

EMERGING  
ECONOMIES  
TRANSITION

# Agricultural Finance and Credit Infrastructure in Transition Economies

FOCUS ON SOUTH EASTERN EUROPE

AGRICULTURE AND FOOD



OECD



2001

# **Agricultural Finance and Credit Infrastructure in Transition Economies**

FOCUS ON  
THE SOUTH EAST EUROPE REGION

Proceedings of OECD Expert Meeting,  
Portoroz, Slovenia, May 2001



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

## **ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original Member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996), Korea (12th December 1996) and the Slovak Republic (14th December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

### **OECD CENTRE FOR CO-OPERATION WITH NON-MEMBERS**

The OECD Centre for Co-operation with Non-Members (CCNM) promotes and co-ordinates OECD's policy dialogue and co-operation with economies outside the OECD area. The OECD currently maintains policy co-operation with approximately 70 non-Member economies.

The essence of CCNM co-operative programmes with non-Members is to make the rich and varied assets of the OECD available beyond its current Membership to interested non-Members. For example, the OECD's unique co-operative working methods that have been developed over many years; a stock of best practices across all areas of public policy experiences among Members; on-going policy dialogue among senior representatives from capitals, reinforced by reciprocal peer pressure; and the capacity to address interdisciplinary issues. All of this is supported by a rich historical database and strong analytical capacity within the Secretariat. Likewise, Member countries benefit from the exchange of experience with experts and officials from non-Member economies.

The CCNM's programmes cover the major policy areas of OECD expertise that are of mutual interest to non-Members. These include: economic monitoring, structural adjustment through sectoral policies, trade policy, international investment, financial sector reform, international taxation, environment, agriculture, labour market, education and social policy, as well as innovation and technological policy development.

© OECD 2001

Permission to reproduce a portion of this work for non-commercial purposes or classroom use should be obtained through the Centre français d'exploitation du droit de copie (CFC), 20, rue des Grands-Augustins, 75006 Paris, France, tel. (33-1) 44 07 47 70, fax (33-1) 46 34 67 19, for every country except the United States. In the United States permission should be obtained through the Copyright Clearance Center, Customer Service, (508)750-8400, 222 Rosewood Drive, Danvers, MA 01923 USA, or CCC Online: [www.copyright.com](http://www.copyright.com). All other applications for permission to reproduce or translate all or part of this book should be made to OECD Publications, 2, rue André-Pascal, 75775 Paris Cedex 16, France.

## FOREWORD

In countries recovering from political and macroeconomic instability and transforming their economies to market-based systems, the scarcity of finance for rural areas and for agriculture is a widespread phenomenon. Poorly functioning financial markets make recourse to informal finance an important option. The OECD's third Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies was designed to address this specific set of circumstances in South Eastern Europe, Russia and Ukraine.

Experts sought to assess what has been achieved in rural finance and institutional reform during more than a decade of transition and to identify the remaining challenges. The meeting addressed the role of government policy in facilitating the development of sustainable rural finance and credit systems. Participants examined changes in the banking sector and suggested innovations that would respond to significant transformations in farm ownership and production structures. The advantages of rural credit co-operation and its development potential in South Eastern Europe were discussed, together with the options offered by trade and manufacturer credit. The potential for micro-finance in helping to reduce rural credit constraints and stimulate rural development was assessed. The meeting also took up the special case of equity finance for women entrepreneurs.

The policy dialogue between OECD Members and target countries on issues of rural finance and credit in the transition period began in Paris (1997), moved to Moscow (1999) and was continued in Portorož, Slovenia on 29-30 May 2001. Over 90 experts from 22 countries attended the Portorož meeting, with active participation by the World Bank, FAO and the European Commission. The meeting was co-organised by the Directorate for Food, Agriculture and Fisheries and the Directorate for Financial, Fiscal and Enterprise Affairs of the OECD under the aegis of its Centre for Co-operation with Non-Members, with co-sponsorship by the Government of Japan and local support from the Slovenian authorities.

These Proceedings begin with a summary of the discussions and highlights from each paper, followed by the full contributions of 30 international experts. Five specific target country situations are also presented. They offer the reader an up-to-date collection of country experiences, analytical findings and the results of recent field studies in the South Eastern European region. The Proceedings present the views of finance and agriculture practitioners, researchers, and experts from international organisations on the current issues faced by transition economies in rural finance and credit and on policies and instruments to address them.

These Proceedings are published under the responsibility of the Secretary-General of the OECD.

Gérard Viatte  
Director  
Directorate for Food, Agriculture  
and Fisheries

William Witherell  
Director  
Director for Financial, Fiscal  
and Enterprise Affairs

Eric Burgeat  
Director  
Centre for Co-operation  
with Non-Members

## **ACKNOWLEDGEMENTS**

The organisation of the conference and the preparation of these proceedings were carried out with the support of the Japanese government by staff from three units of the OECD: Fujiki Hayashi, Jaimie Ellis and Lynn Whitney, Directorate for Financial, Fiscal and Enterprise Affairs; Makoto Asano and Alexandra de Miramon, Centre for Co-operation with Non-Members; Alexandra Trzeciak-Duval, Olga Melyukhina, Sally Taylor and Anita Lari, Directorate for Food Agriculture and Fisheries. The Slovenian Ministry of Agriculture, Forestry and Food, in particular Ms. Snežana Popovič and Mr. Marko Verbič, provided substantial local support.

## TABLE OF CONTENTS

|                                                                                                                                                                    |            |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|
| <b>FOREWORD .....</b>                                                                                                                                              | <b>3</b>   |
| <b>EXECUTIVE SUMMARY .....</b>                                                                                                                                     | <b>7</b>   |
| <b>SESSION I. OVERVIEW OF AGRICULTURAL FINANCE AND CREDIT IN<br/>TRANSITION ECONOMIES .....</b>                                                                    | <b>15</b>  |
| <b>Results of the Second Expert Meeting on Agricultural Finance and Credit Infrastructure in<br/>Transition Countries - Mr. Fujiki Hayashi .....</b>               | <b>17</b>  |
| <b>An overview of agricultural credit instruments, institutions and challenges in<br/>Bulgaria, Romania and Slovenia - Mr. Michael Ryan .....</b>                  | <b>26</b>  |
| <b>Public policy and preconditions for sustainable rural finance systems -<br/>Mr. J.D. Von Pischke .....</b>                                                      | <b>35</b>  |
| <b>Agricultural finance and institutional reforms in transition economies: the 1990s and<br/>challenges ahead (focus on SEE region) - Mr. Ulrich Koester .....</b> | <b>53</b>  |
| <b>Agricultural finance and institutional reforms in Bulgaria -<br/>Ms. Lena Roussenova and Mr. Dimiter Nenkov .....</b>                                           | <b>69</b>  |
| <b>Farm debt in the CIS: multi-country study of major causes and proposed solutions -<br/>Mr. Csaba Csaki and Mr. Zvi Lerman.....</b>                              | <b>87</b>  |
| <b>Large farm debt in Ukraine - Mr. David Sedik.....</b>                                                                                                           | <b>105</b> |
| <b>SESSION II. PRIVATE AND CO-OPERATIVE BANKING FOR THE<br/>AGRICULTURAL SECTOR AND RURAL AREAS .....</b>                                                          | <b>123</b> |
| <b>Agricultural and rural co-operative banking: EU experience and lessons for<br/>emerging markets - Mr. Gerard van Empel.....</b>                                 | <b>125</b> |
| <b>Multi-service co-operative financing and other facilities of agri-financing:<br/>Japan's experience - Mr. Tamotsu Kawamura.....</b>                             | <b>136</b> |
| <b>Romanian Banca Agricola: Agony and Ecstasy - Mr. Eugen Radulescu .....</b>                                                                                      | <b>165</b> |

|                                                                                                                                                                                    |            |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|
| <b>Agricultural credit co-operation in Slovenia: lessons from the past and strategy for the future - Mr. Franci Avsec and Mr. Tomaž Sila.....</b>                                  | <b>182</b> |
| <b>SESSION III. INFORMAL CREDIT FOR THE AGRICULTURAL SECTOR AND RURAL AREAS.....</b>                                                                                               | <b>193</b> |
| <b>The role of trade credit and foreign direct investment in improving the agricultural finance situation in transition countries - Mr. Johan Swinnen and Mr. Hamish Gow .....</b> | <b>195</b> |
| <b>Equity financing for women - Ms. Astra Michels .....</b>                                                                                                                        | <b>207</b> |
| <b>Financing agriculture through vertical integration: the case of Hungary - Mr. Tamás Székelyhidi.....</b>                                                                        | <b>218</b> |
| <b>The role and development of informal and co-operative financial channels in Albanian agriculture - Mr. Hamish Gow, Mr. Zef Preçi and Mr. Drini Salko .....</b>                  | <b>231</b> |
| <b>The experience of rural micro-credit in north-west Russia - Ms. Renata Yanbykh.....</b>                                                                                         | <b>246</b> |
| <b>Hidden credits in the agro-food system in the Czech Republic: a farmer's point of view - Mr. Michal Pospíšil .....</b>                                                          | <b>263</b> |
| <b>COUNTRY NOTES .....</b>                                                                                                                                                         | <b>267</b> |
| <b>Croatia - Ms. Jasna Mikulecky and Ms. Vesna Matijašević .....</b>                                                                                                               | <b>269</b> |
| <b>Romania - Experts from the Ministry of Agriculture, Food and Forestry.....</b>                                                                                                  | <b>278</b> |
| <b>Russia - Ms. Renata Yanbykh.....</b>                                                                                                                                            | <b>281</b> |
| <b>Slovenia - Mr. Dušan Vujadinovič.....</b>                                                                                                                                       | <b>295</b> |
| <b>Ukraine - Ms. Olga Kovalenko and Ms. Inna Chapko .....</b>                                                                                                                      | <b>304</b> |
| <b>ANNEX.....</b>                                                                                                                                                                  | <b>309</b> |
| <b>Programme.....</b>                                                                                                                                                              | <b>311</b> |
| <b>List of Participants .....</b>                                                                                                                                                  | <b>315</b> |

## **EXECUTIVE SUMMARY**

The situation of agriculture in countries recovering from crisis conditions calls for adapted, flexible finance and credit approaches, building on economic and institutional fundamentals. The third Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies, held in Portorož, Slovenia on 29-30 May 2001, addressed the particular conditions of South Eastern Europe (SEE), as well as Russia and Ukraine. Experts from OECD and transition countries shared experience and continued the policy dialogue in this major policy domain.

The range of topics covered included the preconditions for sustainable finance systems, financing sources, types of credit and credit instruments, and banking sector restructuring. The dialogue on these issues was complemented by new topics of particular relevance to the target South Eastern Europe region, especially the development of co-operative credit, viable forms of non-bank lending such as trade and micro-credit, and equity financing for women. The specific role for government policies in developing rural financial infrastructure was examined.

This Executive Summary presents the main issues raised and conclusions drawn during the meeting as well as the highlights from the papers published in these Proceedings.

### **A stable macroeconomic and institutional framework - emerging from transition**

Macroeconomic stability and developed institutions are fundamental to sustainable finance and credit systems. A stable economy ensures confidence and predictability through which value is created in financial markets. These markets are institution-intensive: they function properly when effective legislation and ground rules are in place; property rights are well established; contracts are enforced; and information on which to base decisions is available. Financial markets operate efficiently when factor and commodity markets are well developed and transparent.

In many transition countries, the early reform period was characterised by significant political and economic disturbances. Countries where macroeconomic stabilisation has been achieved, have advanced farthest in establishing viable financial markets. In contrast, where prolonged political and economic instability and delayed reforms undermine confidence and inflate risks, financial markets are slow to develop. This leads to reliance on quasi-money arrangements and on the state as the main credit provider.

The transition brought about a radical reform of traditional institutions and the emergence of new ones, inherent in a market economy. However, those institutions most relevant to initiate and promote the development of financial markets emerge late in the transition. This process is affected by various factors, including a society's cultural values and core beliefs. Attitudes to debt and to saving and lending, as well as willingness to take risk or to offer land as collateral, are largely related to cultural traditions. Cultural background, therefore, influences the approaches to and speed of financial and credit market formation, particularly for rural finance.

Heterogeneity among transition economies increased during the 1990s. Progress in economic recovery, and in the agricultural sector in particular, is highly uneven across the countries, as is the success in establishing new political, legal and market systems. Hence, the socio-economic conditions under which finance and credit systems develop in various countries have become more diverse. The growing heterogeneity among transition economies calls for more differentiated approaches to financial development in the region. Policy options that have worked well in developed market



economies, or in some transition countries, may not be successful in others, unless they take sufficient account of the specific economic, political and cultural context of the country concerned.

### **Profitable agriculture – a precondition**

To attract finance and credit, agriculture needs to generate sufficient profits. Several issues of agricultural profitability with regard to rural finance were raised at the meeting. First, adequate finance is never likely to reach a non-restructured agricultural sector. Farm consolidation or downsizing and reform of business management at the farm level remain crucial in creating incentives for profit making. Farm restructuring also underlies the problem of debt resolution for large agricultural enterprises. The resolution of large farm debt is, in turn, an essential precondition for establishing viable rural credit systems in countries where large farms prevail. Progress in farm restructuring remains a key issue in the context of agricultural finance requiring continuous policy attention at the national, sub-national and local levels.

Second, agricultural policies should not create systemic impediments to profit making. Price controls, restrictions on trade in agricultural products, “tied” state credits or other conditional support lead farmers to produce and market in conflict with rational economic criteria. Such policies undermine, if not impede, development of viable rural finance, and government efforts to stimulate agricultural credit are largely wasted.

Third, profitability of the farm sector is created through the efficiency of the whole food chain. Targeting overall efficiency prompts vertical co-ordination of food production and marketing. This co-ordination drives out low quality and inefficient producers, thus yielding more stable and higher farm income. However, intensifying vertical links in the agro-food sector fosters the problem of “fair pricing” or the “fair balance” between different players, producers, processors and traders, in agro-food markets. In many transition countries the privatisation of food processing and retailing, together with foreign direct investment (FDI) inflows, have led to substantial industry concentration in some sub-sectors. This increases the risk of unequal distribution of bargaining power in the food chain. Market transparency and competition issues have growing implications for the financial sustainability of the farm sector and, therefore, need greater attention from policy makers.

### **Sustainable rural banking – lessons learned**

Economic and systemic transformation has led to sharply falling and unstable agricultural incomes, which create substantial disincentives to commercial lending. The risks of agricultural lending are further inflated under the rapidly evolving conditions of farm restructuring, land reform, and privatisation of agro-food industries. The land reform in many South Eastern European countries has led to a radical change in the farm structure, with small individual producers replacing large state farms. The banking sector, geared previously to serving mostly large collective enterprises, lacks experience and adequate information for working with small-scale borrowers. Dealing with such small clients also involves higher transaction costs.

In parallel, the banking sector itself is undergoing reform. Privatisation of former state banks and the emergence of new private credit institutions has led to greater commercialisation of the banking sector. Banks’ portfolios are shifting away from low-yielding sectors, such as agriculture. Bank restructuring, often carried out as rescue operations, increases banks’ aversion to risk. This contributes to their reluctance to invest in the agricultural sector. Bank credit for agriculture and rural areas becomes increasingly scarce; the term structure of credit shifts to short-term lending; long-term credit virtually dries up.

The adoption of principles of sustainable rural banking is essential to ensure successful recovery and further development of this sector. Experience has shown that retail financial institutions with sector-concentrated portfolios, like specialised agricultural banks, common in many transition countries, have limited sustainability. Their risk exposure to a single sector is too high. Governments tend to protect such banks from risks with the consequences of moral hazard and budgetary burdens growing to unsustainable levels. Lending to agriculture needs to be dealt with in the context of the rural sector as a whole. Addressing the diverse needs of rural areas, including the full range of financial services required by small- and medium-size clients, facilitates the development of a diversified rural economy. The latter helps to absorb redundant agricultural labour, improve infrastructure and create additional demand for agro-food products, in turn contributing to agricultural development. For any financial institution to be sustainable, a high loan recovery rate is of prime importance, and the enforcement of discipline to repay loans is necessary.

### **Co-operative banking may offer advantages - a revival of credit co-operation**

Credit co-operation and co-operative banking can have advantages in delivering financial services to rural areas. These advantages include: proximity to clients; integration into the local community and good knowledge of local circumstances; high flexibility in adapting financial services according to the changing needs of their clients; peer pressure; ability to mobilise savings, including from non-members; operating in a network that permits the consolidation of certain functions and the enlargement of the scope and efficiency of services.

Revival of co-operative structures in transition economies is a positive development, and the long-standing European practice of rural co-operation suggests valuable lessons. Japan's experience of multi-service co-operatives raises questions about the sustainability of financial services provided by multi-purpose institutions, *i.e.* those engaged in providing a range of financial and non-financial services. The single-purpose co-operative is usually the preferred model: financial operations need their own economies of scale and expertise and are difficult to combine with other activities.

### **Some options for developing financial infrastructure - and bank restructuring**

Experts suggested several possible options for developing rural financial infrastructure in transition countries. First, large specialised agricultural banks can be transformed into "all finance" rural banks. These banks already have a developed local network and, in principle, can be transformed into co-operative structures. Sufficient initial capitalisation can be obtained by adopting a requirement for loan applicants to contribute a certain share to the bank's equity. Second, where a large number of small stand-alone financial institutions co-exist, their consolidation into a network can be considered. Many of these institutions operate without a banking licence and have poor access to financial markets. A two-tier structure with an apex organisation dealing with information technology, inspection and auditing, payment clearing, product development, etc. will ensure the sustainability of the whole system. Third, commercial banks can establish separate specialised rural financing units. This option may be particularly relevant for countries where a developed urban banking infrastructure and a sound legal base exist. The above options could be adopted in any combination, depending on the specific conditions of each country.

With respect to large state agricultural banks, their privatisation and restructuring should be based on clearly defined business strategies. In many cases privatisation of state agricultural banks was implemented as part of a macroeconomic stabilisation package. This process was dominated by short-term goals, while longer-term perspectives of the banks' business, their "philosophy", were not given sufficient attention. Furthermore, restructuring of the banking sector in many transition

economies led to substantial inflows of foreign capital into the system. Foreign interest undoubtedly creates favourable preconditions for self-sustainable, innovative banking. However, ownership changes are often followed by the re-orientation of banks' portfolios to areas with quicker and higher profits and diversion away from agriculture and rural lending. Striking the right balance between banks' profit maximisation objective and the need for them to service agriculture and rural areas is one of the governments' most difficult challenges.

### **A non-bank approach – processor, trade and manufacturer credit**

Developments in the agro-food sector forge closer relationships between farmers, input manufacturers, processors and retailers, including foreign companies, which offer sources of funding and/or in kind supplies to farmers. Under the transition, such credit mechanisms develop as a way to overcome the scarcity of primarily shorter term bank credit and reduce mutual risks. Non-bank credit, being a principle source of financial inflows to agriculture in the early period of transition, plays a unique catalytic role for the recovery and further development of the farm sector.

As the transition progresses, the agricultural sector recovers and financial infrastructure develops, then traditional bank credit generally increases its importance. However, trade and supplier credit has always existed in parallel with formal finance, even in developed financial markets. Up- and downstream operators may often be better placed than banks to offer operating credit because of better local knowledge, proximity to farmers and the ability to provide credit in a package with other tailored services. Under certain conditions, trade and manufacturer credit has lower transaction costs and is more efficient in terms of contract enforcement than traditional bank credit.

### **Recourse to micro-finance – the low-income borrower**

Micro-finance is a practical vehicle for serving the needs of low-income rural borrowers. It can play an important role in the reduction of poverty and the development of rural areas. Micro-finance is of growing interest in transition countries, particularly those with a large share of rural population and substantial rural poverty pressures. A number of donor-supported, pilot micro-finance projects are being implemented in the region.

There has been a permanent trade-off in donor-funded micro-finance projects between social objectives, *i.e.* the need to help people under economic stress, and the need to create a self-sustainable financing facility. Self-sustainability has often been compromised, and many donor-driven micro-finance initiatives are subsidy-dependent and short-lived. One solution is to provide a subsidy to reduce the transaction costs of setting-up the micro-credit institution, which, once established, should function on a commercial basis. Micro-finance is a highly adaptive and flexible financing vehicle with considerable potential for financial innovation. However, due to the failure thus far to establish commercially sustainable micro-finance institutions, it has not yet been possible to exploit this potential sufficiently.

### **The main role of government – creating an enabling environment**

Governments' main role is to create an enabling environment for finance systems to develop by minimising uncertainty and reducing transaction costs on financial and credit markets. Governments should ensure competition to drive innovation and efficiency on these markets. Much remains to be done in transition countries to create an adequate legal framework and law enforcement. As they put into place a binding legal infrastructure, governments need to follow consistent policies and avoid discretionary action. They must not weaken their resolve to follow-through with land reform and

institution of clear property rights. The process of ensuring full-fledged ownership rights needs to be completed, not only to provide collateral, but also incentives to invest and prevent abuse.

The state is not an efficient credit provider, lacking adequate knowledge, information and infrastructure. Borrowers usually perceive government loans as grants. They can be diverted to unintended purposes and may be repaid last, if at all. Many countries have resorted to interest subsidies, but these policies have proven unsustainable and economically distorting. Those benefiting from subsidies tend to regard them as permanent entitlements, making it politically difficult to end them. Large-scale preferential credit programmes have, in the majority of cases, resulted in a substantial accumulation of farm debt, which has had destructive macroeconomic effects. Successive debt rescheduling and write-offs implemented without real reform of farm enterprises, have only ensconced market distortions and increased moral hazard. State interventions affecting credit allocation and its cost, if undertaken, should be targeted and limited in scope and time. Government initiatives that have proven successful in some countries, for example, credit guarantees or warehouse receipts, should be identified and evaluated.

In order to support the development of co-operative credit, governments should ensure that the adequate legislative base and reliable controls and auditing systems are in place. Some assistance, *e.g.* a preferential tax regime or risk-sharing arrangements, may be needed at the start-up stage, but should be phased out as soon as the co-operative is sufficiently established. Rural credit co-operatives should be generally self-sustainable institutions. Rural co-operative banks should be capable of constant innovation to withstand competition of commercial banks on the financial markets.

In the case of non-bank credit, the challenge for public policy is to stimulate the desirable effects of such financing schemes and prevent possible harmful impacts. This task is particularly relevant under the conditions of the transition. When institutional and regulatory bases are not sufficiently developed, and producers have limited supply/marketing alternatives, dependence on a particular integrator may bear the potential danger of monopolisation. Thus, competition policy is an increasingly important component of the policy mix. Like all forms of credit, trade and manufacturer credit must be based on trust and transparency.

### **An appropriate policy mix – responding to the complexity of agricultural finance and credit**

Agricultural and rural finance is a highly complex sector cutting through all aspects of economic and social development. The specific conditions of the transition, such as instability, underdevelopment of basic markets and lack of supporting institutions, further complicate the situation. Policies dealing with agricultural and rural finance therefore have multiple objectives and require multiple policy instruments. This poses the problem of developing an appropriate policy mix. Furthermore, countries go through different phases of the transition. At each stage, different policy priorities emerge, making policy sequencing inevitable. In designing policies, it is important to look not only at failures, but also at opportunities. Both negative and favourable evidence from countries on the same transition path should be better explored and made widely available. Policy analysis should focus on seeking options and building on best practices, such as diversified finance, repayment discipline, and adequate regulatory standards. It is essential for governments to monitor, review and evaluate all policies on an ongoing basis and to adjust and, if necessary, discontinue them.

## Highlights from papers

### *Session I. Overview of agricultural finance and credit in transition economies*

The papers in Session I provide a framework for the discussion of agricultural finance and credit problems in transition economies. The first paper by **Hayashi** synthesises the results of the previous expert meeting held in Moscow in February 1999. **Von Pischke** presents the complexity of rural finance and its inter-linkages with other economic activities. Sustainability of rural finance and credit depends on various preconditions relating to the macroeconomic environment, financial systems as such, farm sector performance, as well as public policies. According to Von Pischke, financial development essentially means creating debt capacity, defined as the amount that a borrower can borrow on a sustainable basis. Competitive financial markets move naturally to create debt capacity. The public policy challenge is to ensure competition. Von Pischke argues that public policies should aim at creating confidence, incentives and controls, rather than aim at meeting “credit needs” and repairing market failures.

**Ryan** sets the focus on the target region. Based on recent comprehensive OECD studies of the agricultural sectors in Bulgaria, Romania and Slovenia, he presents an overview of agriculture finance and credit in the three countries. **Koester** continues the theme, bringing together the experience of central and eastern European countries (CEECs) and SEEs during the past decade of transition. Stressing that finance plays a key role in transition, he argues that the rural financial markets in CEECs and SEEs are late to develop in the transition process. In fact, the emergence of financial markets is inseparable from institution building. The latter is the most difficult challenge of transition as it requires collective action and often concerns the cultural values and core beliefs of a society. **Rousse nova** and **Nenkov** explore the importance of institution building in their overview of agricultural finance and institutional reform in Bulgaria. The revitalisation of monetary and banking systems implemented in Bulgaria since 1996-97 was the first necessary step towards creating viable financial markets. However, the establishment of a functioning rural credit market further implies the removal of existing institutional and legislative gaps. Among the problems to be addressed are the imperfect legal base, weak contract enforcement, difficulties in seizing collateral, and lack of competition in the banking sector.

All authors outline farm profitability as one of the fundamentals of sustainable rural finance and credit. Particular attention to this issue is paid by **Csaki**, **Lerman** and **Sedik** who analyse the large farm debt problem in NIS. Low profitability is the main cause of chronic indebtedness of large-scale farms in these countries. This is mainly the result of irrational government policies, which reduce incentives for internal farm restructuring. Inability of farms to generate sufficient profits deepens their debt and prevents commercial credit from flowing into the sector. The state remains the principal credit provider and the claimant on commodity markets, and the vicious circle is closed. The authors suggest strategic and tactical options for resolving the problem of destructive farm debt accumulation.

### *Session II. Private and co-operative banking for the agricultural sector and rural areas*

The papers in Session II focus on the experience of OECD and non-member transition countries in providing banking services to the agricultural sector and rural areas. The special focus of this session is on co-operative credit. **Van Empel** points at the developmental role of rural finance, stressing that it needs to target all rural groups to be sustainable, which at the same time provides the basis for the prosperity of the whole rural economy. He suggests key principles for sustainable rural finance and discusses the main lessons learned from EU rural co-operative banking, which may be applicable to transition economies. Armbruster elaborates further on the fundamentals of rural credit co-operation,

pointing out its voluntary and independent nature. In this connection he stresses that credit associations should not be used by the government as vehicles for delivering social support. He also underlines the importance of co-operatives' integration into a common structure. This makes it possible to centralise certain functions in order to render financial services competitively and at the same time maintain a solid local base.

**Radulescu** reveals the difficult process of restructuring of the former large state sectoral bank into an independent commercial enterprise, based on the experience of the Romanian Banca Agricola. He concludes that the necessary preconditions for the Bank's future success were created when the Bank stopped delivering preferential state credit to non-restructured agricultural enterprises and a comprehensive business development strategy replaced previous halfway restructuring measures.

**Kawamura** draws on Japanese practice of rural finance, focussing on the system of multi-service agricultural co-operatives. He argues that the multi-service framework of delivering services to farmers, including financial ones, has a number of advantages, which can be exploited by transition countries. **Avsec** and **Sila** provide a historical overview of rural credit services in Slovenia, as well as an analysis of the present situation and the main challenges. The paper is noteworthy for revealing the importance of an appropriate legal and operational framework for the development of rural credit. Savings and Loan Services currently constitute the core of Slovenian rural financial infrastructure. However, uncertain rulings on their legal status, scope of permitted operations, client base, etc. severely limit the potential for improvement of rural financial services.

### ***Session III. Informal credit for the agricultural sector and rural areas***

The papers in this session cover various aspects of providing non-bank credit for agriculture and rural areas, which according to **Swinnen** and **Gow**, can play an important role in reducing finance and credit constraints experienced by the sector during the transition. Based on surveys in CEECs, they analyse the driving forces and benefits of manufacturer and trade credit, stressing the positive spillover effects such as increased efficiency and product quality throughout the food chain. The latter issue is further elaborated by **Székelyhidi** who reports on the experience of vertical agro-food integration in Hungary, pointing to the potential of global quality management systems for attracting capital, improving farm incomes and achieving financial integrity. **Pospíšil** introduces another perspective on vertical integration, expressing farmers' concern over the imbalance of bargaining power in the food chain and arguing that it leads to hidden transfers up- or downstream from the farm sector.

**Michels** brings into consideration equity financing, concentrating on women-owned businesses. She discusses direct benefits for primary producers from equity investment in agro-processing, which provides the opportunity for the inclusion of farmers in the ownership structure of food processing businesses. **Gow**, **Preçi**, and **Salko** trace the development of Albania's agricultural financial market and the emergence of rural micro-financing institutions. They also present the results of a 2001 survey of access to finance by rural households and small farms in Albania. **Yanbykh** points to the importance of micro-credit schemes in providing start-up capital for alternative economic activities and alleviating poverty in rural regions, which is exemplified by the experience of a micro-finance project in north western Russia.



**SESSION I. OVERVIEW OF AGRICULTURAL FINANCE AND CREDIT IN  
TRANSITION ECONOMIES**





# **RESULTS OF THE SECOND EXPERT MEETING ON AGRICULTURAL FINANCE AND CREDIT INFRASTRUCTURE IN TRANSITION ECONOMIES**

**Mr. Fujiki Hayashi**  
**Head, Outreach Unit for Financial Sector Reform**  
**Directorate for Financial, Fiscal and Enterprise Affairs**  
**OECD**

## **Abstract**

*Financial stability, and sound systems and institutions to provide access to credit, are indispensable to the development of a sustainable agricultural sector. The meeting was designed to share OECD experience in this field with non-member countries. The papers presented, and the discussion, covered a wide range of issues concerning policy instruments, sources of credit and alternative solutions to current problems. Over the course of the meeting, a large measure of agreement emerged on the advantages and disadvantages of different types of credit, on institutions for delivering credit, and on the role of Government. This summary highlights the views of experts on the prevailing macroeconomic situation in transition economies, as well as on the position of agriculture. The key issues that arise in the provision of credit to the agricultural sector are summarised and this is followed by highlights from the presentations in each session.*

## **Introduction**

The second OECD Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies was held in Moscow on 10-12 February 1999. This meeting, co-sponsored by the Japanese government, was organised in co-operation with the Russian government.

The meeting was the second in a series; the first one was held in Paris on 18-19 February 1997. The Moscow meeting was attended by over 200 participants from 33 countries, of which 18 non-OECD countries (Belarus, Brazil, Bulgaria, China, Croatia, Estonia, Indonesia, Kazakhstan, Latvia, Lithuania, Moldova, Mongolia, Republic of Georgia, Romania, Russia, Slovak Republic, Slovenia and Ukraine) and 15 OECD countries (Canada, Czech Republic, Finland, France, Germany, Hungary, Japan, Korea, Netherlands, New Zealand, Spain, Sweden, Turkey, United Kingdom and United States), three international organisations [the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the World Bank (WB)] and the European Commission. The meeting was divided into four sessions: (1) Overview of agricultural finance in transition economies; (2) Banking for the agricultural sector; (3) Complementary commercial credit schemes in the agricultural sector; and (4) Credit subsidies and credit guarantees in agriculture.

## **Macroeconomic situation and market infrastructure in transition countries**

The lack of a stable financial structure in many transition economies, and the current financial situation in Russia, create particular problems. The macroeconomic instability affects the profitability of the agricultural sector because of the uncertainties and risk created for producers and the difficulty for lenders to assess that risk. Furthermore, it undermines existing financial institutions and damages confidence, not only in government policies and programmes, but also in the banking system.

Of particular importance is the problem of properly functioning markets. The lack of reliable information on which to base decisions, and the inadequate market infrastructure, jeopardises the profitability of enterprises. Many reasons underlie the failure of markets to operate effectively, including ineffective or inappropriate legislation, the absence of ground rules for conducting business, and the lack of institutions to implement and monitor the rules. Problems also arise when government is too quick to intervene or when policies in non-agricultural areas have undesirable implications for agriculture. One instance of the latter is the widespread use of quasi-money arrangements, including barter, in the context of a general payment crisis. The very high incidence of barter arrangements is, itself, a sign of uncertainty and systemic failure.

No matter what measures are put in place to increase access of the agricultural sector to credit, it is clear that these are likely to fail in the absence of macroeconomic stability and a financial sector which functions competitively and can command the confidence of lenders and borrowers.

### **Agriculture in transition economies**

Agriculture is no different from any other sector in its need for credit and it must compete for the limited funds available. The uncertainty of climatic conditions, the instability of market prices and the relatively small size of enterprises - even large farms are relatively small in comparison to businesses in other sectors - imply greater risk and higher transaction costs than for other sectors. Nevertheless, experience in OECD countries is that, given a competitive financial environment, profitable agriculture can obtain the credit it needs.

In transition economies, agriculture presents additional, more acute, problems, although problems may differ significantly between countries. At the time of price liberalisation, the loss of working capital was aggravated by the lack of an adequate credit system and high inflation. Currently, where markets are not functioning competitively, farmers are paying higher prices for their inputs and receiving lower prices for their outputs; profits are low. This situation can only be overcome by removing the constraints which prevent markets from functioning. In most countries, this will require measures to increase competition in upstream and downstream industries.

A critical factor is the need to restructure farm businesses. It is important to encourage those businesses which are likely to be profitable in the longer term and, equally, not to sustain unprofitable businesses. Some restructuring of debt will be necessary and this will require public funds. However, enabling uncompetitive businesses to continue would prove a costly and unproductive use of scarce resources. Another key element in the restructuring of the agricultural and agro-food sectors, which also has credit implications, is the completion of land reform and the establishment of property rights. Providing the agricultural sector is profitable, this will provide collateral and enable the sector to perform more effectively.

### **The provision of credit to the agricultural sector**

The papers presented during the course of the meeting contain a wide range of information on the instruments and institutions used in the provision of credit to the agricultural sector in both OECD countries and countries in transition. They illustrate that, while there are necessary pre-conditions, success has been achieved with different instruments. Clearly the instruments must be suited to the particular situations. The papers also provide illustrations of failure and the lessons to be drawn.

## ***Forms of credit***

The most common form of credit is that supplied by the commercial banking sector. In transition economies, where funds are scarce and risks are high, this may prove a limited source of finance for agriculture in the early stages, especially given the small size of loans. On the other hand, the suppliers of inputs and the purchasers of outputs are likely to become important sources. However, this credit has proved costly in cases where competition among those supplying the credit has been insufficient. While agri-business, rather than agriculture, is the more likely recipient of Foreign Direct Investment (FDI), there is evidence that investment in upstream and downstream businesses can, indirectly, improve access to credit for agriculture. Examples include service packages provided by multinational agro-industrial companies in transition countries. As well as providing a source of credit, these address a number of constraints simultaneously, including the supply of inputs, a guaranteed outlet for products with prompt payment and access to production technology. While it is clear that the conditions to attract FDI are not always present in all transition economies, there is scope for encouraging local agro-industrial companies to offer similar services.

