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CREDIT AND FINANCE POLICIES IN THE AGRO-FOOD SECTOR OF TRANSITION ECONOMIES

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DRAFT SPECIAL ISSUES PAPER

CREDIT AND FINANCE POLICIES IN THE AGRO-FOOD SECTOR OF TRANSITION ECONOMIES

1. Of the three main production factors (land, labour and capital), it is the latter that was of the greatest scarcity in transition economies (not only in agriculture, but also in the economy as a whole). During the first years of reform, agricultural enterprises in many transition economies reduced their labour forces and portions of agricultural land were left idle. Capital, on the contrary, was the most expensive and scarce factor of production. Thus, preliminary indicators of factors affecting the comparative advantage and competitiveness of agriculture in transition economies include: relatively low wages and land prices; relatively high capital costs (including difficult access to credit); and poor input supply, processing and marketing facilities.

2. Even in the most advanced countries agricultural and rural credit and risk markets work imperfectly, largely due to imperfect and costly information, which are particularly predominant in agriculture. In addition to these “standard” imperfections, a series of specific, transition-related problems have further constrained the financing of agriculture in transition economies. These transition-specific problems are related to: the role of credit in the economic system; institutional reforms occurring within the financial system; low profitability in agriculture; accumulated debts; high inflation; risk and uncertainty; and collateral problems. The agricultural and rural financial institutions of the CEECs, NIS and Baltic countries have had to adapt simultaneously to a new macroeconomic framework as well as to the restructuring of the banking systems. They have also been faced with uncertainties related to developments occurring within the restructuring of the agricultural markets, farm organisations, food industry and the related reallocation of resources and property rights; this has often slowed reform and lowered the level of intermediation.

3. In an attempt to overcome financial and credit constraints during the transition period, governments have provided support to agriculture by subsidising credit, setting up credit guarantee funds, stimulating institutional innovation and investing in human capital and retraining programmes. The results of these policies have been mixed so far. In some cases, careful government loan guarantee policies have resulted in increased credit supplies and higher repayment rates, but the scope of these programmes has been rather limited so far. On the other hand, in several transition countries government programmes that provided subsidised credit and government loan guarantees have failed to stimulate the development of a sustainable financial system. Instead, they have caused a worsening of the debt accumulation of farms and financial institutions, as well as an increase in government budget deficits.

4. The first section of this chapter discusses the general imperfections of agricultural credit markets and examines the agricultural finance and credit problems in transition. It then analyses the policies implemented during transition and their impact. Finally, it discusses endogenous institutional innovations in rural finance.

1. Agricultural finance and credit problems in transition

5. Credit and risk markets work imperfectly even in the most advanced countries, largely due to imperfect and costly information. Problems of imperfect information and incomplete risk markets are particularly important in agriculture. Agricultural production incorporates timelags inherent in biological

processes and is subject to the random influence of weather, disease and pests. Producers can trade away some price risk on futures markets, but farmers are typically at an information disadvantage relative to larger trading companies. Even in the most developed economies, farmers make relatively little use of futures markets. While informational asymmetries limit the ability to insure against price risk, yield risk cannot be fully covered without attenuating incentives. In general, the ability of farmers to share risk is limited.

6. Some of these supposed imperfections reflect real economic costs. Credit rationing and high interest rates may not be due to exploitation by banks and money lenders, but instead may be a rational and efficient response to the information problems that are inherent to agricultural credit markets. High interest rates may reflect high default rates or high costs associated with screening and monitoring loans. At the same time, imperfect information generally gives rise to imperfect competition, so that there may be some scope for lenders to exploit borrowers. Limited credit and high interest rates often appear as an impediment to agricultural development, inhibiting the acquisition of capital necessary for modern agriculture. This seeming market failure often results in pressure for government intervention.

7. In addition, specific, transition-related problems worsen the problems of financing agriculture in transition economies. However, many of the challenges of agricultural and rural finance in transition economies are the same as those confronting economic reforms generally. They include the adoption of a new macroeconomic framework, the development of a competitive market environment for agriculture, and the effective restructuring of agricultural resources.

a) Institutional reform in finance and credit allocation

8. In centrally planned economies the main monetary policy instrument was credit allocation. A financial plan ensured the realisation of physical targets as expressed in the state plan. The plan specified quotas for working capital long term loans, for financing investment, and for public money holdings. Under the centrally planned system, credit was less a monetary than a fiscal and accounting instrument. The role of credit and finance is different in a market economy, where the main monetary policy instrument is the control of the total money supply. The allocation of credit inside the economy is largely left to independent financial institutions that base their lending policies on assessments of risk and financial returns. The changing role of credit and finance during the transition requires a psychological change for users of credit and finance, as well as a reorganisation of the financial institutions and retraining of their employees.

