all the crops and other activities financed but this increased production was not matched with enhanced capacity of the related sectors such as storage, transportation and most importantly marketing which caused many farmers' produce to remain unsold and in most cases got spoilt or sold at a very low market price which could not enable them to pay back the money they had borrowed.

(b) **High Operational Costs**

The operational costs of the scheme were very high due to the vast area coverage of a radius of 50 km from the participating branches. This was compounded by the varied nature of enterprises financed. Different crops had different planting and harvesting period. This meant that monitoring became very difficult to be made effectively leading to many farmers to perform badly.

(c) **Disbursements in kind**

Disbursing inputs in kind did not work out well as some inputs were procured at higher costs than on-going market prices and others were procured very late leading to dislocation in implementation of the projects and hence non-payment of the loans.

(d) **Character Loans**

RFS loans were mainly character loans that required proper scrutiny of borrowers to know their character which capacity RFS did not have resulting in some dubious characters getting loans that they did not pay back.

(e) **Low productivity and low quality**

The participants in the scheme were mainly the smallest farmers whose production and productivity levels were very low which resulted in producing at very high costs and low quality products which cold not fetch much from the market.

This implied that when such production is financed the cost of production will most likely end up exceeding the selling price hence losses on such investment.

(f) **Repayment Criteria**

Repayment of principal and interest was to be in one or several installments. Where total repayment was expected from more than one harvest the repayment regime would be based on the front loading on the first harvest i.e. the large portion of the outstanding loan would be covered then. Where marketing is institutionalized, funds were to be recovered directly from the participants accounts. For those with daily sales, daily bankings were expected.

These recovery efforts were to be backed up by a vigorous supervision and monitoring of enterprises and marketing of produce which was unfortunately not done mainly due to lack of logistics and trained personnel.

### (g) Attitude of the peasants on funds from government

Many peasants in receiving RFS funds were of the view that this was free money from government which they were not obliged to pay back. They thought it was payment in return for what they lost during the reigns of previous regimes. Some were even of the opinion that since these were government funds, government should use its money it collects from taxes to pay off these loans.

Such attitudes could not make conditions favourable for the scheme to succeed as had been anticipated.

## VII What lessons to be learnt from RFS

Rural Farmers' Scheme has shown that it is possible and desirable to improve the welfare of the rural poor through the provision of credit either directly injected in selected enterprises or injected in the form of infrastructure. There is evidence that many farmers who received credit from the Rural Farmers Scheme actually improved in their production methods, yields both in quantity and quality. This also had a trickling effect even to those who did not receive assistance from the scheme but got the knowledge, skills and information from their colleagues who had received the funds.

All in all the farmers did benefit from both the funds and technical knowledge provided by RFS.

However, financing the rural sector should be done in form of a package with linkages to and from the sector. That is to say, if it is agricultural production that is being targeted other related aspects such as storage, transport, inputs, markets etc have to be considered and where loopholes are found solutions must be sought.

Financing should be done to any enterprise that is viable. People in urban areas should also be considered. The viability of the project to be financed should be of utmost importance. The would -be beneficiaries should also be educated as to how to choose projects that are viable.

When a farmer is introduced to banking, that farmer is able to appreciate the need to do costing and book keeping in the business. It helps that farmer to engage in those activities that are economically viable and this greatly helps in repayment of borrowed funds.

Lending to the rural area is very risky and costly which means that carefully selected participants should be considered and they should be closely supervised. If possible, a pilot scheme should have been carried out first to identify the likely problems and bottlenecks.

A comprehensive insurance scheme favourably backed by government has to be put in place to cover the likely losses.

It is true that most rural people lack collaterals and even those who have them can rarely use them which imply that it is very essential to critically scrutinize the intending borrowers at the onset.

It was observed that lending in kind is not per se more effective than giving out cash. What is most important is monitoring the financed projects to make sure that the loans are paid back.

Uganda need to build a culture of paying back their loans without necessarily being pressurised. The legal framework should also be strengthened to enable following up of defaulters easier.

## VIII Concluding remarks

Making the poor less impoverished through credit finance is possible and desirable especially when it is done systematically to ensure that those who receive the finance apply it to productive enterprises. They also have to be monitored very closely to ensure that the funds injected are recovered. The question which needs examination is whether institutional credit agencies can provide sufficient and efficient rural outlets to meet the various credit need of the rural poor.

It is a fact that the poor people shall continue needing assistance if they are to break away from the vicious cycle of poverty. Therefore, educating them on how best to use credit and giving them technical assistance is inevitable. Effectiveness of a credit system is at best when it is perfectly synchronized with the rest of development activities. Ensuring accessibility by designing programmes to suit local conditions giving appropriate criteria for the selection of beneficiaries, introducing flexibility in terms of lending should form part of the system.

With careful handling of any credit or other forms of finance availed to the poor, their living conditions can definitely be improved.

# *Notes for Contribution*

**Aims and Scope**

The Economic Policy Research Bulletin is intended as a means of communication between researchers and officials involved in the process of economic policy management. It is especially interested in the interface between economic policy analysis and the institutional process through which policy is formulated and implemented.

It is expected that issues and questions that emerge for further research by economists, public administration specialists, sociologists, political scientists and others, will stimulate a more informed and productive relationship between policy administrators and researchers.

To achieve this aim, it is intended to select one topic or theme for each issue of the Bulletin. Contributors will be requested to draw the attention of those from different occupations and disciplines than their own, to aspect of the topic which are important from an institutional or, more generally, from economic policy management standpoint. The hope is that this format will generate a creative and interactive relationship which will advance the practice and study of economic policy formulation and analysis.

**Length and Style**

Contributions to the Bulletin are expected to be no longer than 15 typed pages. Contributors should aim to isolate for description, conceptualisation and analysis particular aspects of the policy issue under review in each issue of the Bulletin. All contextual material should be strictly eliminated unless essential for focussing the attention of readers on the primary points that are being made.

Contributors should have in mind that in most instances the editor will wish to present two or more statements which by giving differing perceptions highlight the nature of the conflicting judgements and facilitate the identification of the institutional issues involved. Thus a somewhat didactic and controversial style rather than a fully balanced and consensual presentation will often be desirable.

**Editorial Role and Responsibility**

The decision to accept for publication either volunteered or requested contributions may be acceptable with minor or major changes in content and/or style. It may be that an iterative process between contributor and editor will be required in order to reach an agreed text.

Moreover, because it is intended that the Bulletin should contribute substantively to the intellectual discussion of policy management issues, it might be necessary on some issues to request contributors to meet jointly as a study-group with the editor to determine the precise content and form of publication. Expenses incurred in attending such meetings will be catered for.

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**Address for Contributions**

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**The Editor-in-Chief,**
**Economic Policy Research Bulletin,**
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