## ***Subsidised credit and credit guarantees***

Subsidised credit and credit guarantees have been used in many countries on the assumption that they improve credit availability and provide an incentive for investment and innovation. However, this type of credit has often proved ineffective and costly. To the extent that subsidised credit is introduced to offset perceived distortions affecting agriculture, experience shows that it would have been more effective to remove the initial distortions. In addition, low interest rates unduly favour capital intensive technologies and the rationing mechanisms employed often result in scarce funds being diverted to inefficient enterprises. Of a different nature, however, is start up capital for credit institutions, which can be regarded as an investment in institution building and a more efficient credit system.

Credit Guarantees are seen as less distortionary than subsidised credit and can encourage greater participation by commercial banks. However, while a distinction needs to be made between a refusal to pay, and an inability to pay because of force majeure, many such schemes have had a debilitating affect on credit markets.

Credit subsidies and guarantees cannot be abandoned overnight and they have a role to play in debt restructuring. Evidence was presented of a credit guarantee system operating effectively in Hungary. Nevertheless, given the distortions created in financial markets, a time limit needs to be placed on such schemes. During this time, subsidies should be progressively removed and credit institutions increasingly subjected to financial discipline.

## ***Financial institutions***

In different countries, various financial institutions have been established that provide an effective service to agriculture. Indeed a variety of financial institutions are preferable to a single specialised institution because this creates more opportunities for farmers, and others in the food chain, to have access to appropriately tailored sources of credit. This will also tend to diffuse political power and to spread risk. Financial institutions, and arrangements outside the banking sector, are likely to predominate in transition economies, at least initially. This is because they can offer tied or linked contracts, as in the case of the multinationals. These types of contracts permit better risk management than banks can provide. Banks are likely to serve as indirect lenders, supporting the input suppliers and produce buyers who offer contracts to producers. However, banks can be expected to become

direct lenders to agriculture as competition increases in credit markets and as rural lending risks become better understood.

In some countries co-operative institutions or specialised agricultural banks have proved successful. However, the key to success is not so much the type of organisation but rather acceptance by the local population and the presence of the trained staff with a knowledge of the sector and an ability to analyse loan applications and assess risk. Local knowledge and access imply local institutions or branches of national institutions.

### ***Role of government and legislation***

Another conclusion, based on many years of experience, is that Government has an important role to play in creating the environment for the development of soundly based financial institutions. However, the administration of loans, or of credit subsidies, is best left to the commercial financial sector.

The creation of the right environment requires legislation to control and regulate financial institutions, as well as to ensure the enforcement of contracts. Government also has a role in monitoring compliance with legislation. Transparency is essential so that failures can be reviewed with as much care as successes and lessons learned. Furthermore, the burden of risk must be borne by all parties in order to establish a culture that rewards producers who repay loans.

### **Conclusion**

The meeting concluded that, given the severe macro economic problems in Russia and the effects on other transition economies, there are few specific solutions for agricultural credit as long as these problems remain unresolved. Furthermore, without a market economy, the room for adopting market-based financial instruments in the agro-food sector is limited. The restoration of trust and confidence is needed and priority must be given to putting in place the fundamental elements of an integrated legislative, financial and institutional framework.

Government policy has to be carefully designed to create institutions and an infrastructure that are sustainable over the long run, rather than intervening in the market and implementing short-term measures, such as credit subsidies. Loan guarantees can be effective in stimulating lending to agriculture in the short term, as long as they are designed to maintain repayment incentives. Different types of financial institutions are needed for different sets of clients according to the scale of the farming operation but it is essential for those assessing applications for loans to have adequate knowledge of the agricultural sector. Non-bank credit schemes, vertical integration and FDI may offer channels for injecting the necessary capital into the agricultural finance system and spurring competition and innovation in financial markets.

### **Session I. Setting the stage: overview of agricultural finance in transition economies**

The papers in Session I provide a background against which the issues and options relating to agricultural credit in transition economies are considered. The first paper by **Hayashi** reports on the previous meeting on agricultural finance in transition economies held in Paris in February 1997. **Sutherland** draws attention to the current difficulties in the Russian banking system and the implications for transition economies, especially in respect of the reduction in Russia's imports. Banks in countries heavily dependent on exports to Russia, or with loan exposure, face particular problems.

Furthermore, countries that have made least progress in macroeconomic stabilisation and structural reform are likely to face the greatest uncertainty in respect of capital inflows given the depressed state of the international capital market.

The paper by **Von Pischke** considers the rural and financial pre-conditions for sustainable agricultural finance and, in particular, the issues of profitability, assessment of risk and enforceable contracts. It also points to those policies that had not contributed to financial market development or had even worked against it. According to **Swinnen and Gow**, the fact that access to finance has been severely constrained for agricultural producers in transition economies is due to a combination of standard problems of imperfect and costly information and other more specific factors. The credit situation is improving due to increased profitability and institutional innovations but the financial situation remains more problematic in those countries which have postponed reforms. This latter factor is illustrated in the paper by **Serbanescu**. Only since 1997 have significant reforms been implemented in Romania and problems of access to credit by private agricultural households remain. However, reform, privatisation and the development of a diversified banking system would enable an appropriate rural financial system to be established. **Khlystun** recognises the tight financial constraints in Russia but suggests that the situation could be improved by the creation of a favourable investment climate and by making agrarian projects attractive for investment. Actions needed to achieve these outcomes are listed.

It was accepted in the discussion that there are **common problems of agricultural finance in transition economies**. Similar problems have been faced by OECD countries and advice based on past experiences could be valuable. At the same time, forms and systems of agricultural finance for each country in transition would vary depending on the structure of agricultural production and cultural backgrounds. The importance of differentiated approaches, and the need for different types of loan according to specific conditions, was noted. Another crucial issue is the **profitability of agriculture**. Low profitability in transition economies was initially due to a reduction in subsidies and price and trade liberalisation policies which resulted in a substantial deterioration in the terms of trade for agricultural products. However, the financial situation of agriculture has been especially poor in those countries which have failed to implement or enforce the necessary institutional reforms to enable markets to function competitively. A **sustainable agricultural finance system requires a dynamic agriculture** based on market principles which ensures that efficient producers, and structures created by successful reforms, survive and develop but that less efficient ones leave the sector. Failure to enforce bankruptcy laws has been a particular problem. However, if general profitability in agriculture is low, the position is more difficult. The relationship between low profitability in agriculture and unsuccessful reform attempts can be seen in the problem of using **land as collateral**. Failure to establish well-defined property rights restricts such use of land. However, introducing a legal basis for the use of land in this way is not a sufficient condition for producers to gain access to financial resources. A profitable, but soundly based, agriculture is needed to create a demand for land and to ensure price stability, in order for land to be used as collateral.

Attention was drawn to the problems created by policies in Russia which result from the huge export potential of mineral resources and materials, allowing for a positive current account balance. This contributed to the substantial real appreciation of the rouble exposing many branches of domestic industry, including agriculture, to a rapid increase in imports. The financial crisis of 1998, and the resulting devaluation, has been a severe blow to Russia's economy, especially for the finance and trade sectors and consumers have suffered from the renewed inflation spiral. On the other hand, the **devaluation of the rouble has raised the cost of imported food and has provided Russian agriculture with an opportunity to recover competitiveness**. The lack of normally functioning markets, the predominance of barter transactions, accumulated arrears and the failure to establish an appropriate financial mechanism for agriculture are, however, preventing this. Restructuring of the

accumulated debt of agricultural enterprises is needed. **The Government has a role to play in developing normally functioning markets and in providing procedures for the restructuring of debt.**

## **Session II. Banking for the agricultural sector**

The papers in Session II focus on the experience of a number of different countries in providing banking services to the agricultural sector. For instance, **Duncan** points to the evolutionary process of agricultural banking systems in OECD countries, especially the United States. The need for a sound statutory, regulatory and institutional foundation is emphasised as well as recognition of the impact of structural changes on producers and lenders. In New Zealand, according to **Gow**, the role of the Rural Bank in a debt restructuring process, following major macroeconomic policy changes in the 1980s, ensured that all parties bore their share of the cost. Armbruster points to the long tradition of rural finance which indicates the need for a system with no tax privileges, that is available to all and provides multipurpose credit. However, co-operative banks (like those in Germany) cannot solve macroeconomic problems. **Neveu**, drawing on the experience of Crédit Agricole, stresses that, before decisions are taken to create a bank for the farming sector, it should be ascertained whether a less expensive system is available; for instance, by utilising the existing banking system. Any system must provide an effective answer to the requirements of farmers with cash flow needs, as well as the needs for long term finance.

**Kawai** reports on the experience of financing agriculture in a number of transition economies and suggests that credit co-operatives could be a powerful tool in fostering the economic culture needed to remove bottlenecks in the rural sector. High transaction costs and lending risks tend to restrict penetration of the rural sector by traditional banks. However, **Deschamp** draws attention to many instances of ineffective intervention by Governments although they do have an important role to play in creating a better environment in which private initiatives can flourish. **Trushin** charts the difficulties of Agroprombank in Russia and stresses that the lack of an agricultural credit system approved at the legislative level, and the adverse environment, affects the financial standing of all forms of agricultural enterprises. More efficient intra-bank procedures of decision making are needed.

During the discussion, some supported the view that agricultural banking should focus on restructuring and revitalising large insolvent units. Others pointed to the necessity of small scale lending for private small holdings (PSH). In practice, the two points of view are not contradictory. **Sound parts of insolvent enterprises should be saved** but there is also a need to provide credit to private small holdings and rural families, especially where collective farms have been economically destroyed.

There was some **scepticism over the development of credit co-operatives** in Russia and other CIS countries. First, the confidence of the rural population in financial institutions has been broken by the financial crisis making it difficult to attract savings. Secondly, there was some doubt over the availability of the necessary start up capital. Although Sberbank (Russian Savings Bank) is trusted and has branches in all regions, and deposits guaranteed by the Government, it has no experience in handling agricultural credit or small loans for the rural population. It was concluded that **different systems are required to meet different needs.**

Agriculture in western countries has benefited from subsidised credit but has now turned to more market solutions. Government support may be relevant but the right conditions for agriculture have to be created and more modern approaches need to be introduced instead of ineffective disbursement of budget funds via State controlled institutions. The countries of central and eastern Europe (CEECs)

can provide valuable information based on **experience with setting up micro-credit schemes, guarantee funds and credit co-operatives, as well as funds to finance other rural activities.**

It was frequently emphasised that credit systems and institutions cannot solve the problems arising from macroeconomic instability. Any finance and credit system for agriculture would need a legal base, and education and training in lending to agriculture, as well as adequate information for borrowers and lenders. It is also important that risk be shared. **The State has a role in developing a competitive environment** and, in some countries, the State has been involved in setting up co-operative banks. However, the general view was that state involvement and support should be limited to the initial phase. Experience in western countries was that **specialised institutions have remained viable without government assistance by diversifying activities to meet local needs more effectively.**

### **Session III. Complementary commercial credit schemes in the agricultural sector**

The papers in this section focus on the use of instruments, other than traditional bank credit, to finance agriculture and, according to **Pederson**, the use of leasing, trade credit and commodity financing is increasing in OECD countries. This is because of the changing structure of production and also the cost competitiveness of these sources of credit. However, success depends not only on the profitability of the sector but also on the presence of supporting institutions and markets so that contractual arrangements are enforceable and risks can be assessed. **Gow and Swinnen** note that a lack of restructuring of the food processing sector is a major cause of problems for agricultural producers. Delay in payments causes cash flow and profitability problems which constrain access to credit. Supply contracts, co-operatives or vertical integration are not short term solutions, but there is evidence that Foreign Direct Investment (FDI) in the food processing sector could have beneficial spillover effects for lending to producers. Research by **Foster**, supports the view that FDI may be one of the few means for farmers to acquire critically needed credit, access to inputs and markets and management skills. However, the providers of FDI require a stable macroeconomic and political environment, which is not always present in transition economies.

**Zlochevskiy** suggests that the lack of an integrated approach to the provision of credit in Russia is largely responsible for the failure of private agricultural credit. On the other hand, **Martin**, drawing on EBRD experiences, reports on the success of the Grain Receipts Programmes in helping to overcome the shortage of working capital in some transition economies. Although crop yield insurance is a means of sharing risk in agriculture, **Skees** concludes that this has been a failure in most countries. He proposes indexed contracts as a market-based risk-sharing alternative for agriculture.

Participants agreed that **non-traditional forms of credit provide opportunities for finance at the farm level where bank credit has failed.** This is particularly the case with leasing (financial leases for equipment) and trade credit (either from suppliers or from processors). Other instruments, although not necessarily appropriate in present circumstances to the CEEC and NIS countries, have shown promise in economies at a similar level of development; for instance, the use of forward contracts in Brazil. Experience in eastern Europe, as well as in the NIS countries, also points to the positive effect that FDI can have on financing agriculture.

However, it was made clear that there are pre-conditions to the success of providing these non-traditional forms of credit which are, in some cases, absent in transition economies. These include an appropriate legal framework and contract enforcement, an adequately developed financial sector and an environment which allows non-bank financial institutions to become established. In addition, a regulatory and tax environment, which does not discriminate against such financing, is necessary.



Concern was expressed at the impact on farmers' incomes of predatory practices of large-scale suppliers or purchasers. Solutions were seen to lie in the establishment of long-term relationships between farmers and providers and in increased competition in the provision of finance.

#### **Session IV. Credit subsidies and credit guarantees in agriculture**

Preferential credit systems and credit guarantees, and the role of government in rural credit markets are considered in this section. It was generally recognised that most credit guarantee programmes incorporate some form of interest rate subsidies. **Van Empel** provides a bank perspective and suggests that preferential credit schemes are instruments of the past due to the high costs involved and they do not facilitate structural adjustment in agriculture. At the very least, they should be evaluated against other policy instruments in terms of their costs and impacts. He argues that the State is not effective in credit delivery and its role should be limited. Transaction cost subsidies might be more effective and project finance might solve the financial requirements of groups of producers during restructuring.

Case studies are presented on existing agricultural credit guarantees schemes. Deficiencies are identified by **Doucha** in the establishment of the credit support and guarantee fund in the Czech Republic and ways to improve the structure and management of the fund are suggested. According to **Yurugi**, experience in Japan is that credit guarantee schemes are important, but require clear rules that are enforced. **Ulrich** notes, however, that the Rural Credit Guarantee Foundation (RCGF) in Hungary has achieved an efficient operating system and strong bank participation. **Matusevich** reports on a new guarantee scheme that is currently under development by the World Bank in Nizhny Novgorod. The proposed guarantee fund is small and already faces significant implementation barriers due to the adverse conditions that are found in the agricultural and banking sectors in Russia. The paper presents an account of the process in establishing the design of the scheme.

It was the general view of the presenters that credit guarantees improve the access of farmers to formal credit institutions, since the guarantee addresses the problem of inadequate collateral that many farmers face when banks are approached. At the same time, it was recognised that credit guarantees have a minimal effect on farm profitability and farmer debt repayment capacity.

In discussion, **general and specific concerns were expressed over the use of credit subsidies and credit guarantees in agriculture**. There is a danger that credit subsidies have a corrosive effect on rural financial markets by eroding credit discipline among farm borrowers and by unfairly displacing commercial credit. A major concern is that these instruments provide for the strong involvement of the State in rural financial markets. Yet it is not clear that the actions of the State provide an effective response to credit market failure.

A second major concern is that there is relatively little evidence that these programmes constitute an efficient use of public resources. They represent costly credit market interventions, yet the performance indicators of most funds suggest that they are not self-sustaining and nor do they result in a build up of funds. **More needs to be known about how the operations of the funds have responded to changing conditions** and to interpret how these changes have affected fund performance.

It was concluded that **credit subsidies are least distortionary if they are pursued for short periods with a clear end point**. To the extent that governments frequently use credit subsidies to compensate agriculture for the effects of other distortionary policies (tax, trade, price, etc.) that are biased against agriculture, a more rational policy would be to remove the distortions and to promote the important role of rural finance institutions.

It was agreed that **correct incentives would bring greater bank participation, would improve access to credit and would enhance fund performance.** Conversely, poorly designed or ineffective incentives would result in increased problems of moral hazard and adverse selection in rural credit markets. The process of establishing the guarantee scheme in Nizhny Novgorod was seen as a good example of the difficulty of getting incentives right when designing a credit intervention scheme.

**Note:**

The proceedings of the “Second Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies” is available as an OECD publication:

*Agricultural Finance and Credit Infrastructure in Transition Economies*, Proceedings of OECD  
Expert Meeting held in Moscow on 10-12 February 1999, Paris.

# **AN OVERVIEW OF AGRICULTURAL CREDIT INSTRUMENTS, INSTITUTIONS AND CHALLENGES IN BULGARIA, ROMANIA AND SLOVENIA**

**By Mr. Michael M. Ryan**

## **Abstract**

*Lending by commercial banks to agriculture has been constrained during the 1990s in the central and eastern European region due to several factors including the high risks associated with greater economic uncertainty, privatisation and restructuring of the economy, as well as dramatic institutional reforms, especially in the financial and banking sector. The lack of competition in the banking sector has often resulted in high interest spreads, which in turn has restricted lending. Developing confidence in the banking sector has also been a problem with financial crises in several countries in the region. Lending to agriculture has been further impeded by the lack of collateral, low profitability and higher perceived risks associated with the sector. In general, commercial banks have taken a rather conservative approach in lending to agriculture and often lack the in-house expertise to adequately assess the risks associated with lending to the sector. Moreover, agricultural land is generally not accepted as collateral for loans as an active land market does not yet operate in the region. This has led to a range of credit policy instruments and specific lending schemes being introduced in an attempt to increase the flow of credit to agriculture and to facilitate modernisation and restructuring of the sector. The paper examines these developments with particular reference to the situations of Bulgaria, Romania and Slovenia.*

## **Introduction**

Considerable progress has been made across the region of central and eastern Europe, in a relatively short period of time, in macroeconomic stabilisation, establishing the legal framework for private property rights and developing the economic structures and conditions for the functioning of a market economy. Substantial improvements have also been made in the dissemination of market information, as well as in developing price information systems and physical market infrastructure.

For more than a decade the lack of, or limited access to, credit has been a major impediment to the development of primary agriculture, as well as the upstream and downstream sectors in all transition economies. Access to credit has been made more complicated due to the rapid changes in the macroeconomic environment, privatisation and the implementation of structural reforms. In an attempt to overcome market imperfections with respect to finance and credit, Bulgaria, Romania and Slovenia (BRS) have introduced an array of credit policy instruments during the 1990s to supplement commercial credit. These include various forms of loan guarantees and preferential credits designed to increase the availability of credit to farmers and the food-processing sector. Moreover, several countries in the region have also established specialised credit institutions to channel credit to primary agriculture, as well as to the upstream and downstream sector. However, the impact of these measures to-date have been rather mixed, and much remains to be done.

While there are many common problems associated with the provision of agricultural finance in transition countries, nevertheless, the forms and systems of agriculture finance suitable for each country in the region is strongly influenced by the structure of agricultural production and cultural background. The importance of differentiated approaches and different types of loans according to

specific conditions has been well documented in the literature. It would appear that the financial situation in agriculture is more acute in those countries where economic, structural and institutional reforms were delayed or only partly implemented. With the privatisation of agricultural land in all central and eastern European countries (CEECs), the structure of demand for agricultural credit changed considerably. This has resulted in a radical adjustment in the agricultural credit systems and the development of new structures to serve the credit needs of small-scale producers.

While the issue of agricultural credit has been widely debated by policy makers, researchers and academics, many of the difficulties and challenges faced by private farmers in transition economies in obtaining adequate working and investment capital remain. The purpose of this short paper is twofold: first, to provide an overview of the main agricultural credit instruments and institutions that are used in Bulgaria, Romania and Slovenia; and second, to outline some of the outstanding challenges to policy makers on the issue of credit and finance in transition economies.

## **Agricultural credit instruments and institutions in Bulgaria, Romania and Slovenia**

### ***Bulgaria***

The provision of preferential credits to agricultural producers has been an important plank of the agricultural policy framework in Bulgaria since the start of the reform process. During the 1990s, subsidised credits have been the main form of budgetary support to agricultural producers. Most commercial banks had little interest in lending to agriculture due to the perceived high-risks involved, arising from the severe macroeconomic uncertainty, especially up to 1997. Moreover, the underdeveloped banking sector and lack of financial resources further hindered farmers access to credit. In the mid-1990s, the *State Fund "Agriculture"* was established, with the specific function of financing agriculture including granting preferential credit to farmers, both short and long term, as well as the provision of collateral support for investment credits.

### ***Preferential credits and loan guarantees***

In Bulgaria the Government intervened in the agricultural credit market by providing interest rate subsidies and loan guarantees for producers. Preferential short-term credits were granted mainly to grain and oilseed producers over the period 1991-1998, prior to the beginning of the autumn and spring sowings. In addition, short-term credits were also provided to wheat producers for harvesting. In 1998, bank guarantees were introduced in order to help farmers overcome the problem of inadequate collateral. For livestock producers, preferential credits were mainly in the form of medium and long term credits. In the early 1990s the uptake of subsidised credits by producers was limited and a large part of the allocated credits was not used. The low uptake of these credits was due to several factors including the difficult financial situation of many farms, high nominal interest rates, insufficient information on the eligibility of farmers for credits, as well as the lack of collateral.

The development and administration of preferential credits have had a complex evolution in Bulgaria. In 1991/92, preferential credit schemes were established by Government decrees and in 1993/94 were administered under the laws on financial support to spring and autumn seasonal work. In 1995, the administration of credits became part of the new Law for Protection of Agricultural Producers. Credits given under the various Government decrees and laws for financial support to seasonal work were invariably short-term credits and supported farmers' cash flow. In 1992, about 320 million leva were allocated from the state budget to subsidise interest payments on short-term working capital to

agricultural producers. Between 50% and 70% of the interest rate was covered by the state budget. The credit subsidies were paid from an extra budgetary account of the Ministry of Agriculture. Moreover, commercial banks were more inclined to provide loans to farmers where credit subsidies had been approved. With the high and rising rates of inflation in Bulgaria, credit subsidies rose during the 1990s to reach 1.8 billion leva in 1996, but fell sharply the following year with the monetary tightening under the Currency Board system.

### *Investment credits*

Under the *State Fund "Agriculture"* credits were provided for capital investment in machinery, livestock, livestock buildings and glasshouses. By the beginning of 2000 over 550 projects had been approved for funding. In 1999, about 75 million leva was allocated to support capital investment in agriculture, for example.

### *Collateral in agriculture*

Agricultural land in Bulgaria, like in most CEECs, has not been accepted as collateral for bank loans during the 1990s due to problems of establishing clear ownership rights. Even when property rights were fully restored, banks often refused to accept agricultural land as collateral because of the absence of a functioning land market. Moreover, the continuous reorganisation of agricultural enterprises and the high transaction costs in monitoring the use of credit makes agriculture an unattractive sector for investment for most commercial banks. Typically banks require residential property in urban areas and accept about 50% of the market value of fixed assets in urban areas and 30% in rural areas as collateral. The requested collateral may range from 150% to 200% of the value of the loan. In an attempt to overcome the collateral problem, the warehouse receipts system (WRS) was introduced in 1999. The workings of the WRS are described in the following box.

#### **Box 1. Warehouse Receipts System (WRS)**

In 1998 the adoption of new regulations covering the storage and trade in cereals was approved. This set of regulations created the basic framework for the functioning of the warehouse receipts system, which in essence improves access of grain producers to commercial bank credit. The main purpose of the WRS is to increase liquidity to cereal growers at a reasonable price. This system is based on licensed public warehouses that are entitled to issue receipts for grain storage. The warehouse receipts can be used as collateral for loans from commercial banks. In practice, this gives agricultural producers the opportunity to use credits for working capital without being forced to sell their crops immediately after harvest. Participation in the WRS was low in 1999, but rose sharply in 2000. The number of licensed warehouses has increased appreciably in 2000 and the storage capacity has more than doubled to 1.6 million tonnes. The amount of grain stored is estimated at 85 000 tonnes of wheat and about 5 000 tonnes of barley.

### *Credit Co-operatives - Agricultural Capital Fund Scheme*

In 1995, new regulations were introduced to enable the establishment of a network of credit co-operatives of private farmers - Private Mutual Rural Credit Associations (PMRCAs). The key objective of these credit co-operatives is to provide financial support for production and processing of agricultural produce, as well as the purchase of agricultural machinery. In 1996, several groups of farmers established credit co-operatives. Participation in the scheme requires that all new

co-operatives must register and implement the statutes of the Scheme. In addition, each co-operative should have a minimum of 100 members (at least half should be private farmers) and have a share capital of at least 500 000 leva.

The European Commission, through the PHARE Programme, and the Bulgarian government provided seed funding of 7 million and 3 million, respectively, to facilitate the establishment of the co-operatives. These funds were given to the co-operatives as capital grants. Following several amendments to the Law for the Support of Agricultural Producers, almost, 4 billion leva were allocated to the Scheme in the form of a non-repayable grant. In 1997, further changes were made to the requirements for establishing credit co-operatives including an increase in share capital to at least 34 million leva and the number of members was raised to a minimum of 200 people. Essentially, these changes were made so as to develop more stable PMRCAs.

At this juncture, there are over 30 PMRCAs in Bulgaria with a total membership of about 10 000 people, and share capital of over 2 billion leva. Each of these co-operatives has at least 200 members. The PMRCAs have achieved a loan repayment rate of over 90% and have gained the reputation as a very reliable source of financing in rural areas.

In addition to the credit schemes described above, special medium and long term loans have also been provided through bilateral programmes, as well as through World Bank structural adjustment loans.

## ***Romania***

### ***Preferential short-term credits***

Prior to 1997, the main objective of agricultural credit policies in Romania was to support the state-controlled food production and distribution system. Preferential credits were given to large-scale farms who supplied raw material to large state-owned processors and state agencies that purchased agricultural and food products. Funds allocated to preferential credit were provided from the National Bank of Romania (later from the state budget), and the State decided on the allocation of these credits, controlled its administration and set the price. The loan allocation procedures were based on the system of credit rationing rather than through assessing the creditworthiness of producers and processors. The state bank, Banca Agricola, has been the main institution for disbursing preferential credits in Romania.

A wide array of preferential credit schemes operated in Romania between 1992-1996. These schemes were based on a combination of three elements: reduced or zero interest on government funds transferred to intermediary banks; strict margin limits for banks handling preferential credit to borrowers; and, strict limits on interest rates to borrowers.

The most important type of loan was short-term, which accounted for about 95% of total preferential credit disbursements over the period 1992 to 1996. During this period the rules and regulations governing the disbursement of credits changed frequently and each year new government decrees were made, often on an ad hoc basis. For 1992, preferential credits were estimated at over 200 billion lei, and accelerated rapidly up to 1996 (almost 20 fold). However, since 1997 they have fallen sharply due to a change in the policy instruments for supporting agriculture and the introduction of input vouchers, as well as the substantial fall in the rate of inflation. In 1999, preferential credits were estimated at 650 billion lei.

After the introduction of the new reforms in 1997, preferential credit was limited to mainly short-term credit for planting and harvesting and loans to livestock producers. The government created a Revolving Fund, which handled the disbursement of these credits and the system of purchase loans was abolished. However, in 1997 the government created a temporary Wheat Fund, which provided subsidised loans to downstream agents for wheat purchases. Moreover, there was a substantial re-focusing of policies away from credit subsidies for the large-scale sector to direct input grants (voucher system) for small-scale individual producers.

### *Preferential investment credit*

Preferential investment loans played a very minor role in Romania and represented less than 5% of the total preferential credit disbursements in the period 1992-1996. Nevertheless, several different types of investment loans existed:

- five-year loans for the purchase of agricultural machinery and livestock;
- long-term loans for land improvement; and,
- long-term loans for farm restructuring.

#### **Box 2. Banca Agricola (BA)**

During the 1990s, Banca Agricola was the principal lending institution to agriculture and was responsible for implementing the various agricultural credit programmes. Almost 90% of the preferential credits disbursed to the agro-food sector was channelled through the BA. In 1997, the Bank came close to collapse, due to its high exposure to bad debts. The Bank had a rather narrow portfolio and focused mainly on agricultural lending and, in particular, the administration of preferential credits. With the restructuring of the Bank, it has further diversified and reduced its exposure to the agricultural sector. With the privatisation of the Bank, there is likely to be further streamlining of its organisational structure and modernisation. The government took up most of the bad loans of the Bank.

### *Credit co-operatives*

A number of formal arrangements are currently used to provide credit to small scale producers in Romania. In 1994 a Rural Credit Guarantee Fund (RCGF) was set up, with 90% of its start-up capital coming from the European Union. The RCGF was designed to facilitate lending to small and medium sized farms and agro-business firms by providing a guarantee of the loan recovery risk. A Romanian Loan Guarantee Fund for private Entrepreneurs, established in 1994, also extends credit guarantees to small private farmers.

The CREDITCOOP is a nation-wide credit association consisting of 700-800 active co-operatives. The co-operatives that belong to this association combine producer and consumer credit functions, including lending to small-scale agricultural producers. In addition, individuals are eligible for state preferential credits and loan guarantee facilities through the commercial bank sector.

During the transition decade, small scale producers have had little opportunity to obtain commercial credits, as much of the existing formal credit facilities were not suited to the needs of small-scale producers. Rural credit co-operatives are also limited by the availability of funds. Moreover,

institutional borrowers mainly used trade credits and credit guarantees. Therefore, small-scale producers have relied predominantly on family financing or on informal credit, *e.g.* financial self-help groups.

### *Input vouchers*

In 1997 a voucher programme was launched in an attempt to improve the availability of inputs to small-scale producers. The programme was targeted at financing agricultural inputs to small-scale private producers, and, at the same time, to stimulate the development of the upstream input supply sector and services. This scheme allocates small-scale landholders a number of vouchers with which they could purchase agricultural inputs. Input suppliers accepted these vouchers and could redeem them at the government-authorised banks. The cost of voucher redemption was fully covered by the state budget. In 2000, the programme became administratively very complex and difficult to manage and was discontinued. For 2001 the programme of input vouchers has been replaced by a new direct payments scheme.

## **Slovenia**

Following independence, Slovenia has applied a range of direct and indirect price policies to support agriculture and the agro-food sector. Direct price regulation has been based on fixed administered prices for the main commodities. Indirect support involves an array of policy instruments including export promotion payments, preferential credits to food processors, and intervention purchases of some products. The new policy mix envisages the abolition of the administrative price regulation mechanism and the implementation of CAP type policy instruments to support agriculture.

In Slovenia, market price support and direct payments have been the dominant policy instruments, while credit policies have played only a minor role in the overall policy mix during the 1990s. More specifically, while the provision of preferential credits to primary agriculture has been limited; the provision of such credits to the food-processing industry has had an important role in developing the processing sector.

### *Preferential short-term credit*

Preferential short-term credits have been used in Slovenia during the 1990s, especially preferential credits to food processors. The main purpose of these interest rate subsidies was to improve liquidity in the agro-food chain and to encourage domestic processors to purchase commodities from farmers. In 1999/2000 all remaining subsidies on agricultural short-term loans were abolished.

### *Preferential investment credit*

Investment support is provided in the form of subsidised long-term loans and capital grants to farmers. There are four main types of agricultural investment programmes in Slovenia: the land improvement programme (*e.g.* irrigation, consolidation, etc.), the farm investment programme, the young farmer investment programme, and the programme for upgrading and renewal of permanent plantations (*e.g.* orchards, vineyards).



During the 1992-1999 period, the amount of budgetary funds allocated to interest rate subsidies and for capital grants grew substantially, especially during the latter half of the 1990s. In general, there is no limitation on investment support to individual farmers. In addition to supporting primary agriculture, investment support is provided to the downstream sector for improvements in marketing, storage and processing facilities. Support is also provided in the form of capital grants, long-term loan subsidies and state guarantees for capital investments. In 1997/98, this type of support was particularly important when significant investments were made in the construction of new storage facilities for perennial fruits.

### *Credit co-operatives - Savings and Loans Services (SLS)*

Credit co-operatives have played a crucial role in providing finance to small-scale farmers and rural entrepreneurs over the years. These co-operatives have been an important institution in rural areas, accepting money on deposit and providing relatively easy access to funds at low interest rates to farmers. Credit co-operatives are widely distributed in the different regions of Slovenia and have a high reputation amongst small-scale farmers. They are generally considered to be well placed to understand and respond to the needs of small-scale farmers. During the 1990s, the rules and regulations governing the operation of the SLS have been changed on several occasions and the credit co-operatives now face a formidable challenge to meet these new banking requirements.

### **Conclusions and challenges**

- There has been considerable **government intervention** in agricultural credit markets in the BRS since the beginning of reforms in 1989/90. Intervention has often been justified in response to the perceived market failure with respect to the lack of access to finance and credit for developing the agro-food sector. The lack of access to credit, as well as the high cost of credit to agriculture, has been viewed as a major impediment to the development of a competitive and sustainable agro-food sector.
- The lack of access to both working capital and investment capital in the BRS during the 1990s is a **symptom** of more fundamental underlying problems such as the unstable macroeconomic environment, under-developed financial and banking institutions, weak market infrastructure, as well as the lack of reliable information on production, pricing and profitability in the sector.
- The lack of functioning **factor markets** (land, labour and capital) and **product markets** have contributed to the severe price-cost squeeze in agriculture, especially during the early part of the 1990s. This has contributed to low profitability in the sector and has reduced the attractiveness of agriculture when competing for investment credit.
- The slow **process of privatisation** of land and agricultural assets in CEECs (with the exceptions of Poland and Slovenia) has contributed to the high degree of uncertainty and risk associated with lending to agriculture. Moreover, the small scale of production units emerging from the land restitution process increases transaction costs to financial lenders and hence the cost of lending to farmers.
- Bulgaria, Romania and Slovenia have used a wide **range of credit measures** to support agriculture and the food processing sector including preferential short-term and long term credits, loan guarantees, debt write-offs, etc. In addition, inflows of FDI to the

upstream and downstream sectors, albeit limited, have contributed to an increase in trade credit to farmers in some sub-sectors.

- There appears to be some trend away from **short-term preferential credits**, except under exceptional circumstances, toward medium to long term investment loans and grants in the BRS.
- While much progress has been achieved in economic stabilisation, institutional reform and privatisation in the BRS, nevertheless, many **challenges** remain:
  - How to develop a market based, but differentiated approach that meets the needs of both large scale and small-scale family farmers. Preferential credits are not a solution to overcoming economic distortions arising from price and trade policies. The first best option is to remove existing distortions in the economy that impede the development of a market based agricultural credit system.
  - Since there is no single approach that satisfies the needs of agriculture in the BRS, therefore a range of new institutional innovations should be examined. For example, this could include the following:
    - leasing arrangements;
    - trade credits - with greater vertical integration in the production and processing of food, there is likely to be greater scope for an increase in trade credits in many transition countries;
    - future contracts/markets;
    - farmers' credit card system, *e.g.* Indian experience.
  - All new approaches and measures adopted to provide credit to agriculture need to be regularly reviewed and assessed in light of the ongoing changes in structural and support policies, as well as developments in the macroeconomic environment.
  - Further changes in credit policies in the EU pre-accession countries are likely to be closely linked to changes in the EU's structural and domestic price policy regime. For the BRS, and indeed for most of the pre-accession CEECs, a large part of all future budgetary support to agriculture, including credit subsidies, is likely to be channelled through the Special Accession Programme for Agriculture and Rural Development (SAPARD).

## **BIBLIOGRAPHY**

OECD (2001a),  
*Agricultural Policies in Emerging and Transition Economies 2001*, Paris.

