

The Impact of Low Interest Rate Policies on Rural Economy in Developing Countries

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INTRODUCTION

An increasing concern about the low interest rate policies in most developing countries has made the development of rural economy a much debated issue in the recent past. Aside from confronting with acute economic problems, the development of rural economy has been questioned, the growth of income per capita has been arrested, investments are being postponed and efforts to reduce poverty have been interrupted. Small farmers constitute large numbers of the rural population, so they are an important group which must be included in any agricultural development effort (Tinnermeier & Finn 1975). It requires a broad participation of the low income people in the developmental process, so they can increase their income levels and the productivities of resources. Since land is fixed, and labour is in excess supply, there is a need for rural institutions to mobilise the factors of production to bring about economic efficiencies.

Most developing countries adopted the low interest rate policies in order to help the poor, particularly, the bottom 40 percent of the population. There is however, an increasing evidence suggesting that many developing countries have failed to attain this goal and none of the expected results has occurred. The objective of this paper is to investigate economic policies that are formulated and implemented by governments of the third world countries, and what the impact of these policies have on the participation of farmers in agricultural production, farm employment, distribution of land, demand for consumer goods and capital formation.

LOW INTEREST RATE POLICIES

Low interest rates that would stimulate investment was first argued by Keynes (1936) to justify the use of subsidised credit. Keynes dealt with an economy during the depression years with stable or even deflated prices. Most developing countries today face significant high inflation rates. The

policy of low interest rates will lead to an excess demand for credit and will create a lot of problems.

The use of concessional interest rates as an income transfer mechanism to facilitate the attainment of the welfare goal has been counter productive. In Malaysia, for example, low interest rate policies provided encouragement to credit institutions to select applicants with large operational land holdings (Well 1978). In India (Giri & Sain 1971), the interest charged on agricultural credit was substantially below the interest rates for non-institutional farm credit markets. These low real interest rates typically generate an excess demand for loans and force lenders to ration their lending capacity. Gross interest rates charged by moneylenders are composed to such elements as pure rate of interest or opportunity cost of loan, administration, premium of risk and monopoly profit (Giri & Sain 1971). One of the main criteria used to determine eligibility for loan by moneylenders is creditworthiness or the amount of collateral a prospective borrower can muster.

Free market interest rates are often substantially above the relatively low interest rates prevailing in most credit programmes in agriculture (Eckaus 1973). It means that the rate of interest does not come near market rates or shadow prices of capital. The rate of interest charged on agricultural credit is lower than the prevailing commercial bank rates. This low rate of interest implies a subsidy. A more fundamental view in which rates of interest charged are low is that they do not equate the demand and the supply of institutional funds. It is normally below the equilibrium level. Another view in which the rates charged are low is that they do not cover the costs of delivering credit to small farmers (Gonzales 1973). In short, the objective of the low interest rates is to help the small farms to increase their income level. The argument that low interest rate policies are needed to effect transfers of income and resources to a badly neglected agricultural sector may be viable in the short run if one is considering investment in the form of needed appropriate research. Beyond this, however, growth in the agricultural sector cannot in the long run occur at the detriment of other sectors that have a greater potential for employment and growth.

The results of holding interest rates inordinantly low are truly depressing. It has been found that farmer's investment policies have been distorted. They often shift to great reliance on capital intensive methods, long before they have the managerial skills to benefit from such technology. This shift also displaces labour in areas where labour is already abundant, and most of the times the workers are not fully employed, exacerbating rural unemployment problems.

Low interest rates will raise few funds for lending institutions. So, they are unable to pay an adequate return to depositors. This will retard the generation of local savings and also prevents private financial markets

from developing normally. In general, this lack of private markets continues to retard the development to the economy.

LOW INTEREST RATES AND PARTICIPATION OF FARMERS

Miller found that low interest rates attract the majority of large, low-cost and low-risk customers to credit agencies. This idea is further supported by Gonzales (1973) who stated that subsidised credit is captured by the larger farmers. The lower the interest rates charged on loans, the lower the proportion of the lender's portfolio that will be devoted to small farmers. Therefore, agricultural credit tends to flow in favour of the larger farmer and the small farmers continue to be handicapped in obtaining credit from institutional credit.