9. Under central planning, most banks were mere branches of the central bank, with very little independent decision-making. These banks primarily carried out fiscal functions: distribution of subsidies, making loans based upon need, and supporting production plans. However, with the concurrent restructuring of the banking system and reforms to the agricultural sector, a number of problems related to the financing of agriculture and agribusiness have surfaced: agricultural production units (clients) are in transformation; ownership rights (collateral) are being reallocated; and the fundamental role of the financial system is being shifted from fiscal to intermediary.

Table 1. **Private Farmers and Farm Managers Attitudes towards Credit (in percentage of respondents)**

a) Individual farmers access to borrowing

	Albania	Bulgaria	Hungary	Poland	Romania
Good Access	20.0	16.0	15.0	8.2	19.0
No, interest rate too high	67.4	80.6	81.2	86.1	76.0
No, access limited	11.3	1.7	3.1	3.8	4.4
Answer missing	1.3	1.7	0.7	1.9	0.6

b) Large scale farm managers access to borrowing

	Albania	Bulgaria	Hungary	Poland	Romania
Good Access	7.7	30.0	34.6	18.2	36.6
No, interest rate too high	92.3	56.7	65.4	72.7	57.8
No, access limited	-	10.0	-	9.1	5.6
Answer missing	-	3.3	-	-	-

c) Individual farmers attitudes towards borrowing at market rates

	Albania	Bulgaria	Hungary	Poland	Romania
Yes	12.1	7.3	8.4	8.7	15.1
No	65.4	31.2	77.7	42.7	65.3
Maybe	20.4	59.8	13.2	13.0	17.6
No answer	2.1	1.7	0.7	35.6	2.0

Source: Survey of households of private farmers and farm managers, Euroconsult (1995)

10. The market mechanism requires different approaches and skills for the evaluation of loan applications. Banking officers often lacked the necessary skills and experience for loan evaluations, thus requiring substantial investments in human capital and retraining by banks. These restrictions reduced the efficient operation of many financial institutions and intermediaries during the initial stages of transition. Also the costs of monitoring and screening loans are higher during the transition in comparison with the relatively stable market structure of developed market economies. The reorganisation of the agricultural enterprises during this transitional period has farther increased the difficulties of monitoring for the financial institutions. The lack of a well-developed accountancy and bookkeeping system only exacerbates these information and monitoring problems, especially in countries with fragmented farm structures.

b) Accumulated debts

11. During the period of central planning, the supply of credit for the agricultural sector was directed and controlled by the national banking systems. Credit worthiness of the borrowers was estimated on the basis of cash flow needs with no collateral or asset pledging requirements. When loans where defaulted upon they were often written-off due to the lack of clear property rights and responsibility for decisions

that were taken. This reduced the incentives for better management and made it difficult to distinguish between credit and subsidies. As a consequence, many enterprises within the agricultural sector accumulated significant bad debts. These bad debts were inherited mostly by state farms and transformed collective farms. This indebtedness has severely inhibited the provision of new loans and the process of land restitution and restoration of property rights.

12. In those countries, where governments maintained control over credit allocation and used this control to direct credit to specific (groups of) enterprises, it caused a further accumulation of bad debts during transition and has created large problems for the banks. This has been the case mainly in NIS and Balkan countries. Where the banks did not collapse, the accumulation of bad debts forced them to charge high interest rates on the remainder of their loan portfolio in order to remain viable. Low profitability is reflected both in farmers' reduced ability to repay existing debt and their decreased demand for new credit.

c) Profitability constraints

13. Agricultural profitability declined strongly in the early years of transition and is now slowly recovering in some countries and sectors. Price liberalisation induced a strong deterioration of input/output ratios, and consequently in profitability, in agriculture. In the first years of the reforms declining economic performance in agriculture resulted from:

- a fall in domestic and international demand, in turn induced by the price liberalisation, the cut in domestic subsidies both to food consumers and agricultural producers and the collapse of the former CMEA trading system; and

- the disruptions in the agro-food chain that resulted in farms facing monopolistic structures in both upstream and downstream markets.

14. Profitability and cash flow problems also resulted from delayed payments by monopolistic processing and wholesale firms after product deliveries by farms. In times of high inflation, delayed payments, without nominal price adjustments, caused important income declines for farms.