OECD (2001b),  
*Review of Agricultural Policies: Slovenia*, Paris.

OECD (2000a),  
*Review of Agricultural Policies: Bulgaria*, Paris.

OECD (2000b),  
*Review of Agricultural Policies: Romania*, Paris.

# **PUBLIC POLICY AND PRECONDITIONS FOR SUSTAINABLE RURAL FINANCE SYSTEMS**

**By Mr. J.D. Von Pischke**

## **Abstract**

*Public policy preconditions for sustainable agricultural finance include: 1) confidence at the macroeconomic and societal levels, 2) rational agricultural production incentives, 3) competitive financial markets, and 4) enforceable contracts. Rural preconditions for sustainable agricultural finance and credit include: 1) profitable farms, 2) adequate supply and timely delivery of appropriate productive inputs, 3) efficient input application, 4) adequate storage and transport, and 5) market demand. Financial preconditions include: 1) access to credit institutions, 2) information to evaluate risk, 3) adequacy and quality of lender capital and loanable funds, and 4) well structured loans. Formal agricultural credit in transition economies is probably most likely to be characterised initially by tied transactions involving input suppliers, produce buyers or landlords as lenders. Essential characteristics of financial markets offer building blocks for sustainable systems. Recent history provides a catalogue of failed efforts and policies.*

## **Introduction and definitions**

Preconditions suggest something prior, a sort of root. In this context it is useful to reflect on the etymology of "credit." Its Latin root is *credere*, which means to trust or believe (Oxford English Dictionary). Trust is the fundamental precondition for credit. Borrower and lender must have a bond of mutual trust: they must be confident about the behaviour of each other as it could affect their relationship.

"Sustainable" requires definition, not least because it has become widely used in the vocabulary of development assistance. In finance, sustainability can easily be defined as positive net present value. Nothing exists forever, and sustainability in finance means merely that the owner recoups an initial investment plus a surplus that equals or exceeds an opportunity cost of capital. This definition is consistent with a dynamic, ever-changing financial system that embraces innovation through all sorts of financial instruments, which include debt, equity or ownership capital, and guarantees. Variations such as leasing as a form of debt and futures contracts as a form of guarantee are important in modern agriculture. Finance is defined to include permanent investment by owners, or equity finance, as well as temporary investment by creditors, or debt.

This paper refers to the "frontier" of formal finance which separates those who cannot get credit from formal financial institutions such as banks and co-operatives from those who can. Every credit project and every competitive financial institution attempts in some way to expand the frontier. In a more subtle sense there are a number of frontiers, one for each type of financial service. Changes in terms and conditions of these services and the introduction of innovative new services move the frontier. (Innovation reduces costs; things that are merely new are not always innovative.) Financial development moves the frontier in directions that provide more and more people with an expanding range of financial services.

This paper views preconditions as steps in the continuing process of financial development. Accordingly, it examines how debt capacity is created. It explains how the frontier is moved outward

in agricultural finance, with special attention to features that are important for transition economies. It begins by examining how trust is created in financial markets, and how financial innovation occurs and why it is useful economically and socially. The discussion then turns to the credit process and the specific requirements for the creation of sustainable agricultural finance and credit systems. Public policy touches all of these variables, and hence requires careful consideration, and by its nature, scepticism.

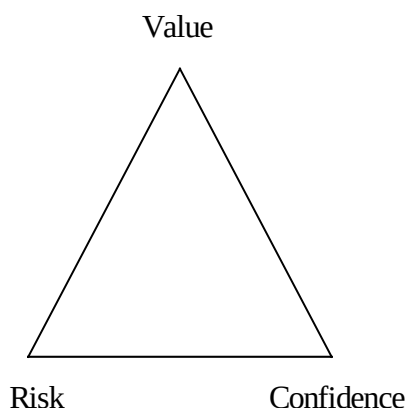
### **How financial markets create value**

Financial contracts create value in the sense that funds are exchanged for promises. Credit markets deal in promises to repay, exchanging cash now for repayment in the future. The value created in a credit transaction equals the size of the loan. Equity markets deal in promises to share in control and in allocation of expected earnings, and value created is equal to the price of the share of stock. Participants in financial markets clearly have incentives to create more value by issuing and obtaining more and larger loans and by increasing share prices.

But why would anyone give money in exchange for promises? The answer is found in the building blocks of finance, which are value, risk and confidence. Value is created only when confidence offsets risk. Risk is created by every financial transaction because the future cannot be predicted with certainty: repayment in full is never completely secure until it is achieved, and stock prices fluctuate. When risk is small, which occurs when confidence is great, lots of value can be created. When confidence is weak, value creation is difficult. These simple truths can be illustrated by the financial triangle found in Figure 1.

How can more value be created, given these building blocks? Here again, the principles are simple. There are only three ways in which financial markets create value and expand the frontier: by lengthening term structures, by reducing transaction costs, and by refining valuation processes.

**Figure 1. The financial triangle**



### ***Lengthening term structures***

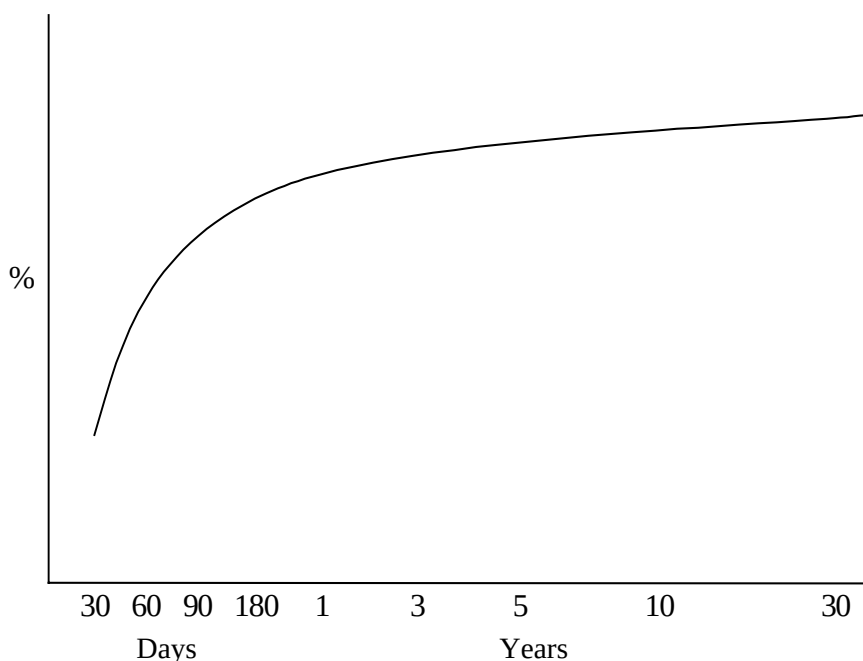
Term structure is a financial phrase that denotes a time horizon, or movement toward a time horizon, in credit markets. Term structure is created by exchanges of cash in the present for promises to repay in the future. Thus, term structure is essential for creation of value.

Term structure is related to loan size. When time horizons are short, it may be possible to borrow against the next pay cheque or the next harvest. If term structures are longer, it may be possible to borrow against a large number of expected pay cheques or against several expected harvests. Clearly, a loan against the next pay cheque or harvest would not exceed the amount of the pay cheque or the value of the harvest. However, a loan against a series of expected sources of income can be much larger.

In normal times, banks are willing to lend at longer maturities than they borrow, in order to increase the spread between their cost of funds and their lending rate of interest. For example, a bank's sources of funds may consist largely of demand deposits that depositors can withdraw at any time, which gives these funds a technical maturity of zero days. However, experience indicates that not everyone will withdraw their funds at the same time, but rather that demand deposits turn over at a certain rate, or in effect, have a maturity equal to the number of days it takes the deposit portfolio to turn over. A core of deposits is likely to remain on the books regardless of the normal or expected changes in economic conditions. Bankers have an incentive to lend these deposits at longer maturities because interest rates on longer-term loans are higher than those on shorter-term loans.

The gain from this strategy of "term transformation" can be illustrated by the "normal yield curve," shown in Figure 2. It indicates that interest rates rise steeply at first as maturities lengthen and then tends to level off, with very long maturities of 30 years yielding only slightly more than ten year maturities.

Figure 2. The normal yield curve



But what creates the yield curve? Term structure depends upon expectations, which relate to confidence. The longer into the future a promise extends, the higher its risk, other things remaining equal. This is because the distant future is more uncertain than the near future. More time means more chances for things to go wrong, and in more ways. Hence, more confidence is required to offset more risk.

### ***Reducing transaction costs***

Transaction costs are the admission tickets to financial markets. They determine who has access to financial services and the types of financial services that are provided. Transaction costs must be borne by all parties to financial transactions because they are the costs of establishing and maintaining financial relationships. Typical transaction costs include information gathering, security arrangements to protect cash and documents and other data, recording systems for transaction processing, and queuing and decision making.

At the frontier, loan applicants often face large transaction costs in obtaining access to formal credit. First, they have to locate potential sources of credit and find out what sorts of services, with various terms and conditions, might be available, and they must provide information to establish their credibility. They may have to wait for uncomfortably long periods in order to obtain decisions from lenders, with lots of negotiation regarding loan terms and conditions. In some countries loan applicants have to offer "gifts" to officials of the lending institution. They may have to find guarantors and meet their conditions, too. Borrowers in rural areas with poor communications may face high transport costs and spend lots of time travelling to visit potential providers of credit.

Loan applicants' transaction costs are concentrated in the activities prior to the credit decision. Hence, applying for a loan is something of a lottery, as funds are invested before the outcome is known. Poor odds easily discourage serious applicants, and even if an application results in a loan, the cost to the borrower may be quite high. High transaction costs may encourage borrowers to default if the consequences of default are not serious. Default is simply the cheaper alternative: The funds can remain in circulation in the borrower's business, while the transaction costs of repaying and applying for a new loan would absorb a significant portion of the loan.

Lenders likewise incur high transaction costs in introducing new types of business and in cultivating new clienteles. Risks are difficult to evaluate before experience is accumulated. The types of information that are most important may not be entirely clear and may be difficult to obtain. Potentially new types of credit arrangements that have high transaction costs may discourage lenders from innovating.

### ***Refining valuation processes***

The third way in which financial markets innovate is by refining the valuation processes used to evaluate and create creditworthiness. Valuation processes are based on what a lender believes he or she is lending against. Changes in the perception of the lender greatly influence the credit decision, the size and the terms and conditions attached to the loan.

Over a number of years the author collected examples of these perceptions by asking lenders, "What are you lending against?" in seed and fertiliser loans. Responses have included:

- "Here's the bag of seeds and there're the sacks of fertiliser."
- "I'm lending against the next harvest."
- "I used to think that I was lending against the next harvest, but harvests sometimes fail. So, I'm probably lending against several harvests."

- "I'm lending against household income. Farmers around here have several sources of income."
- "His son has a good job in town and sends money back regularly."
- "I've known the guy all my life. Our fathers were friends."
- "The loan is secured by a mortgage on the land."
- "Here's the loan contract with the borrower's signature. If the son-of-a-bitch doesn't repay, I can put him in jail."

Each of these responses reflects a valuation process, a particular perception in a particular situation, involving risk and confidence. Each of these responses has its own logic, however broad or limited. Some would appear to be vulnerable to competition from other lenders having more comprehensive or dynamic views of their clients and their clients' worlds.

Which of these lenders has the best understanding of the client and of the loan? That lender would be in a position to offer the borrower a better deal, such as a larger amount, a longer term, lower interest rate, less risk of ever indebtedness, less stringent collateral requirements or lower transaction costs. In this way, refinement of valuation processes constitutes financial innovation. (It is not clear from the examples above who has the strongest competitive position, but the first and last examples clearly have weak ones.)

Another example is found in two attitudes bankers take toward lending to small businesses in the United States. One is that small businesses are often undercapitalised, the markets in which they operate are often highly competitive, their market positions are often tenuous, they depend on a single person, their owners may not be well-trained in business or technically skilled, etc. The lender with this view is hesitant to make small business loans. The alternative view is that a portfolio of small business loans closely resembles a credit card portfolio, and most American bankers know how to get good returns on credit card lending. The lender with this perspective is much more likely to lend to small businesses, moving the frontier.

Innovation occurs when lenders find new things to lend against. The most widely known example of refining valuation processes in a way that finds value where none existed before is that of Grameen Bank in Bangladesh. Its clients are almost entirely very poor women. Some of its borrowers had never handled money, had never even had notes or coins in their hands, before borrowing from Grameen Bank. How was it possible for Grameen to create value in this situation?

The response to this question is likewise well-known in micro-finance circles. Grameen Bank lends through groups of five women each who are not closely related by blood or marriage. Each group is formed by the members themselves. Members are supposed to support each other and help any member who has a problem repaying her loan. Groups in turn belong to "centres" which meet weekly. All transactions are conducted openly at these meetings where each group member's loan application is discussed. This framework is animated by dedicated bank workers and by group leaders who themselves are borrowers. High levels of repayment were reported for many years.

Similar processes created the Raiffeisen co-operative credit unions in rural areas of central Europe and their urban counterparts for artisans and shopkeepers in the 19<sup>th</sup> century. Perceptions of risks, so large that ordinary farmers and tradesmen had difficulty getting credit, or getting it relatively cheaply, were altered by institutional arrangements that created confidence that offset these risks or perceptions of



risk. The frontier of formal finance expanded to include many more people and many more types of economic activities.

This was accomplished in the Raiffeisen model by including large farmers, clergymen and foresters as leaders of credit unions and by the unlimited liability of all members. No member lost money from his unlimited liability, and over time this guarantee became unnecessary. Instead, new views of valuation found confidence in the quality of the loan portfolios of these co-operative financial institutions.

### **Public policy and creation of debt capacity**

In building an agricultural finance system, many factors have to be considered. This is a tedious but necessary to gain an understanding of proposed transactions and an appreciation of risk. There are two classes of factors to be considered in the effort to create debt capacity: those inside financial markets and those outside financial markets. The factors inside financial markets that determine debt capacity are mentioned above; term structure, transaction costs and valuation processes.

Factors outside financial markets are those that have to do with risk and confidence generally and those that influence the returns to various types of activities. There are many such factors, too many to be comprehended or even counted. Common important examples include the rate of inflation, the efficiency of legal systems, official pricing policies for goods and labour, production quotas that reduce returns to farmers, ownership structures in agriculture, usury laws, the legal standing of collateral, and infrastructure that determines the costs of getting inputs to the farm and getting agricultural products to markets. In the design of credit programmes and systems the overwhelming majority of these factors outside financial markets have to be taken as given.

### ***Common public policy concerns***

The most useful approach to expanding the frontier is to view the challenge as creating debt capacity, defined as the amount that a borrower can borrow on a sustainable basis. Competitive financial markets move naturally to create debt capacity. But major public policy issues arise and have to be dealt with for competition to occur. The approach presented here, based on value, risk and confidence, contrasts sharply with the political view which worries about credit needs and with the tools of "national economic management" which concentrate on credit demand.

Credit demand and needs are useless concepts for building credit systems because they contain no information about ability and willingness to repay loans. Politicians and many in the economic development business will insist that credit needs remain unmet. They fail to understand that the job of financial markets and institutions is to separate good proposals from bad ones so that finance is used efficiently. Hence, some "credit needs," however defined, will always remain unmet. When no "credit needs" remain unmet the financial system will have been destroyed by the accumulation of uncollectible loans. This is obviously a contradictory situation, but it does illustrate the perverted logic of "credit needs," which in fact are virtually infinite.

Likewise, many economists serving public policy and economic development interests will claim that credit supply is insufficient to meet demand. They may not understand that there is a false demand for credit and a true demand. True demand consists of loan applications for viable projects properly financed and backed by credible sponsors. False demand fails to meet these criteria.

Economists and policy analysts may also believe that market failure provides an excuse for intervention in financial markets to meet demand in a more efficient manner. Market failure is said to occur when information is insufficient and when incentives do not equate the public good with the private good of, in this case, lenders. Obviously, these conditions are widespread. Hence, *market failure is a public policy wild card*.

To the best of this writer's knowledge government or donor intervention motivated by the desire to overcome market failure in a developing or transition economy has never - never - produced a viable credit institution or programme. This is because *government officials cannot escape the factors that are said to produce market failure*. They also face information constraints and have incentive problems. Creating debt capacity is the only viable alternative to trying to meet credit needs or satisfy credit demand, and attempting to repair market failures.

### ***Public policy preconditions supporting rural finance***

Beyond these general technical and analytical strategies, there are several important public policy preconditions for the creation of debt capacity. These include confidence, incentives, controls and contracts. By their nature, public policy preconditions have no absolutes, only trade-offs required through political processes determined by the distribution of power. Hence, these preconditions are of the "more is better" variety.

**Public policy precondition 1: Confidence at the societal and macroeconomic levels:** Predictability commands high rewards in financial markets by creating value. Governments greatly influence confidence because of their role in "national economic management" and because one task of government is to frame and enforce laws, including those on which financial contracts are based.

Short of civil war and breakdown in the payments system, the most common feature of government activity that destroys confidence is inflation in double digit or higher rates. Inflation keeps term structure short because it makes financial calculation difficult or impossible. The higher the inflation the less stable its rate, rendering sustainable financial arrangements difficult to locate or create. This occurs because reciprocity among parties that would otherwise like to make financial contracts is impossible to balance.

Confidence may be difficult to create for many reasons. In many countries large social forces, *i.e.*, culture, make contracts difficult to enforce and access to legal services costly. In many societies it may be hard or even impossible to build a constructive consensus about the ownership and use of money and wealth. Where governments are not very representative or accountable, creation of confidence in the long run may be elusive, although controls may create stability and confidence in the short run. These negative conditions tend to be strongest in poor countries and in transition economies. Hence, term structures remain short in these financial markets - the pen that sketches the yield curve runs out of ink at some point not far from the vertical axis.

**Public policy precondition 2: Rational agricultural production incentives:** Past behaviour that ignored efficiency was focused on maximising physical output. This led to uneconomic agriculture because marginal costs far exceeded marginal gains. It sometimes contributed to depletion of the natural resource base through over use of inputs with potentially harmful environmental effects such as salinisation and depletion of ground water from irrigation, and wasted fertiliser. This behaviour, essentially exploitation of capital by labour, was facilitated by disregard for market prices and a lack of commercial orientation.

To the extent that these anti-developmental attitudes persist and *if quotas and other tools of government intervention are used to tax agriculture or to subsidise it, inefficiencies will remain*. These tend to have adverse consequences for investment and finance, especially in the long run. *One cost of these distortions is that they are often discontinued abruptly*: perceptions of the trade-offs between winners and losers alter, programmes become unaffordable, political winds shift, the world moves on. These abrupt changes tend to produce much larger dislocations than those that would be created over time by markets, which produce an infinite series of frequent adjustments, most of them relatively small and hence less painful.

When these abrupt changes occur in ways that diminish farm incomes and the value of farming assets, the repercussions on rural financial markets can be massive. Farmers are unable to pay their debts, rural lenders become illiquid, agricultural systems and systems serving agriculture freeze up and deteriorate. Debt restructuring is usually required if any recoveries of past debts are to be obtained at all. When these changes favour rural activities, as in the liberalising reforms in China in the 1980s, the opposite occurs: rural incomes grow and debt capacity expands.

Public policy and law are also important to protect incentives for productive behaviour. Accordingly, *security of tenure, the ability to enforce contracts regarding access to and use of land, and provision of services and freedom to buy and sell in the most rewarding ways and places are helpful*.

**Public policy precondition 3: Competitive financial markets:** Competition is the best guarantee of innovation and outreach by financial institutions. Since the 1980s there has been a movement toward financial liberalisation, which stimulates competition. There are several key elements in this policy thrust.

Relative freedom of entry into finance is important. Most governments limit the formation of banks and other financial institutions in order to curb abuse, promote economies of scale and simplify official regulation and supervisory tasks. However, in only a few countries do state-owned financial institutions retain monopoly power in financing agriculture, small and medium industry and other hard-to-finance activities. Many of these government banks have been closed, facilitating competition from many sources ranging from foreign commercial institutions to NGOs. In some countries new categories of financial institutions have been authorised, with regulations that relate the scope of their permitted functions to the amount of their capital. Smaller institutions have limited possibilities for risk management through diversification, and their sponsors may not be able to provide much additional capital in an emergency.

Banking regulations have also been liberalised to permit the use of unconventional collateral by micro-lenders, which may enable these institutions to engage rural clients. Without this change in official approaches to valuation processes, lenders would have to set aside provisions for loans that are not backed by traditional collateral acceptable to regulators, such as land or other officially registered assets. This would absorb their capital and reduce their income.

Likewise, regulatory regimes that are favourable to reducing the transaction costs of regulated lenders and that promote effective risk management are helpful.

Transparency is increasingly recognised as a tool that can curb excesses that could destabilise financial markets. Portfolio condition or quality is a focus of transparency, backed up by provisioning requirements that give lenders incentives to run a tight ship. Without transparency, bad things easily get worse, creating abrupt dislocations, while transparency provides incentives for frequent small corrections.

Another aspect of liberalisation is a great decrease in “directed credit” programmes that openly reserve certain funds for certain politically-favoured groups or “priority sector” purposes, usually at below-market interest rates. These funds may be extracted directly from commercial banks through quotas for specific types of lending, or indirectly through high reserve requirements against deposits. In either case, such requirements are a form of taxation. Credit quotas usually work to the detriment of financial sustainability in the long run by reducing liquidity and because they do not reduce costs through innovation.

Freedom in decision making by lenders requires that they can charge interest rates and fees that cover their costs, that they can set loan terms and conditions in negotiation with loan applicants. Ceilings on interest rates have constrained lenders’ ability to move the frontier outward to serve more and different types of clients.

A cost that may be large and difficult to quantify is inflation: the lender that wants to be sustainable has to recover the loss in monetary value created by inflation so that new loans can be made with roughly the same purchasing power as those previously issued. If this condition is not met, the lender's capacity to serve clients declines.

**Public policy precondition 4: Enforceable contracts:** To return to *credere*, finance will fail quickly if lenders and borrowers have no recourse against abuse by each other. In most developing countries and transition economies the legal system cannot provide justice in a manner consistent with modern commercial practice. This restricts debt capacity and constricts the frontier. Timeliness of justice is a major problem: corruption is another. In many countries it is difficult or impossible for a formal creditor to seize a defaulting farmer's land. This may occur because the land is not registered in the first place, because of laws or practice that prohibit or greatly delay repossession by creditors, or by actions that intimidate potential buyers of foreclosed land from making offers.

Steps that can increase debt capacity include creation of efficient registries for land and movable assets that can be used as collateral, laws that permit transfers and subdivision of agricultural land, low registration or transfer fees or stamp duties. Likewise, commercial codes that make it easy to file liens and to realise collateral pledged by defaulters, backed by registries of claims or other means of recourse, can greatly increase debt capacity.

Collateral is not a panacea, and asset-based lending in which loan size is determined by the value of collateral is not aggressively developmental from a social perspective because it tends to concentrate agrarian structure. Those who have assets acceptable as collateral can obtain loans and grow. Those lacking such assets remain beyond the frontier. Cash flow lending, on the other hand, bases debt capacity on the size of the borrower's projected cash flow, suitably adjusted for risk and for "senior claims" that are more important to the borrower than repaying the loan. This strategy facilitates structural change in a way that expands the frontier. It also subjects lenders to greater risk and therefore requires more confidence. While cash flow lenders may still require collateral, loan size is not based simply on the resale value of the collateral pledged.

*Force majeure* renders some contracts unenforceable. Debt restructuring is required unless both parties simply walk away from loan contracts that have clearly become unworkable. In other cases politicians may argue for changes in loan terms or urge borrowers not to repay. Attempts to forgive debts on a large scale can create moral hazard in the form of expectations that further restructuring will be offered if debtors are again under stress at some point in the future. Moral hazard clearly raises costs and can weaken contracts, making the way in which restructuring is done very important.

## Rural preconditions for sustainable rural finance

Within any given environment shaped by public policy and other factors outside financial markets, what are the preconditions for sustainable finance? These can be classified in several ways, and the approach taken below focuses first on rural preconditions and second on financial preconditions. (Some of these preconditions are not mutually exclusive.) The context assumes, for purposes of illustration and simplification, that agriculture consists of annual field crops, but the illustration is suitable for tree crops, vineyards, livestock enterprises and mixed farming. It is also applicable to medium- and long-term investments in irrigation and other agricultural infrastructure that directly or indirectly produce income.

**Rural precondition 1: Profitable farms:** The prosperity of agriculture and the sustainability of agricultural finance depend upon the production of a financial surplus from agricultural operations. In other words, *farm households must produce more than is required for their subsistence and farms organised as co-operatives, corporations or partnerships must more than cover their costs.* Because of the variability of performance on specific farms due to weather and other events beyond the control of operators, this general condition must be satisfied in the normal year and on average over time. Farms that are not yet profitable but that are likely to become so meet this precondition.

Tools used to ensure good commercial performance in modern commercial agriculture begin with farm plans or farm budgets that determine cropping patterns. These planning tools can be quite simple, but can also include complicated statistical and analytical techniques. Their use can optimise the *economic use of land and the efficient use of labour* to allocate resources in *strategic responses to projected market conditions.*

If farmers are not investing in their own farms, such farms are probably not profitable. Sustainable agricultural finance requires investment by owners of land or by farm operators. The form of this investment almost always includes labour as an investment in kind. It should also take the form of reinvestment of part of the profits earned in normal and better-than-normal years.

**Rural precondition 2: Adequate supply and timely delivery of appropriate productive inputs:** Once the cropping pattern or resource allocation plan on the farm has been determined, inputs must be procured to implement the plan. Inputs include seeds, fertiliser, pesticides, fungicides, tools, fuel, sacks or other containers for harvested crops, etc. Cropping patterns presuppose an *adequate supply of inputs in markets or other supply channels which can be delivered in a timely manner.*

The logistics of stocking and delivery can be exceedingly complex. Many inputs are required at a very specific time, measured in days or even hours in the agricultural calendar. Those that are not produced on the farm but manufactured through industrial processes may take a relatively longer period, measured in weeks or months, to produce. In addition, where transport is difficult because of rains, snow or poor transport infrastructure there may also be a relatively narrow window of time during which delivery to farms must occur.

Other problems include the quality of purchased inputs. Some deteriorate over time, especially where storage facilities are absent or inadequate. Some are easily adulterated. Quality is most likely to be a problem when seed certification procedures are not strictly applied, where farmers lack the equipment or knowledge to test purchased inputs, where self-regulation by input producers and suppliers is lacking, and where government standards are not specified or goods are not tested against standards by government agencies, by wholesalers and retailers, by farmers, or by associations serving farmers, such as supply and marketing co-operatives.

In view of the requirements of the agricultural calendar, it is also essential that *finance is available on a timely basis*. (Finance is not an input because it does not make crops grow or prepare them for consumption.) Some input suppliers require payment in cash, others may demand cash before delivery.

**Rural precondition 3: Efficient input application:** Inputs obtained and ready for use on the farm must be applied. Labour is of course required in any event and may be a constraint for crops that require lots of labour within a short period of time. Mechanisation is widely used in modern agriculture. *Farm machinery is likely to break down only when it is in use*. Rapid repairs are usually required because of the demands of the agricultural calendar. This requires expertise and supplies of spare parts.

The alternative is having excess equipment capacity on hand, so that pieces temporarily out of service are replaced by machinery that would otherwise be idle. This solution can be quite expensive because overall utilisation rates decline. The question is whether this cost is balanced against the costs of output lost as a result of equipment downtime in critical periods. Where multiple pieces of similar equipment are on hand there are intermediate solutions, such as more intensive use of available machinery. Repairs that cannot be completed on the farm often require *transport for repair specialists or to take the machinery to a location where it can be fixed*.

As with inputs, equipment repairs and replacements require finance, and the main concerns of farmers in this regard are timeliness, sufficiency and cost.

**Rural precondition 4: Adequate storage and transport:** Storage and transport are immediate concerns following harvest. The critical role of these factors depends on considerations such as the costs of storage, degree of perishability, security against post-harvest losses, and price movements from one harvest to the next. Post-harvest losses can be large where infrastructure is lacking. In each of these cases "adequate" should be equated with the economically optimum trade-off. For example, some post-harvest storage losses are inevitable. Optimal measures to reduce these losses equate the value of the reduction of losses to the value of the investment in preventing this loss, both suitably discounted to reflect the time value of money.

**Rural precondition 5: Market demand:** Unless harvests are bought, their cash value cannot be realised. These transactions require effective demand, or desire to buy backed up with purchasing power.

The post-harvest period is the most interesting part of the agricultural calendar for finance. This is because *the value of the harvest is supposed to provide cash that can liquidate seasonal loans*. It also has to meet debt service agreements on term loans repayable over several years, usually provided for the purchase of fixed assets such as land, buildings, equipment and capital improvements such as land levelling, drainage and irrigation. *Repayment of loans requires that farmers can obtain payment in cash reasonably soon after delivering their crop, or that the creditor can take the harvest or some portion of it to settle the debt*.

Transaction costs for transport, storage and related steps beyond the farm gate play a major role in determining cropping patterns. Reductions in transaction costs may create debt capacity on farms. However, relationships between production and price are complex, depending upon elasticities and risks related to production and post-harvest activities. Agriculture is affected by a perverse paradox: there are only two certainties in agricultural development: cheaper food and fewer farmers. Hence, debt capacity is always under stress for those farmers who face relatively high production costs or transaction costs or poor markets. Failure to repay debts is the most frequent cause of households' involuntary exit from agriculture in market economies.

## Financial preconditions for sustainable rural finance

The steps in the credit process provide a basis for identifying financial preconditions that determine whether credit is forthcoming once rural preconditions are in place.

**Financial precondition 1: Access to credit institutions:** For credit to be obtainable, the *transaction costs* of dealing and communicating with credit institutions must not be prohibitive to loan applicants. This requires a certain *geographical or spatial presence and procedures that are reasonably efficient*. Access is facilitated by competition and innovation.

**Financial precondition 2: Information to evaluate risk:** Lenders require information to gain *confidence* in a loan applicant and to increase the credit limits of an established client. This information is obtained from clients themselves, from public records, and from knowledge of the markets in which clients operate.

*Risk* can be managed in a number of ways, and collateral often provides useful information and comfort for a lender. *For collateral to be effective, timely possession or legal protection for creditors is required.*

Following disbursement of a loan, the lender should be able to inspect, observe and obtain documentation about loan use and about the overall health of the borrower's activity in order to test confidence.

**Financial precondition 3: Adequacy and quality of lender capital and loanable funds:** Lenders structure their lending to manage their *risks*. Ultimately, risk that is not well managed erodes capital and liquidity, and can ultimately cause lenders to fail. Risk that is well managed is a source of profit, which can augment capital and liquidity as more funds are attracted by successful financial intermediaries.

Prudent lenders seek to maintain a certain ratio between their capital and their total assets. They do this because their capital, which consists of funds invested by owners, retained earnings, various reserves, and possibly grants from development assistance agencies, serves as a cushion to the lender's creditors, such as depositors and other financial institutions. Any deterioration in the value of assets, such as loans, reduces capital by an equal amount. When capital is exhausted by losses, creditors such as depositors stand to lose money - at least in theory.

International norms applied to commercial banks, for example, specify a capital-to-assets ratio of 8% to 10%, assuming that assets are weighted for their relative risk. This relatively low ratio reflects the types of business banks normally undertake and also their protection through deposit insurance, which means that depositors bear less risk in dealing with banks insured by government guarantees on deposits. Because of risk, an 8% to 10% ratio is too low for banks in transition economies and also for lenders with large exposures to the agricultural sector. No one knows precisely what sorts of capital-to-asset ratios would be appropriate, but levels of 20% or more may be in order. Higher capital ratios also require higher interest spreads in order to produce adequate returns for bank shareholders.

These higher ratios are required because arrears can easily accumulate in a bad agricultural year. This may debilitate the bank that is not well-capitalised, putting it in a position where it has difficulty serving farmers in a sustainable manner. From farmers' perspective, credit is especially useful in the season following the bad harvest because their assets have been depleted by crop failure. They remain in debt, they may be consuming their savings to survive, and they want to have money to buy inputs at the start of the next season. How can a bank be in a position to obtain funds in such circumstances?

Having a strong capital position at the outset is essential, as fresh borrowing from other banks, government authorities, donors or from investors is required to offset the loss of the bank's liquidity. The question is then what sort of capital ratio will it have after it has obtained the funds to continue to serve its clientele as they recover and attempt to repay their old debts from the bad year as well as their current loans taken at the start of the season following the bad one.

Rural lenders without specific plans to deal with bad years will never be sustainable, in much the same way that ancient farmers who were not able to manage bad years have few descendants on the earth today.

An additional feature of the funds a lender can offer is their quality, which is determined primarily by their *pricing and maturity*. These parameters strongly influence the types of facilities lenders offer their clients. While it was noted earlier that lenders tend to borrow short and lend long, the larger this "gapping" or mismatch, the greater the risk to the lender. Lenders that engage in maturity mismatches that are too long risk large losses if they cannot keep short-term funds on their books because of confidence or pricing constraints. This possibility is enlarged when pricing mismatches are also involved and interest rates rise, usually in response to inflation.

In the worst case scenario long-term lending at fixed rates of interest is financed by short-term funds at market rates that greatly exceed the fixed rates specified some time ago when outstanding loans were issued. Lenders with this double mismatch see their liquidity drying up and their profits turning to losses as interest income is less than interest expense, which depletes their capital. This is the classic case, and can destroy lenders even if no borrowers default.

After disastrous experiences of this type in the 1980s, most lenders today insist on variable interest rates on loans that have maturities of more than a few years. Re-pricing arrangements in loan contracts specify the frequency at which re-pricing may occur and how the price may be determined, often with reference to some benchmark or reference rate such as a bank's prime rate or the yield on government securities. Variable rates pass the price risk to the borrower, which may turn the price risk into a credit risk if the increased debt burden caused by higher interest rates exceeds the borrower's debt capacity, *i.e.*, ability to repay on a sustainable basis.

Another quality issue is the currency in which a loan is issued and the currency obtained by the lender to make the loan. Here again mismatches can be catastrophic as experienced in the late 1990s in Russia and in certain southeast Asian countries. These problems were created not so much by market forces as by structural problems in finance and in corporate governance. In Indonesia many large firms were favoured by those exercising political power. This meant that prudent credit standards did not apply. In Korea, banks and industrial firms had relatively little capital in relation to their assets, an artefact of the government's export-oriented growth policy that worked so enviably well for so many years but which also ignored the basics of creditworthiness.

Andrew Mellon, an American banker and Secretary of the Treasury some years back, is credited with the phrase: "In a depression, assets return to their rightful owners." This conveys the essence of sustainability in finance and also the tragedy of misguided public policy or capricious intervention. His "rightful" framework is of course limited by an assumption about the rule of law.

**Financial precondition 4: Well structured loans:** Well structured loans are "workable." They do not have to be renegotiated in order to remain current, to keep from incurring default. Well structured agricultural loans fall due when the borrower has money to repay, which is usually at or after harvest. Well structured loans are modest enough so that the farmer does not feel that repayment consumes too much of the household's income. Well structured loans are designed with the bad year in mind,



accommodating reasonably expected risks, including the risk of inflation. Well structured loans are thoroughly understood by borrower and lender, so that no surprises occur that would upset their relationship. Well structured loans are intended to build good, sustainable relationships between lenders and their clients.

