ABSTRACT

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ACCESS TO CREDIT AND ITS IMPACT ON WELFARE IN MALAWI

ALIOU DIAGNE AND MANFRED ZELLER

Poor rural households in developing countries lack adequate access to credit. Many development professionals believe that this lack of credit has negative consequences for poor people's agricultural productivity, food security, health, and overall household welfare. Improved access to credit, they argue, will help poor rural households engage in more productive income-generating activities both on and off the farm and raise their living standards. Community and member-based microfinance programs have thus enjoyed considerable political and financial support during the 1990s. Yet in *Access to Credit and Its Impact on Welfare in Malawi*, Aliou Diagne and Manfred Zeller argue that access to microcredit may not be an effective way of alleviating poverty if the necessary infrastructure and socioeconomic environment are lacking.

THE CASE OF MALAWI

As in many African countries, the rural financial system in Malawi neglects the majority of smallholders. Malawi smallholders, characterized by landholdings of about one hectare on average, cannot grow enough food to feed themselves. Because land is scarce, these smallholders can climb out of poverty only by farming more productively and diversifying into nonagricultural activities. Yet such changes require capital and pose considerable risk for subsistence households in a highly drought-prone environment. Some policy analysts have argued that most of these smallholder households are too poor to benefit from any kind of access to credit, and even if credit were available, their land constraints are so severe that any increase in productivity would still fall short of guaranteeing their food security.

To gain a better understanding of the potential role of credit in improving household food security and alleviating poverty, Diagne and Zeller analyze the determinants of access to credit in Malawi and its impact on farm and nonfarm income and household food security. They also quantify the relationship between the demand for formal and informal loans.

Their study reveals that formal lenders in Malawi, such as rural banks, savings and credit cooperatives, and special credit programs, prefer to lend to households with diversified asset portfolios and therefore more diversified incomes. The majority of households cannot borrow as much as they want from either the formal or informal credit market. When households are deciding which microfinance institution to participate in, interest rates on loans do not appear to be an important factor; other characteristics of credit institutions and their services play a larger role.

In terms of the impact of access to credit on household welfare, the study does not support the notion that improving access to microcredit is always a potent means of alleviating poverty. In fact the analysis shows that when households choose to borrow they realize lower net crop incomes than nonborrowers. While this result is not statistically significant, it nonetheless indicates the risk of borrowing.

POLICY IMPLICATIONS

This study shows that the contribution of rural microfinance institutions to smallholder income can be limited, or outright negative, if the design of the institutions and their services does not take into account the constraints and demands of their clients. Developing attractive credit services requires identifying farm and nonfarm enterprises and technologies that are profitable under the conditions experienced by subsistence-oriented farmers.

The risk of drought in Malawi, which can be extrapolated to much of rainfed Sub-Saharan Africa, constitutes a considerable challenge for developing sustainable rural financial institutions. Why? Because a strategy of expanding financial institutions in rural drought-prone areas without adequate markets and other infrastructure may—at least in below-average rainfall years—have no significant positive welfare effects. Yet the evidence also shows that without access to credit the ability of smallholder farmers to recover from a crop failure is extremely limited. Also, simply the knowledge that credit will be available in case of crop failure can be beneficial to poor farmers by inducing them to adopt new and riskier, but potentially profitable, crops or technologies. In such environments, rural financial institutions must have diverse portfolios and related provisions for loan defaults if they are to prosper and be of benefit to resource-constrained households.

It is clear that the necessary infrastructure and socioeconomic environment for Malawi's rural population to fully realize the benefits of access to formal credit are not in place. It is difficult to establish sustainable rural financial institutions in areas that lack both hard and soft infrastructure and support a poorly educated and malnourished rural population. Moreover, the benefits of credit at the household level may not materialize in drought years. The authors therefore recommend a cautious and gradual strategy for expanding rural financial institutions in Malawi. Such a strategy would require the state to establish an adequate legal and regulatory framework and to support institutional innovations and pilot programs in rural areas that might reduce transaction costs in providing savings, credit, and insurance services to a rural clientele.

Diagne and Zeller recommend a two-pronged approach. Rural financial institutions should focus primarily on high-potential agricultural areas where they not only lend for production of an array of cash and food crops, but also offer financial services for off-farm enterprises, at low transaction costs. This does not mean that low-potential and drought-prone agricultural areas should be neglected. However, the expansion of microfinance into marginal areas with poor markets and infrastructure should be coupled with a greater emphasis on other growth- and welfare-enhancing investments, such as health and communications, along with targeted safety net interventions for the very poor.

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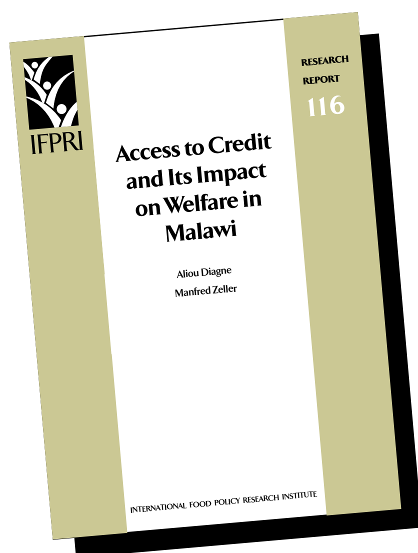

Please send me a copy of *Access to Credit and Its Impact on Welfare in Malawi,* by Aliou Diagne and Manfred Zeller.

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