15. Low farm profitability is currently a major challenge to rural credit markets, since it is one of the primary factors in any financing decision. The profitability problem of agriculture in the transition economies underlies restricted demand for, and supply of, credit. Thus, dealing with the various inefficiencies of rural financial markets may not be sufficient to increase the flow of agricultural credit. Reasons for low profitability in agriculture must also be addressed: low (or negative) profit margins on farm products, which reflect adverse pricing conditions; and low levels of financial efficiency, which reflect the lack of effective farm restructuring. Lenders and farmers recognise the implications of reduced financial efficiency for lower farm profitability, reduced loan repayment capacity, and the higher potential for loan default. From this perspective, the lack of profitability has reduced both the supply of and the demand for, agricultural credit and indirectly contributed to higher interest rates through greater risk of losses occurring in the sector.

d) Collateral requirements and provisions

16. Collateral plays an important role in farmers' abilities to secure external financial resources. Financial institutions use the pledging of assets (collateral) as a means of protecting their loans in case of

default. In transition economies, the collateral requirements of financial institutions for agricultural loans have often been very high. These high levels of collateral requirements are primarily due to transitional factors: a lack of clear property rights, non-functioning assets (land) markets, high inflation, risk and uncertainty during transition.

17. As long as land reform and land property rights are non-functioning, a land market cannot develop. This reduces the possibility for the use of land as collateral. In addition, legislation typically prevents the pledging of assets in so far as they are in the process of privatisation and restitution. Furthermore, banks often refuse agricultural land as collateral, even when property rights are fully restored, because of the absence of a land market or because land prices are too low. Banks typically require high liquidity value assets such as residential property and machinery.

18. The combinations of these factors have restricted the flow of credit to farmers, particularly poorly-collateralised farmers. Finally, it should be emphasised that some available empirical information suggests that farmers were often unwilling to provide residential property or land as collateral for loans (Table 2). A potential problem could arise with collective farms transformed into large scale corporate farms, as the land on which these farms operate is owned by individuals and cannot be used for loan pledging. However, some of these large scale farms have overcome this problem by using their fixed assets and machinery as collateral. For this reason the large scale corporate farms are suffering less than other farmers from the current absence of a land market.

Table 2. **Willingness of private farmers to use own land as collateral for a loan (in percentage of respondents)**

	Albania	Bulgaria	Hungary	Poland	Romania
Yes	19.6	40.5	16.0	14.4	26.0
No	61.7	42.5	70.0	66.4	66.2
Undecided	18.3	13.6	12.2	17.3	7.8
No answer	0.4	3.3	1.7	1.9	-

Source: Survey of households of private farmers, Euroconsult (1995)

2. Government policies in agricultural credit and finance

19. Agricultural producers have put strong pressure on governments in transition countries to intervene in the credit market -- and to provide support to agricultural finance and credit. An overview of government assistance in transition economies shows that they have all introduced many different forms of government intervention into credit markets, ranging from complete debt write-offs to credit guarantees. In general, countries have been increasing levels of support provided through credit subsidies.

a) Credit subsidies

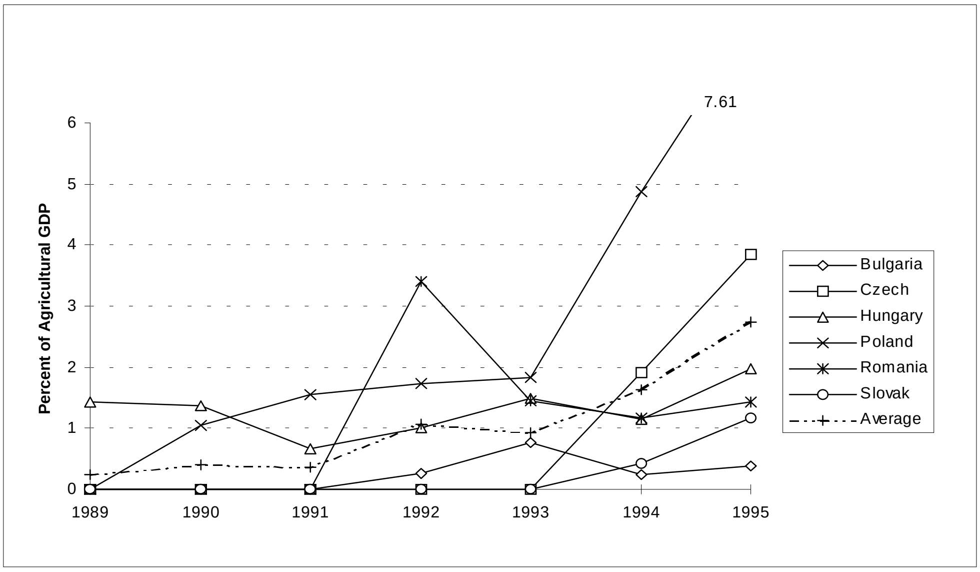
20. Governments of all transition countries have introduced some form of subsidised credit. Moreover, Figure 1 shows that (at least in CEECs) the amount of credit subsidies has increased since the beginning of transition. What are the arguments in favour of credit subsidy programmes? First, and most obvious, providing credit at "preferential interest rates" to agricultural producers makes credit cheaper