The farm plans or budgets used to plan rational resource allocation can serve as a basis for lending decisions. Of course, the economically ideal farm plan may not be able to attract finance if the plan does not address risk, as perceived by the lender. Hence, negotiation and amendment of farm plans are often required in the loan application process. Loan applicants are often more optimistic than lenders, creating tension. This reflects the asymmetric interests of each party. The most the lender can hope for is to be repaid with interest and on time, and that the borrower will continue to be a good client. The borrower, on the other hand, gets the residual cash flow from the farm enterprise, after all expenses are paid and loan principal is repaid. Hence, the borrower has variable returns while the lender hopes for constant returns. In good years the borrower's return may be very large, while the lender's is always relatively small, at least in the formal financial sector.

### **The structure of sustainable rural finance and credit systems**

Given that the preconditions listed above are often missing or poorly developed in poor countries and transition economies, what can be said about the development of sustainable agricultural finance and credit systems in these areas? At the outset, it is worth noting that building such systems is quite difficult.

For example, the US co-operative farm credit system, which traditionally supplied about one-third of agricultural finance in America, collapsed in the early 1980s following a boom. Failure was made worse by government measures that decreased the amount of equity or down payment that was required to buy agricultural land. High levels of debt, close of 100% of the price paid for a property, required large mortgage payments. When the inevitable down turn occurred, many farmers were unable to meet their payment obligations, which precipitated the crisis. This required the complete reorganisation of the structure of land banks and production credit associations. This was the largest single financial disaster in the US since the Great Depression. (It is little remembered today because it was eclipsed by the even larger savings and loan and banking crises that quickly followed, which were also made worse by public policy.)

In a classic agricultural finance system credit rotates throughout the production and processing cycles. Starting at an arbitrary point such as planting, one typical, simplified cycle would work as follows: Farmers obtain debt to buy inputs, shortly after harvest a series of transactions occur almost simultaneously; the buyers of the harvest obtain debt in order to pay farmers for their harvests which enables farmers to repay their loans. If the buyers are middlemen, such as transporters who temporarily store the crop, the processor of the crop obtains credit to pay the middleman, who in turn repays his debt. Soon thereafter the farmer obtains credit to begin the next season.

The sources of funds for this type of cycle are potentially numerous, as are the channels through which they flow. In a highly developed system banks may be at the centre of transactions with all parties that borrow during the production and processing processes. Where the transaction costs of bank credit are high and where confidence is low and risk is correspondingly high, "tied transactions" are more common. For example, input suppliers, produce buyers or landlords provide credit to their customers or tenants, who are expected to repay following harvest. Repayment is in cash when the creditor has no interest in buying the crop. In other cases the lender who finances inputs expects to take possession of the crop following harvest. Such arrangements are common among co-operatives that handle input

supply and marketing. They are also found when large, often multinational companies deal in input supplies and also act as crop buyers. In other cases in developing countries farmers may sell their crop for cash shortly after germination to buyers who do the harvesting.

Tied or linked transactions across different markets, such as those for input supplies, farm produce, land and credit often provide more security for the lender. At the same time a cost to the grower is diminished freedom of action. The lender's legal claim to the crop, based on a loan agreement, gives the lender comfort in that the source of repayment is identified. However, in those cases in which the price for the crop, such as dollars per ton, is specified in advance in the loan contract the grower may find that the market price is significantly higher than the price agreed at the time credit was obtained. This gives the grower an incentive to evade the contract, especially where competing sources of credit are available. It also gives the lender an incentive to offer a low price to accommodate the possibility that prices may in fact be unusually low at harvest.

Large farmers in rich countries often balance their "long" positions in the commodities they produce with "short" positions in commodity futures markets in order to stabilise their incomes. Small farmers and farmers outside rich countries are often not able to use this risk management tool, but bankers in some of these countries may use such contracts to hedge their risks of lending for commodity production that is traded at world prices.

Tied credit is the most likely to evolve in any agricultural finance system. This tendency reflects the superior information that input suppliers, produce buyers or landlords are likely to have concerning their clients or tenants, putting them in a much stronger position than a banker might occupy, especially if banks are large, not very efficient and if branch office staff are not from the area in which they work. Local knowledge enables these suppliers, buyers or landlords to have low incremental information costs in their credit decision processes. Business people such as these may have the size and standing to obtain credit from banks and they are also likely to be linked to wholesalers or larger buyers who certainly have access to banks.

For these reasons one would expect that credit systems in transition economies would be characterised initially by supplier credit or buyer credit or through landlords in areas where tenancy exists. Over time these lenders would be challenged by commercial banks seeking retail business. Farmers would then be drawn to banks for several reasons. One is that interest rates charged by suppliers and buyers are usually not very transparent, except in those cases where suppliers have two prices, a cash price and a credit price. Also, banks may be able to offer lower interest rates directly to farmers than those charged by suppliers or buyers; these parties would often also borrow from banks and would tend to add a spread of their own to cover their lending risks.

But possibly the most important reason that farmers would prefer to deal with banks is that they can get loans for a number of purposes and because they have greater freedom of action. For example, a farmer with cash in hand may be able to negotiate a better deal with an input supplier, and can shop among different input suppliers, than one who is begging for inputs on credit. This flexibility can reduce the borrower's transaction costs.

An interesting question is whether farmers can obtain more short-term credit from suppliers than from banks. Suppliers may be willing to offer 100% financing, requiring no cash input from the borrower. Banks may require that the farmer contribute a certain portion of projected cash costs. This creates a cushion for the banker by lowering the debt burden and also creates comfort by indicating the farmer's commitment to the farm plan.

## **Fatal public policy flaws in agricultural credit programmes**

Agricultural credit once occupied a major place in the portfolios of the World Bank, regional development banks and bilateral donors. It was popular, much as micro-enterprise credit is today, but the level of enthusiasm was narrower and lower because it was largely technically based rather than tied to social causes. The writer of this paper participated in that phase of development assistance as a project team member and as a policy specialist. In spite of more than ten years' experience in this type of lending over many projects, this writer was not involved in any farm credit projects that were sustainable. And this was in the World Bank, which it might be argued worked harder at project design than did many other donors. When donors finally came to understand in the late 1980s that these projects were not achieving their objectives they simply abandoned this type of project rather than attempting to devise a better project.

Reasons for this massive failure – thousands of millions of development dollars worth – were numerous. Some projects were hijacked by political interests in the countries in which they were implemented. The money went to larger farmers or to others with special avenues of access, and repayment was not a priority. Others may have worked reasonably well, at least for a time, in obtaining repayment, but interest rates were such that the lending institutions could not cover costs. Many of these projects involved state-owned financial institutions and co-operatives that used project funds to lend to farmers or members. Pricing, incentives and accountability were wrong in most of these instances. These factors have the potential to cause problems in transition economies, too.

Donors failed to address the effects of risk on farm cash flow and capacity to service debt; incorporating these inconveniences would have resulted in smaller loans. Donors were also not very interested in keeping score in a manner consistent with financial sustainability, preferring to concentrate on getting the money out the door. They virtually never calculated whether the institutions they funded made money, broke even or lost money on the donor funds they borrowed under a project and loaned to farmers.

The "economic" priority of lending in order to stimulate export crops, promote cash crops, rearrange the national cropping pattern to suit government priorities, or simply to transfer funds to a poor country, overwhelmed the basic financial aspects of credit projects. There is a broad literature on this large and almost total public policy failure: the road to unsustainability is well-marked and heavily travelled. The potential risks of similar priorities in transition economies require examination.

## **Public policy blind alleys in agricultural finance**

As a generalisation and based on 35 years of credit projects aimed at farmers and others, support channelled through the financial system that is not provided on at least a quasi-commercial basis is unlikely to promote sustainable financial relationships at the farm level. It is also likely to delay institutional development in finance and in agriculture.

This unfortunate history makes it worthwhile to list and reflect on those things that have not contributed to financial market development or even worked against it. Four can be mentioned. The first is failure to understand fungibility, the second is increasing the supply of loanable funds without concern for value, risk and confidence or for term structure, transaction costs and valuation processes. The third is subsidised interest rates. The fourth is all-risk or comprehensive crop insurance not provided on a commercial basis. Efforts in these areas tend to be a waste of time, effort and money anywhere. In a transition economy time is of the essence, effort has to be directed carefully and money is scarce.

**Failure to understand fungibility** leads to fallacious conclusions about the role of finance in production and development. Fungibility refers to the interchangeability of things that are identical or uniform, such as units of a national currency. Loans are issued to farmers and households, not to crops. A loan applicant will tend to try to find the most convenient source of credit, having the lowest overall costs. For farmers, this may be subsidised credit from a government programme or institution.

The economic question posed by fungibility is whether the activity financed by the loan is the same as the borrower's activity at the margin. In other words, was the addition of liquidity essential for the activity for which the borrower received the loan? In many cases small farmers have enough internal cash flow to continue their operations, such as dairying, but obtain the dairy loans for which they are eligible and use these for some other activity. The activity may be improving the farm house, a wedding, buying a car, education for children, etc. Using this example, the point is that more loans may not produce more milk.

If the dairy loan is subsidised and does not result in increased milk production, the subsidy is wasted. If the dairy loan is not subsidised and is instead viewed as a loan against household income, it may represent an innovation.

**Increasing the supply of loanable funds** does not in itself expand the frontier. Unless risk is managed, the loanable funds disappear into bad debt losses. In most cases the three types of financial innovation, as discussed above, will attract funds. If innovation to provide an expanding array of financial services to more and more people is the objective, simply providing funds is like pushing on a string.

Increasing the supply of loanable funds may be useful in relief activities when lenders and their clients are illiquid because of macroeconomic or natural disasters. This is the "Marshall Plan" approach to credit provision, which worked well in Western Europe but which, when expanded to poor countries in the form of bilateral and multilateral aid, generally failed or produced results inferior to those projected because the institutions of growth were not in place and because of incentive problems. Lots of money was wasted.

**Low interest rates to farmers** characterised much of the rural credit that donors provided through about 1990, when they switched out of agricultural and industrial credit and into micro-finance. Artificially low rates corroded the institutions that were used to distribute this credit. These intermediaries could not earn enough to cover their costs, especially their bad debt losses. These losses were excessive because the low rates attracted lots of borrowers who were more interested in the credit than in the purpose for which it was ostensibly provided.

Larger borrowers were often favoured because they had political or social connections, and also because the lender's cost of making a loan does not vary greatly with loan size, assuming use of a given lending technology. Lenders naturally chose the easier, cheaper path of larger, fewer loans. Also, subsidies come from government, and this influenced who got loans, who managed state-owned credit institutions and the degree of emphasis accorded to recovery of loan arrears. In short, artificially low interest rates create incentives that are precisely the opposite of those required for sustainable credit systems.

**All-risk crop insurance** was the subject of promotional euphoria by several United Nations agencies and bilateral assistance organisations in the late 1970s and early 1980s. Crop insurance, like credit, was viewed as a tool that could reorganise the national cropping pattern in a manner chosen by government officials, emphasising export crops, food crops, or high value crops, etc. Their efforts demonstrated that few farmers are willing to pay, and few governments are willing to charge,

actuarially fair premiums for all-risk insurance. (The actuarially fair premium covers the cost of indemnities in the long run.) Hence, state-owned insurance schemes tended to decapitalise. Their management was also often poor and they failed to establish business relationships with large numbers of farmers. Rich countries' schemes are all subsidised. Major reorganisations of these programmes had to be undertaken in France and the US to curb abuses and to correct gross inefficiencies.

The only programmes that appeared to work in developing countries were for sugar cane in Mauritius, European tobacco farmers in Rhodesia/Zimbabwe, and for coffee growers in Puerto Rico - all special cases. Many governments still provide all-risk crop insurance, but it should be viewed as a political feature, a form of rural welfare, rather than as a production feature. Some economists have concluded that there are no net welfare gains from government-sponsored all-risk crop insurance. Costs to taxpayers and savers equal or exceed the benefits to farmers. Private markets for specific-risk crop insurance, such as for hail, flood, fire and frost have existed for many years and provide considerable protection to farmers where confidence is high and transaction costs are low.

**Official loan guarantee programmes**, often supported by donors, are an additional category. Their effect remains a subject of controversy. Unfortunately, comprehensive information on these programmes in developing and transition economies is often hard to obtain, making analysis difficult. Given their similarities in rationale, organisation and approach to the fiascos of official credit programmes and crop insurance, it is quite possible that they are also a net welfare drag on development. At best, they should be viewed with scepticism.

# AGRICULTURAL FINANCE AND INSTITUTIONAL REFORMS IN TRANSITION ECONOMIES: THE 1990s AND CHALLENGES AHEAD (FOCUS ON SEE REGION)\*

By Mr. Ulrich Koester

## Abstract

*Functioning rural financial markets play a key role in transforming agriculture from a centrally planned to a market economy. In the absence of sound rural financial markets, the revitalisation of agriculture will be delayed and the structural adjustment and transition of the agricultural sector to a market economy will take longer than for most other sectors of the economy. The experience of both Central and East European Countries as well as Southern and Southeast European Countries shows that rural financial markets are still underdeveloped. The present status of rural credit markets is the result of an incomplete establishment of institutions in these economies. This paper argues that institutions, which are relevant to initiate and promote the evolution of financial markets, emerge late in the transformation process. These institutions are in part culturally embedded and these markets are property-right intensive. Hence, financial markets in general, and agricultural finance markets in particular, do not function well in all transition countries. The design of adequate policies in order to address the above problems should be based on a diagnosis of market and policy failure. It is argued that the inherent market failure has been enhanced by policy failure. First best policies should not start with setting up rural financial organisations, but with creating an enabling environment for the functioning of an informal rural credit market. Specific policy instruments are discussed in detail.*

## Introduction

Financial markets are important for the functioning of today's markets, but they also link today's markets with tomorrow's markets. If this linkage does not function well, today's and tomorrow's markets do not function well. Hence, "financial markets can be thought of as the 'brain' of the entire economic system, the general locus of decision making: if they fail, not only will the sector's profits be lower than they would have been otherwise, but the performance of the entire economic system may be impaired" (Stiglitz, 1994). Without functioning financial markets, it is difficult to mobilise savings and funds are not directed to the most profitable use. Thus, the economy is distorted in favour of consumption goods at the expense of capital goods and in favour of short term, rather than medium and long term, investment, and grows less quickly than economies with functioning financial markets. Functioning rural financial markets play a key role in transforming agriculture from a centrally planned to a market economy. Experience has shown that privatisation will transform agriculture more effectively if it is linked to restructuring (Swinnen and Gow, 1999). However, restructuring implies that some former investments will become obsolete and, hence, a significant amount of new short, medium and long-term investment is needed. In most countries the new owners of farms have to finance investments with external funds. Without a sound rural financial market the revitalisation of the farm sector will be delayed and the adjustment of the agricultural sector to a market economy situation will take longer than for most other sectors of the economy.

---

\* The paper has benefited from the author's affiliation as a visiting expert to the FAO during his sabbatical in 2000. The support received from FAO is highly appreciated.

This paper first addresses the framework for financial markets in the Central and East European Countries (CEECs) and Southeast European Countries (SEECs). The focus in this section is not on rural finance, but on finance in the economy. This broader approach is applied because rural finance is only a subset of overall finance in the economy. Both are highly interrelated. The reasons for deficiencies in the functioning of rural financial markets cannot be adequately identified if overall financial conditions are not taken into account. Accepting a wider view is also in line with the new reasoning in rural finance literature (Yaron and Charitonenko, 1998; Hoff and Stiglitz, 1993). According to these findings, the functioning of rural financial markets can far more effectively be improved by establishing a transparent and efficient overall legal framework and thus a healthy overall environment for the financial system in the economy rather than by direct interventions. The second part of this paper analyses the importance of institutions for the functioning of rural financial markets. Market failure as well as government failure will be identified. The paper ends with a discussion of recommendations that are likely to improve the functioning of rural financial markets.

### **Evolution and status of financial markets in CEECs<sup>1</sup>**

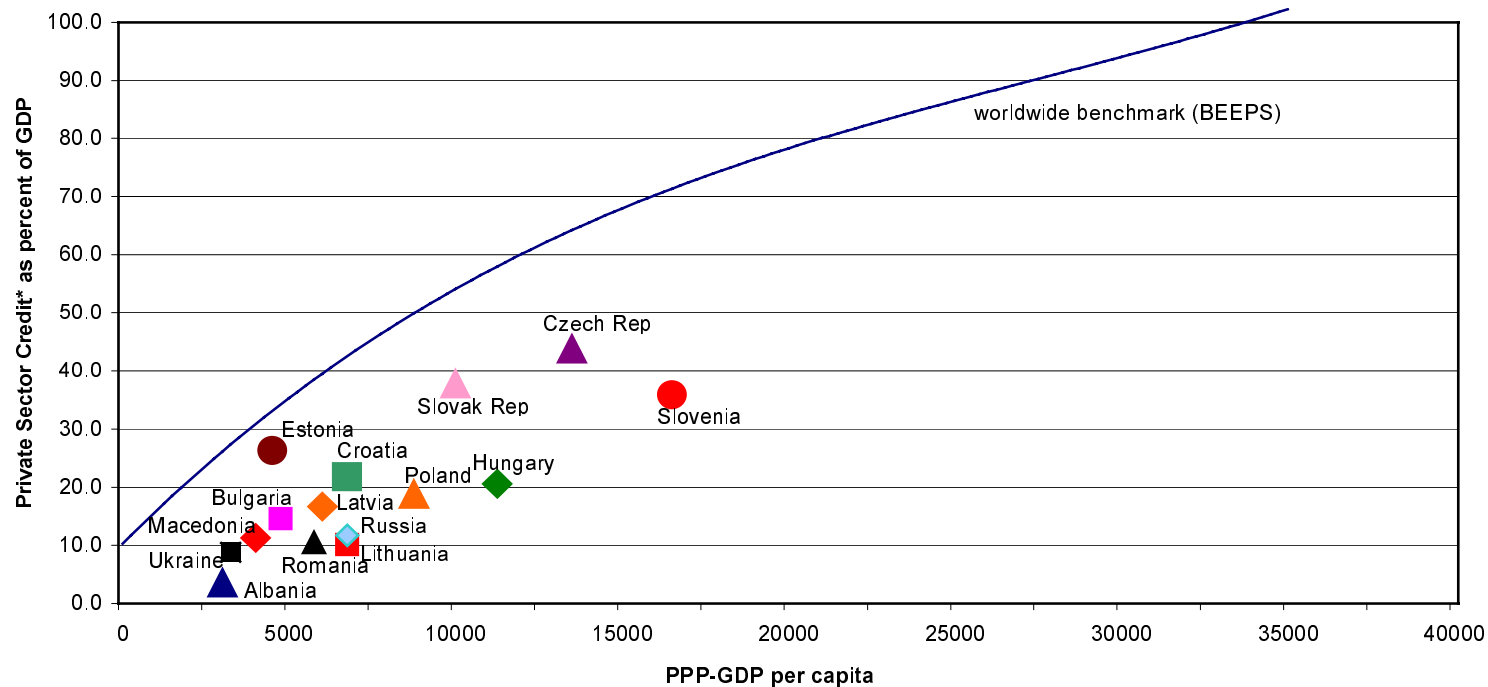
Financial markets are still underdeveloped in all transition economies. Figure 1 shows the ratio of private credit to GDP in relation to purchasing power per capita in 1999 and compares these figures with a world-wide benchmark. The transition economies are clearly well below the benchmark line. Even 10 years after the start of transition, financial markets are largely underdeveloped. Based on the above criteria, Albania is the country with the least developed financial market.

The difference between lending and deposit rates has generally remained high in transition countries. The variance of this margin over time is also high, indicating the risk that lenders and borrowers have had to bear (see Table 1). In most transition economies, short and medium term credits were inaccessible during the first years of transition and even today they remain inaccessible in some countries. For the economy as a whole, the financial market situation still has significant repercussions on rural financial markets.

---

1. This section draws heavily on Koester (2000).

Figure 1. Private Sector Credit to GDP Ratio\* against PPP-GDP per capita 1999



Source: EBRD, Transition report; IMF, World economic outlook Oct 2000; Pistor, Raiser and Gelfer (EBRD), 2000, Law and finance in transition economies.

\* "Domestic Credit to Enterprises" is used for "Private Sector Credit".



**Table 1. Lending and deposit interest rates in SEECs  
in per cent**

|                               | 1991 | 1992    | 1993 | 1994  | 1995 | 1996  | 1997 | 1998 | 2000 |
|-------------------------------|------|---------|------|-------|------|-------|------|------|------|
| <b>Albania</b>                |      |         |      |       |      |       |      |      |      |
| Lending rate                  | n.a. | n.a.    | 30.0 | 20.0  | 21.0 | 28.8  | 43.0 | 25.0 | 27.8 |
| Deposit rate                  | n.a. | n.a.    | 23.0 | 16.5  | 13.6 | 19.1  | 27.8 | 16.5 | 7.8  |
| Spread                        | n.a. | n.a.    | 7.0  | 3.5   | 7.4  | 9.7   | 15.2 | 8.5  | 20.0 |
| <b>Bosnia and Herzegovina</b> |      |         |      |       |      |       |      |      |      |
| Lending rate                  | n.a. | n.a.    | n.a. | n.a.  | n.a. | n.a.  | n.a. | 43.8 | n.a. |
| Deposit rate                  | n.a. | n.a.    | n.a. | n.a.  | n.a. | n.a.  | n.a. | 12.0 | n.a. |
| Spread                        | n.a. | n.a.    | n.a. | n.a.  | n.a. | n.a.  | n.a. | 31.8 | n.a. |
| <b>Bulgaria</b>               |      |         |      |       |      |       |      |      |      |
| Lending rate                  | 83.9 | 64.6    | 83.7 | 117.8 | 51.4 | 480.8 | 13.9 | 13.5 | n.a. |
| Deposit rate                  | 57.7 | 45.3    | 53.6 | 72.3  | 25.3 | 211.8 | 3.0  | 3.3  | n.a. |
| Spread                        | 26.2 | 19.3    | 30.1 | 45.5  | 26.1 | 269.0 | 10.9 | 10.2 | n.a. |
| <b>Croatia</b>                |      |         |      |       |      |       |      |      |      |
| Lending rate                  | n.a. | 2 333.0 | 59.0 | 14.4  | 22.3 | 18.5  | 14.1 | 16.1 | n.a. |
| Deposit rate                  | n.a. | 434.5   | 27.4 | 5.2   | 5.5  | 5.5   | 4.5  | 5.9  | n.a. |
| Spread                        | n.a. | 1 898.0 | 31.6 | 9.2   | 16.8 | 13.0  | 9.6  | 10.2 | n.a. |
| <b>Macedonia</b>              |      |         |      |       |      |       |      |      |      |
| Lending rate                  | n.a. | n.a.    | n.a. | n.a.  | n.a. | n.a.  | n.a. | n.a. | 19.0 |
| Deposit rate                  | n.a. | n.a.    | n.a. | n.a.  | n.a. | n.a.  | n.a. | n.a. | 10.7 |
| Spread                        | n.a. | n.a.    | n.a. | n.a.  | n.a. | n.a.  | n.a. | n.a. | 8.3  |
| <b>Romania</b>                |      |         |      |       |      |       |      |      |      |
| Lending rate                  | n.a. | n.a.    | 80.6 | 60.6  | 43.7 | 50.6  | 60.4 | 63.7 | 55.8 |
| Deposit rate                  | n.a. | n.a.    | 71.5 | 47.4  | 36.7 | 41.0  | 45.7 | 54.6 | 42.3 |
| Spread                        | n.a. | n.a.    | 9.1  | 13.2  | 7.0  | 9.6   | 14.7 | 9.1  | 13.5 |

n.a. = not available.

Source: Internet, various sources.

The share of bad loans in total loans is generally high in transition countries (Table 2), but has declined over time. It is worth noting that many loans were bad in spite of the low share of credit as a percentage of GDP.

All transition countries still suffer from the legacy of constraints and incentives that governed the credit market. Loans used to be backed by the government. They were mainly provided to overcome liquidity problems, and were regularly written off. Hence, both the state and collective farms had access to credit. But neither farm households nor private households were granted access to credit for consumption or investment purposes. Therefore, there were no incentives for borrowers and lenders to collect information on whether a credit might be used profitably. And there was no incentive to calculate adequately the rate of return on investment based on a business plan, and/or to check whether the loan could be paid back in time. Similarly, there were no incentives for state banks to investigate the creditworthiness of a borrower as the state had been ordered to whom to lend. Thus, the banking sector was ill-prepared to contribute to a functioning rural financial market. Moreover, there were no institutionalised credit markets based on private lending and borrowing.

Table 2. Credit market indicators in selected CEECs

|                                             | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---------------------------------------------|------|------|------|------|------|------|------|------|------|
| <b>Albania</b>                              |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | n.a. | 34.9 | 40.1 | 91.3 | n.a. | n.a. |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | n.a. | 3.9  | 3.6  | 3.9  | 3.8  | 3.2  | 3.6  |
| <b>Bulgaria</b>                             |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | 6.6  | 6.8  | 12.6 | 14.6 | 12.9 | n.a. | n.a. |
| Domestic credit to enterprises <sup>2</sup> | 7.2  | 5.8  | 3.7  | 3.8  | 21.1 | 35.6 | 12.6 | 12.7 | 14.6 |
| <b>Croatia</b>                              |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | 12.2 | 12.9 | 11.2 | 10.1 | 13.7 | 23.8 |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | 37.7 | 21.2 | 22.9 | 21.4 | 25.3 | 26.5 | 21.8 |
| <b>Czech Republic</b>                       |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | n.a. | 32.9 | 28.2 | 26.6 | 26.3 | 31.4 |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | 51.0 | 50.3 | 46.7 | 47.1 | 54.7 | 48.0 | 43.8 |
| <b>Estonia</b>                              |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | 3.5  | 2.4  | 2.0  | 2.1  | 4.0  | 3.1  |
| Domestic credit to enterprises <sup>2</sup> | 18.8 | 7.6  | 11.2 | 14.1 | 14.4 | 18.2 | 25.9 | 25.3 | 26.3 |
| <b>FYR Macedonia</b>                        |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | n.a. | n.a. | 21.7 | 21.1 | 7.8  | 9.4  |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | 59.3 | 45.3 | 23.1 | 26.5 | 27.4 | 18.1 | 11.3 |
| <b>Hungary</b>                              |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | 25.6 | 17.6 | 10.3 | 7.2  | 3.6  | 5.4  | 2.8  |
| Domestic credit to enterprises <sup>2</sup> | 29.9 | 23.4 | 20.7 | 21.4 | 18.6 | 18.7 | 20.4 | 20.0 | 20.6 |
| <b>Latvia</b>                               |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | 11.0 | 19.0 | 20.0 | 10.0 | 6.3  | n.a. |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | n.a. | 16.4 | 7.8  | 7.2  | 10.5 | 14.9 | 16.7 |
| <b>Lithuania</b>                            |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | 27.0 | 17.3 | 32.2 | 18.3 | 12.5 | 11.9 |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | 13.8 | 17.6 | 15.2 | 8.7  | 8.6  | 8.9  | 10.1 |
| <b>Poland</b>                               |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | 36.4 | 34.0 | 23.9 | 14.7 | 11.5 | 11.8 | 14.5 |
| Domestic credit to enterprises <sup>2</sup> | 10.9 | 11.4 | 12.2 | 12.0 | 12.7 | 15.9 | 17.1 | 17.6 | 18.8 |
| <b>Romania</b>                              |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | 18.5 | 37.9 | 48.0 | 56.5 | 67.5 | 36.6 |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | n.a. | n.a. | n.a. | 11.5 | 13.7 | 15.2 | 10.5 |
| <b>Slovak Republic</b>                      |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | 12.2 | 30.3 | 41.3 | 31.8 | 33.4 | 44.3 | 40.0 |
| Domestic credit to enterprises <sup>2</sup> | n.a. | n.a. | 30.4 | 23.0 | 26.3 | 30.4 | 42.1 | 43.9 | 37.8 |
| <b>Slovenia</b>                             |      |      |      |      |      |      |      |      |      |
| Bad loans <sup>1</sup>                      | n.a. | n.a. | n.a. | 22.0 | 13.2 | 14.3 | 12.5 | 11.4 | 10.2 |
| Domestic credit to enterprises <sup>2</sup> | 34.9 | 23.3 | 22.0 | 23.1 | 27.5 | 28.8 | 28.6 | 32.8 | 35.9 |

n.a. = not available; (1) in per cent of total loans; (2) in per cent of GDP.

Source: Internet, various sources.

Although some access to rural credit was given in all countries at the beginning of transition, it was not granted on the same basis as in market economies. The farm sector, which was highly protected in socialist times, came under hard economic pressure from the outset of transformation. Some government credit was given to enable the survival of the former state and collective farms; other state credit was given to the newly emerging private farm sector. The credit provided was not and possibly could not have been based on profitability calculations. Such calculations were nearly impossible, as information about the future was very uncertain, mainly due to monetary instability. However, it should have been made clear from the outset that credits had to be paid back. Instead, some large farms believed that credits had been granted under the former rules to be written off at some time in the future. Indeed, some countries, which have not completely dismantled the former large-scale farming sector, continue to provide credits to these farms. The soft budget constraint helps them to survive; however, these credits are not given on a market basis where expected rates of return are one of the main determinants. Slovakia seems to be noteworthy among the CEECs for continuing to distort the rural credit market by soft budget constraints for large farms. Most countries have begun to set up new organisational structures for rural finance (Csaki and Fock, 2000).

Bulgaria, Hungary, Poland, Romania and Slovenia, have supported the creation of rural or agricultural credit co-operatives and proposals are underway in Macedonia. The three Baltic States have refrained so far. While it is recognised that credit co-operatives can mobilise savings and provide credit, the concept can face resistance. In Albania, for example, there appears to be resistance towards such organisations which are perceived as a relic of the communist era.

A smaller number of countries (Albania, Hungary, Latvia, and Lithuania) have succeeded in creating a private banking structure. For some other transition countries the World Bank has proposed to assist the development of a private banking sector. It is not surprising that a private rural banking sector is slow to emerge in transition countries. Private lending is not very attractive for banks in rural areas. First, while the amount of credit needed is often quite small, the transaction costs for the bank are related to the number of loans rather than to the size of the loan. Hence, the per unit transaction costs are lower for large loans than for small loans. Regardless of the size of the loan, the bank has to scrutinise the creditworthiness of the borrower. However, the banks often do not have the necessary expertise, nor do the farmers have the necessary history to demonstrate their creditworthiness. Credit co-operatives may have lower transaction costs if they are smaller, located in villages and have better knowledge of the potential borrowers' credit history and creditworthiness. Agricultural credits can appear riskier than other credits, especially compared to credits to traders. Moreover, agriculture needs not only short term but also long-term loans. Information checks to assess the profitability of these loans are costly and their returns remain more uncertain than in other sectors of the economy. As the new generation of small farmers has neither credit history, nor experience in preparing business plans, private banks are likely to incur higher costs when providing credit to these farmers compared to other businessmen. In addition, it may be more difficult for private banks to mobilise funds in rural regions. The level of savings in rural areas depends on the level of income. As the average income in rural areas is lower than in urban regions, the volume of savings is likely lower per capita than in urban areas. Moreover, rural people have more opportunity to invest in non-monetary assets. Building up grain stocks or increasing animal numbers may be a more attractive option as it is perceived as protecting against inflation and possible bank crises. This consideration highlights the importance of institutions for a viable private banking system. The findings of a field study in Romania confirm the asserted behaviour of banks and credit co-operatives (Breitkopf, 2000). Banks provide larger amounts of credit and largely insist on collateral, while co-operatives give smaller loans and only request co-signers for 80% of loans. Interestingly, some co-operatives prefer to give small loans in order to spread the risk of bad loans. Higher transaction costs are thus accepted.

It is often stated that rural credit markets in transition economies are underdeveloped because farmers do not yet have the possibility to provide land as collateral. However, while collateral is important as it reduces the lender's risk, its importance is perhaps overestimated. In a survey conducted in Romania in 1997 (Breitkopf, 2000) 18 farmers out of 220 interviewed expressed an aversion against credit (high risk aversion) while 50 stated that they had adequate monetary resources either through own savings or from external sources. Thus, 31% of farmers did not want to enter the credit market. It is unlikely that there were no profitable investment projects on the farm (the status of the farm and the use of yield increasing inputs were quite low in Romania at that time). If 31% of farmers refrained from taking credit, it is likely that they did not know how to find profitable investment projects, and/or that the information costs were too high. In the absence of a rural financial sector, costs of getting a loan might also have been too high. All suppositions point to the importance of institutions. A similar observation holds for Poland. A EU Commission report states that "Polish farmers use relatively little debt in their farming operations and rural businesses generally use their own funds to finance investment." Most likely, this does not indicate that there are no credit needs; rather that farmers are risk averse, are not aware of investment opportunities, and, possibly, lack access to credit. Concerning the latter point, it should be noted that farmers in Poland can provide collateral, as most farmers own their land. Hence, the ownership of land as collateral is not likely to be the most binding constraint in creating a rural financial market. A functioning land market is necessary to allow the value of the collateral to be realised. When the land market is not working (which is likely to be the case in all transition countries) banks do not know the value of land, and cannot realise its value easily. For long-term loans, however, land as collateral would be important.

In all CEECs government plays an important role in providing credit to agriculture and often also to enterprises in rural areas. The role of governments has been twofold: they have improved credit access, often through a credit guarantee fund, and they have subsidised interest rates. Hungary even set up two funds; one for small and medium holders and one for large farms. Such a distinction might be worthwhile, as management expertise to provide credit to small farms has to be different from that required for large farms.

During the first years of transition the effective interest rate for farm credits was lower than the rate of inflation in most countries. Hungary is a classic example: interest rates were subsidised by 30% to 50%, making the real interest rate even negative. While some countries claim that they do not provide preferential credit treatment for farmers, not only officially granted credits have to be taken into account, but also credit lines to the former collective and state farms. Slovakia seems to be a special case in point. Some large farms in Slovakia would go out of business if no soft budget constraints existed.

Some CEEC governments appear to have recognised the high risk associated with subsidised investment and have therefore based the allocation of credit on business plans and proof of past performance. Of course, this method is only valid if the potential investor has been in business for some time. The Estonian government introduced the criteria of proof of past performance in 1997, while other CEECs appear to have disregarded this requirement up to now. The World Bank generally recommends banks and governments to insist on a business plan, which certainly help to assess creditworthiness, while not entirely eliminating risk. Of course, the more qualified the person who prepares the plan, the better the plan. This supports the World Bank recommendation to the governments of Estonia, Latvia, and Lithuania to support training in preparing business plans. As banks and other formal financial intermediaries are reluctant to grant loans to agriculture due to high risk, most governments in the CEECs have tried to overcome the problem by setting up credit guarantee funds, often with foreign financial assistance. Hungary was the forerunner in 1991 and the experience seems to be positive. However, it should be noted that these official guarantees impede the

development of a private financial sector if the guarantees are only given for bank credit and sometimes even only to State Banks.

