Chapter 1

1. INTRODUCTION

1.1 MOTIVATION

The central tenet of institutional economics is that a modern economy is a complex, evolving system whose effectiveness shows in meeting diverse and changing human purposes. Observers of economic growth in Less Developed Countries (LDCs) and new industrials countries found that important and essential dimensions of the problem of economic development, in particular institutional development to achieve freedom, economic prosperity and security. One of the most important government organizations are financial one, because of their role play in rural credit markets. There a more general question. Are rural areas sufficiently equipped with institutions?

The majority of formal lenders in LDCs are not well educated for the job, highly inefficient due to technical and management problems, particularly agricultural finance organizations. Adams, et.al, (1984); Braverman, et.al, (1984) and Adam, et.al, (1985) have reported that the varieties of these organizations particularly the so called Agricultural Banks (ABs), Agricultural Development Banks (ADBs) and Rural Banks (RBs) are established to provide credit at subsidized interest rates, these banks have failed to achieve their objectives to serve the rural poor and establish themselves as sustainable credit organizations. Empirical studies of rural credit markets discovered that the variety of these banks are characterized by high lending costs, resulting from high credit demand and high interest rates being charged by these banks. Other financial organizations such as the traditional Commercial Banks (CBs) have no motivation to lend to poor households in the rural areas, due to the lack of feasible collaterals and high risks of lending and the problems of repayment.

However, a number of recent papers provide empirical evidence that confirms the importance of financial intermediaries' quality for economic growth performance. Financial intermediaries perform important function in development process.

Increase in the availability of the financial instruments' for instance reduces transaction and information costs. Reducing the transaction costs[1] and offering more information[2] by lenders to borrowers will lead to increase in the borrowing rates among households that will increase the investment in rural areas and therefore economic growth. Understanding the function of financial organizations throughout the credit market gives policy-makers and financial intuitions knowledge of why some organizations have succeeded and others have failed in serving the poor in rural areas. Understanding the factors that have impact on credit market, which include formal lenders' characteristics that are mainly related to loans' contracts or other characteristics that are related to borrowers are also important for understating the functioning of financial organizations, particularly formal lenders who deal with poor households in rural areas. Study of such factors will describe the interaction between poor households and formal lenders that are usually owned by governments in LDCs. This will also give an overview of credit market in rural areas and the ability of formal lenders to serve poor households.

1.1.1 Agricultural sector in the Libyan economy

Libyan economy during the 1950ies, before the era of oil wealth, was a very small economy and the country was one of the poorest countries in the world. The total population was less than one million, living mainly in the northern part of the country and they depended on rainfall for their livelihood activities. Population in the southern part of the country lived in small cities surrounded by villages, where the majority was depending on ground water for small agricultural activities, mainly for self –sufficiency during those years. The large numbers of people engaged in agriculture during the 1950ies reflect the absence of attractive alternative employment opportunities in the other sectors of the economy. During the last 30 years and after Libya starting exporting oil, the Libyan economy has been depending heavily on in this sector. It remains largely state controlled and regulated. According to the International Monetary Fund (IMF) (2003), the non-oil and private activities remain hindered by a complex regularity regime, widespread government intervention, and restrictive labor market practices.

[1] Transaction costs mean any other costs borrowers will pay to get credit such as traveling costs and other costs which do not include interest rates.
[2] Information that describes loan contracts in term of interest rate charged, repayment period collateral requirements...etc

The share of the agricultural sector in the Gross Domestic Product (GDP) during the (1950ies) was about 26%. In (1962), when oil production started, the share of agricultural sector in the GDP fell to 9% of the GDP, due to the increase of revenues from oil production. The value of food imports increased by 37% as compared to the (1950ies). Libya currently imports nearly 80% of its total food requirements. In the period (1970-1980) the shares of oil sector was around 50-65% of total GDP. Despite the greater political emphasis on the agricultural sector, still the oil sector reached the highest percentage in GDP. The share of agricultural sector in the GDP was very small during the (1970ies), and in fact in the (1980ies) the share fell to 2-3% of the GDP. During (1990ies) and up to (2004), the contribution to GDP has increased to 5-12% as depicted in figure 1-1.