than commercial market rates. Besides, the main argument in favour of credit subsidies is -- if the collateral problem is addressed as well -- that the fall in agricultural production and disruption "below a long-run equilibrium" may be mitigated or reversed (because of the special conditions of transition).

21. These arguments are essentially arguments for providing temporary (transition) credit subsidies. However, world-wide experience of government policies in agriculture shows that short term crisis interventions and "temporary" programmes have the tendency to become permanent programmes. This is because: *(a)* they create expectations on the part of the producers (and possibly also other groups) that they will be continued or repeated under certain circumstances; *(b)* they tend to create their own constituency, and for political-economic reasons it is difficult to remove them afterwards; *(c)* they become incorporated in prices for less mobile production factors (e.g., land values), raising production costs for new producers and therefore the demand for the continuation of the programmes. Empirical information suggests that in transition economies, as in many other countries, once implemented, the credit subsidy programmes have been repeated or expanded (see Figure 1).

22. Studies of credit subsidy programmes in developing countries and OECD countries conclude that subsidised credit can have many negative effects on the efficiency of credit allocation and on the development of alternative financial institutions, both of which are important for the development of a sustainable rural financial infrastructure. For example, credit subsidies have a negative effect on the development of alternative sources of agricultural credit (such as credit from up- and downstream industries) if those alternative sources face uneven competition from the subsidised credits.

Figure 1. **Evolution of Agricultural Credit Subsidies in CEE countries, 1989-95**
(Per cent of agricultural GDP)



23. Another important consideration is that credit subsidies benefit mainly large farms and have perverse effects on small farmers' access to credit (the so-called "Iron Law of interest rates restrictions"). This has been the case in many transition countries. Directed subsidised credits go overwhelmingly to large farms, often with unclear ownership structures. Furthermore, it is a well-known problem that due to the scarcity of credit, credit subsidies intended for agriculture may flow to other, more profitable, activities. Depending on the allocation procedure, they might induce opportunities for corruption. Abuse of these programmes, including corruption, has been particularly important in countries such as Russia

with heavy government involvement in credit and subsidy allocation. However, even in countries where the programmes are more carefully managed, the credit subsidies do not reach smaller private farmers. For example, in Hungary, small private farmers are often not eligible for the subsidy, and more generally, for the subsidised loan due to their lack of appropriate collateral.

24. The latter reflects a more general problem of credit subsidy programmes: unless the problem of collateral is addressed, credit subsidies will have little effect on credits allocated to agriculture. For example, the 1992 credit subsidy programme in Bulgaria had little effect as the banks continued to refuse to lend to agriculture because they could not obtain sufficient collateral. The government then obliged the banks to accept future crop output (backed by crop insurance) as collateral. In case of default, the law specified the sharing of collateral risk between banks and government. When the banks were still reluctant, the government included a regulation that would penalise bank managers for obstructing loans to agriculture.

25. A second problem with transition credit subsidies is their tendency to give the wrong signals to the reforming enterprises. Economic adjustments that eventually will have to be made might be postponed, making their implementation later on even more difficult. In some countries subsidies and directed credit have ended up primarily with large farm enterprises under restructuring. For example, in Romania prior to 1997, only large scale farm organisations had access to the banks and the subsidised loans. Only 20 per cent of the funds went to private farms, which produced 80 per cent of output. Furthermore, the collection rate of cheap credit was low as cheap credit policies were accompanied by state guarantees. Much of the support lead to large losses and debts. Moreover, subsidised loans reduce the incentives for those organisations to proceed with the reforms, and thereby have an adverse impact on the reform process.

26. Finally, large directed credit and subsidy programmes such as in Romania (1992-1996) and many NIS have resulted in major budget outlays by the governments. This reduced available funds for more productive public investments and often increased the budget deficit or government borrowing, having a negative impact on inflation and nominal interest rates. As the main reason for their initiation is high nominal interest rates, this effect is counterproductive.