Government activities in most transition economies, whether with or without foreign assistance, have contributed to creating a **formal** rural financial organisational structure. However, government activities have not contributed significantly to building up an **informal** financial sector nor the necessary institutions for functioning formal and informal sectors. Most activities have focussed on allocating government or donor funds to selected investors (Sarris, 1996). However, a sound rural financial market requires that savings are mobilised, handed over to a financial intermediary, and that intermediaries incur low information costs in assessing the credit risk. Moreover, an efficient rural financial market entails that potential borrowers know how to prepare business plans and incur low information costs in assessing the profitability of an investment. A sound rural financial sector should also provide credit for consumption purposes as this type of loan can help to resolve difficult circumstances such as illness. Consumption credit may also be justified if the income of a borrower is lower than the level that can reasonably be expected in the future. None of the CEECs has yet succeeded in setting up this type of formal financial system.

Little information is available on informal financial systems. The governments of Albania, Hungary, and Slovakia supported the acceptance of warehouse receipts as collateral. However, it has been reported that this instrument contributed only marginally to an expanding financial market. It seems that lenders are not sure about the value of this collateral and, moreover, borrowers can only use this mechanism rather than selling stored grain if they expect significant positive changes in grain prices which would outweigh the interest to be paid on the capital borrowed. Warehouse receipts can contribute little to the development of rural financial markets if uncertainty on commodity markets and uncertainty on legal enforcement of rights are a major problem. If these problems are resolved, it is highly questionable whether the need for warehouse receipts would persist.

Little is known about informal rural credit markets through private moneylenders and input suppliers. It is known that input suppliers in market economies are prepared to grant at least short-term credit. Grain before harvest is even occasionally accepted as collateral. Input suppliers can therefore contribute significantly to building up a rural financial market in the first phase of transition. Farmers may need short-, medium, and long-term credit. However, in the first stage of transition, long-term investment is most risky due to the economic uncertainty. The profitability of short-term investment – namely yield-increasing inputs – can be assessed with greater certainty and, hence, the private trader is often willing to provide credit to the input purchaser. The advantage of this route to the development of financial markets is that input suppliers often have personal long-term contacts with the purchaser and, therefore can better assess the risk. Moreover, this type of credit can support the principle of repaying credits and create trust which is one of the most important components of a viable credit market. It has been reported that supplier credits play an important role in Estonia, where the United Milk Processors and the Tart Lease provide substantial credits to farmers.

### **The importance of institutions for agricultural finance**

Financial markets are property intensive and tend to emerge late in the transition process. (Olson, 2000). Some markets such as those for barter goods do not carry a high risk for the market partners and develop spontaneously. However, where the fulfilment of an exchange contract is not guaranteed, there is a risk involved for the trading partners. A contract may only be concluded if the partners have some assurance on how the situation will be resolved in the case of non-fulfilment of obligations. In most cases, after a contract has been signed and some market transaction has taken place, problems arising from the contract need to be dealt with through specific institutions (rules) and organisations

and these have to be created by collective action. It might appear simple for transition countries to establish these institutional settings as mature market economies could export their experience. However, there is evidence that transferring institutions from one country to another is not easy. What matters is not just the official existence of institutions, but the ability to make them function. The ability to enforce new institutions depends very much on the institutions that are already in place. If some of the latter are embedded and partly or totally conflict with the newly introduced rules, the latter may be impeded from becoming effective. Following Williamson (2000) we can identify four levels of institutions. Here we show their importance for the functioning of financial markets in a transition country.

**Embedded institutions** (First level institutions) include the cultural values and core beliefs of a society. Society's attitude to debt, personal willingness to save; willingness to take risk and to exploit opportunities, as well as the propensity to offer land as collateral are part of a society's culture and, thus, affect the country's credit market. Interviews in Novosibirsk and Shitomir revealed that only 33% of the farmers were willing to mortgage their land (Schulze *et al.*, 1999). The demand for loans and the supply of credit will be restricted under these conditions even if the official institutions are in place. A market economy is supposed to channel savings to the most efficient use. The main idea is that individual investors will find out what the most profitable projects are. However, if society ranks the welfare of specific groups very highly (examples would include members of a family or a clan), it might at the same time rank an individual's endeavour for gainful activities rather low. Moreover, it cannot be presumed that many individuals have learned to collect information effectively in order to identify the most profitable investments and/or to assess the risk of the activity appropriately. As it takes a long time to change these embedded institutions, the development of financial markets lags behind the development of other markets.

**Second level institutions** concern the formal rules of the game (Williamson, 2000). They are of high importance for property-right intensive markets as they include the establishment of the executive, legislative, judicial, and bureaucratic functions of the governments. It may appear simple to introduce this institutional environment into a transition economy. However, the effectiveness of these rules is very much dependent on level one institutions. For example, the cultural bias in Albania favours obligations towards family members. This can act as an impediment to the establishment of an efficient bureaucracy as it can inhibit recruitment of the most effective and highly trained candidates. In this context, how can rules be effective if corruption and state capture is pervasive in a society. Transition countries generally rank much lower in the corruption perception index than EU member countries.

**Third level institutions** concern the governance of contractual relations. "Governance is an effort to craft order" (Williamson, 2000). These institutions focus on *ex ante* realignment of contracts and, thus, help to mitigate conflicts and realise mutual gains. In the early years of transition, countries were relatively ineffectual at setting up efficient systems to deal *ex post* with contractual relations between private agents, between the government and private agents, and between governmental organisations. Courts are still overloaded in some countries and are unable to handle cases in a timely fashion; government organisations are not willing to provide information to other public or private entities; corruption is still pervasive in many countries and limits the effectiveness of property rights. If enforcement of property rights is a problem, the development of rural financial markets is a special problem. Lenders have to incur high transaction costs as the risk of default is high and enforcement of contracts is more costly in rural areas than in cities. These third level institutions are highly underdeveloped in the CEECs. Land titles are not available on a large scale and contract default seems to be more the rule than the exception in some countries. Hence, banks undertake a high risk when lending money to agents in the agricultural sector. Screening of credit demand with a demand

overhang (Stiglitz and Weiss, 1981), high interest rates and the emphasis on short-term credit are the consequences.

**Fourth level institutions** are the main environment for neo-classical economic theory. The focus is on *ex ante* contractual relations, and designing the rules for optimising given objective functions. Hence, optimisation and marginal analysis are the main areas of interest. However, before neo-classical theory can be applied, the design and training of the main players (organisations) is needed. Transition countries used to have large banks that provided credit based on directions from the planning centre. The shift to a market economy demands a different set of organisations, *e.g.* smaller banks, co-operative and savings associations or micro-finance organisations, depending on the specifics of the country under consideration. The work of the World Bank has emphasised the need for a new banking structure from the very beginning of transition. However, what appears to have been widely neglected is that there is little incentive to set up new financial intermediaries in rural areas as long as the institutional framework outlined above has not been put in place.

### **Policies for the future**

The foregoing discussion of the lack of institutions for well functioning rural financial markets clearly indicates that market and policy failure prevail in transition countries and that this is even more pronounced in the SEECs. Therefore policies need to be designed to overcome market failure, while simultaneously attempting to minimise the associated distortions and policy failure (Besley, 1994; Stiglitz, 1994; Schrieder and Heidhues, 1998). As a “first best” approach, policy measures to vitalise rural financial markets should address the problem of market and policy failure, *i.e.* the divergence between social marginal costs (social marginal willingness to pay) and private marginal costs (private marginal willingness to pay) and the wedge between market prices and shadow prices should be reduced in such a way that measures are implemented which reduce the divergence and wedge at minimal costs, taking account of by-product distortions. A summary is presented below of specific origins of market and policy failure as well as a summary of policy instruments, and some of the policy measures are discussed in more detail.

**No credit subsidies:** Credit subsidies to agriculture are given in most transition countries, with the exception of Albania. The World Bank and other advisers recommend ending this policy. The argument is that investment in agriculture is generally a risky business and even more so in times of high uncertainty during the transition period. Therefore, it is likely that some of the investment financed by subsidised credit will not be profitable. The risk of investment will be lower if the potential investor collects information effectively in order to assess the risk and if he takes into account the likelihood of making a profit or a loss. Subsidised credits biases the decision of the investor. He may undertake specific investment projects at subsidised credit rates that he would not pursue at market rates. Indeed, experience from developed market economies supports this view. Moreover, the experience from East German agriculture is that a high economic failure rate emerged in the new generation of family farmers. The new farms did not meet expectations – in spite of high subsidies – even after 4 years. Their income was insufficient to make a living, and about 40% suffered a loss in equity year after year. The failure of newly established family farms arose because some farmers were not as good at managing a farm as they had hoped, some just had wrong expectation about the future development of markets, and some did not like farming as much as they thought they would.

Table 3. Market and policy failure on rural financial markets

| Origin of Market Failure                                                                                                                                                                                                                                                                          | Focus of policies                                                                                                                                                                                                                                                                             |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Core beliefs                                                                                                                                                                                                                                                                                      | Education                                                                                                                                                                                                                                                                                     |
| Ignorance                                                                                                                                                                                                                                                                                         | Human capital formation                                                                                                                                                                                                                                                                       |
| Uncertainty                                                                                                                                                                                                                                                                                       | <ul style="list-style-type: none"> <li>• Stable monetary policy</li> <li>• Stable agricultural policy</li> <li>• Support of insurance markets and strategies</li> </ul>                                                                                                                       |
| Asymmetric information                                                                                                                                                                                                                                                                            | <ul style="list-style-type: none"> <li>• Private credit rating agency</li> <li>• Market information systems</li> <li>• Support of markets for information</li> <li>• Support of assessment of credit worthiness</li> <li>• Legislation to improve acceptance of warehouse receipts</li> </ul> |
| Inadequate banking structure                                                                                                                                                                                                                                                                      | <ul style="list-style-type: none"> <li>• Support of rural savings and deposit banks</li> <li>• Support of micro-credit organisations</li> </ul>                                                                                                                                               |
| Market failure on markets related to credit markets <ul style="list-style-type: none"> <li>• Badly functioning markets <ul style="list-style-type: none"> <li>❖ for information</li> <li>❖ for insurance</li> <li>❖ for land</li> <li>❖ for assets</li> <li>❖ for products</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Clarification of land ownership</li> <li>• Transparent collateral system</li> <li>• Speeding up of administrative barriers for land transactions</li> <li>• Market information systems</li> <li>• Support of markets for information</li> </ul>      |
| Origin of policy failure                                                                                                                                                                                                                                                                          | Policy activities                                                                                                                                                                                                                                                                             |
| Unstable monetary policy                                                                                                                                                                                                                                                                          | Stable monetary policies                                                                                                                                                                                                                                                                      |
| Unstable agricultural policy                                                                                                                                                                                                                                                                      | Stable, transparent and market oriented agricultural policies                                                                                                                                                                                                                                 |
| Regulation of internal markets                                                                                                                                                                                                                                                                    | Market liberalisation                                                                                                                                                                                                                                                                         |
| Insecure property rights                                                                                                                                                                                                                                                                          | Secure property rights                                                                                                                                                                                                                                                                        |
| Implicit taxation of agriculture                                                                                                                                                                                                                                                                  | Liberal trade regime                                                                                                                                                                                                                                                                          |
| Lack of transparent agricultural policies                                                                                                                                                                                                                                                         | <ul style="list-style-type: none"> <li>• Provision of information</li> <li>• Transparent decision making</li> </ul>                                                                                                                                                                           |
| Credit subsidisation                                                                                                                                                                                                                                                                              | <ul style="list-style-type: none"> <li>• Indirect subsidisation by the provision of guarantee funds</li> <li>• Subsidisation of credit assessment for small loans</li> <li>• Subsidisation of small loans</li> </ul>                                                                          |
| Screening of borrowers                                                                                                                                                                                                                                                                            | Withdrawal from this activity                                                                                                                                                                                                                                                                 |
| Soft budget constraints                                                                                                                                                                                                                                                                           | Withdrawal from this activity                                                                                                                                                                                                                                                                 |

Source: Internet, various sources.

**Measures to reduce information costs:** It has been shown above that the lack of information has negative effects on savings, on investment, and on the behaviour of intermediaries. The amount of information needed by an individual decision maker can be reduced if there is a legal framework in place which allows contract enforcement. Financial markets are more affected by the high costs of contract enforcement as breach of contract is more likely for these contracts than for exchanges where there is not a long period between contracting and delivery.



**Enforcement of contracts:** Information costs would be lower if parties could rely on contracts. The likelihood of cheating would be reduced if contract enforcement was as easy as is generally the case in market economies. The present conditions in Croatia may serve as illustration. The Croatian government has not yet fulfilled the appropriate role of a market economy by securing a functioning legal framework. While the Croatian Parliament has approved the necessary framework, the implementation is still lacking. Overloaded courts should be avoided and the procedure of bankruptcy should be accelerated. Secure property rights reduce information costs as the contractor can use the property as collateral or as mortgage. Property of land is not clarified yet in Croatia. While this is partly due to the socialist legacy updating of land books should have high priority.

**Support for a private credit rating agency:** There are private organisations in most developed market economies that provide information on the creditworthiness of individuals and legal persons. Such a central credit registry has existed in Germany since 1927 (Striwe *et al.*, 2001). These organisations collect information on bad credit history and sell this information to interested parties. To ensure privacy, the borrower must agree that the lender will use this information. It goes without saying that the borrowers agree in order to signal that they are good borrowers who do not fear disclosure of information on their creditworthiness. This type of organisation reduces information costs for individuals and, thus, improves the market performance on financial markets. Moreover, the existence of such an organisation in transition economies would strengthen competition on product markets and help reduce arrears. The purchasers of agricultural products could use their proven credit history to support their transactions. As the set-up costs for such an organisation can be high and as the private benefit is currently lower than the economic benefit, governments in transition economies could support the creation of such an organisation.

**Measures to deal with uncertainty:** Uncertainty is related to information. With complete information, the problem of uncertainty vanishes. However, it is impossible to provide complete information. Hence, individuals and society have to deal with uncertainty. There might be market failure if individual decisions are suboptimal from the point of view of society at large. The argument presented above was that society as a whole is less likely to be affected by uncertainty in special fields than individuals. However, there is hardly a first best policy to address this failure as the appropriate policy option may differ from case to case and the information on the divergence between private and social marginal costs and benefits is not available. Hence, it is only possible to institute policy measures that should result in a reduction in the divergence.

**Setting up a Credit Guarantee Fund:** The Government may consider setting up a Credit Guarantee Fund (see Gugler, 1998 for the pros and cons of such funds; the following proposal considers the main counter-arguments). Such a Fund could somewhat reduce the effects of uncertainty for the lender. It would partly compensate for the lack of land collateral due to unclear land ownership and badly functioning land markets. Hence, loans provided by commercial banks could be backed by the Credit Guarantee Fund. However, the fund can only work if Commercial Banks carry the main share of the risk. Hence, the Fund should not underwrite more than 50% to 70% of the loan. Investigating creditworthiness is one of the main tasks of banks. Banks will only perform this task properly if they have sufficient incentives to avoid bad loans. To ensure a high repayment ratio, guaranteed credits should only be granted if the farm has no overdue payments. Of course, it should remain at the bank's discretion to ask for additional collateral in order to reduce remaining risk.

**Subsidies for assessment of loans:** Subsidisation of loans related to the size and the term of the loan may be considered. Loans needed by agriculture are often small, short-term first and long-term later. Banks may not be interested in providing small amounts of credit; the costs for assessing creditworthiness are not only related to the size of the credit, but to some extent to the loans as such. Hence, what might be considered is to subsidise a fixed amount to the bank for new loans up to a

certain size. Uncertainty is more significant for long-term than for short-term credits. This explains why agriculture in Croatia may get some short-term loans, but no long-term ones. However, based on the arguments presented above, from an economic point of view, the outcome of the market for long-term credits may be even less optimal than for short-term loans. Private costs for collecting information and addressing the uncertainty embodied in long-term credit is higher than the costs to society. Hence, subsidisation may lead to a reduction in divergences. The subsidy could be related to the maturity of the loan, but tied to the loan as such and not to the size of the loan.

**Support of rural financial organisations:** The causes of market failure on rural financial markets are not solved by the creation of rural financial organisations. However, supporting the creation of rural credit and savings organisations will help to mobilise rural savings and to distribute funds at lower transaction costs; the rural organisations may have lower transaction costs as information on the prospective borrowers is cheaper to get and the staff might be better trained in assessing creditworthiness of borrowers in rural regions. These rural financial organisations would be well advised to rely on group-backed credits and peer-managed schemes.

**Support of micro-finance projects:** There is a long history of direct intervention in rural financial markets. International donors, especially the World Bank have supported programmes to subsidise rural credit. However, the experience has been disappointing (Yaron and Charitonenko, 1998) and the programmes may even have delayed the development of financial services in rural areas. It is now widely agreed that rural financial markets will emerge without direct government intervention if there is a supportive policy environment. Malfunctioning rural financial markets are not mainly the result of factors which directly affect the rural credit market, but are the result of a wider range of variables, which include the financial system in the country, the security of property rights, the profitability of farming, the land market, etc. Consequently, the new approach to rural financial markets gave rise to the 'micro-finance promise' (Morduch, 1999). This approach aims at developing a rural financial market by providing small-scale credit, mainly to the poorest groups in rural areas. Even if experience with micro-credit has been praised, especially by NGOs who are involved in micro-finance projects, the proof that they have led to self-sustained rural financial markets has not yet been delivered (Morduch, 1999). These projects all started out with credit allocation mainly or solely based on funds raised outside the region, and with subsidies. Hence, these organisations were not sound intermediaries on a sustainable basis from the outset. Morduch reports that out of a survey of 72 micro-finance programmes with a commitment to be or to become financially sustainable, 34 were profitable. Moreover, according to Morduch it is estimated that no more than 1% of NGO programmes world-wide are currently financially sustainable. However, this experience does not necessarily lead us to conclude that such micro-finance programmes should be neglected. There might well be a rationale to promote such schemes in some of the Balkan countries. It was argued above that there is evidence of significant market and policy failure which suppress the evolution of rural financial markets. Micro-finance projects could be a first step in establishing a sound rural financial scheme (Ledgerwood, 1999). First, they contribute to the accumulation of knowledge. Due to the close contact with borrowers they can teach us what kind of information has to be collected to use a loan profitably and how to access this information. Thus, the information problem will be partly addressed. Second, banks are unable to rely on collateral in SEECs. The ownership of land is not clear, there is no active market for agricultural property and the juridical system is weak. A micro-credit project in rural areas might be based on group lending and, hence, can provide loans without collateral and with less risk than a bank. Third, agriculture needs primarily small loans as farms are very small in many transition countries. Commercial banks would have to accept high transaction costs as uncertainty remains high even after careful assessment of credit worthiness. It was explained above that social costs of uncertainty are lower than private costs and, hence, some government interference might be welfare increasing. Fourth, such projects can build up trust in the finance system and, hence, can be considered as seed for the creation of a banking system. Finally, micro-credit projects aim at reducing poverty in

rural areas (Zeller, 1999). Micro-finance programmes could make a contribution to poverty alleviation in Albania, for example, where rural poverty is pervasive. Hence, the performance of these projects should not only be measured on the basis of financial soundness, but should also take into account the external effects. Albania has some positive experience of micro-credit projects, although the Albanian Development Fund (ADF) is the only formal lender in rural Albania. However, these projects still have a limited impact. First, the availability of credit is restricted to about 7.7% of villages in Albania and second, these organisations do not yet mobilise funds in rural regions, but only allocate funds from outside the region. Nevertheless micro-credit projects can be considered as a first step to building up a rural financial system and they can be extended to rural savings and credit associations, as it is presently the intention in Albania.

**Support of banks with small credit clients:** The Foundation for Enterprise Finance and Development (FEFAD) Bank) is one Albanian bank which has successfully served small and medium-sized enterprises in the cities. The history of this bank can be considered as a model for financial reform (see Winkler, 2000). The organisation, which began its operations in January 1996, was initially not a bank as it was founded to distribute funds, and not to collect deposits. The funds were provided by an external donor, the German Bank for Reconstruction and Development (Kreditanstalt für Wiederaufbau). Only after the lending experience under the specific conditions in Albania proved positive, was a bank license provided. This bank could serve as a model. The focus on small and short-term credit needs specific expertise that the staff of large state-owned banks generally do not have. Granting small loans limits risk for the lender and, most importantly, helps to build up a credit history. Many projects have shown that the likelihood of being qualified for further loans serves as an incentive for repayment. Understandably transaction costs are quite high and so the interest spread has to be high. So far the FEFAD Bank has had access to subsidised funds and has not been forced to recover costs. However, taking into account that there are few alternatives for developing the financial sector, and in the light of the positive external effects of such market intervention, the subsidisation can be justified.

## BIBLIOGRAPHY

- Besley, T. (1994),  
*How do market failures justify interventions in rural credit markets*, World Bank Research Observer, Vol. 9, No. 1. pp. 27-47.
- Breitkopf, B. (2000),  
“Gaps between Supply and Demand of Rural Finance at the Small and Medium Private Farm Level”, In: Heidhues, F. and G. Schrieder (eds.), *Romania – Rural Finance in Transition Economies*, Frankfurt /M.
- Csaki, C. and A. Fock (2000),  
“The Agrarian Economies of Central-Eastern Europe and the Commonwealth of Independent States, An Update on Status and Progress, ECSSD Environmentally and Socially Sustainable Development”, Working Paper No. 24.
- European Bank for Reconstruction and Development (EBRD),  
*Transition report 2001*.
- Gugler, M. (1998),  
“Credit guarantees, An assessment of the state of knowledge and new avenues of research”, *FAO Agricultural Research Bulletin 129*, Rome.
- Hoff, K. and J. E. Stiglitz (1993),  
“Imperfect Information and Rural Credit Markets: Puzzles and Policy Perspectives”, In: Hoff, K., A. Braverman and J. E. Stiglitz (eds.), *The economics of rural organisation: Theory, Practice and Policy*, pp. 33-52.
- International Monetary Fund (IMF),  
*World economic outlook*, Oct. 2000.
- Koester, U. (2000),  
“Rural Credit”, In: *The experience of other Central & Eastern European Countries in the Transition and EU Integration Process, A review*, Prepared for Ministry of Agriculture and Forestry, Croatia, pp. 50-56.
- Ledgerwood, J. (1999),  
Case Studies in Microfinance – Albania – Albanian Development Fund (ADF),  
<http://www-esd.worldbank.org/sbp/end/albania.htm>.
- Morduch, J. (1999),  
“The Microfinance Promise”, *Journal of Economic Literature*, Vol. 27. pp. 1569-1614.
- Olson, M. (2000),  
*Power and Prosperity, Outgrowing Communist and Capitalist Dictatorships*, Basic Books, New York.

- Pistor, K., M. Raiser and S. Geller (2000),  
 “Law and finance in transition economies”, Working paper No. 48, European Bank for Reconstruction and Development (EBRD).
- Sarris, A. (1996),  
 “Rural informal credit markets and the effectiveness of policy reform”, FAO, Economic and Social Development Paper 134.
- Schrieder, G. and F. Heidhues (1998),  
 “Transition and Rural Finance”, *Quarterly Journal of International Agriculture*, Vol. 37, No. 4, pp. 265-282.
- Schulze, E. P. Tillack, O. Dolud, and S. Bukin (1999),  
 “Eigentumsverhältnisse landwirtschaftlicher Betriebe und Unternehmen in Russland und in der Ukraine”, Discussion Paper No. 18, Institute of Agricultural Development in Central and Eastern Europe, Halle.
- Striewe, L., S. von Cramon-Taubadel and K. Sirin (2001),  
 “Financing problems in Ukrainian agriculture: Diagnosis and possible solutions”, International Centre for Policy Studies (ICPS), *Policy Study* No. 15, Kiev, January 2001, pp. 25-38.
- Swinnen J. and H. R. Gow (1999),  
 “Agricultural credit problems and policies during the transition to a market economy in Central and Eastern Europe”, *Food Policy* 24, pp. 21-47.
- Stiglitz, J. E. and A. Weiss (1981),  
 “Credit rationing in markets with imperfect competition”, *American Economic Review*, Vol. 71, No. 3, June, pp. 383-410.
- Stiglitz, J. E. (1994),  
*The Role of the State in Financial Markets*, Proceedings of the World Bank Annual Conference on Development Economics 1993, Washington, DC, pp. 19-61.
- Williamson, O. (2000),  
 “The New Institutional Economics: Taking Stocks, Looking Ahead”, *Journal of Economic Literature*, Vol. XXXVIII, pp. 595-613.
- Winkler, A. (2000),  
*Financial Sector Development and Financial Institution Building in Albania*, Manuscript.
- Yaron, J. B. D. and S. Charitonenko (1998),  
 “Promotional Efficient Rural Financial Intermediation”, *The World Bank Research Observer*, Vol. 13, No. 2, pp. 147-70.
- Zeller, M. (1999),  
 “Towards Enhancing the Role of Microfinance for Safety Nets of the Poor”, ZEF – Discussion Papers on Development Policy, No. 19.

# AGRICULTURAL FINANCE AND INSTITUTIONAL REFORMS IN BULGARIA

By Ms. Lena Roussenova and Mr. Dimitar Nenkov  
(Paper presented by Ms. Roussenova)

## Abstract

*Agriculture has traditionally played a significant role in the Bulgarian economy. Since 1997, the government has made rapid progress in implementing a wide-ranging reform programme in agriculture, the financial sector and in the economy in general. The highest priority has been given to actions that result in a market-driven restructuring, rather than to financial support that would reproduce existing inefficient structures. The banking sector restructuring has been accompanied by the banks' cautious approach to lending in general and particularly to agriculture. Some sector-specific lending programmes have been introduced but they could barely compensate for modest bank credit to agriculture. Most of these programmes are undergoing continuous change, consistent with developments in the agricultural and banking sectors. With continuing recovery of public trust in banks, and with more than 70% of banks' assets owned or controlled by foreign private banks, the sector is expected to overcome conservative lending.*

## Introduction

Agriculture has traditionally played a significant role in the Bulgarian economy. Before the beginning of transition, Bulgaria was a major exporter of fresh and processed fruits and vegetables within the former Council for Mutual Economic Assistance (CMEA). The process of reforms and transition to market-based agriculture has been rather difficult for Bulgaria. Due to the disintegration of traditional Bulgarian markets, specific procedures used to privatise state assets and restructure assets into private ownership, as well as the relative instability of the overall economy until 1997, there has been more disruption in the farming sector in Bulgaria than in many other Central and Eastern European countries. Since 1997, the government has made rapid progress in implementing a wide-ranging reform programme with significant implications for agriculture and the financial sector. The highest priority has been given to actions that result in a market-driven sectoral restructuring, rather than to financial support that would reproduce existing inefficient structures. This approach has been expected to improve the sector's competitiveness and performance and thus contribute to maximising the benefits for the economy as a whole. The banking sector restructuring has been accompanied by banks' conservative approach to lending in general and particularly to agriculture. Some modest sector-specific lending programmes were introduced but the funding levels were insufficient to compensate for modest bank credit to agriculture. Most of these programmes are undergoing continual change, consistent with developments in the agricultural and banking sectors.

## 1. The economic and agricultural situation in Bulgaria

### 1.1. Major economic developments

Following the 1996-97 banking sector and currency crises, the new Bulgarian Government implemented a radical economic reform programme. Supported by the IMF, it introduced a currency board arrangement (CBA), which imposed prudent fiscal policies, tight prudential regulations,

enhanced banking supervision, and imposed radical economic restructuring. The implementation of the reform programme resulted in improved macroeconomic fundamentals. Inflation and budget deficits have been brought under control and the economy has experienced growth for a couple of years. The CBA introduction reduced inflation to about 1% in 1998. Some increase in inflation was recorded in 1999 (6.2%) and 2000 (11.4%) due to the strong US Dollar and high oil prices, but it is expected to subside to about 5% in 2001 (Table 1). Prudent fiscal policies have kept the budget deficit fairly low within the boundaries of 1-1.5%. In 2001 GDP growth is expected to be 5%, driven by private consumption and investment, as well as by productivity gains from structural reform.

**Table 1. Bulgaria: selected economic indicators**

|                                   | 1996  | 1997  | 1998 | 1999 | 2000* | 2001** |
|-----------------------------------|-------|-------|------|------|-------|--------|
| Real GDP                          | -10.9 | -7    | 3,5  | 2.4  | 5.8   | 5.0    |
| CPI, end of period                | 310.8 | 578.5 | 1.0  | 6.2  | 11.4  | 4.5    |
| General Government balance/GDP, % | -10.4 | -2.5  | 1.0  | -1.0 | -1.0  | -1.5   |
| Current account balance/GDP, %    | 0.8   | 4.4   | -0.5 | -5.2 | -5.8  | -4.4   |

Source: Bulgarian National Bank, National Statistics Institute, MF, IMF.

\*Preliminary, \*\*Projection.

Since 1997 the government reform programme has speeded up the pace of privatisation and as a result about 80% of the assets of commercial banks together with most of the former state-owned enterprises (SOE) have been privatised. A deeper and more substantial restructuring of the newly privatised enterprises remains to be completed in order to improve the efficiency and competitiveness of the economy. Weak financial intermediation and the high level of annual external debt service<sup>1</sup> may constrain investment and economic growth. In the medium term, the risks include low growth owing to slow pace of reform, fiscal pressures on the expenditure side, and contagion from other CBA countries or emerging markets as Bulgaria moves toward reliance on market borrowing.

## **1.2. Importance and performance of agriculture**

The importance of agriculture in Bulgaria has remained high when compared to other Central and Eastern European countries (CEECs). However, during the transition period the share of agriculture and forestry in GDP fluctuated widely: it more than doubled between 1993 and 1997 to about 24%, and then fell to about 13% in 2000 (Table 2). Agricultural employment in Bulgaria is high by European standards and has been growing continuously since the beginning of transition. In 1999 employment in agriculture reached close to 26% of total employment, cushioning to a certain extent the rising levels of unemployment in other sectors, particularly in industry. The rise in employment in agriculture together with the fluctuations in agriculture's share in GDP could be explained by different factors, including restructuring of the economy, de-capitalisation of agriculture, rise in subsistence farming, etc.

---

1. In 2001 total external debt service is expected to increase to USD 1.6 billion (10.8% of GDP) from USD 1.1 billion (9% of GDP) in 2000.

**Table 2. Share of agriculture in GDP and in total employment, 1991-2000**

|                                             | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000*<br>Q1-Q3 |
|---------------------------------------------|------|------|------|------|------|------|------|------|------|----------------|
| Share of agriculture in GDP, %              | 15.2 | 11.3 | 10.6 | 12.3 | 13.4 | 14.6 | 23.8 | 18.8 | 15.1 | 13.4           |
| Share of agriculture in total employment, % | 19.1 | 20.7 | 21.7 | 22.8 | 23.4 | 24.2 | 24.3 | 24.7 | 26.0 | 26.2           |

Source: National Statistics Institute, 1999; European Commission, IMF.

\*Preliminary.

Despite the increase in agriculture's share in GDP and employment, observed since 1992, the economic transformation resulted in a decline in agricultural production both in terms of output and yields of main products. The yields of the main crops (cereals, vegetables, tobacco) declined (with the exception of tobacco) during the 1990s by some 60%. Output of the major livestock products (meat, dairy and eggs) declined even more than crop production. The relative importance of crop and livestock production has been changing continuously, but in general, the crop sector has preserved its dominance.

In 1991 prices of agricultural inputs were liberalised while output price increases were restricted until 1997, when almost all price and trade restrictions were eliminated. The price-cost squeeze until 1997 was more severe and lasted longer in Bulgaria than in other CEECs. It penalised agricultural producers and resulted in a decline in output and a limited use of fertilisers and agro-chemicals.

The fall in agricultural production has been caused by a number of supply-side factors: reduction in subsidies for fertilisers, decline in mechanisation, reduction in herd numbers, resulting from privatisation of animal production by ill-equipped farmers, etc. In addition, declines in both domestic and external demand for agricultural products magnified the adverse effects of the domestically generated supply-side disruptions:

- reduction in per-capita consumption of meat and other major agricultural products due to significant decline in the purchasing power of the population;
- decrease in external demand by traditional importers of Bulgarian agricultural produce, as the CMEA and the Former Soviet Union (FSU) disintegrated.

Despite these developments, together with Hungary, Bulgaria continues to be the only CEEC that has a positive balance of food and agricultural trade.

In addition to the decline in demand for agricultural products, the fall in production in the transition period could be attributed to general disruptions linked to the implementation of land reform, as well as to insufficient investment in agriculture and food processing. Investment in rural infrastructure has declined sharply over the last decade. The level of support to agriculture, as measured by the OECD methodology indicates that since 1997 Bulgarian agriculture has been operating in a fairly neutral policy environment<sup>2</sup> (OECD, 2000). In addition, as explained by Section 2, bank credit for agricultural

2. Support to agriculture, as measured through Total Support Estimate (TSE), was slightly negative in 1999, reflecting the relatively small budgetary transfers to producers and transfers to general services, as well as the low market support. At minus 0.1% the percentage TSE (% of GDP) was lower than the average for transition economies, OECD and EU (OECD, 2000).



producers has been insufficient. The provision of subsidised credit through different programmes has been a part of the overall agricultural policy framework but has not been enough to make up for limited access to bank credit.

### **1.3. Reforms in agriculture**

The transformation of agriculture in Bulgaria was based on the principles of ownership of land and other agricultural property. The aim of the reform programme was to create a market-oriented and internationally competitive agricultural sector. In 1991 the Law for Agricultural Land Ownership and Land Use launched the restitution of land ownership rights. The Law was designed on the basis of historic justice, and efficiency objectives were not considered a priority. As a result of land reform 98% of agricultural land is privately owned and the remaining 2% is under legal dispute. Forest ownership restitution is underway and is close to completion.

The first stage of restructuring and restitution of agriculture has already been completed, and the next stage of consolidation of farm ownership has just begun. The process of land restitution has resulted in highly fragmented land ownership. However, the land-use pattern is less fragmented, because producer co-operatives and formal and informal leasing arrangements have resulted in the establishment of larger farms. Within the emerging farm structure there are both large farms (private co-operatives and private individual farms), and a large number of small-scale farms. The future viability of the small-scale agricultural producers is questionable but they still play an important role as self-sufficient units.

The legal framework for the functioning of a land market has been completed but an active agricultural land market has not developed yet. A Cadastre and Property Register Law was adopted by Parliament in 2000, which allows for the creation and administration of a unified cadastre and property register. A Cadastre Agency was created at the Ministry of Regional Development and Public Works. Additional efforts need to be made to create a complete unified cadastre as well as to make the administrative structures operational. The Ministry of Agriculture and Forestry (MAF) created a land market information system in end-1999. The adoption of legislation and creation of administrative structures are only the first steps to the creation of a functioning and transparent land market. However, the lease/rental market has developed quite successfully and is currently playing an important role in the emergence of private farms. Some of the main obstacles, hindering the development of the land market are: low profitability of the sector, high transaction costs, difficulties in finding collateral and obtaining credit, etc. The development of a true land market will facilitate the acceptance of land as collateral by banks.

## **2. Banking sector reform and performance**

Compared to most other CEECs, the Government of Bulgaria has very limited intervention programmes in agriculture and agricultural finance. The main form of Government intervention is the subsidised credit programme of the *State Fund Agriculture* (SFA), which uses commercial banks as its agents. Apart from SFA credit and lending under some other smaller programmes (see Section 3), agriculture relies mainly on commercial bank credit as any other sector. The banking sector performance is of major importance for agricultural finance, as it determines to a great extent the amount of credit available to agriculture, as well as the terms under which it can be extended.