Ames and Brown (1973) used an example in India and found that the credit agencies have covered only 33 percent of small farmers. The benefits of agricultural credit flow to big farmers. The participation of small versus large farmers in the agriculture credit program is analyzed with the help of a number of field studies conducted by the Agro Economic Research centre in selected districts of South India between the years 1966-67 and 1968-69 (Table 1).

TABLE 1. The participation of the farmers (%)

District	Less than 5 Acres	5 Acres and Above
1. West Godavari, Khariff, 1967	19	81
2. West Godavari, Rabi, 1967 - 68	16	84
3. Khrishm Kharif, 1966	8	92
4. Chingleput, Kharif, 1968	23	77
5. Erononkerling, Kharif, 1966	50	50

Source: The Agro Economic Research Centre, 1971.

Thus, those data in the table suggest that agricultural credit is unevenly distributed. The large farmers are favoured. It has been shown that the small farmer is at a disadvantage as far as the financial resources are

concerned. Not only his own resources are not sufficient to meet the increase cash needs arising from the cultivation of new crop varieties, but also he does not have ready and easy access to credit institutions. Another problem, is that the farmer often faces considerable risk and uncertainty when borrowing money to finance new technology. Yield and price variability can cause large fluctuations in farm incomes from year to year and a farmer must be able to absorb those fluctuations if he adopts the technology. In addition, the farmer faces other uncertainties such as, being sure of external financing after a crop failure. All of those factors discussed above can affect the participation of small farmers in the development process.

Another factor that can affect the participation of small farmers are risk and uncertainty. Small farmers are more risk averse, and since new technology increases risk, these farmers tend to use less or to reject the use of that input. If small farmers face higher levels of uncertainty (because of limited access to sources of information or because of inability to secure risk reducing infrastructure such as irrigation) they will plant less of the modern crop. Mellor (1976) argued that one of the reasons why the farmer rejects the new varieties is that the cash expenditure is so much larger on the High Yielding Variety (HYV) types and the farmer's exposure to risk is greater if he borrows money. Therefore, the inability of the small farmer to get access to agricultural credit and to manage risk and uncertainty serves, in any situations, further widens the income disparities between small and large farmers. A similar concentration of formal loans in the hands of relatively few larger farmers has taken place in Brazil (Adams & Tommy 1974). In order to minimise the risk and uncertainty, the existence of small farmer credit programme can come into play. In this case, the small farmer credit programme can look at the certain target group. Wells (1978) found that the relative weighting attached to productivity of welfare goals has important implications for the selection of the target group.

It can be argued that the criteria employed in selecting the target group exercises a major bearing on the likely level of goal attainment. The assumption is, that heavier the weighting assigned to the productivity goal the more likely it is that the target group will be selected from the category of the larger-small farms. However, in the programmes in which the welfare goal is paramount the target groups would tend to be identified from among smaller farms. Wells further clarifies that the identification of target groups for small farmer credit programmes require the delineation of small farmers into categories and category populations, location and other attributes as presented in Table 2.

Based on the classification in Table 2, category A and category D small farms are not suitable for incorporation into small farm credit programmes because they are not viable borrowers. For these categories of small farms,

TABLE 2. Small-farm categories

Category	Commercial Viability	Intensity of Purchased Inputs	Labour Intensity	Subsidy
A	Commercially	Intensive	very Intensive	Subsidy not required
B	Potentially commercially viable	Moderate	Intensive	Subsidy not required
C	Potentially commercially viable	Extensive	Moderate	Temporary subsidy required
D	not commercially	Minimal	Extensive viable	Permanant subsidy required

Source: R.J.G. Wells, 'Some Reflections on Selection of Target Groups in Small-Farmer Credit Programmes,' *United Malayan Banking Corporation Economic Review*. Vol. XVII. No. 1. 1981. p. 40.

the solution lies not in providing formal credit but rather in providing off-farm employment opportunities to enable their income to be raised. The two categories that have been left for small farm credit programmes are B and C. If higher priority is accorded to the equity goal then we may presuppose that the target group will be selected from the lower end.

LOW INTEREST RATES AND FARM EMPLOYMENT

The existence of labour surplus in most developing countries is a dominant factor of production, and the effective use of labour is a key element in any programme to increase input and incomes among small farmers.