27. Overall, credit subsidy programmes seem to have addressed primarily the symptoms of the problems instead of the causes. For example, delayed payments to producers by processing and distribution enterprises caused an undue burden on farmers' cash flows. This has induced governments to provide special funds for credit relief, but they still have not solved the cause, e.g., lax regulation of downstream industries, weak enforcement of contracts, and complicated bankruptcy procedures.

b) Loan guarantees

28. Loan guarantee programmes have been commonly used in developed market economies to stimulate lending, usually targeted towards small businesses. These programmes typically cover a portion of the losses incurred by lenders in the case of default (e.g., 10 per cent of the loan collateral is provided by the farmer, 20 per cent by the banks and 70 per cent by the government), hence act as a risk-sharing mechanism. These programmes are designed to increase the supply of loans under guarantee to borrowers who would otherwise be unable to attain these funds due to credit rationing and collateral problems. Underlying these programmes is the assumption that additionallity will occur (that is the loan volume with guarantee exceeds the expected loan volume without guarantees) and that there will be minimal substitution of funds within the lending institutions or among lenders as a result of the programme.

29. Given the acute problems of collateral, many governments in transition economies have introduced some form of government guarantee programmes in an attempt to stimulate the availability of credit to the sector. Special guarantee funds were established for that purpose in most of the CEECs and Baltic countries. The basic idea is to partly cover bank loans and share the risk of non-payment between the bank and the guarantee fund. This form of support to agricultural credit was implemented at the more advanced stage of the reforms. Hungary had already established the Rural Credit Guarantee Fund in 1991. Several other CEEC governments introduced similar schemes in 1994 (Czech Republic, Slovak Republic, Poland and Romania). The Baltic countries and Croatia followed in 1997. The summary in Table 3 shows that the recipients (farmers and food industry), the loan conditions (short, medium, or long term) and the extent of the guarantees differ. However, all programmes cover at least 50 per cent of the loan, and typically more for longer term loans. In the NIS, credit guarantee programmes have not been developed so far.

Table 3. **Credit Guarantee Programmes in CEECs and Baltics**

Country	Programme Name	Est.	Details	Guarantee Level
Czech Republic	Support and Guarantee Fund for Farmers and Forestry (SGFFF)	1994	- provides short and long term guaranties through commercial banks	up to 50% short-term up to 80% long-term
Estonia	Credit Guarantee Fund (CGF)	1997	-	-
Hungary	Rural Credit Guarantee Fund (RCGF)	1991	- provides short and long term guarantees to agricultural enterprises	up to 50% of principle plus first year interest
Latvia	Credit Guarantee Fund (CGF)	1997	- instead of guarantees subsidised interest rates in 1997, from 1998 the Fund finances a part of the investment	-
Lithuania	Guarantee Fund for Agricultural Loans	1997	- provide guarantees on investment loans to individual farmers (with no less then 9 ha of agr. land)	up to 80%
Poland	Agency for Restructuring and Modernisation of Agriculture (ARMA)	1994	- provides guarantees to both farmers and food processors	up to 80% for farmers up to 70% for food processors
Romania	Guarantee Fund for Rural Credit	1994	- provides guarantees on agricultural medium/long term loans through banks	up to 60% of loan value plus interest
Slovak Republic	Slovak Guarantee Bank	-	- provides guarantees for short-term ‘green’ credit through Polnobanka for both farmers and downstream processors	up to 80%
Slovak Republic	State Support Fund for Agriculture and Food Industry	1994	- provides both guarantees and special loan programmes to farmers and food processors	up to 70% of project expenses

Source: Swinnen & Gow, 1997, and OECD

30. Government guarantees soften the budget constraints for lending institutions and therefore increase the supply of funds for borrowers. However, in transitional economies with a developing banking structure, there is a danger that these guarantees could induce an increase in loan defaults and write-off, as opposed to increasing the amount of financial resources available to suitable borrowers. This is due to the guarantee programmes altering the incentive structures within the financial contracts and being unable to target the desired clientele. Specifically they may reduce the incentives for banks to

screen, monitor and analyse loans and reduce the incentives for farmers to repay their loans, as they may be viewed as an implicit government subsidy. Additionally, guarantees may adversely affect the development of a viable rural financial system as they discriminate against alternative credit sources and, when limited, may induce lobbying and crowding out effects.

31. When setting up such loan guarantee schemes, it is important to prevent as much as possible the diminution of incentives for the agents involved. Therefore, one should be careful to ensure that the borrower has to provide the first part of the collateral and is forced to repay as much as possible in case of default. The bank has to take its share of the risk in order to be stimulated to monitor and screen the loans sufficiently. Furthermore, the project should allow several banks to participate in order to induce competition. Finally, the government should limit its involvement to setting general, simple and transparent rules, and should not be allowed to interfere with specific applications or actual loan decisions.