The Bulgarian banking sector has been undergoing significant institutional reforms since the 1996-97 banking sector crisis. The new Law on the Bulgarian National Bank (BNB) introduced the CBA in

mid-1997, which represented a major change in the Bulgarian monetary regime. The CBA introduced a limited lender of last resort (LOLR) facility and required new stricter prudential regulations. Foreign exchange reserves in excess of what is needed to cover the monetary base provide a limited LOLR facility in the case of liquidity risks, affecting the stability of the banking system<sup>3</sup>. These funds are kept as a deposit of the Banking Department with the Issue Department, and bank refinancing is limited by the size of the deposit, which is also subject to negotiations with the IMF. One of the performance criteria of the IMF-supported programme under the current Extended Fund Facility requires consultations with the IMF when a loan above BGN 2 million<sup>4</sup> is to be extended to a bank.

The CBA introduction speeded up bank privatisation. The majority of state-owned banks has already been privatised by foreign investors. At present more than 80% of banks' assets are privately owned and more than 70% of banks' assets are held or controlled by foreign banks. As of October 2000, publicly owned banks (State Savings Bank, Biochim, Promotional Bank and Municipal Bank) held 18.8% of the total banking sector assets. By end-2001, the Government intends to sell Biochim and the State Savings Bank.

The CBA introduction together with the new Law on Banks (1997) required the introduction of new much tighter prudential regulations. For example, risk weighted capital adequacy requirements were raised initially to 10% and subsequently to 12%. The minimum required reserves were kept at a relatively high level. Initially, BNB Regulation 21 fixed them at 11% of deposits, while in mid-2000 they were reduced to 8%. The conditions for access to the minimum required reserves were eased by the new version of Regulation 21 in early April 1998, which introduced daily averaging, and allowed banks access to 100% of required reserves on any given day. Tightening of prudential regulations included new requirements on large loan exposures, aggregate exposure to a single party, open foreign exchange position, etc. In addition, the government introduced stricter policies for providing government guarantees for loans.

**Table 3. Quality of loan portfolio of commercial banks**

|                      | Dec-97 | Dec-98  | Dec-99 | Dec-00 |
|----------------------|--------|---------|--------|--------|
| Loans (million, BGN) | 3 806  | 5 945.9 | 5 042  | 7 395  |
| Standard, %          | 78.8   | 86.6    | 86.2   | 91.8   |
| Watch, %             | 3.7    | 3.6     | 4.4    | 2.8    |
| Substandard, %       | 2.7    | 1.9     | 1.4    | 1.2    |
| Doubtful, %          | 2.0    | 0.6     | 0.9    | 0.8    |
| Loss, %              | 12.9   | 7.3     | 13.1   | 3.4    |
| Provisions, %        |        |         | 10.0   | 6.5    |

Source: Bulgarian National Bank.

Both on-site and off-site banking supervision has been enhanced since 1997, which has contributed to improved compliance with prudential regulations. Since the adoption of the new banking law and related prudential regulations, the incidence of violations of major requirements, such as capital adequacy, open foreign exchange position and loan concentration to individual borrowers, has been

3. Regulation 6 of the BNB establishes the terms of extending collateralised Lev loans to banks in cases of liquidity risks affecting the stability of the banking system. The total amount of the highly liquid assets pledged as a collateral should cover at least 125% of the loan amount approved by the BNB. The loan should be repaid within three months.

4. BGN = BGL 1 000 since mid-1999.

reduced significantly. Total risk-weighted capital adequacy increased from 10.2% in June 1997 to 35.6% in December 2000. The quality of banks' loan portfolios kept improving, with standard loans representing close to 92% of all loans at the end of 2000 (Table 3). For comparison, non-performing loans represented more than 70% of loans in the pre-crisis 1995. Tighter prudential regulations and enhanced banking supervision required more conservative lending policies from banks, which challenged intermediation but resulted in a generally sounder banking sector.

**Table 4. Domestic credit**

|                                          | Dec-95 | Dec-96 | Dec-97 | Dec-98 | Dec-99 | Dec-00 |
|------------------------------------------|--------|--------|--------|--------|--------|--------|
| Domestic credit/GDP, %, including:       | 67.4   | 61.5   | 28.8   | 20.7   | 19.0   | 18.2   |
| Claims on general govt., %               | 30.6   | 47.0   | 11.4   | 4.3    | 2.0    | 2.1    |
| Claims on non-financial public sector, % | 19.2   | 30.1   | 6.5    | 4.8    | 3.5    | 1.6    |
| Claims on private sector, %              | 21.6   | 37.0   | 11.0   | 11.6   | 13.5   | 14.7   |

Source: Bulgarian National Bank.

Although the banking sector is sound, monetary aggregates and deposit-to-GDP indicators suggest that the public's trust in banks is growing but has not been fully restored to its pre-crisis level yet. Once the CBA was introduced, re-monetisation began to speed up without reaching pre-crisis levels except for the Lev currency. At the end of 2000, monetisation, measured by broad money (M3) as a percentage of GDP, marked some progress, but at 36% in end-2000 it is still below the end-1995 level. Deposits-to-GDP ratio remained stable at about 21% throughout the post-crisis period but is also below the pre-crisis level, as the revival of confidence in banks since the CBA introduction has not been strong enough to restore deposits to their pre-crisis level. The banking sector crisis affected depositors' preference and shortened the maturity structure of deposits, making demand deposits the preferred ones, which puts certain limitations on banks' long-term lending.

Banks prefer to invest in low-risk government securities and deposits with foreign banks. At the end of 2000 banks' loans represented only 31% of banks' assets, while more than 50% of banks' assets are invested in securities and deposits with banks, mainly foreign. Domestic credit-to-GDP ratio and all its components marked a substantial contraction from 67% in end-1995 to 18% in end-2000 (Table 4). Since the second half of 1997 credit to the central government has begun to decline due to improved fiscal discipline and lower interest payments on domestic debt. Credit to the private sector has been growing both in absolute terms, and as a share of domestic credit (close to 80%) but as a percentage of GDP is still low at 14.7% in end-2000. The modest deposit base and credit to the private sector limit the potential contribution of banks to economic development in general and to agriculture in particular.

The relatively slow growth of credit to the private sector as compared to private sector growth is usually explained by banks' risk aversion related to the slow recovery of public trust in the post-crisis period, the CBA limited LOLR facility, and new tighter prudential regulations. In addition, there are some other important factors behind banks' behaviour (Ulgenerk, Esen and L. Zlaoui, 2000):

- Economic restructuring of both the real and financial sectors makes banks increasingly risk averse. Banks that have been undergoing privatisation have become conservative in order to avoid portfolio deterioration prior to privatisation. At the same time some of their traditional customers have ceased to exist or have cut back operations, while new customers from the emerging private sector do not have a credit history or appropriate collateral. Intensification of industrial restructuring, accompanied by substantial firm exit

and new entry has created an uncertain customer base that makes banks increasingly conservative in lending.

- Insufficient competition in the banking sector also impedes lending. Interest spreads are high and banks have not yet come under pressure to cut costs and diversify their products.
- The imperfect legal environment and uncertain protection of creditors' rights also contribute to banks reluctance to increase lending. The resolution of financial disputes is often slow, and contract enforcement weak, collateral is hard to seize, and bankruptcy and liquidation procedures remain clumsy and uncertain.

Banks' cautious attitude to lending has had a serious affect on agriculture. At the end of 2000, bank credit to agriculture, including SFA credit amounted to less than 1% of GDP. In addition to all factors determining banks' lending policies, there are some sector-specific factors, such as absence of collateral, low profitability and higher uncertainty, contributing to even more limited lending to agriculture (See Attachments 1 and 2). Banks demand higher collateral for loans to farmers both due to stringent prudential regulations, and because they view agriculture as a risky sector, in which they do not have enough expertise in assessing risk. On the other hand, farmers continue to be reluctant to mortgage their homes, which are the only collateral banks consider acceptable. Land cannot be accepted as collateral, because a true land market has not yet developed.

Some specific measures, such as use of warehouse receipts as collateral for bank loans for working capital, have already been introduced but remain insufficient to increase lending to agriculture<sup>5</sup>. Additional policy measures are expected to be implemented soon and to boost credit to agriculture. Among them are improvements of the legislative framework for equipment and machinery leasing, as well as creation of functioning registers to which potential lenders can refer to check whether the collateral has already been used on another loan. In order to strengthen creditors' rights, improvement of collection of collateral, and a new bankruptcy law to deal with closed banks, are underway.

With continuing recovery of public trust in banks, and with more than 70% of banks' assets owned or controlled by foreign private banks, competition in the sector is growing and banks are gradually overcoming their conservative lending policies. In order to make up for insufficient lending to agriculture by commercial banks, several specific lending schemes were introduced in the mid-1990s. However, they cannot be considered substitutes for bank credit.

### **3. Programmes supporting lending to agriculture**

Apart from commercial bank credit, agriculture currently relies on specific lending programmes, based on the SFA and *Tobacco Fund*. Other institutions, providing lending to agriculture are the Private Mutual Rural Credit Associations. There are internationally supported programmes such as SAPARD, as well as bilateral programmes that provide either loans or grants, to agriculture. All these lending programmes are continuously undergoing changes, reflecting the developments in agriculture and banks.

---

5. The use of warehouse receipts is still limited due to the underdeveloped trade with grain on the Commodity Exchange. Other obstacles include the limited capacity of licensed warehouses, insufficient capitalisation of the fund that guarantees the loans extended against warehouse receipts, and insufficient protection of creditors' rights.

### 3.1. *Tobacco Fund and State Fund Agriculture*

There are two major funds, set up to provide credit to agriculture within specific programmes. These are the *Tobacco Fund* and the SFA. The *Tobacco Fund* lends funds to tobacco processors for unsold quantities of contracted tobacco<sup>6</sup>, while the SFA provides loans to support regular farming activities. The SFA was established in 1995 on the basis of the Law on Support of Agricultural Producers and began operating in early 1996. The SFA is a legal entity, which has its own budget, subject to annual approval by the Council of Ministers of the Republic of Bulgaria upon a proposal of the Minister of Agriculture and Forestry. The SFA's main activity is to provide funds directly to farmers, using commercial banks as agents. The different types of schemes financed by the SFA vary from year to year, and include a seasonal credit facility<sup>7</sup>, short-term credit<sup>8</sup>, long-term investment credit<sup>9</sup> and subsidies<sup>10</sup>.

The SFA extends its short-term loans under specific regulations and requirements. The transaction costs involved in the administration of the SFA scheme are somewhat distortive as they favour certain groups of farmers and certain crops over others. Specific regulations provide incentives to farmers to change their production activities in a way that is not in line with improving the sector's overall net income contribution. The SFA short-term credit lines compete to a certain extent with potential credit lines of commercial banks. Banks might generally be more interested in short-term lending, as it is relatively less risky than long-term credit in unknown markets and for unknown clients. Though competition with the SFA subsidised credits could hardly be considered the major cause for banks' conservative lending policies, it might well contribute to them. Recognising these problems, the Government intends to gradually phase out SFA short-term credit lines.

In addition to short-term credits, the SFA also has a number of longer-term investment credit lines that provide access to long-term credit to farmers, which is difficult to obtain from banks, since banks are constrained by their short-term deposit base and make very few long-term loans. However, even the SFA investment credit lines are scarcely used because banks are reluctant to make what they consider relatively small high-risk loans at low interest rates. To overcome banks' unwillingness to make use of the SFA's investment credit lines, the SFA might wish to shift emphasis from direct long-term credit to providing partial risk guarantees for these credit lines. This approach creates an incentive for banks to carry out a more careful risk assessment for each loan, as they will bear most of the risk of default. Banks, not the SFA should be given the opportunity to determine the procedures and risk assessment of investment projects, supported by the SFA.

Some important steps have been undertaken to reform the SFA's investment programme, including requirements for annual repayments of at least principal, rather than lengthy grace periods, so that the

---

6. In July 2000 the Council of Ministers issued Ordinance No. 511, according to which, Fund *Tobacco* could lend to tobacco processors for unsold quantities of contracted tobacco, produced in 1999, which had not been purchased by April 2000. Under a decision of the Board of Directors, Fund *Tobacco* extended BGN 1.311 million loans to tobacco processors for purchasing 634 tonnes of tobacco, from tobacco harvest 1999.

7. Usually finances inputs for wheat, maize and sunflower production with a 50% interest subsidy.

8. In 2000 the SFA earmarked short-term credit of about BGN 34.5 million, out of which close to BGN 30.0 million (close to 87%) was disbursed.

9. In the first half of 2000 about BGN 40.0 million was allocated for investment projects but only part of it has been disbursed.

10. The SFA has disbursed subsidies of about BGN 10.3 million.

adverse effect on the credit market is minimised. Nevertheless, the Government is to develop a strategy to promote alternative private bank facilities, such as equipment leasing, mortgage loans, etc.

The SFA investment programme is undergoing reform. Currently the MAF has decided to make the SFA an agent for SAPARD in order to make use of its institutional capacity to provide technical assistance in project assessment. According to the agreement achieved with the European Commission (EC) the functions of a SAPARD Agency for Bulgaria will be performed by a functional structure set up within the State Fund Agriculture. Applicants for grants under SAPARD are expected to apply at the SFA Regional Directorates, which are supposed to review and assess applicants' documentation as well as to make on-site inspections of applicants. The SFA Regional Directorates have to approve or reject applicants for SAPARD co-financing within a period of three months.

The State Fund Agriculture launched the accreditation programme in July 1999. The process of establishing the administrative structure of the Agency, staff recruitment, elaboration of manuals and other necessary documentation defining the rules of procedure of the operational, paying and auditing unit of the Agency, has already been completed.

### **3.2. SAPARD**

The European Union (EU) created SAPARD with the objective of supporting and preparing applicant countries in the field of agriculture during the period 2000-2006 through providing annual subsidies of about Euro 53 million to co-finance different projects. The adoption of a National Agriculture and Rural Development Plan (NARDP) is a precondition for launching the EC programme for agriculture and rural development. The NARDP<sup>11</sup> was prepared by the MAF in compliance with the main objectives of the National Economic Development Plan and covers the period 2000-2006. The NARDP was drafted in close collaboration with representatives of regional and local authorities, farmers' associations, regional development agencies and other non-governmental organisations. The two main objectives of NARDP are:

- “development of an efficient, sustainable and competitive agriculture and food-processing, through improved market and technological infrastructure, as well as strategic investment policies aimed at reaching EU standards;
- achievement of sustainable rural development, consistent with the best environmental practices through creating alternative employment and appropriate infrastructure, diversification of economic activities, leading to improved living conditions, higher income and better employment opportunities for the rural population.”

For the purpose of achieving these two objectives, four priority areas for Bulgarian agriculture were defined:

- (1) improvement of the conditions for production, processing and marketing of agriculture, forestry and fishery products in accordance with EU standards; development of environmentally friendly agriculture, as well as improvement of the activities for environmental protection in agriculture and forestry;

---

11. The NARDP was adopted by the Council of Ministers by a Decision No. 726 dated 22 Nov. 1999 and presented to the EC. In October 2000, NARDP 2000-2006 was approved by the European Commission.

- (2) integrated development of rural regions aiming at preservation and consolidation of their economies and communities in order to cut down the depopulation process in these regions;
- (3) investment in human resources – qualification and training in the production and processing of agriculture, forestry and fishery products;
- (4) technical assistance.

The above **4 priority areas** determine more than 10 measures, which are the focus of investment projects financed by the European Union under SAPARD. Priority area (1), for example, includes 6 measures - 1.1 to 1.6. Measure 1.1 – Investments in agriculture farms, is for supporting private investments for the improvement of technologies and quality of production in the major agriculture sectors.<sup>12</sup> Measure 1.1 includes 4 sub-measures (supports 4 sectors), which are shown in **Table 5** below.

**Table 5. SAPARD, Measure 1.1: investments in agriculture farms in Bulgaria - Budget allocation by sectors**

| Sector                                                                                                           | Allocated, % |
|------------------------------------------------------------------------------------------------------------------|--------------|
| Milk and milk processing                                                                                         | 23.28        |
| Meat and meat processing                                                                                         | 8.96         |
| Fruit-growing and vine-growing                                                                                   | 51.60        |
| Vegetable-growing, ethereal plants, herbs, corn/wheat growing, oil plants, cotton, tobacco (high-quality brands) | 16.16        |
| Total                                                                                                            | 100.00       |

SAPARD financing under measure 1.1 can be summarised as follows:

#### *Potential beneficiaries*

Beneficiaries may be private agricultural producers – natural/physical persons or legal entities, both have to be registered as agriculture producers. Legal entities with more than 25% of state-owned shares are not eligible.

#### *Financing conditions*

Financing is in the form of subsidies. The total amount of the subsidy (national funds + EU funds) is 50% of the approved investment costs. The amount of the subsidy is calculated by deducting aids/funds received from other public donors. The financial contribution of the beneficiary shall be 50% of the approved investment costs.

---

12. Measure 1.1 is quite representative for the conditions of supporting investment projects of farmers under SAPARD and for the purpose of this report we will present in more detail the characteristics of SAPARD support for this measure only.

The maximum amount of the funds to cover 50% of the approved costs of investment projects is Euro 500 000 per farm for the period of programme implementation (2000 – 2006). The minimum amount of the funds to cover 50% of the approved costs of investment projects for the period of programme implementation is:

- Euro 15 000 for the first two sectors in **Table 5** – milk and meat;
- Euro 10 000 for the third and fourth sectors in **Table 5** – orchards, vineyards, vegetables, tobacco, etc.

Investment costs may include project preparation costs up to 5% of total investment costs, and up to 12% in the cases of development of detailed design for construction.

*General eligibility criteria (applicable for all 4 sectors)*

- young farmers – age between 18 and 40 years<sup>13</sup>;
- full employment;
- at least 50% of total income of the beneficiary comes from the farm;
- at least three years of experience in agriculture or a recognised diploma in the field of agriculture, issued by a reputable school;
- less than 50 employees in the farm<sup>14</sup>;
- the investment project is for protection of the environment;
- the investment project is for improvement of the hygienic conditions of production.

SAPARD is expected to begin financing the following projects, included in three of the four priority areas: investments in agricultural farms, processing and marketing improvement of agricultural and fish products, development and diversification of economic activities, setting up producer groups, and provision of technical assistance.

The SAPARD Agency was accredited in December 2000 by the Bulgarian Government and in May 2001 by the European Commission. The SAPARD Agency is responsible for project selection, tendering and contracting, execution of on-site inspections both prior to and after project approval, monitoring progress against indicators, reporting on progress against indicators, authorisation of payment, execution of payment, setting up a reliable programme implementation database, etc.

---

13. Currently less than 15% of the farmers in Bulgaria are under 40 years of age.

14. Prevailing is the number of small and medium private farms in Bulgaria. Only 0.2% of them have more than 10 ha of land. The average amount of arable land for private farms is between 1.5 ha and 2 ha.



### 3.3. *Agricultural Capital Fund Scheme (ACFS)*

Small farmers will continue to constitute a substantial part of the rural sector for some time, though their number is expected to dwindle as land consolidation proceeds. However, their access to commercial bank credit remains quite limited and they definitely need some assistance in obtaining loans. The Private Mutual Rural Credit Associations (PMRCAs) represent another programme that provides easier access to credit for small-scale farmers.

The PMRCAs' operation is made possible by paragraph 17 of the Transitional and Final Provisions to the Law on Banks, which authorises them to undertake lending activities, without being licensed as banks. The General Implementation Rules of the ACFS and the standard Organisation Statute appended to the Memorandum of Understanding determine the scope of the PMRCAs' operations. The PMRCAs may benefit from some improvements in the legislative framework concerning their operations.

The PMRCAs operate under the ACFS, which is financed by PHARE and the Government of Bulgaria. Under the Memorandum of Understanding, between the Government of Bulgaria (GOB) and the European Commission (EC), both parties agreed to co-fund the project. The EC granted ECU 7 million and the GOB provided the Leva equivalent of ECU 3 million. These funds were used to increase PMRCA capital and to extend loans. In 1998, the GOB provided to ACFS another BGN 4 million equivalent through the SFA. In February 2000, the Federation of the PMRCAs entered into partnership with the German Co-operative and Raiffeisen Union. It committed itself to providing technical and consulting assistance to PMRCAs under the *Bulgarian Co-operative System Facilitation* project financed by the German government.

As of end-1999, PMRCAs extended 5 500 loans of total value of BGN 15 million. The repayment rate was estimated at 93%. One-year loans of value BGN 3 000 represent the prevailing number of loans extended under the PMRCAs. However, there have been a number of investment loans of value up to BGN 30 000 maturing in 3 years.

### 3.4. *Swiss Co-operation with Bulgaria in the field of agriculture development*

The Swiss Co-operation Programme with Bulgaria has grown substantially within the last four years, and has developed two specific projects, providing finance for agriculture. The **Swiss Agency for Co-operation and Development (SDC)** is in charge of Technical Assistance including about 20 projects/programmes in various sectors. Two of the projects/activities of the Swiss Co-operation Programme, related to the agriculture sector are (i) Development of Sustainable Agriculture in the Central Balkan Range Region and (ii) Credit Commission.

#### *(i) Development of Sustainable Agriculture in the Central Balkan Range Region*

The project is managed by the Swiss Foundation for Sustainable Agriculture in Bulgaria (Foundation), which was set up in 1998 by the Research Institute for Biological Cultivation (FiBL), Frick, Switzerland. The project promotes the effective use of resources that can help farmers meet the demands of the market in the best possible way. The aim is to promote farming efficiency by acquiring more information and applying the methods of sustainable bio-agriculture. The target group are independent, efficient and market oriented farmers from eight municipalities in the Central Balkan area. The project foresees the following measures: (1) development of concepts for the environmentally friendly use of resources; (2) dissemination of ecological production methods (use of

fertilisers, cultivation of pasture, harvest rotation, etc.) through information, specialised publications, training, on-farm demonstrations, consulting by Swiss and Bulgarian experts; (3) extension of investment loans to increase production capacities and (4) support for the regional marketing of farm produce through market research and marketing strategies. One of the consultants' main activities is to assist farmers in drafting business plans to support loan applications.

## *(ii) Credit Commission*

At the end of 1999 the United Bulgarian Bank (UBB) and the Swiss Agency for Development and Co-operation (SDC) signed an agreement to open a credit line to support private farmers and independent small and medium enterprises (SME) from the mountain regions of the Central Balkan Range – the Region of activity of SDC's projects for promoting sustainable agriculture (FiBL) and assisting SME's (FAEL). A Credit Commission responsible for the lending procedures has been set up within the framework of the Co-ordination Office of the SDC in Sofia, which makes the final decisions on extending loans.

### **Credit line for private farmers (investment credits)**

The size of the credit line is 500 000 CHF for the first three years of the projects. The maximum loan is up to the Leva equivalent of 15 000 CHF. Financing is provided for up to 70% of the total project cost. The term of repayment is up to 3 years with the possibility of a 6-month grace period and an interest rate of about 10-11% (the base interest rate + 7). Eligibility is limited to producers from the target region that are market oriented and apply organic farming methods.

The loans are extended to the farmers by UBB. Loan recipients usually put up buildings, equipment, livestock, etc. as collateral. The amount of collateral required by the credit commission varies depending on the type of assets and their liquidity but the estimated market price of assets used as collateral rarely exceeds 110-120% of the loan amount. This is quite preferential for farmers as the collateral for investment loans, required by commercial banks is normally much higher.

Some major specific requirements (eligibility criteria) for providing loans from the Swiss credit line include: (1) The farmer applies biological agriculture methods, (2) Age – under 50 years, (3) The farmer is registered as an agriculture producer (4) Agriculture accounting is introduced and strictly applied after the loan is extended, (5) Co-operation with the Swiss Foundation for Sustainable Agriculture in Bulgaria, (6) The farmer has the necessary land on the territory of the investment project, either owned or rented, (7) At least 50% of the production is for the market, (8) At least two years experience in agriculture/farm management.

The SDC credit line for farmers is a small-scale one, and it has not been set up solely for the purpose of providing loans to farmers. The project aims at improving the capacity of farmers to apply for bank loans, and the capacity of bank staff to review and appraise loan applications from the agriculture sector. One of the major objectives is to test mechanisms for encouraging and promoting the involvement of commercial banks in providing loans to private farmers on a much broader scale.

The loan applications are reviewed, analysed and appraised independently by both the Foundation and the staff of the respective regional branches of UBB. Most of the work on drafting loan applications, including business plans, is done by the responsible Foundation team, who acts as the main consultant to the farmers in this process. After that loan applications are submitted to the Credit Commission,

which makes the final decisions on financing. The Credit Commission includes representatives of SDC, the Foundation and UBB, as well as independent experts.

One major reason for banks to refrain from providing loans to farmers is that their lending departments are not familiar with the specifics of agriculture business. The work of the Foundation, the Credit Commission and UBB has indicated that at this stage, loan officers of Bulgarian banks are not adequately prepared for appraising farmers' loan applications. In this respect the programme of the Credit Commission envisages training banks' loan officers in Switzerland in developing and adapting methodology/guidelines for review, analysis and appraisal of farmers' credit files.

#### **4. Conclusions**

The first stage of restructuring and restitution of agriculture has already been completed, and the next stage of consolidation of farm ownership has just begun. Although the legal framework for the functioning of a land market has been completed, an active agricultural land market does not exist yet. Economic transformation resulted in a decline in agricultural production both in terms of output and yields of main products. The decline in production could be attributed to general disruptions linked to the implementation of land reform, insufficient investment in agriculture, and decline in external demand by traditional importers of Bulgarian agricultural produce. Availability of investment capital continues to be a constraint on the ability of agricultural and agro-industrial producers to restructure, improve their competitiveness and grow. Bulgaria has limited intervention programmes in agriculture and agricultural finance. The level of support to agriculture, as measured by the OECD methodology indicates that since 1997 Bulgarian agriculture has been operating in a fairly neutral policy environment. In addition, bank credit for agricultural producers has been insufficient.

Agriculture relies mainly on commercial bank credit as any other sector, which makes the banking sector performance of major importance for agricultural finance. The Bulgarian banking sector has been undergoing significant institutional reform since the introduction of CBA in mid-1997, which represented a major change in the monetary regime, and imposed new conditions of operation on the banking sector. It provides only a limited LOLR facility and together with the new Law on Banks required the introduction of new much tighter prudential regulations. Banks' cautious approach to lending has posed challenges for intermediation but has resulted in a generally sounder banking sector.

In addition to all factors determining banks' conservative lending policies, there are some sector-specific factors, such as absence of collateral, low profitability and higher uncertainty, contributing to even more limited lending to agriculture. Banks demand higher collateral for loans to farmers both because of the stringent prudential regulations, and because they view agriculture as a risky sector, in which they do not have enough expertise and are unable to assess risk. On the other hand, farmers continue to be reluctant to mortgage their homes, which are the only appropriate collateral banks consider acceptable. Land cannot be accepted as collateral, because a true land market has not been developed yet.

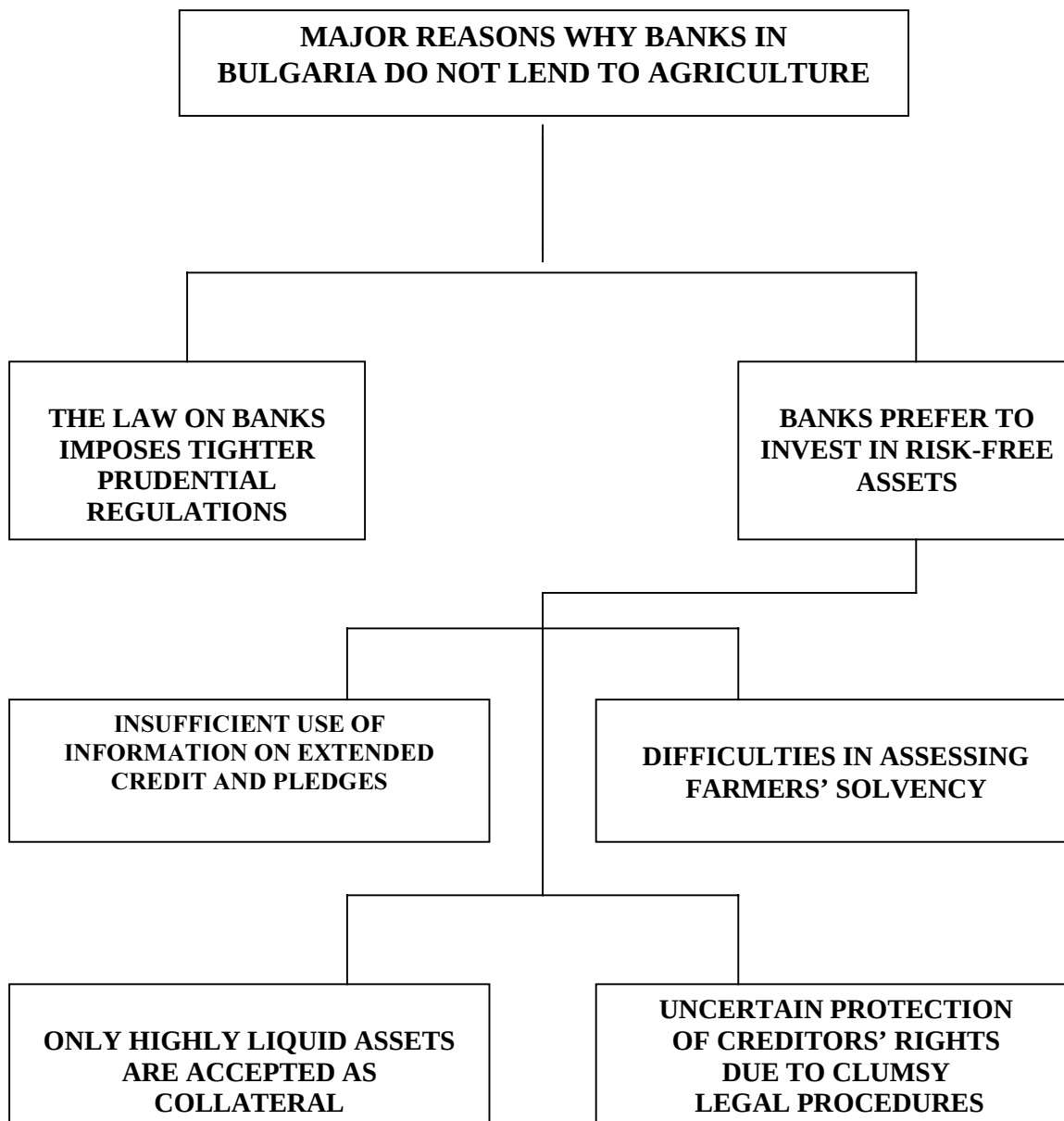
Some sector-specific measures, such as use of warehouse receipts as collateral for bank loans for working capital, have already been introduced. Additional policy measures will be implemented to boost credit to agriculture. Among them are improvements in the legislative framework for equipment and machinery leasing, as well as improvements in the registers to which potential lenders can refer to check whether the collateral has already been used on another loan. In order to strengthen creditors' rights, improvement of collection of collateral, and a new bank bankruptcy law to deal with closed banks, are underway. With continuing recovery of public's trust in banks, and with more than 70% of

banks' assets owned or controlled by foreign private banks, competition in the sector is growing and stimulating banks to overcome their conservative lending policies.

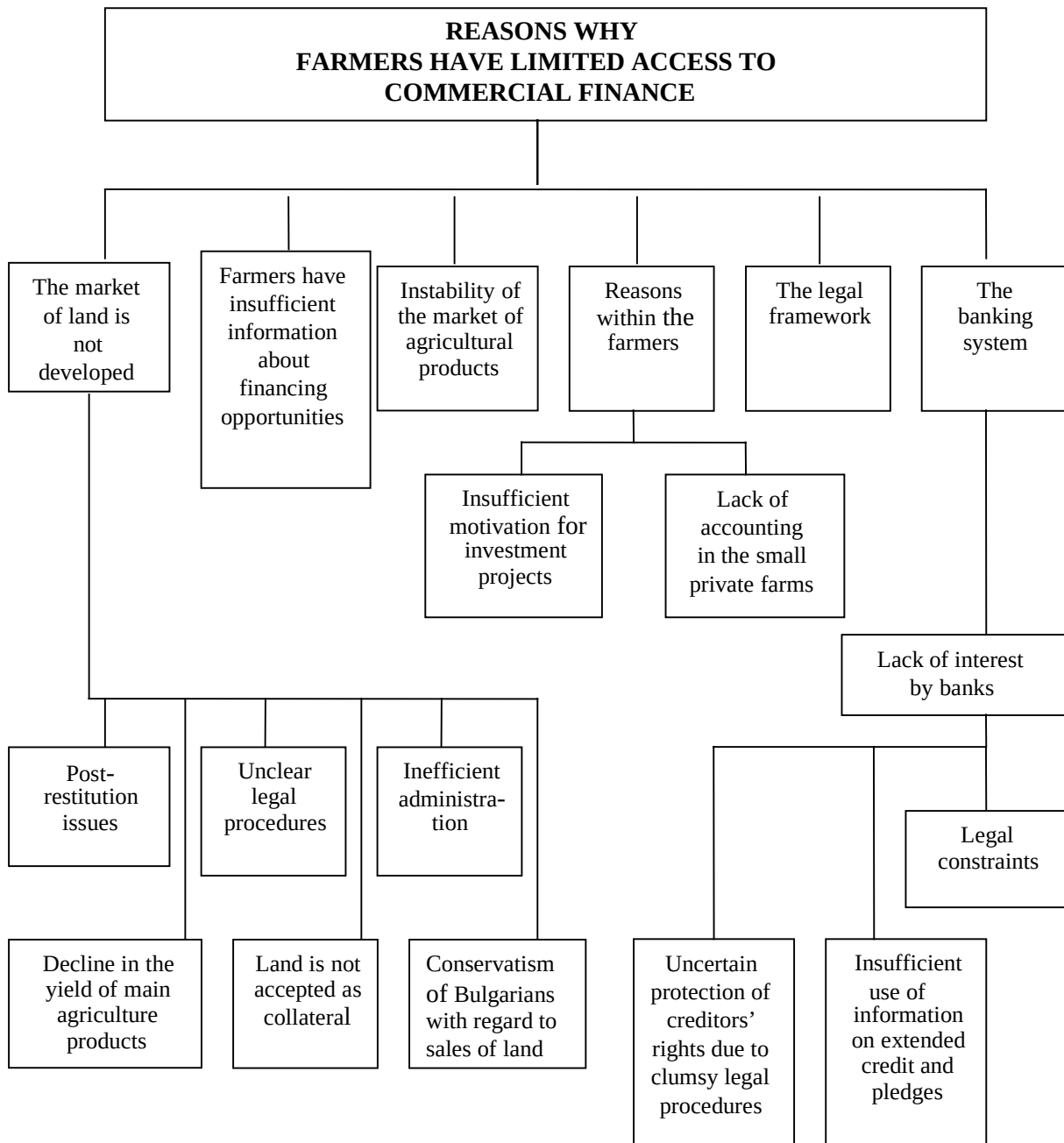
Apart from commercial bank credit, agriculture currently relies on specific lending programmes, based on the SFA and *Tobacco* Fund. Other institutions, providing credit to agriculture are the Private Mutual Rural Credit Associations. There are internationally supported programmes such as SAPARD, as well as bilateral programmes that provide or will soon begin providing either loans or grants to agriculture. The existing programmes cannot be considered substitutes for bank credit, as the credit they provide cannot make up for bank lending. Most of these programmes rely on commercial banks as their intermediaries. However, they have failed to address seriously the issues of lack of sufficient incentives for banks to provide finance to agriculture. This has been one of the main deficiencies of the SFA operation, which should not be repeated under new programmes, including SAPARD.