Since agriculture is the dominant sector in most developing countries, the agricultural sector is a crucial source of wage goods – the goods purchased with wages. It provides much of the increase in employment directly through the stimulus of increased income to the cultivator class and the demand effects of the consequent expenditure. Accelerated growth of agriculture may be an important condition for a high employment policy, but a high employment policy is an important condition for continued growth rates in the agricultural sector (Mellor 1976).

Generally, small farms are significantly more labour intensive than large farms in the sense of employing greater mounts of labour per hectare for each field operation (Berry 1973). The low interest rates policies tend to reduce the demand for labour and the participation of poor people in the development process. The large farmers tend to use labour-saving technology. The use of labour-saving technology tends to maintain a high rate of return to capital and thus leads to a decrease of the wage rate. With this decrease in the marginal product of labour relative to that of capital, the income of workers decreases relative to that of capitalist, and the personal income distribution worsens (Berry & Urrutia 1976).

The distribution of credit between small and large farms may also affect the distribution of income between small farmers and landless workers. A policy of redirecting credit to smaller farms hires less labour per dollar of credit than do larger farmers. In this case, farmers with greater training and wealth can afford the time and other costs involved in applying for a loan. Further he will be willing to borrow larger amounts because his costs are cut considerably by the low rates. As he benefits from getting credit (from low interest rates), his operation increases and he continues to gain greater income. The small farmer gets no credit and thereby remains stagnant in his production.

If the small farmers were able to get credit, it has been found that their incomes would increase faster than would the incomes of larger farmers using the same inputs. This is because the marginal return to variable inputs for the small producer is much greater in the early stages of production than for the larger producers. With funds to purchase such inputs, both small farm incomes and production would increase. This can only occur, however, if credit is available.

If interest rates were allowed to rise, large borrowers would borrow less: interest costs would be considerable for large producers. Small farmers, because they would borrow small amounts, have been found to be incentive interest rate. The funds not borrowed by large producers would be available to the small producers. As has already been stated, incomes would then be likely to rise for small producers. So, the goals of the low interest rates policies, then, can only be reached by allowing realistic rate of interest to be charged. Other advantages would be the mobilization of savings and the development of efficient financial markets. It is access to credit, not the cost of credit that has been the limiting factor in financing the agricultural development.

LOW INTEREST RATES AND DISTRIBUTION OF LAND

Land is one of the major means of production in most developing countries, especially in the rural economy. A highly skewed ownership of

agricultural land is one of the main features in an agricultured developing economy. So, one can argue that (beside from insufficient data) the most important reasons for unequal distribution of land is the low interest rates policies of agricultural credit programmes. Little or inadequate landholdings for the rural people further contributes to their poverty. There are a number of options to overcome this problem. One can ask, is there enough land to be redistributed among the rural people so that everybody will have an opportunity to work on his own land? The answer will depend on the availability of technology, credit (interest rates policies), inputs and social and economic policies that have been adopted.

In examining the factors which are said to have brought about some changes in the distribution of land, Dahiya (1976) pointed out that the main reason for some shifts of land in a few hands at the top is more in the purchase of land. The observations are not surprising at all when realising that agricultural credit as distributed tends to favour the large farmers. Since large farmers can easily get access to credit and agriculture has suddenly become a highly profitable business, the landlords have bought the land of their neighbours and started cultivation on a large scale. It is further supported by Lakshman and Kanthi (1973) who stated that with commercialization of agriculture and with respect for securing easy, cheap and subsidized credit, technical and other services facilities, the bigger and more prosperous farmers have resorted to buying the land of small or marginal farmers. This will further lead to the inequality in income distribution due to a high concentration in the ownership of land.

LOW INTEREST RATES AND DEMAND FOR GOODS AND SERVICES

A substantial increase in incomes of the poor necessarily increases the demand for food. Within the usual economics and political context, necessary increases in food supply can only occur through technological innovation which normally distributes the initial benefit largely to the already more prosperous rural people. This initial increase in rural income sets in motion a sequence of multiplier effects which can stimulate production and employment in other sectors of the economy. In line with it, the technological change in agriculture is a necessary condition for the success of all other programmes for the poor (Mellor 1976). The solution to the problem of rural poverty depends upon the spread of yield-increasing technological innovation that may markedly boost the income of the landowning classes. The increased food supplies, are essential to the improved welfare of the poor.