32. The credit guarantee system should be considered as a type of financial institution and managed for the most part in the same manner as commercial banks. Risk management is of utmost importance, and includes the following factors: an assessment system of loan projects, portfolio analysis, assets liabilities management and a decision making procedure.

33. Empirical observations on transition agriculture indicate that there appear to be two groups of loan guarantee programmes. First, those that have tried to carefully implement incentive structures as outlined above. As a consequence these programmes have resulted in high repayment rates, but at the same time they have been limited in their scope as their requirements were (as a consequence of the careful design) quite strict. Producers generally complained about their overly tight requirements.[1] For example, the government loan guarantee schemes in Hungary are well managed and have a default rate between one and three per cent. However, their scope has been too small to make a sizeable impact on the sector so far.

34. The second approach occurred in countries where the government relied on the use of “directed credits” to solve the credit demands in agriculture. This often coincided with the provision of loan guarantees by the government as the banks were unwilling to provide loans without such guarantees. These programmes have generally resulted in shifting credit to (former) state farms, at low repayment rates and in a worsening situation (and sometimes the collapse) of the banks channelling the credit to the farms. This in turn had negative effects on government budgets where important budget resources were used to bail out these banks.

c) Reform of financial institutions

i) Agricultural banks

35. Under the centrally planned economy there were specialised agricultural banks existing within the framework of state financial institutions. In Poland, Slovenia and Croatia, where agriculture was dominated by small individual farms, the rural finance system remained based on rural co-operative banking. However, this co-operative banking was controlled by the state and was increasingly relying on state subsidies to channel cheap credit to agriculture. In the former Czechoslovakia (Czech and Slovak Republics) there were no specialised agricultural banks under the former regime[2].

36. During transition the specialised agricultural banks have generally been privatised and have diversified their loan portfolios into other sectors of the economy, including (rural) savings. For example, by 1996 the Russian Agroprombank had 40 per cent of its loans to the agro-industrial complex. In many

countries the agricultural banks have lost their monopoly position in agricultural finance and more commercial banks are supplying credits to agriculture. However, some countries still have a banking structure under which agriculture and rural finance are still dominated by one bank (Belarus, Bulgaria, Romania). Several governments, especially during the early years of transition, continued to subsidise these "agricultural banks" because these institutions were struggling with large portfolios of non-performing loans and operating losses.

37. Furthermore, many governments initially used the specialised agricultural bank as their primary means of allocating subsidised credit and loan guarantees. The most important problem arising from the exclusive provision of government subsidy allocation and loan guarantees through these agricultural banks was that producers viewed them as pseudo-government institutions and viewed loans from these institutions as government handouts rather than as commercial contracts. As a consequence, an important part of these loans was defaulted on, forcing the governments to restructure these loan policies. In those cases in which agricultural banks continued to be government instruments for directing subsidies to farms, the results were poor. A large part of the loans was not recovered and the banks ended in serious financial difficulties caused by bad loans. In turn, the government had to intervene and cover part of the bad loans which resulted in negative impacts on the state budget. Another effect was observed in Russia, where the government used Agroprombank to channel credits to agriculture and allowed only three per cent margin for the bank. The reaction from Agroprombank was to curtail its activities in agriculture and to shift its activities to other sectors.

38. In other countries such problems were recognised earlier on and government programmes are now available for loans extended by the whole commercial banking sector. Governments now channel credit subsidies and loan guarantees through all suitable financial intermediaries. For example, in Hungary, up- and downstream businesses (so-called "integrators") now have the ability to provide many of the same government subsidised financial packages to farms as other financial institutions. Moreover, they are often in a better position to monitor and screen applicants as they are also supplying them with inputs and purchasing the production. A number of additional factors have combined to induce this shift in methods used to channel government funds to the agricultural sector. These include pressure from international donor organisations and the general realisation that the development of alternative financial institutional arrangements are required for expansion of the pool of available funds to the rural communities and reduces governments' liabilities.

ii) Credit co-operatives

39. Credit Co-operatives, which place much stress on local initiatives and peer group assessment of loans, could be one of the alternatives to agricultural financing. In some countries, where the system already existed (Poland, Slovenia, Croatia), there are some movements to reorganise the system of credit co-operatives, including establishing umbrella financial institutions. In some countries new rural financial institutions, such as credit co-operatives, have emerged. Thus far, the size of the co-operatives is too small to provide loans to the agricultural sector, notwithstanding the vigorous public and private initiatives. Of course, they may become more important in the medium run if their successful approach can serve as a stepping stone and as an example for similar initiatives in other regions, or with extended funding.