The programmes supporting lending to agriculture are continuously evolving. For example, the SFA investment programme has undergone reform. The MAF decided to make the SFA an Agency for SAPARD in order to make use of its institutional capacity to provide technical assistance in project assessment. The SAPARD Agency was accredited in December 2000 by the Bulgarian Government and in May 2001 by the European Commission. SAPARD is going to play a major role in preparing Bulgarian agriculture for EU accession. The European Union created SAPARD with the objective to support and prepare applicant countries in the field of agriculture during the period 2000-2006. The adoption of a National Agriculture and Rural Development Plan, which Bulgaria has already done, is a precondition for launching EU programme for agriculture and rural development.

## ATTACHMENT 1



## ATTACHMENT 2



## BIBLIOGRAPHY

- Agrosvjat-Biblioteka (2000),  
*The Money for Your Business*, Sofia.
- Bulgarian National Bank (2000),  
*Information Bulletins*, 2000.
- Bulgarian National Bank (1999),  
*Annual Report*, 1999.
- Commission on Bulgaria's Progress Towards Accession (2000),  
*Regular Report*, November 2000.
- Credit Commission at the Co-ordination Office of the Swiss Embassy,  
*Internal Rules and Procedures for the Work of the Credit Commission*, Sofia.
- Ministry of Agriculture and Forestry (2000),  
*Annual Report*, 2000.
- OECD (2000),  
*Review of Agricultural Policies: Bulgaria*, Paris.
- Roussanova, Lena (2001),  
"The Bulgarian Currency Board: Specifics, Experience, and Possible Challenges", paper presented at a London Business School conference, London, March 2001.
- Swiss Co-operation in Bulgaria (2000),  
*An Issue of the Co-ordination Office of Swiss Embassy*, Sofia.
- Swiss Foundation for Sustainable Development in Bulgaria,  
*Internal Procedures, Conditions and Criteria for Approval of Loan Applications by Private Farmers*, Sofia.
- Ulgenerk, Esen and L. Zlaoui (2000),  
"From Transition to Accession", *World Bank Technical Paper* # 473.
- World Bank (2001),  
*Bulgaria. The Dual Challenge of Transition and Accession*, A World Bank Country Study, February 2001.

# FARM DEBT IN THE CIS: MULTI-COUNTRY STUDY OF MAJOR CAUSES AND PROPOSED SOLUTIONS<sup>1</sup>

By Mr. Csaba Csaki and Mr. Zvi Lerman  
(Paper presented by Mr. Csaki)

## Abstract

*The objective of this study is to support the farm privatisation and restructuring process in CIS by presenting a wide range of strategic and tactical options that could be applied to eliminate, or at least reduce, the main factors responsible for the destructive accumulation of debt in large farm enterprises. This objective has been accomplished by documenting and analysing the indebtedness of large-scale farms in five countries of the Commonwealth of Independent States (CIS): Belarus, Kazakhstan, Moldova, Russia, and Ukraine, developing appropriate proposals, and initiating a dialogue with the government on the subject of farm debt resolution. The study presents a region-wide analysis of the farm debt problem based on data collected from selected countries in CIS, and develops proposals for the respective countries as well as for the region as a whole.*

The accumulation of debt in large-scale farm enterprises in CIS is regarded as a major obstacle to successful privatisation and restructuring of the agricultural sector. The World Bank implemented a study with the objective of supporting the farm privatisation and restructuring process in CIS by presenting a range of strategic and tactical options that could be applied to eliminate, or at least reduce, the main factors responsible for the accumulation of debt in large farm enterprises. This objective has been accomplished by documenting and analysing the indebtedness of large-scale farms in five CIS countries (Belarus, Kazakhstan, Moldova, Russia, and Ukraine), developing appropriate proposals to deal with farm debt, and initiating a dialogue with the governments on the subject of farm debt resolution. Although based on the analysis of farm debt in selected CIS countries, the analytical approach and the proposals may be appropriate for the region as a whole.

The study was motivated by the concerns that CIS counterparts voice repeatedly in various forums regarding the dire financial situation of the farm sector. In discussions with World Bank representatives and other western experts, officials and economists in CIS stress that the large farm enterprises, which still control most of the agricultural resources in the region, are chronically unprofitable and unable to repay their accumulating debt. It is often claimed by the authorities in Russia and Ukraine, for instance, that 80% of the farm enterprises are “on the verge of bankruptcy” and are unable to function normally because of restraints that the government and other creditors place on their bank accounts and operating assets. Unfortunately, these claims are generally made without adequate quantitative substantiation, and the present study is an attempt to clarify the seriousness of the farm debt situation in CIS by applying standard tools of financial analysis.

For the most part, this paper is based on aggregated CIS data. CIS-5 denotes that the data have been aggregated for all five countries participating in the study (Belarus, Kazakhstan, Moldova, Russia, and Ukraine). CIS-4 denotes aggregation for four countries (Belarus, Moldova, Russia, and Ukraine, excluding Kazakhstan) in cases when the data for Kazakhstan were judged to be substantially less reliable than for the other countries.

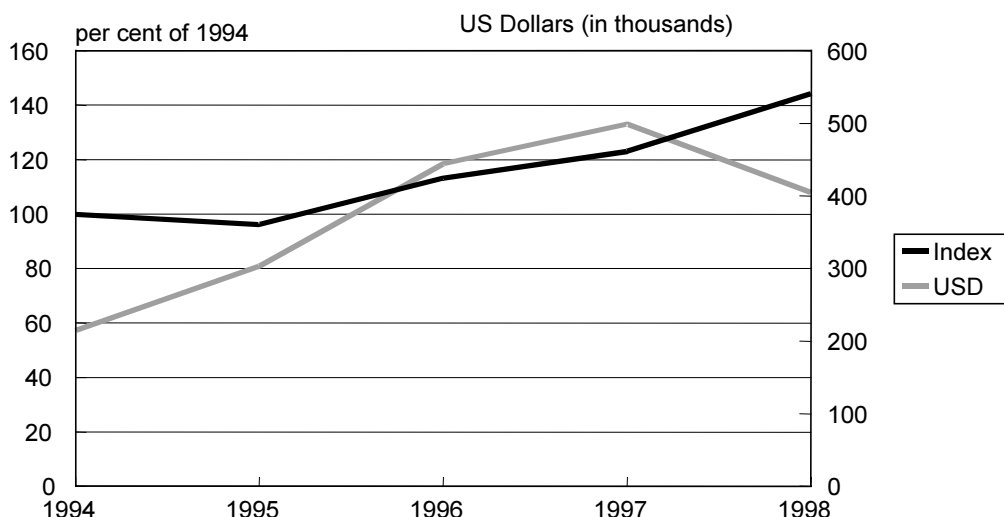
---

1. This paper is based on a World Bank study of Csaki, Lerman, Sotnikov, 2001.



Many recommendations in this paper are aimed at the government. The term “government” is used in the broadest possible sense: it denotes not only the central government (including both the legislative and the executive branches), but also all levels of sub-national government, down to provincial (oblast) and district (raion) authorities (local councils still do not have enough power in CIS to matter). The changes and reforms advocated in this paper cannot be successfully implemented without the full support and co-operation of sub-national levels of government, as the example of recent reforms in Moldova has so strikingly shown.

Figure 1. **Real debt per farm: index and US dollars**



### **The magnitude and nature of farm debt: a deteriorating situation**

The most significant feature of farm debt in CIS is its steady growth in real (CPI-deflated) terms in recent years. The real debt per farm in the five CIS countries increased by more than 45% between 1994-1998 (Figure 1). The total farm debt in the five CIS countries reached nearly USD 30 billion in 1997, more than double the level of debt in 1994 (Table 1). The sharp devaluation of the Russian rouble in 1998 produced a pronounced downward adjustment of the dollar farm debt in Russia, and because of Russia's sheer size this was reflected in a decline of CIS-5 total farm debt in 1998. On a per-farm basis, the average debt in CIS-5 increased from about USD 200 000 in 1994 to a peak of USD 500 000 in 1997, thereafter declining to USD 400 000 in 1998 as a result of the rouble devaluation (Figure 1).

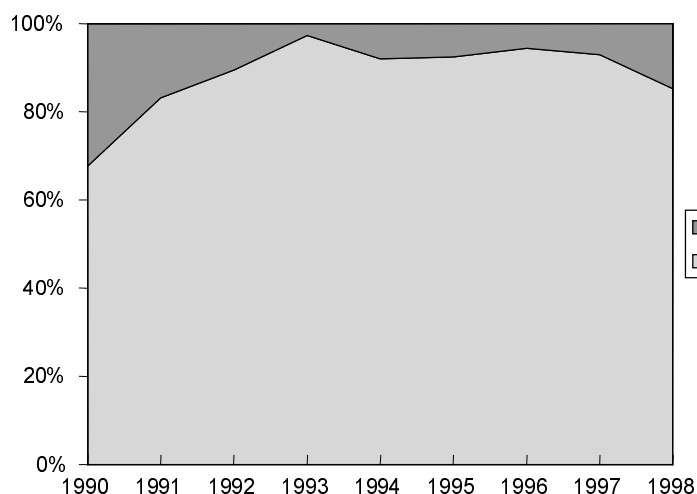
**Table 1. Total farm debt in CIS-5: 1994-98**

USD thousand

|            | 1994   | 1995   | 1996   | 1997   | 1998   |
|------------|--------|--------|--------|--------|--------|
| Belarus    | 320    | 489    | 779    | 734    | 950    |
| Kazakhstan | 1 684  | 1 919  | 2 053  | 1 502  | 1 219  |
| Moldova    | 292    | 372    | 525    | 482    | 539    |
| Russia     | 7 021  | 13 036 | 17 865 | 21 103 | 11 535 |
| Ukraine    | 3 004  | 2 375  | 3 901  | 5 901  | 5 718  |
| CIS-5      | 13 540 | 19 168 | 26 066 | 29 840 | 19 962 |

The second significant feature of farm debt in CIS-5 is the shift of the term structure of debt since 1990 toward short-term, current liabilities (Figure 2). The old long-term debt, never a major component of farm liabilities during the Soviet period, was completely wiped out by the galloping inflation of the early 1990s, and in the absence of appropriate indexation mechanisms the sources of new long-term lending largely disappeared between 1990 and 1993. The growing farm debt in the region is thus generally new and fairly recent debt, not debt inherited from the Soviet period.

**Figure 2. Term structure of farm debt**



### **Government and commercial suppliers are the farms' main creditors**

All through the 1990s, about half the farm debt came from the government and banks and the other half from supplier credit and wage arrears (Table 2).

**Table 2. Sources of farm debt in CIS-4**

|                      | 1990 | 1994 | 1998 |
|----------------------|------|------|------|
| Institutional credit | 57   | 46   | 50   |
| Commercial banks     | 39   | 19   | 7    |
| Government           | 18   | 27   | 43   |
| Wage arrears         | 21   | 22   | 16   |
| Supplier credit      | 22   | 33   | 35   |

The exact role of the banks in the early years of the decade is unclear: some of the debt recorded as bank loans (especially long-term loans) may in fact have been government debt channelled through state controlled agricultural banks. During the recent years, when the division between commercial banks and the government became much sharper and clearer than in the past, the share of bank lending in farm debt shrank to a minimum, and debt to the government became a dominant component.

\*\*\*Contrary to bank debt, which is usually classified as “active debt” in the sense that it involves active application to the lender, government debt in recent years is mostly “passive debt”. These are not formal loans received from the government, but generally accumulations of various arrears in the form of taxes and levies payable or amounts due in unpaid deductions to pension and health insurance funds for farm workers. This component of farm debt is “passive” in the sense that it accumulates automatically, simply as a result of the farms’ failure to make the statutory payments. The government imposes draconian penalties on these arrears, which contribute to the growth of this passive debt component over time, but does not really enforce a strict collection discipline.

Another feature in the development of the sources of farm debt over the last decade is the substantial increase in the share of suppliers’ credit, which nearly doubled from about 20% of total debt in the early 1990s to 35% in recent years (Table 2). While this may be a sign of progress toward commercial normalisation of financial transactions in agriculture, it is explainable, at least in part, by the privatisation of formerly state-owned suppliers (including power companies), which were formerly recorded as debt to the government. Contrary to the prevailing impression, wage arrears are not and have never been a significant component of sources of farm credit. Their share of farm debt actually declined over time from slightly more than 20% in the early 1990s to 16% in 1998 as the government and suppliers gained in importance as sources of farm credit.

Overall, farm debt in CIS originates primarily from “passive” or “spontaneous” credit sources, which grow simply because farms do not pay their obligations. These sources include all levels of government (central, provincial, and district), trade credit from suppliers, and to a certain extent also farm workers, who extend involuntary credit to farms through wage arrears. “Active sources” – commercial banks – are of marginal importance accounting for less than 7% of total debt.

### **Measuring the burden of debt at the farm level**

All three basic ratios measuring the capacity of farms to repay their debt – the ratio of debt to sales, the ratio of debt to current assets (including inventories), and the ratio of debt to liquid current assets (excluding all inventories) – increase over time, which is a definite sign of rising indebtedness (Table 3). Yet while the values of the first two ratios are not particularly alarming by world standards, the ratio of debt to liquid current assets rises to stratospheric levels. On average in CIS-4 (Russia, Ukraine, Belarus, and Moldova) this ratio rose from 0.6 in 1990 to over 4 in 1998. This means that the

liquid assets, when converted into cash at their full book value, will cover less than 25% of current farm debt. The corresponding ratio for US farms is 1.5, *i.e.*, liquid assets of US farms cover 67% of current debt. Moreover, for US farms all three ratios have remained perfectly steady over the years: there has been no deterioration in the solvency of US farms, while CIS farms have become much less solvent over the decade of transition.

**Table 3. Financial ratios: averages for CIS-4**

|                               | 1990 | 1994 | 1998 |
|-------------------------------|------|------|------|
| Debt to sales                 | 0.16 | 0.49 | 1.20 |
| Debt to current assets        | 0.28 | 0.60 | 0.89 |
| Debt to liquid current assets | 0.58 | 2.27 | 4.27 |

There is an apparent contradiction between the ratio of debt to liquid assets, which presents a grim picture of debt repayment capacity, and the ratio of debt to sales, which optimistically suggests that debt can be repaid from just one year of sales revenue. The reason for the contradictory conclusions presented by these two basic ratios is that farm sales in CIS simply do not produce profits, while it is profits that are needed to repay debt.

The proportion of farms reporting losses has increased markedly since 1994, and well over 50% of farm enterprises are unprofitable in recent years (Figure 3). Sales revenue is entirely absorbed by wages and other production costs, which add up to 140% of sales. In other words, farms are losing on average almost 40% on each rouble of sales revenue (Figure 4). Farm operations do not generate net income that can be used to repay debt, however small.

**Figure 3. Percentage of unprofitable farms: CIS-5**

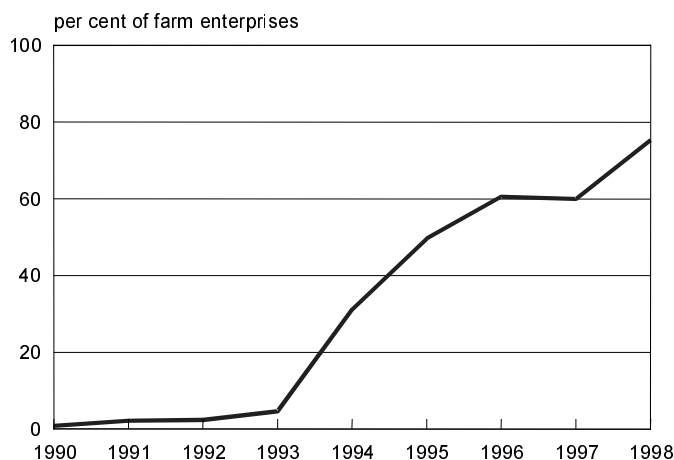
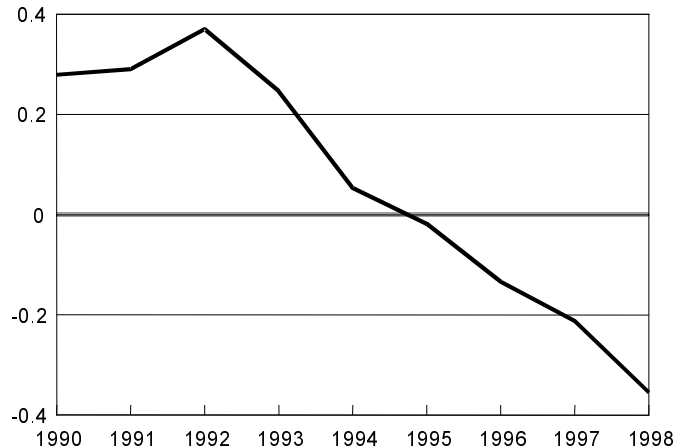


Figure 4. **Profit-to-sales ratio: CIS-5**



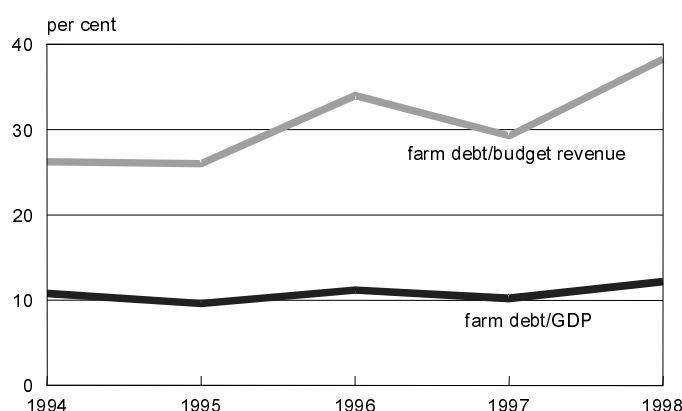
Declining profits (and increasing losses) appear to be the major technical determinant of debt accumulation in CIS farms. The level of debt increases in inverse proportion to the level of profits: as profits decline and losses grow, the real level of farm debt increases. This result, observed both for the entire farm sector over time and across thousands of farms in one year (1998), is naturally understandable: debt is repaid from profits, and lack of profitability makes it impossible for farms to repay their debt, inevitably leading to a vicious circle of debt accumulation.

### **Farm debt is a significant burden on the national economy**

In CIS, the traditional way of dealing with accumulation of farm debt has been through periodic rescheduling and forgiveness of overdue obligations. Since the state budget ultimately bears the cost associated with debt write-offs, this policy is tenable only as long as the level of debt is relatively low. This is no longer the case in CIS countries, where farm debt has risen to levels that are not negligible compared with budget revenue and even GDP.

Figure 5 plots the ratio of total farm debt to budget revenue and GDP in CIS-4 for the period 1994-98. Outstanding farm debt in CIS-4 increased from about 25% of budget revenues in 1994 to nearly 40% in 1998. It exceeded 10% of GDP in 1998. Farm debt today constitutes a significant burden on the economy as a whole, and the state budgets in CIS cannot continue to deal with this problem according to traditional prescriptions of periodic debt rescheduling and forgiveness. Despite frequent write-offs in the past, the amounts involved have become too large for the budget to continue absorbing every three to five years.

Figure 5. **Farm debt as a macroeconomic burden: CIS-4**



Beyond aggregated tendencies, it is important to stress that different countries face different levels of macro-economic burden associated with the outstanding farm debt. In Moldova, the farm debt reached 29% of GDP and 83% of total budget revenues in 1998 – a much higher burden on the economy than in other CIS countries (Table 4). It is therefore not surprising that Moldova is a lead player in developing a debt resolution strategy, as is discussed in the body of the text. Farm debt also appears to have reached the level of a serious macro-economic problem in Ukraine and Kazakhstan.

Table 4. **Farm debt as a macroeconomic burden 1994-98**

|                                          | 1994 | 1995 | 1996 | 1997 | 1998 |
|------------------------------------------|------|------|------|------|------|
| <b>Farm debt as % of GDP</b>             |      |      |      |      |      |
| Belarus                                  | 7    | 5    | 6    | 5    | 7    |
| Kazakhstan                               | 14   | 12   | 10   | 7    | 6    |
| Moldova                                  | 22   | 22   | 27   | 22   | 29   |
| Russia                                   | 3    | 3    | 4    | 5    | 6    |
| Ukraine                                  | 8    | 6    | 9    | 12   | 13   |
| <b>Farm debt as % of budget revenues</b> |      |      |      |      |      |
| Belarus                                  | 14   | 12   | 14   | 12   | 14   |
| Kazakhstan                               | 78   | 67   | 71   | 51   | 40   |
| Moldova                                  | 64   | 65   | 85   | 61   | 83   |
| Russia                                   | 8    | 10   | 13   | 13   | 18   |
| Ukraine                                  | 19   | 17   | 24   | 31   | 38   |

### Why debt is accumulating

Technically, farm debt is growing because of inadequate farm profits. On a substantive level, however, the accumulation of debt is attributable to lax financial discipline made possible by the persistence of soft budget constraints.

In market economies, the allowable level of debt is limited by the risk of bankruptcy. Farms, as all business enterprises, operate under hard budget constraints: if they are unable to generate sufficient

profits to repay their financial obligations, they go out of business. In socialist economies, on the other hand, farms operated under soft budget constraints: they always relied on flows of funds from the state to cover their losses and repay their debts.

Janos Kornai, in his classical work on the socialist economic system, characterises the softness of budget constraints by the commitment of the bureaucracy (*i.e.*, the government in our terminology) not to tolerate persistent loss-making. Soft budget constraints prevail when economic agents believe that they can negotiate various benefits after the fact in case of adverse outcomes (lack of profitability). The feasibility of this vertical negotiation process stems from the paternalistic attitude of the government toward the farm enterprises, which according to Kornai is akin to the attitude that parents show toward financial difficulties of their children, regardless of age. In this conceptual setting, soft budget constraints are not limited to actual allocation of subsidised credits or debt write-offs. They often include an implicit component that arises when the government does not insist with all strictness on collecting tax arrears or, even more indirectly, signals suppliers or banks not to press too hard for collection of overdue obligations from farms.

The mentality of soft budget constraints continues to persist in CIS countries during transition. Unprofitable farms with steadily rising levels of debt do not go bankrupt. There are no self-limiting risk mechanisms on the amount of accumulated debt. They are able to continue borrowing from suppliers, from the state, and sometimes even from commercial banks, presumably because everybody – the borrowers and the lenders – believe that the government will not let the large farm enterprises go bankrupt and will continue to arrange for periodic bailouts.

Persistence of soft budget constraints makes debt accumulation possible, while lack of profitability makes debt accumulation necessary. Without profits farms do not generate sufficient funds to finance their operations and must resort to borrowing. Lack of profitability in CIS farms can be attributed to a mix of two broad groups of factors: external policy-related factors and internal farm-level factors.

External factors related to government policies – elimination of direct producer support, control of food prices exacerbating the deterioration of terms of trade for agriculture, restrictions on trade in agricultural commodities – certainly have a negative impact on farm profitability and thus lead to accumulation of debt. More important and more fundamental, however, are the internal farm-level factors related to the traditional collective farm structure, which basically has not changed during the decade of farm reorganisation in the CIS.

- The farm enterprises have not reduced their size to more manageable dimensions.
- Farm managers are still committed to provide all members with jobs, regardless of cost-efficiency considerations.
- Farm enterprises are obliged to maintain the social infrastructure in the village, including the traditional free support to household plots.
- Farm operations remain largely production oriented, with no overriding emphasis on markets, consumers, and sales: farm managers are still production maximisers, not profit maximisers.
- Member-workers continue to function in a traditional collective environment, without any direct accountability for the results of their effort or their contribution to profits and losses.

All these internal reasons are obstacles to improving the cost-efficiency of farms and necessarily lead to suboptimal profits. As long as CIS farms continue their strategy of formal reorganisation, avoiding radical internal restructuring prescribed by market principles, they will not be able to improve their efficiency and profitability.

Yet the governments' attitude and policies in CIS create only modest incentives for the farms to restructure. Persistence of soft budget constraints allows unprofitable farms to continue to exist and does not create any pressure for restructuring and internal reform. While production targets have been largely eliminated, both central and regional governments in CIS countries often set fixed procurement prices and demand preferential deliveries to state organisations instead of purchasing food products through market channels at competitive prices. In return, the governments compensate the farms with soft credits for these loss-making operations, as well as for their special role as caretakers of the social rural infrastructure and providers of lifetime employment to rural population.

Government policies must be changed to eliminate the disincentives that have so far prevented most farms from switching to a genuine market orientation. Specifically, governments should stop imposing loss-making activities on farm enterprises, on the one hand, and cease allocating soft credits, on the other. Banks should stop lending to non-creditworthy farms in anticipation of write-offs and bailouts. Farms, in turn, must respond to these changes in the economic and political environment by reorganising and restructuring for greater cost efficiency and higher productivity. This is what farms in market economies normally do to remain profitable in a changing world, and this is the lesson that CEE farms successfully adapted to their transition in the 1990s. The combination of external and internal changes – introduction of hard budget constraints and restructuring for cost-efficient operation – will provide the ultimate solution to improving profits and reducing the burden of debt.

### **Unsuccessful attempts to stop farm debt accumulation**

CIS governments have tried a wide range of policy instruments to address the issue of farm debt. These instruments include:

1. price support and input subsidies;
2. subsidised government credit and commodity credit;
3. debt write-offs;
4. debt rescheduling;
5. inter-enterprise offsets and barter transactions to settle claims;
6. financial rehabilitation through farm reorganisation;
7. bankruptcy and liquidation.

The cross-country analysis indicates that these instruments have been applied in an inconsistent, ad hoc manner. Nor have they addressed the two major roots of farm indebtedness, namely the lack of profitability associated with insufficient restructuring of the inherited farm structure and the persistence of soft budget constraints linked with continued government intervention in farm operations. It is not surprising therefore, that these instruments have not produced any real relief.



## **The debt problem and its farm-level impacts**

The farm debt problem in CIS is not a problem of the magnitude of debt, as the accumulated liabilities are not excessively large compared to the asset base of farm enterprises. The debt problem is associated mainly with the farms' inability to repay their debt because of inadequate profitability. Farm enterprises in CIS suffer from a debt overhang relative to their cash flows, not relative to their assets.

Inability to service the current debt is highly disruptive to normal operation, as it forces creditors – both government agencies and commercial organisations – to impose various restraints on the defaulting farms. Farm enterprises are thus exposed to conflicting and confusing signals: on the one hand, they are given access to soft credits through government policies (explicit or implicit) and the lenient attitude of the banks predicated on these policies; on the other hand, they are harassed by collection efforts, which often look quite arbitrary and may take highly aggressive forms. This situation inevitably encourages the farms to shift to barter operations, and thus contributes to demonetisation of their activities and further exacerbates their inability to repay the outstanding debt.

The unresolved debt problem is also an obstacle to effective privatisation and restructuring of farm enterprises. First, asset shares are distributed to individual members net of liabilities, and individuals may be hesitant to leave the farm enterprise in favour of private farming as long as their entitlement to assets is shrouded in uncertainty and lack of transparency because of outstanding debt. Second, and perhaps much more importantly, outside creditors generally refuse to distinguish between the original debtor farm and any new farms created in the process of restructuring. They regard these new farm structures as responsible with their assets and cash flows for the debt of the original farm enterprises, even if there is no strict legal justification for this attitude. They may accordingly refuse to do business with the new farms as long as the old debt remains outstanding, thus severely hampering the prospects for profitable operation after genuine restructuring.

## **What can be done to resolve the farm debt problem**

Accumulation of farm debt is caused by two sets of factors: external factors related to government policies that produce a non-conducive economic environment for farm operation, and internal factors related to farm organisation and structure that lead to low productivity and growing losses. Effective resolution of farm debt requires governments to address both sets of factors. Only then can they decide to invoke bankruptcy, which is the standard market tool for dealing with highly indebted insolvent farms.

### ***Why not traditional court-driven bankruptcy proceedings?***

In market economies, unprofitable farms that are unable to repay their liabilities are declared bankrupt by a court of law and go into liquidation. Perhaps the most obvious option for resolving farm debt would be to follow the practice of market economies and the experiences of some countries in Central Eastern Europe. Insolvent farms would be declared bankrupt and go into liquidation, clearing the stage through debt restructuring for the creation of new financially viable units. This is how insolvent farms are treated in mature market economies, and how the more successful transition countries, such as Hungary, have dealt with the resolution of farm debt problems since the beginning of transition. Indeed, many experts recommend following this path in the CIS countries as well. All CIS countries have bankruptcy laws that in principle can impose liquidation of insolvent farms with the objective of satisfying the creditors' claims (at least partially).

However, the present study and certain experiences in other parts of the world suggest that the traditional court-driven bankruptcy procedures may not offer a desired solution given the specific circumstances in the CIS. First, a very large number of farms (in some countries more than 50%) are technically bankrupt in the sense that they report losses and cannot repay any debt from current cash flows. A strict approach to bankruptcy would require initiating court proceedings in a volume that is simply not practicable given the fragile administrative and judicial structures in CIS. There are no effective bankruptcy courts, and very few bankruptcy cases have actually been tried to completion in any of the CIS countries.

Second, the experience in the few farm bankruptcy cases launched in CIS indicates that the lack of potential buyers for farm assets is another obstacle to formal court-driven procedures. In CEECs, subsidised credit schemes were offered by the governments to support the purchase of farm assets in the process of liquidation. Such schemes do not exist in CIS, and the rural population suffers from a severe shortage of capital. The absence of potential buyers would be a significant constraint in a mass bankruptcy and liquidation of insolvent farm enterprises.

Third, mass bankruptcy and liquidation of farm enterprises will affect the very large rural population in CIS, which is basically dependent for its livelihood on these farm enterprises, however unprofitable. By satisfying the claims of the creditors, the traditional bankruptcy procedures are likely to cause irreparable social damage to the rural population, thus producing a politically untenable situation in the transition countries, which still have no alternative employment opportunities for their farmers and peasants. This danger is particularly acute because of the unclear standing of collectively shared land in bankruptcy proceedings: courts may decide to auction off not only buildings, tractors, and livestock, but also farmland, leaving the rural families without any sources of income.

If an industrial enterprise goes bankrupt, the employees lose their work place; if a farm enterprise goes bankrupt, the rural population loses its livelihood and the entire village community may be destroyed. Since this effect will be multiplied by tens of thousands of villages that are dependent on failing farm enterprises, the process may spell the destruction of the entire rural sector. In the end of the day, when politicians, social scientists, and even economists have to weigh the interests of creditors – businesses or government – against the interests of a large rural population, the balance naturally tilts in favour of the rural population. It can be argued that the creditors were lending to the farm enterprises in the expectation of making a profit, and if they have miscalculated, they should bear at least part of the responsibility. Since courts would not necessarily be guided by such considerations, this is another argument against imposing traditional bankruptcy proceedings on CIS farms.

### ***General principles for resolution of farm debt problem***

Given the actual conditions in CIS, the optimal approach to resolving the farm debt problem should include a set of actions that address both macro- and micro-level factors.

- Creation of an incentive system and a macro-policy framework for agriculture that allows efficient agricultural producers to make profits and to invest.
- A one-time process of expedited debt settlement conditioned on genuine internal restructuring and privatisation of the farms participating in the debt-settlement programme.
- Creation of necessary economic conditions for the recovery of the restructured farms emerging from the debt-settlement procedure.

- Introduction of hard budget constraints forcing the farms to operate under strict financial discipline.
- Reorientation of the banking sector to lending on strict creditworthiness principles.
- Implementation of a working bankruptcy system to prevent accumulation of new debt in farms created through the process of restructuring and debt settlement.

The unique feature of this general programme is the integration of debt resolution (handled as an out-of-court managed process) with internal restructuring of farms and a shift to hard budget constraints. Experience shows that if debt is written off while the farm organisation remains unchanged, the result has never prevented re-accumulation of new debt. In parallel with treating the outstanding debt, it is essential to implement a genuine restructuring of the farms based on market principles with the goal of improving productivity and profitability. Without addressing basic ownership and management problems, including the development of realistic business plans, debt restructuring programmes have very little value. We recommend starting the process of restructuring with the allocation of physically identified land parcels with ownership titles to individuals.

### ***Implementable framework for out-of-court debt settlement and farm restructuring***

Instead of invoking blanket bankruptcy procedures, we recommend an approach that implements a one-time comprehensive out-of-court debt settlement linked with farm restructuring and introduction of hard budget constraints. Such a process has been recently implemented in Moldova. It is still too early to judge the long-term impacts of the process, but it has certainly met with initial success: the outstanding farm debt was practically liquidated within one year, in part by transfer of assets and in part by offsets between the government and commercial creditors; the rural population was not deprived of its rights to land, livestock, and farm machinery; and the former collective farms were restructured into new debt-free entities based on private ownership of land and assets.

The Moldovan experience is an example of an integrated approach to managed out-of-court settlement of farm debt. The more general features of this approach could be applied also in other countries in the region. Following is a brief characterisation of these general features.

- The major objective of the one-time managed intervention is to create new farm entities that are free of past debt burden and have the potential to become economically viable. The goal is not reorganisation of existing enterprises, but actual creation of new entities compatible with market principles of operation.
- The decision to launch the debt settlement process in each farm enterprise and the choice of the form of the new entity is left to farm members. The decision-making process is supported by sufficient information outlining in detail all implications and alternatives, informing the members of the basic market principles of farm organisation and management.
- The debt settlement process is managed by a debt-settlement committee appointed by a national body and consisting of local and outside experts. The committee announces the start of the process and collects the claims from the creditors.
- The outstanding debt is settled primarily from the assets of the farm enterprise. Land remains outside the debt settlement procedure. The non-land assets are divided into three

groups: (a) machinery and livestock, which are earmarked for distribution to farm members and are exempt from the debt-settlement process; (b) inventories, cash, receivables, other current assets, and all production fixed assets (*i.e.*, storage, farm buildings, processing facilities, etc., excluding housing and social infrastructure), which are used for settling the debt of commercial creditors; (c) social assets and non-privatised housing, which are used for settling the debt to the government and to payroll.

- The full settlement of debt to commercial suppliers is an integral part of the process. All assets under lien are automatically transferred to the entitled creditor. The residual farm assets, excluding the portion distributed to farm members and used for settlement of wage arrears and government debt, are offered to the creditors up to the limit of the debt. The unsettled debt, if any, is taken over by the budget and used as a future tax credit for the suppliers or in the form of long-term bonds.
- The debt settlement process is implemented with the full support of the government, and the budget acts as a last resort to reach a full settlement of all residual amounts remaining after the farm assets are exhausted. Usually, this is not a serious constraint, as in most cases farm assets are more than sufficient to satisfy all obligations.
- The process ends with the full liquidation of the old entity, without any legal successor, and registration of new entities by the former farm members.

The process should have a definite completion date for each farm (four-five months duration), and the overall time frame for the entire project nationally also should be set in advance. A core group of experts should be assembled to work on the preparation of detailed procedures and manuals, and to travel across the country with the objective of training local forces and supervising the implementation.

### ***Pre-conditions for success of debt-settlement programme***

Certain conditions are essential for successful implementation of such a framework:

- legal framework for land ownership and titling is in place;
- procedures for farm privatisation have been adopted;
- there is political consensus for a complete and comprehensive approach to farm privatisation and farm debt settlement;
- the task is of manageable size and the technical implementation is feasible (*e.g.*, adequate donor support is available).

