Fulbright School of Public Policy and Management

Fall Semester, 2017

INTRODUCTION TO PUBLIC POLICY

POLICY MEMO SAMPLE

POLICY MEMO QUESTION

You are advising a high government official. She has heard about the Grameen Bank and wants to promote it in her country. The country has many small, mostly agricultural, villages and there are not enough funds available in the government budget to place the program in every village. She in particular wants to know how to design the credit institution intervention so that it increases the "welfare" of poor households. She also wants to know how she can tell if the program is effective.

Write a one-to-two page memo providing your best advice on how to design the program – where it should be placed (what village characteristics matter); what rules it ought to use if any (loan size, eligibility, etc.); how long the program should last; whether it is likely to require, after start-up, a continuing subsidy; and how it can be evaluated.

POLICY MEMORANDOM

To: The Ministry of Agriculture and Rural Development and the State Bank

Re: Micro Credit

I am writing to provide recommendations on the design and implementation of a micro-credit program based on the experience of the Grameen Bank. In my opinion, we should proceed first with a pilot scheme in the first three years given widely different institutional structures of our villages, our past failures, and mixed international evidence regarding these programs' effectiveness.

Currently, private money lending dominates the rural credit markets. Real interest rates are as high as 75% a year due to large transaction costs. Because borrowers differ widely in their default likelihood, tend to follow opportunistic behavior, and it is hard to compel repayment, moneylenders are totally absent in many villages, except activities among relatives and friends. Seeing these market failures, some rural credit programs were setup by the government in the past. Run by a state-owned agency, they suffered from massive operational inefficiencies. Credit officers focused more on lending out their allocated funds than on screening and enforcing loan contracts. The results were low repayment rates and chronic subsidy dependence. A new approach to rural micro-credit is needed.

First, getting the operational aspect right is very important to achieve economies of scale and reduce costs. Modern commercial bank techniques in loan appraisal, monitoring and evaluation should be considered. In addition, the program should be decentralized with the set up of village or commune banks so that local characteristics are taken into account. Credit officers should have good knowledge of the serviced area. To align their incentives with those of the overall program, besides providing bonus for making loans, a penalty for all non-repaid loans should be part of the compensation package.

Second, as the Grameen Bank experience has proved, the program should extend credit to groups of poor households with the size of 5-10, optimal to ensure efficient intra-monitoring. As loans to the group cease when one member defaults, members have an incentive to exert peer pressure so that little or no collateral is required. The groups may form voluntarily. This creates self-selection that helps identify credit worthiness. To ensure poor people's access to the scheme, decision making needs to involve village councils which often have the best knowledge of who the poorest in the village are.

Third, other dynamic incentives can be designed. Loan size and term are kept small and short for starting groups ($50-150 in 3 months) and are increased overtime conditional on timely repayments (up to $500-$1000 in 12-15 months). Equal-installment repayment schedule may also be used. Compulsory deposits and emergency funds can serve as substitutes for collaterals. Furthermore, priority in lending should be given to women since they tend to have better credit risks, spend and invest more responsibly, and have traditionally limited access as compared to men.

Fourth, attention should be paid to geographical coverage. There are a fair number of villages with viable informal credit markets, in which local traders are often found to be lenders. On the one hand, they get valuable information from their borrowers by frequently supplying critical inputs. On the other hand, farmers find it worthwhile to try to pay back loans to avoid being cut off valuable supplies. Little intervention is needed in these well-functioning markets. In fact, the village banks in our selected areas should lever on these institutional structures such as using traders as part-time credit officers. Rural areas adjacent to urban centers where formal banking services are available should not be covered. In fact, for our incentive mechanisms to work, we need villages of low mobility and low level of competition. Therefore, we need to focus on poor remote regions, particularly, the pepper and cashew nut farms in the west, and the shrimp farms in the coastline. They all have a lot of potential given large export markets, but production has not been expanded as farmers cannot have access to credit.

Having provided the above recommendations, I now want to stress the importance of the project's financial aspect. Rough estimates show that interest rates should be in the range of 24-28% to break even. The 20% rate, as currently suggested to make the program pro-poor, would require subsidies. Since we do not have a large number of villages, the total amount of subsidies is not large for the first three years. In the long-term, however, the program needs sound financial viability. This, however, is not certain at the present. Therefore, careful evaluations need to be conducted annually in the first three years.

The program has to be evaluated about its impact on the well-being of the borrowers, which needs to avoid biases caused by our selection of the villages and by the self-selection of the loan groups. In the design, we will have some villages included at the start, and others after 2-3 years with groups formed in advance. Thus, based on annual surveys, we can compare household production, wealth, savings, indebtness, healthcare, and education between the borrowers and non-borrowers of village banks with those in the 'control' group of would-be village bank members. We also need to assess the operational and financial performance of the village banks. Indicators such as loan outstanding, delinquent rate, profits, direct grants, soft loans from other institutions, and interest rates may be used to determine whether the village banks' revenues can cover their operating costs, and whether they are becoming less dependent on subsidized inputs. A cost-benefit analysis may also be undertaken to see whether the subsidies are smaller than the benefits they create, in which case they may justified in the longer term.

In short, the proposed credit program has the innovation of combining modern banking structures with traditional institutional arrangements such as inter-market linkages, rotating schemes, and reputation mechanisms. However, its success depends crucially on a number of uncertain factors, particularly, positive welfare impact and financial viability. Therefore, I support the program, but only on an experimental basis. A program evaluation should be carried out annually in the first three years of implementation, after which we can have much better information to decide whether to enlarge and institutionalize it. Finally, I believe that that the rural credit markets can be better improved through the provision of public goods such as irrigation, technical changes, and investment opportunities rather than the supply of cheap credits to some target borrowers.