40. For example, in Romania co-operative banks have been very successful in making loans to small private farmers and innovative in the methods used to facilitate this process. In Bulgaria, a mutual fund programme for agricultural producers has been developed with the support of the EU Phare programme. Producers are required to make a deposit in the institution and receive subsidies up to twice the deposit

and may borrow up to 15 times the deposited amount. In the first nine months of operation, the 33 mutual funds presently running have made 1200 loans averaging ECU 20,000. However, the repayment rate of these loans will determine the longer term viability of the project. The Lithuanian government, in 1995, passed laws allowing the creation of credit unions. There are now 20 credit unions, 12 of which are in the agricultural sector. Eight are currently active and have a combined capitalisation of US$192,000, the other four are in the process of establishment. The Albanian Development Fund (ADF) has been successfully using international donor funds to provide remote and poor villages with small-scale rural credit and infrastructure. In Russia attempts to create rural credit co-operatives have been mixed at best, and many private farmers credit co-ops have failed.

41. These institutional reforms also reflect the fact that different approaches may be needed for vastly different farm structures, as many transition economies have farms now varying in size from very large to very small. It may require different institutions to address the finance requirements of these structures. For example the new (1997) Romanian rural finance policy reflects such an approach. While large farms' credit requirements may be solved by commercial bank loans, these are unlikely in the medium run to solve the small farmers' problems because of much higher intermediation and transaction costs. The Romanian government has therefore implemented a voucher distribution programme to small farms in order to reduce liquidity problems and finance their operation. Simultaneously it has stimulated the creation of credit and savings co-operatives in rural areas. These may also be important to stimulate rural development rather than agricultural production as such. In Poland and Hungary such institutions are also developing, and the government has supported this development. Even though in Hungary, saving co-operatives are still financially weak, they are collecting savings in rural areas, but have not lent much to the local agriculture sector. In the Czech and Slovak Republics the legislation also enables the existence of credit co-operatives, which had a significant historical tradition (based in the 19th century) in agricultural finance. However, despite that tradition the credit co-operatives are not likely to develop in these countries, mainly due to the fact that their agriculture is based on large scale (corporate) farms.

iii) Human capital development and training

42. Some Governments have made substantial contributions to solving rural financial constraints by investing in human capital and institutional infrastructure development on both sides of the credit market. These activities were mainly focused to support: training for banking officials in market finance skills; financial management training for agricultural enterprise managers; financial consulting services to farmers; and extension and advisory services in agricultural finance.

43. Many of the programmes are funded or supported by international donor organisations and require extensive business plans and financial management training as a pre-requisite for securing funds. These strict conditions may constrain credit provision in the short run under these programmes. However, they have obtained very promising results with low default rates comparable to those in developed market economies. For example, in Latvia, the Agricultural Finance Company with the assistance of the World Bank has established a preferential credit line that has strict requirements in relation to bookkeeping, business plans and collateral. The programme has led to full loan recovery and no default so far.

44. Some governments (i.e., Estonia) subsidise advisory and farm consulting services to lower the price for private farms for these services, while simultaneously allowing the private sector to provide them. Such private services tend to furnish the more effective and higher information and advice that farmers require.

d) Endogenous financial institutional innovations

45. In many CEECs, NIS and Baltic countries leasing and various forms of contracting between agriculture and the up- and downstream sectors are emerging as an alternative form of institutional innovation, which has important effects on the credit and finance problems. Several case studies suggest that these contractual innovations are quite successful in addressing the credit problems (Gow and Swinnen, 1997).

46. The contracts can take various forms, for example:

- leasing of equipment;
- forward contracting of output deliveries in return for inputs and working capital;
- producer loan guarantees backed by processing companies with delivery contracts;
- the provision of commodity loans to contracted farms by processors and input suppliers;
- warehouse receipts, *etc*.

47. All of these contractual arrangements somehow address the collateral problem and the credibility of future cash flows for loan repayment. For example, to solve collateral problems, several banks in transition economies have established leasing companies as their subsidiaries; these companies buy machines and equipment and lend them to the agricultural producers rather than extending loans. They receive rental fees instead of interest and principal. The ownership rights remain in the hands of the leasing companies until the end of the rental period and this plays the same role as collateral. Furthermore, case studies suggest that processing firms even subsidise private consulting and advisory firms to provide financial services and training to the producers they contract with.