The adoption of new technologies by farmers, in most developing countries, may not be uniform among them, depending on their economic status, availability of resources, education and the likes. The purchase of new technology requires a cash outlay and can only be provided by farmers own savings and by obtaining credit. Cutie (1976) elaborated this situation further by viewing that the existence of credit constraint may be one of the explanations to the fact that many larger farmers are observed to apply more fertilizers per acre than smaller farmers. In India, Lele (1974) found that the large farmers tend to control the agricultural credit agency and this policy tends to increase loan delinquency. As a result, the rationing of agricultural credit takes place.

LOW INTEREST RATES AND CAPITAL FORMATION

The repercussion of the vicious circle of poverty which exists in some developing countries, makes capital formation a very crucial problem especially in the rural economy, despite continuous efforts taken by the government to encourage savings and investments. It is often claimed that the government distorts resource allocation through their operations in this field, since they bring about changes in the level and structure of interest rates. According to neo-classical theory, the supply of capital is a monotonic rising function of the interest rate, since the propensity to save is assumed to rise with the rate of interest. Therefore, the rate of interest plays an important role in the growth of saving. It is further supported by Sing and Gugnani (1975) who stated that the growth of savings is crucial for both capital formation and the rate of economic growth.

Concessional interest rate policy is almost always applied to most developing countries because farmers are assumed to be very poor and the marginal propensity to save is very low (Adams 1971). This policy is supported by Owen (1972) who agreed with the assumption that the poor do not save because they spend their money first on consumer goods and services. On the false assumption that the poor cannot save, most government in low income countries have failed to organise a system of capital formation in which the poor can participate. This is supported by the empirical evidence which indicates that the low nominal interest rates combined with high rates of inflation not only erodes the real value of credit portfolios but also provide little incentive for people to institutionalise savings. As a results, the lending agencies have to ration agricultural credit programmes and the capital formations do not take place.

The pattern of borrowing and lending rates, the structure of lending and the terms of credit, all tend to disfavour the small lenders and to favour the large lenders. This is happening in many developing countries. Hence,

financial accumulation seems to be biased in a manner, favourable to upper income groups, resulting in a concentration of financial wealth. In addition, the low interest rates will decrease average savings and rate of return to capital. As a result, unemployment rate and inequality of income distribution will increase. Reynolds & Jaime (1976) contrasted the idea that if credit facilities and financial assets were made available to low income people in more accessible manner and with attractive yields, the net effect might well be to increase the net financial savings of those people while simultaneously increasing their share of financial wealth.

SUMMARY AND SOME CONCLUDING REMARKS

The low interest rates policies do not induce people in rural economy to save their money in the institutional agencies. It is not surprising, therefore, that loanable funds to agriculture in rural economies in real terms have declined despite government credit quotas and special credit programmes. Even higher interest rate subsidies will be ineffective in offsetting penalties from pricing policies because of the fungibility of credit. Cheap credit will not make an unprofitable activity to be profitable. As a result, the investment rate and the productivity in agriculture are very low because an increase in productivity requires more capital outlays.

Agriculture production does not increase and does not make a significant net contribution to capital formation in the expanding sectors. Therefore, in developing countries, the transition from a level of saving and investment that spells stagnation to one permitting a tolerable rate of economic growth can not be achieved. The low productivity in small farmers' subsector and failure to tap surplus of large farmers' subsector tend to worsen the distribution of income between them.

From the various empirical studies there is evidence which shows that low interest rates policies tend to favour larger farmers. These farmers are traditionally and politically powerful rural elites who control the development agencies. So, if the low interest rates policies want to achieve the goal successfully, the target group (among the needed farmers) must be correctly formulated and identified and the selection criteria employed ought to be consistent with the programme objectives. Already commercially viable farmers and small marginal farmers are, it was argued, not really suited for inclusion to get the cheap credit (from interest rates policies). Since the participation of small farmers is so small (little), they cannot increase their income levels. This results in low employment rates, low capital formation, and worsens the distribution of land and assets. Policy reform by enabling the interest rate on deposits to increase could aid in building-up rural savings and it would foster the improvement of

resource allocation. Measures to raise the farm productivity of small farmers are in the long-run likely to prove the most effective means of raising rural incomes. It is, therefore, unlikely that low interest rates policies alone can be very helpful in realising the development potential in rural economy.

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