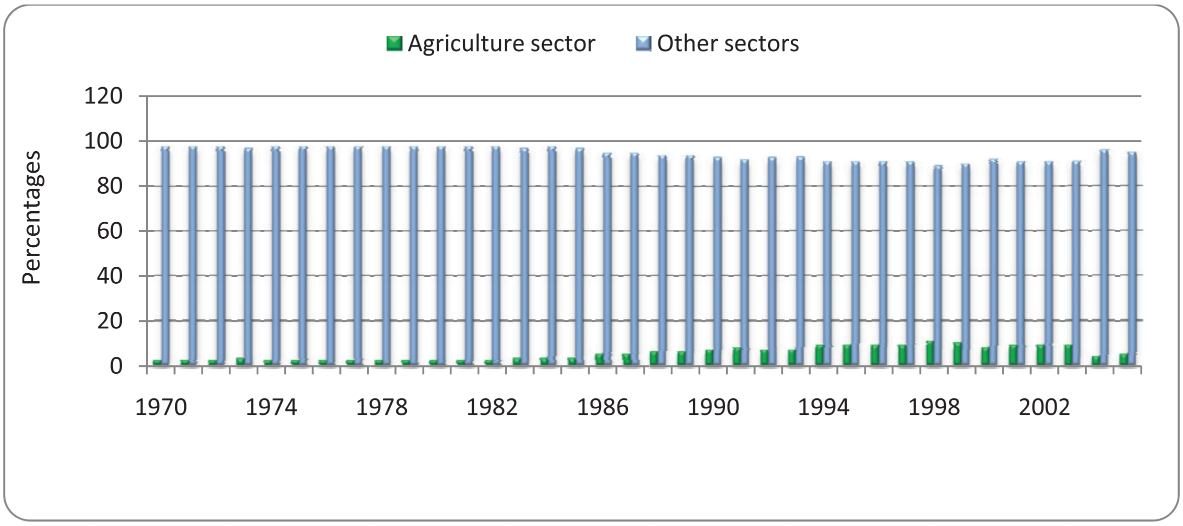

Figure 1-1: The shares of the agricultural sector in the total Libyan GDP

Source: Calculation based on data collected from Libyan Ministry of Planning.

The Libyan economic performance has been shaped by changes in oil revenues, at about 2.6% per year on an average; in (1990ies) for instance the real GDP growth was modest and volatile reflecting inefficiencies of the economy driven by state owned companies, stagnant oil-production and revenues, and the impact of economic sanctions. Since year (2000) according to the World Bank (WB), when the oil price has been increased, the GDP growth has reached 4.6%

in (2004). According to an International Monetary Fund (IMF) (2003), despite the growth of the Libyan economy due to the increase oil prices, non oil GDP is still small, private economic activities remains hindered by a complex regulatory regime, widespread government intervention and restrictive labor market practices as well as by a legacy of policy reversals.

However, investment of non-oil sector still low compared to the neighboring countries such as Egypt. According to WB report (2006), the share of oil production is more than 72% of GDP in (nominal terms), 93% of government revenues and 95% of exporting earning. The Libyan economy appears to be one of the less diversified oil-producing economies in the world, due the government interventions in the economy. The socialist pattern[3] of governance adapted by the government in the (1970ies) by giving local authority in each sector in each city to have employee in government sectors, gave way to more than three quarter of employments in public sectors.

1.1.2 Libyan labor force issues

The high population growth during the last 35 years has lead to high rate of growth in the labor force. During the 1970ies and the early growth rate the 1980ies, Libyan population growth rate reached 4%, before decelerating to under 3% in the 1990ies. As a direct result of improvements in the income and health of the Libyan society, due to oil wealth, the population growth has lead to direct increase in the labor force during 1990ies; the labor force growth has reached 3.5% to 4.0% per year. Public sector employment grew massively between 1990 and 2004 to absorb the additional labor force growth, which leads to 75% of Libyan total employment in the public sector. In the period 2001-2004, the public sector employment capacity reached its limit, with clear evidence of over-employment. This unusual situation resulted in continues fall in public sector labor force productivity. In 2001, for example that according to Libyan Ministry of Labor and Training (LMLT) reports, government civil service and public sector employment represented 53% and 24% of the total employment of Libyan nationals, respectively.

[3] The socialist pattern is a political system for local administration, which is give them the right to employ more labors in each sectors without taken permission for the ministries of each sectors, which lead to more than 75% of total labor in public sector. This system is not working any more since year 2004.

Agricultural employees' share (2005) was about 18% of total labor force, provided only 5% of the GDP. The rate of unemployment in the years 2000 and 2003 was estimated to be at least 30%. Figure1- 2 illustrates the distribution of labor force during the period 1962-2003.