48. Empirical observations suggest that once one company successfully introduces such institutional innovations, there may be an important spill-over effect to other enterprises in the sector (Gow and Swinnen, 1997). All this suggests that leasing and contracting may play a role in improving the credit and finance problems of agriculture during transition. An important question is which role government can play in stimulating such developments. Again, the most important role is to stimulate competition, provide information and create the institutional (legal, etc.) infrastructure to support the efficiency and effectiveness of such contracts and leasing arrangements, rather than to engage directly in the design or heavy-handed regulation of the emerging institutions.

3. Conclusions

49. Agricultural credit markets work imperfectly even in countries with a developed market economy. Agricultural reform and the simultaneous restructuring of the banking sector create additional problems for financing agriculture in transition economies. For most banks in transition economies, financing agriculture is a high risk activity because of several factors such as: low profitability in the sector; high nominal inflation (especially in the first years of reforms); problems with collateral because of uncertain property rights and ineffective land markets; and the lack of well-established relationships between banks and new producers.

50. The rural finance situation is improving in some transition countries due primarily to three factors:

- the improved profitability in agriculture since 1995 in some countries and subsectors;

- the emergence of institutional innovations, such as credit co-operatives, leasing, various form of contracting, etc.; and

- improved financial situation of the downstream sector seeking to establish closer and more stable links with primary product suppliers.

51. The finance situation remains most problematic in those countries that have postponed reforms and have continued to use the banks to channel subsidised credits and loans to the unrestructured large scale farms with heavy government discretion in loan allocation and widespread use of state guarantees. The result has been low repayment, reduced incentives for farm restructuring, accumulation of bad debts, government budget deficits, and, in some cases, the collapse of banks.

52. Not only are there important differences between countries, but also profitability and financial problems differ considerably between farms. Therefore, it is important to realise that financial constraints are also inherently linked with the restructuring of the farms and the profitability of the sector. Furthermore, the emergence of widely varying farm structures within each country requires different financial institutions for intermediation.

53. Governments have a potentially positive role to play in solving the rural finance and credit problems. However, government policies frequently reduce rather than augment general welfare. Political forces have induced the transition governments to select and implement policies during transition that are not necessarily conducive to the development of well-functioning agricultural and rural finance systems. While one should be pragmatic in evaluating these policies, given the significant problems, one should also be careful in promoting government programmes that are presented as “temporary measures”, but which may conflict with the longer term objective of promoting a sustainable and efficient rural financial system.

54. Moreover, many of the credit programmes focus on symptoms rather than on solving the primary causes of the problems. Many of the agricultural credit problems are caused by high inflation, uncertain property rights, ineffective land markets, low profitability in farming, and high transaction costs in financial intermediation. Therefore, optimal government policy should be to address the causes of the problems by: reducing the budget deficit and following cautious monetary policies; speeding up land reform and the privatisation process; developing regulations and institutions for a land market to develop; by creating the environment for a private agriculture to function; investing in rural infrastructure and agricultural research; and creating the conditions for the development of commercial rural financial institutions to develop.

55. It is necessary to develop a financial market and increase the efficiency of the banking sector. In almost all OECD countries banks play a key role in agricultural finance and most of the other financial vehicles; for instance, credit guarantee, leasing and credit line schemes, depend on a stable banking system. If this sector is not well developed, almost all the financial schemes will become ineffective, heavily distorted, and commercially non-viable. Though many banks in transition economies are still reluctant to provide loans to the agricultural sector, increased competition among banks will force them to look for a broader range of customers, including the agricultural sector, and to offer better services.

56. Agricultural finance policies must keep in perspective the long-term situation of the sector. The government should play the role of building and creating long-run sustainable institutions and infrastructures rather than implementing short-run measures focusing on credit subsidies. Short sighted fund provision to the sector has caused serious problems of heavy indebtedness, which may hinder the sound development of the sector. Regarding the financial measures to be taken by the government, any

scheme should be designed to be commercially viable assuring the smallest possible negative effect on the economy. Since collateral is one of the greatest hindrances in agricultural financing, a credit guarantee scheme would be quite a useful vehicle to mitigate the difficulties.

57. Loans for agriculture with some government assistance represent a minor portion of the total financing of the agricultural sector in most OECD countries. The agricultural finance systems in transition economies should gradually become similar to those of OECD countries with respect to the reduced role of the government in this area, the diversification of activities by agricultural banks and widening of competition among banks. In the transition period the role of the government in agricultural financing could be justified provided it is fully transparent and explicitly understood to be of limited duration.

NOTES

1. This was typically also the case with international donor lending programmes.

2. The agricultural banks *Agrobanka* (Czech Republic) and *Polnobanka* (Slovak Republic) are completely private commercial banks, newly established during the reform period. The share of loans to agriculture from these banks represents only 20 per cent of their total loans.