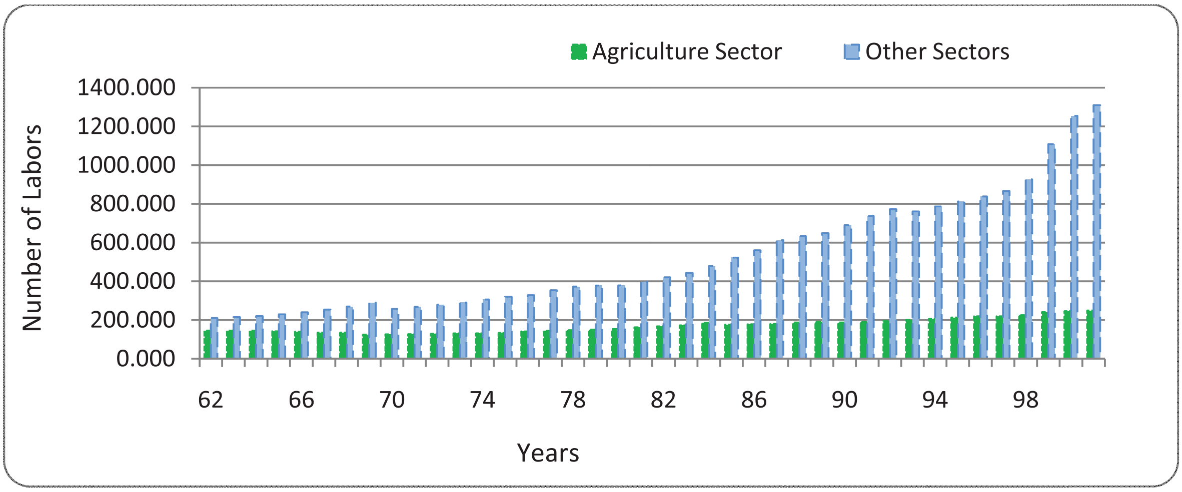

Figure 1-2: Total labor force distributed by sectors.

Source: Data collected from The Libyan Ministry of Labor and Training

In 2003, for example, the public sector has had the greatest share of total employment, it representing 50.7 %, followed by 13.8 % of manufacturing sector, retail trade and restaurants of 12.2 % and agricultural sector 6.3 %, etc. Table 1-1 representing employment by economic activities in year 2003.

Table 1-1: The distribution of employment by economic activities in 2003

Economic Activities	Percentage of shares of total labor force
Agriculture, Forestry and Fishing	6.3
Manufacturing Industries	13.8
Electricity, Gas And Water	4.0
Building and Constructions	2.9
Wholesale, Retailer Trade and Restaurants	12.2
Transportation , Storage and Communication	3.7
Public Service (including Education and Health care)	50.7
Other services	6.4
Total employment	100

Source: Libyan Ministry of Labor and Training, annual report 2003

From the table above it is very clear that the public sector is still over-employed[4]; this lead to a negative impact on the productivity and wages of labor who work in this sector. Since 1981 the nominal wages in the public sector remained frozen, in order to cover the large wage bill, due to the large number of employment in this sector. The Libyan authority is concerned about the situation that lead to 75% of total Libyan forces to the public sector. The following facts might explain the situation:

- People not educated and trained according to what the labor markets demands.
- The absence of the employment opportunities in the other sector, particularly the private sector, with more than 50% of population under the age 20, labor- market tensions will increase in the future.
- Decentralization, that has given the regional governments in the last 8 years the right to expand employment, has added more complexity to the labor problems in Libya.

In 2006, the wage bill increased to 50%. This raise in the public wage was accompanied by an initiation of large civil service reform, with about one third of public employees being transferred to central office for retraining or retrenchment. The Libyan Ministry of Labor Force and Training started to redistribute the employees from the public sector to other sectors, which might take several years to prepare the work force through training and education for new job opportunities outside the public sector. However, the main challenge for the Libyan government is to promote growth of the non-oil sector and foster diversification of its economy. According to the WB report (2006), Libya's unsuccessful experiment with state-driven model of economic development, based on import substitution, shows the limits in using oil revenues for financing investment of the public enterprises in selected industries. Such diversification of the economy will be achieved if far-reaching reforms are put in place to facilitate private sector development in all sectors. About 6.5% growth of the non-oil sector would be needed to reduce the unemployment rate- currently estimated to be 30 to 25% by half in 10 years period.

[4] The shares of public employment is more than 50% from the total employment, this unusual situation, the maximum number of public employment should not be more than 20% of the total employment.