The specific implementation of the debt-settlement programme will naturally vary from country to country, but the general principles adopted in Moldova appear to be valid and workable for all CIS countries. The larger countries, such as Russia and Ukraine, may prefer to adopt a regional approach, first implementing the debt-settlement programme in the most progressive regions. The experiences of this approach can be extended to a national programme at a later stage.

## SELECTED REFERENCES ON FARM DEBT AND FARM RESTRUCTURING IN TRANSITION ECONOMIES

### World Bank Country Reports and Agricultural Sector Reviews

- Food and Agricultural Policy Reforms in the Former USSR: An Agenda for the Transition*, Studies in Economics of Transformation, Vol. 1, The World Bank, Washington, DC (1992).
- An Agricultural Strategy for Albania*, The World Bank and the European Community, Washington, DC (1992).
- Albania: Building a New Economy*, Report No. 12342-ALB, The World Bank, Washington, DC (1994).
- Armenia: The Challenge of Reform in the Agricultural Sector*, The World Bank, Washington, DC (1995).
- Azerbaijan: Agricultural Sector Review*, Report No. 14541-AZ, The World Bank, Washington, DC (1995).
- Belarus: Agriculture and Food Sector Review*, Report No. 12576-BY, The World Bank, Washington, DC (1994).
- Estonia: Agriculture and Forestry Sector Review*, Report No. 13316-EE, The World Bank, Washington, DC (1995).
- Georgia: Agriculture and Food Sector Review*, Report No. 14659-GE, The World Bank, Washington, DC (1995).
- Hungary: Review of Agricultural Policy*, Report No. 13475 HU, The World Bank, Washington, DC (1994).
- Kazakhstan: Agricultural Sector Review*, Report No. 13334-KZ, The World Bank, Washington, DC (1994).
- The Kyrgyz Republic: Agricultural Sector Review*, Report No. 12989-KG, The World Bank, Washington, DC (1994).
- Latvia: Agricultural Sector Review*, Report No. 12401-LV, The World Bank, Washington, DC (1994).
- Lithuania: Agriculture and Food Sector Review*, Report No. 13111-LT, The World Bank, Washington, DC (1995).
- Moldova: Moving to a Market Economy*, World Bank Country Study, The World Bank, Washington, DC (1994).
- Moldova: Agriculture Sector Review*, Report No. 12581-MD, The World Bank, Washington, DC (1995).
- An Agricultural Strategy for Poland*, The World Bank and the European Community, Washington, DC (1990).
- Romania: A Strategy for the Transition in Agriculture*, Main Report, The World Bank, Washington, DC (1993).
- Turkmenistan*, The World Bank, Washington, DC (1994).
- Turkmenistan: Review of the Agrarian Sector*, Report No. 15621-TM (draft), The World Bank, Washington, DC (1996).
- Ukraine: The Agriculture Sector in Transition*, The World Bank, Washington, DC (1994).
- Uzbekistan: An Agenda for Economic Reform*, The World Bank, Washington, DC (1993).
- Uzbekistan Economic Memorandum: Subsidies and Transfers*, Report No. 12934-UZ, The World Bank, Washington, DC (1994).

## World Bank Farm Surveys

- Armenia. *Land Reform and Private Farms in Armenia: 1996 Status*, EC4NR Agriculture Policy Note No. 8, Natural Resources Management Division, Europe and Central Asia Region, The World Bank, Washington, DC (1996).
- K. Brooks and Z. Lerman. *Land Reform and Farm Restructuring in Russia*, World Bank Discussion Paper 233, The World Bank, Washington, DC (1994).
- K. Brooks, E. Krylatykh, Z. Lerman, A. Petrikov, and V. Uzun. *Agricultural Reform in Russia: A View from the Farm Level*, World Bank Discussion Paper 327, The World Bank, Washington, DC (1996).
- C. Csaki, Z. Lerman, and S. Sotnikov. *Farm Sector Restructuring in Belarus: Progress and Constraints*, World Bank Technical Paper 475, The World Bank, Washington, DC (2000).
- C. Csaki, Z. Lerman, and S. Sotnikov. *Farm Debt in the CIS: a Multi Country Study of Major Causes and Proposed Solutions*, World Bank Discussion Paper, The World Bank, Washington, DC (forthcoming 2001).
- Euroconsult. *Farm Restructuring and Land Tenure in Reforming Socialist Economies: A Comparative Analysis of Eastern and Central Europe*, World Bank Discussion Paper 268, The World Bank, Washington, DC (1994).
- Euroconsult. *Regional Study: Farm Restructuring and Land Tenure in Reforming Socialist Economies, Annex V: Report on Land Market Issues*, Arnhem, The Netherlands (1994).
- Georgia. *Land Reform and Private Farms in Georgia: 1996 Status*, EC4NR Agriculture Policy Note No. 6, Natural Resources Management Division, Europe and Central Asia Region, The World Bank, Washington, DC (1996).
- J. Gray. *Kazakhstan: A Review of Farm Restructuring*, World Bank Technical Paper 458, The World Bank, Washington, DC (2000).
- Z. Lerman, K. Brooks, and C. Csaki. *Land Reform and Farm Restructuring in Ukraine*, World Bank Discussion Paper 270, The World Bank, Washington, DC (1994).
- Z. Lerman and C. Csaki, *Land Reform in Ukraine: The First Five Years*, World Bank Discussion Paper 371, The World Bank, Washington, DC (1997).
- Z. Lerman and C. Csaki, *Ukraine: Review of Farm Restructuring Experiences*, World Bank Technical Paper No. 459, The World Bank, Washington, DC (2000).
- Z. Lerman, C. Csaki, and V. Moroz, *Land Reform and Farm Restructuring in Moldova: Progress and Prospects*, World Bank Discussion Paper 398, The World Bank, Washington, DC (1998).
- Z. Lerman, M. Lundell, A. Mirzakhanian, P. Asatrian, and A. Kakosian, *Armenia's Private Agriculture: 1998 Survey of Family Farms*, Environmentally and Socially Sustainable Development Working Paper No. 17, The World Bank, Washington, DC (1999).
- Romania. *Private Agriculture in Romania: Farm Survey*, Romanian Ministry of Agriculture and Food, European Commission, and The World Bank, Bucharest (1997).

## Other Sources

- Agricultural Situation and Prospects in the Central and Eastern European Countries*, Summary Report and Country Reports, Directorate-General for Agriculture (DG-VI), European Commission, Brussels (June 1998).
- J. Aves. *Georgia: From Chaos to Stability*, The Royal Institute of International Affairs, London (1996).
- H. Binswanger, K. Deininger, and G. Feder. "Power, Distortions, Revolt and Reform in Agricultural Land Relations," in: J. Behrman and T. N. Srinivasan, eds., *Handbook of Development Economics*, vol. III, chapter 42, pp. 2659-2772, Elsevier Science (1995) .
- K. Brooks and Z. Lerman. "Farm Reform in the Transition Economies," *Finance and Development*, 31(4): 25-28 (1994).
- K. Brooks and Z. Lerman. "Restructuring of Traditional Farms and New Land Relations in Russia," *Agricultural Economics*, 13: 11-25 (1995).
- P. Craumer. *Rural and Agricultural Development in Uzbekistan*, The Royal Institute of International Affairs, London (1995).
- C. Csaki. "Where is Agriculture Heading in Central and Eastern Europe?" Presidential Address, XXII International Congress of Agricultural Economists, Harare, Zimbabwe, Aug. 22-28, 1994.
- C. Csaki, M. Debatisse, and O. Honisch. *Food and Agriculture in the Czech Republic: From a "Velvet" Transition to the Challenges of EU Accession*, World Bank Technical Paper 437, Europe and Central Asia Environmentally and Socially Sustainable Rural Development Series, The World Bank, Washington, DC (1999).
- C. Csaki and A. Fock, eds. *The Agrarian Economies of Central and Eastern Europe and the Commonwealth of Independent States: An Update on Status and Progress*, Environmentally and Socially Sustainable Development Working Paper No. 24, The World Bank, Washington, DC (June 2000).
- C. Csaki, K. Gray, Z. Lerman, and W. Thiesenhusen. "Land Reform and the Restructuring of Kolkhozes and Sovkhozes," in: *Food and Agricultural Policy Reforms in the Former USSR: An Agenda for Transition*, Background Working Papers, Vol. I, The World Bank, Washington, DC (1992).
- C. Csaki and Z. Lerman. "Land reform and the future role of co-operatives in agriculture in the former socialist countries in Europe," in: C. Csaki and Y. Kislev, Eds., *Agricultural Co-operatives in Transition*, Westview, Boulder, CO (1993).
- C. Csaki and Z. Lerman. "Land Reform and Farm Sector Restructuring in the Former Socialist Countries in Europe," *European Review of Agricultural Economics*, 21(3/4): 555-578 (1994).
- C. Csaki and Z. Lerman. "Agricultural transition revisited: issues of land reform and farm restructuring in East Central Europe and the Former USSR," *Quarterly Journal of International Agriculture*, 35(3):211-240 (1996).
- C. Csaki and Z. Lerman. "Land Reform and Farm Restructuring in East Central Europe and the CIS in the 1990s: Expectations and Achievements after the First Five Years," *European Review of Agricultural Economics*, 24(3/4):428-452 (1997).
- C. Csaki and Z. Lerman. "Land Reform in Ukraine: Slow Progress," *Society and Economy in Central and Eastern Europe*, 19(4):46-70 (1997).
- C. Csaki and Z. Lerman. "Land Reform and Farm Restructuring in Hungary during the 1990s," in: S. Wegren, Ed., *Land Reform in the Former Soviet Union and Eastern Europe*, Routledge, London-New York (1998).
- C. Csaki and Z. Lerman, eds. *Structural Change in the Farming Sectors in Central and Eastern Europe, Lessons for EU Accession*, Second World Bank/FAO Workshop, June 27-29, 1999, Warsaw, World Bank Technical Paper No. 465, The World Bank, Washington, DC (2000).

- C. Csaki and J. Nash. *The Agrarian Economies of Central and Eastern Europe and the Commonwealth of Independent States: Situation and Perspectives*, World Bank Discussion Paper 387, The World Bank, Washington, DC (1997).
- K. Deininger. *Co-operatives and the Break-up of Large Mechanised Farms: Theoretical Perspectives and Empirical Evidence*, World Bank Discussion Paper 218, The World Bank, Washington, DC (1993).
- J. Delehanty and J. Rasmussen. "Land reform and farm restructuring in the Kyrgyz Republic," *Post-Soviet Geography*, 36(9): 565-586 (1995).
- D. Gavrilescu. "Romania Facing the European Agrifood Integration: The Shock of Transition," VIIth EAAE Congress, Stresa, Italy, Contributed Papers, Volume F: *Agricultural Development and Transition*, pp. 15-28 (1993).
- Hungary. *Hungarian Land Reform and Farm Restructuring*, EC2AU Agriculture Policy Note, Agriculture and Urban Development Operations Divisions, Europe and Central Asia Region, The World Bank, Washington, DC (1997).
- I. Jeffries. *Socialist Economies and the Transition to the Market*, Routledge, London (1993).
- N. Kazlauskienė and W. Meyers. "Blueprint for accession to the EU: Transition policies for transition economies," Report 96-BR 23, Centre for Agricultural and Rural Development, Iowa State University (July 1996).
- S. Kodderitzsch. *Reforms in Albanian Agriculture: Assessing a Sector in Transition*, World Bank Technical Paper 431, Europe and Central Asia Environmentally and Socially Sustainable Rural Development Series, The World Bank, Washington, DC (1999).
- U. Koester and K. Brooks. *Agriculture and German Reunification*, World Bank Discussion Paper No. 355, The World Bank, Washington, DC (1997).
- A. Kudat, S. Peabody, and C. Keyder, eds.. *Social Assessment and Agricultural Reform in Central Asia and Turkey*, The World Bank, Washington, DC (2000).
- Z. Lerman. "Changing land relations and farming structures in formerly socialist countries," in: G. Wunderlich, Ed., *Agricultural Landownership in Transitional Economies*, University Press of America, Lanham, MD (1995).
- Z. Lerman. "Land Reform in Uzbekistan," in: S. Wegren, Ed., *Land Reform in the Former Soviet Union and Eastern Europe*, Routledge, London-New York (1998).
- Z. Lerman. "Experience with Land Reform and Farm Restructuring in the Former Soviet Union," in: J. Swinnen, A. Buckwell, and E. Mathijs, Eds., *Agricultural Privatisation, Land Reform and Farm Restructuring in Central and Eastern Europe*, Avebury, Aldershot, UK (1998).
- Z. Lerman. "Does Land Reform Matter? Some Experiences from the Former Soviet Union," *European Review of Agricultural Economics*, 25: 307-330 (1998).
- Z. Lerman. "Land Reform and Farm Restructuring: What Has Been Accomplished to Date?" *American Economic Review*, 89(2): 271-275 (1999).
- Z. Lerman. "Land Reform and Farm Restructuring in Ukraine," *Problems of Post-Communism*, 46(3): 42-55 (1999).
- Z. Lerman and K. Brooks. "Russia's legal framework for land reform and farm restructuring," *Problems of Post-Communism*, 43(6): 48-58 (1996).
- Z. Lerman and K. Brooks. "Land reform in Turkmenistan," in: S. Wegren, Ed., *Land Reform in the Former Soviet Union and Eastern Europe*, Routledge, London-New York (1998).
- Z. Lerman, K. Brooks, and C. Csaki. "Restructuring of Traditional Farms and New Land Relations in Ukraine," *Agricultural Economics*, 13: 27-37 (1995).
- Z. Lerman, J. Garcia-Garcia, and D. Wichelns. "Land and water policies in Uzbekistan," *Post-Soviet Geography and Economics*, 37(3): 145-174 (1996).
- L. Lueschen. "Problems of Agricultural Policy in East Germany," *Agriculture and Human Values*, Winter, pp. 27-39 (1993).



- E. Mathijs and J. Swinnen, "The Economics of Agricultural Decollectivisation in East Central Europe and the Former Soviet Union," *Economic Development and Cultural Change*, 47(1): 1-26 (1998).
- W. Meyers, N. Kazlauskienė, I. Feiferis, and V. Loko. "Agricultural Transformation and Privatisation in the Baltics," Report 92-BR 7, Centre for Agricultural and Rural Development, Iowa State University (December 1992).
- P. Mishev, ed. *Nature, Evolution and Efficiency of Farm Structures in CEE Countries and FSU*, 58<sup>th</sup> EAAE Seminar, Sofia, May 1998, in: *Bulgarian Journal of Agricultural Science*, Vol. 5, special issue (April 1999).
- Moldova. *Moldova Agriculture Policy Update*, EC4NR Agriculture Policy Note #5, Natural Resources Management Division, Europe and Central Asia Region, The World Bank, Washington, DC (September 1996).
- Moldova. *With Farmer's Eyes: A Grassroots Perspective on Land Privatisation in Moldova*, EC4NR Agriculture Policy Note #7, Natural Resources Management Division, Europe and Central Asia Region, The World Bank, Washington, DC (October 1996).
- Moldova. *Land Reform and Private Farming in Moldova* EC4NR Agriculture Policy Note #9, Natural Resources Management Division, Europe and Central Asia Region, The World Bank, Washington, DC (January 1997).
- M. Mudahar. *Kyrgyz Republic: Strategy for Rural Growth and Poverty Alleviation*, World Bank Discussion Paper 394, The World Bank, Washington, DC (1998).
- L. A. Norsworthy, ed., *Russian Views of the Transition in the Rural Sector: Structures, Policy Outcomes, and Adaptive Responses*, The World Bank, Washington, DC (2000).
- R. Prosterman and T. Hanstad, eds. *Legal Impediments to Effective Rural Land Relations in Eastern Europe and Central Asia: A Comparative Perspective*, World Bank Technical Paper 436, Europe and Central Asia Environmentally and Socially Sustainable Rural Development Series, The World Bank, Washington, DC (1999).
- A. Sarris, T. Doucha, and E. Mathijs. "Agricultural Restructuring in Central and Eastern Europe," *European Review of Agricultural Economics*, 26(3): 305-330 (1999).
- G. Schmitt. "Why Collectivisation of Agriculture in Socialist Countries Has Failed: A Transaction Cost Approach," in: C. Csaki and Y. Kislev, *Agricultural Co-operatives in Transition*, Westview, Boulder, Co. (1993).
- A. Schmitz, K. Moulton, A. Buckwell, and S. Davidova, Eds., *Privatisation of Agriculture in New Market Economies: Lessons from Bulgaria*, Kluwer, Dordrecht (1994).
- J. Swinnen, Ed. *Political Economy of Agrarian Reform in Central and Eastern Europe*, Ashgate, Aldershot, UK (1998).
- J. Swinnen, A. Buckwell, and E. Mathijs, Eds., *Agricultural Privatisation, Land Reform and Farm Restructuring in Central and Eastern Europe*, Avebury, Aldershot, UK (1998).
- R. Trendafilov and V. Ivanova-Gidikova. "Reform and Market Adjustment of the Bulgarian Agricultural Sector," VIIth EAAE Congress, Stresa, Italy, Contributed Papers, Volume F: *Agricultural Development and Transition*, pp. 1-14 (1993).
- S. Wegren. "The development of market relations in agricultural land: the case of Kostroma Oblast," *Post-Soviet Geography*, 34(8): 496-512 (1995).
- S. Wegren, Ed., *Land Reform in the Former Soviet Union and Eastern Europe*, Routledge, London-New York (1998).
- G. Wunderlich, ed., *Agricultural Landownership in Transitional Economies*, University Press of America, Lanham, MD (1995).
- R. Zile. "The Development of Privatisation in Latvian Agriculture," Report 93-BR 14, Centre for Agricultural and Rural Development, Iowa State University (October 1993).

# LARGE FARM DEBT IN UKRAINE

By Mr. David J. Sedik<sup>1</sup>

## Abstract

*The present study analyses the nature of Ukrainian farm debt by investigating whether the debt servicing problem of Ukrainian farms is more of a debt problem or a net income problem. Net income generation appears to be the more important underlying problem behind the debt problem. Second, the study recounts the main reasons for apparent farm losses in Ukraine. This analysis suggests that low profits are a result of public policies that reduce incentives for profit making, farm production of livestock products at a loss and lack of restructuring. The study concludes that the debt servicing problem of Ukrainian farms leaves them unable to utilise market instruments to secure seasonal financing and is the primary justification for the presence of the Ukrainian government in financing seasonal input supplies. Such financing creates a substantial burden on the state budget, and ultimately on taxpayers. It also leads to sizeable State claims on commodity markets that are similar to a continuation of the state order system for grain that was discontinued after 1997.*

The purpose of this paper is to analyse the debt problem of large farms in Ukraine. The issues surrounding large farm debt in Ukraine illustrate the fundamental difficulties in CIS transition economies of building economically sustainable agriculture without the liquidation of collective and state successor farms and the establishment of new farms based on private property.

There has been a sizeable number of works investigating the reasons for the poor performance of agriculture and large farms in Ukraine in the past few years. Lerman, Brooks and Csaki (1994), Csaki and Lerman (1997) and Lerman and Csaki (2000) explored the consequences of weak progress in land reform and farm restructuring for large farm performance. British Know How Fund (1997) investigated reasons for farm debt in a sample of farms in southern Ukraine based on an examination of financial ratios. Sablounk and Fesina (1999) analysed a number of policy problems leading to poor performance of the sector. German Advisory Group (1999) provided an exemplary analysis of the problems of the sector.

Despite this large number of informative works, there has yet to be a work which explored the debt problem of Ukrainian farm enterprises both at the level of the farm and at the policy level. British Know How Fund (1997) offered a competent analysis of farm financial ratios, but did not investigate the connection between national and oblast policies thoroughly enough to elucidate the causes of the growth of farm debt. Moreover, the analysis of farm financial ratios itself was often based on "rules of thumb" - perhaps sufficient for accountants, but less so for economists used to comparative analysis. Other studies provided very good analyses of national farm policies, but did not concentrate on their implications for the development of farm debt.

An important policy question of farm debt in Ukraine concerns the underlying problem behind farms' inability to service debt. If substantial debt repayment obligations prevent normally viable enterprises

---

1. The views expressed in this study are those of the author and do not represent official policies or views of FAO. I thank my co-authors on a previous paper on this topic (Sedik, *et al.*, 2000), as well as Zvi Lerman (World Bank and Hebrew University of Jerusalem), Csaba Csaki (World Bank), Robert Jolly and Sergio Lence (Iowa State University) for their guidance and helpful comments.

from being profitable, rescheduling or forgiving part or all of the debt could restore debt-servicing capacity. However, if enterprises have low net incomes then the underlying problem may instead be the lack of profit generation, rather than debt.

In this paper we analyse this policy question, first, by laying out the facts of debt repayment capacity and repayment requirements for an average farm in Ukraine each year from 1994-1998. This allows us to determine the year when an average Ukrainian farm stopped being able to service its debt. Second, we analyse Ukrainian farm debt load sustainability using financial ratios. For this analysis levels of debt on Ukrainian farms are compared with those in a sample of financially healthy farms of similar economic size in a market economy. This method suggests some salient differences between Ukrainian farms and those in market economies. Both methods of analysis point to net income generation as the more important underlying problem behind the debt problem.

The profitability of large Ukrainian farms is then analysed, in order to understand the reasons for weak debt servicing capacity. This analysis suggests that low profits are a result of public policies that reduce incentives for profit making, farm production of livestock products at a loss and lack of restructuring.

The conclusion of this paper, then, is that the "farm debt problem" is largely a chimera. The more basic underlying problem is the continued unprofitability of large farms. Government schemes to "resolve" the farm debt problem by writing off debt have not significantly helped farms, because they have not been addressed at the underlying more basic problems of farm viability.

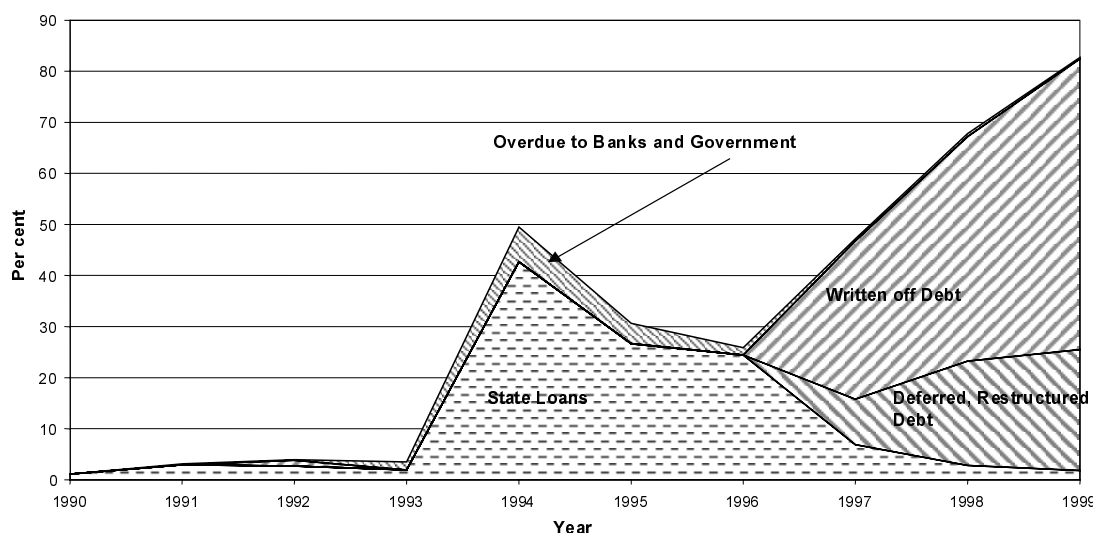
## **A. Analysis of the farm debt problem in Ukraine**

An analysis of the "farm debt problem" in Ukraine must begin with a definition of the nature of the problem. Debt financing is commonly used as part of a business strategy for improving financial performance, and the seasonality of farming is often cited as an important reason for use of debt financing as a normal tool of farm financial management. It is not debt per se, but the prevalence of bad debt that has made for a "debt problem" in Ukraine. Figure 1 illustrates that the portion of farm debt to banks and government either overdue, deferred, restructured, or written off each year from 1990 to 1999 grew from nearly zero to over 80%.<sup>2</sup> "State loans" are in fact restructured tax debts. In addition to banks and government, Ukrainian farms have debt to other organisations and to their own workers (wage arrears). Nearly all wage debt is overdue and a substantial portion of debt to other organisations is thought to be overdue.

- 
2. Aggregate data used in this study are taken from annual Farm Accounting Statements. These statements include financial balances and income statements of Ukrainian large farms from 1985 to 1998 compiled from enterprise reports by the Ministry of Agriculture and the State Statistical Committee. Farm-level data used in this study are taken from two separate databases combined using enterprise codes from the Common Government Register of Enterprises and Organisations of Ukraine. The first database (12 296 observations) contains financial balances of agricultural enterprises in 1998 (form 1 of farm annual financial statements). The second contains selected indicators from Farm Accounting Forms 2, 6, 7, 9 and 13 for 1994 (11 980 observations), 1995 (12 227 observations), 1996 (12 345 observations) and 1998 (12 628 observations).

Reported indicators of Farm Accounting Statements have changed rather substantially since 1985. Therefore, all aggregate (form 1) financial balance data were converted to the format used in the latest reporting year, 1998. Figures and tables in this study utilise this common format, ensuring year to year comparability of figures.

**Figure 1. Cumulative per cent of farm debt (including write-offs) to banks and government that is overdue, deferred, restructured or written off, 1990-1999**



Source: Ukrainian farm annual financial reports.

Bad debt is a policy problem in Ukraine because it severely limits farm access to private bank or other lender credit. In this case the local and national governments step in to effectively finance a significant portion of input purchases, thus allowing the state substantial claims on the grain crop each year.<sup>3</sup>

The relevant policy question regarding debt, then, is "why are farms unable to service their debt?". Is it because substantial debt repayment obligations prevent normally viable enterprises from being profitable? If so, rescheduling or forgiving part or all of the debt could restore debt-servicing capacity and resolve the problem. However, if enterprises have low net incomes then the underlying problem may instead be the lack of profit generation, rather than debt. If this is the underlying problem, then it is farm profitability that should be the focus of policy.

### ***Analysis of farm debt using measures of debt repayment capacity***

In order to differentiate between the "crushing debt load" explanation for farm debt service problems and the unprofitability explanation we construct and compare indicators of farm debt repayment capacity and repayment requirement at the sectoral level. The indicators used are similar to those in Jolly, Smith and Vontalge (2000). A more detailed description of these indicators can be found in Sedik, *et al.* (2000).

To determine whether a farm has the ability to service a given debt load an indicator of debt servicing capacity is compared with the debt repayment requirement for the year. If the farm's repayment capacity is larger than the annual payment required to service the debt, then the farm has sufficient

3. Cf. Centre for Privatisation and Economic Reform (April, June, July 1998); Kobuta and Noga (2000) and Sedik, *et al.* (2000).

repayment capacity. To determine whether rescheduling debt would help the firm to recover repayment capacity the indicator of debt servicing capacity is compared with the present debt load rescheduled (amortised) over a reasonable period of time at prevailing interest rates. If the service payments exceed the repayment capacity of the farm and debt amortisation reflects or exceeds the prevailing time structure of farm debt for other farms, then the farm is effectively in a debt hole out of which it has little chance to escape. In this case the farm and its creditors normally either liquidate the farm or come to an agreement for debt relief along with a plan to raise the income generating capacity of the farm.

**Table 1. Debt repayment capacity for an average Ukrainian large farm, 1993-1998**

|                                                      | 1993 | 1994 | 1995 | 1996  | 1997  | 1998  |
|------------------------------------------------------|------|------|------|-------|-------|-------|
| <i>Debt Repayment Capacity of Farm, 1 000 UAH</i>    |      |      |      |       |       |       |
| Debt Repayment Capacity (1)                          | 21   | 33   | 60   | -232  | -336  | -408  |
| Debt Repayment Capacity (2)                          | 29   | 89   | 272  | -138  | -266  | -337  |
| <i>Debt Repayment Requirement of Farm, 1 000 UAH</i> |      |      |      |       |       |       |
| Note: Total debt of large farms (end year)           | 12   | 76   | 283  | 575   | 904   | 1 141 |
| 2-year payoff annual payment (3)                     | 24   | 206  | 436  | 665   | 806   | 1 075 |
| Annual interest rate (%)                             | 184  | 250  | 123  | 80    | 49    | 55    |
| <i>Comparison Ratios</i>                             |      |      |      |       |       |       |
| Total debt/DRC(1)                                    | 0.55 | 2.30 | 4.75 | -2.48 | -2.69 | -2.80 |
| 2-year payoff/DRC(2)                                 | 0.83 | 2.30 | 1.60 | -4.82 | -3.03 | -3.19 |

*Notes for Table 1:*

1. Debt Repayment Capacity (DRC) (1) = Total revenue from farm, non-farm sales and other operations  
+ state support  
+ market value of ready-to-sell production inventory increases  
- total production costs  
- marketing costs  
- all assessed taxes and payments to government  
- interest payments  
+ actual depreciation expenses included in production costs  
= Total revenue from farm, non-farm sales and other operations
2. Debt Repayment Capacity (2) = DRC(1) + interest payments.
3. 2-year payoff is the annual payment on total debt amortised over 2 years at the prevailing interest rate.

*Sources:*

Calculations based on Ukrainian farm annual financial reports; National Bank of Ukraine (commercial bank interest rates)

Table 1 shows calculations of farm debt repayment capacity indicators, debt repayment requirement indicators and ratios comparing these indicators for an average Ukrainian large farm from 1993 to 1998. Two indicators, DRC(1) and DRC(2) characterise "Debt repayment capacity". The "Debt Repayment Requirement" lists, first, the total debt per farm, followed by the annual sum an average farm would be required to spend to service this debt load at the prevailing commercial bank interest rate if rescheduled over 2 years. The prevailing interest rate for commercial banks is also listed. Note that these nominal interest rates represent negative real interest rates in 1993, 1994 and 1995. In those years the inflation rate was, respectively, over 10 000%, 401% and 182%. Thus, any loans in this

period at such rates actually represented a real subsidy to the farms. This applies even more so for debt rescheduled over two years.

In Table 1 DRC(1) estimates the income available to repay principal (term debt) on loans without rescheduling. In the US this would be called the 'term debt repayment margin.' If DRC(1) is positive the farm can reduce the principal on its debt (or increase earned equity if term debt is zero). If DRC(1) is negative, the farm must borrow either from itself, by drawing down liquid assets, or from an outside source such as a bank or an input supplier, for example.

DRC(2) estimates the debt servicing capacity (the ability to pay off interest and principal) of the farm. This amount can be compared with the debt service requirement based on the outstanding liabilities of the farm amortised at the prevailing interest rate over a reasonable period of time (2 years is used here). Similarly, it is possible to estimate the maximum debt load that a farm with such servicing capacity could repay at current interest rates. If DRC(2) is negative the farm can not service any debt, no matter how small. In this case the problem with the farm is clearly not debt load, but repayment capacity of the farm. If DRC(2) is positive, the firm could pay off existing debt or even add new debt up to a level equal to DRC(2).

In considering the comparison ratios of the table we should keep in mind that during the entire period under consideration the overwhelming majority of loans extended to agriculture were short term, less than one year. Thus, rescheduling loans over 2 years is generous indeed.

Consider the comparison ratios and their interpretation. The first ratio (total debt/DRC(1)) indicates the number of years (in terms of our indicator of debt repayment capacity) it would take an average farm to repay the loan principal it had accumulated at the end of the year without rescheduling. The second ratio "two year payoff/DRC(2)" poses the following question: If the accumulated debt of an average farm were rescheduled to be due in two years, financed at the prevailing interest rate, would an average farm be able to make its annual payments?

If either of the ratios is less than zero, it makes little sense, since the enterprise can not service any debt. If the ratios range from 0 to 1, the enterprise is able to make its annual loan payments (either with or without rescheduling) within one year. In the case of DRC(1) repayment within a year would accord with the farm's obligations, since over 90% of loans in this period were short term, with a payment period of less than one year. In the case of DRC(2), repayment within a year would also accord with the farm's obligations, since the ratio compares the *annual* payment of the farm required if all obligations were rescheduled over two years. If the ratios are greater than unity, then the enterprise requires more than one year to pay off its annual loan obligations (either with or without rescheduling). In this case, it will find itself in default on those payments.

For both scenarios (with and without rescheduling) 1994 - the year of currency stabilisation - appear to be a turning point. This is the first year when an average farm in Ukraine stopped being able to service its debts. Moreover, realistic debt rescheduling would make no difference. This implies that the underlying problem of Ukrainian farms since 1994 is more likely income generation, rather than debt. In a market economy the kind of comparison ratios between debt service requirements and debt repayment capacity indicators surveyed in the previous section are absent precisely because there are natural institutional limits to the accumulation of farm debt and deterioration of repayment capacity. When a farm in a market economy reaches a point at which it is unable to service its debt payments, it either arranges for debt rescheduling or settles up with its creditors and goes out of business. Because there is no such institutional mechanism for the settlement of debt and the passing of property from poor to better management in Ukraine, debt to repayment capacity ratios in Ukrainian large farms are far higher than what would be considered "normal" in a market economy.

Despite the underlying problem of income generation, it is nevertheless true that the negative real interest rates through 1995 acted as an incentive to farms to run up debt. Note that in Figure 1 the amount of "bad debt" was actually declining. But all that stopped in 1996 when real interest rates turned positive. The per cent of "bad debt" out of total debt rose sharply.

### ***Analysis of farm debt using financial ratios***

Financial ratios offer another way to analyse the policy question of why farms are unable to service their debt, though the absence of many markets in Ukrainian agriculture create difficulties in interpreting many of them. However, if interpreted with care, comparison of Ukrainian farm financial ratios with those from a sample of similar but financially healthy farms can offer important benchmarks pointing to what might be loosely termed "deviations from financial health". There are no absolute norms against which to judge financial healthiness. However, sizeable deviations from ratios from financially healthy farms, if supported by other evidence, can point to areas of financial stress.

**Table 2. Comparable performance indicators for US and Ukrainian farms, 1994-98**

|                                                                                      | 1994    | 1995    | 1996    | 1997    | 1998    |
|--------------------------------------------------------------------------------------|---------|---------|---------|---------|---------|
| <b>All Ukrainian large farms</b>                                                     |         |         |         |         |         |
| <i>Financial indicators</i>                                                          |         |         |         |         |         |
| Gross revenue per farm (USD)                                                         | 293 020 | 383 716 | 445 448 | 454 350 | 313 544 |
| Net cash income per farm (USD)                                                       | 94 607  | 64 119  | 24 387  | -23 695 | -49 053 |
| <i>Financial ratios</i>                                                              |         |         |         |         |         |
| Current liabilities to current assets                                                | 0.57    | 0.47    | 0.65    | 0.79    | 0.89    |
| Current liabilities to current financial assets                                      | 1.52    | 2.51    | 3.44    | 4.12    | 4.91    |
| Current liabilities per hectare (USD)                                                | 56      | 73      | 125     | 177     | 140     |
| Current liabilities per employee (USD)                                               | 563     | 772     | 1 440   | 2 151   | 1 809   |
| <b>US farms in Heartland region with gross sales from USD 250 000 to USD 500 000</b> |         |         |         |         |         |
| <i>Financial indicators</i>                                                          |         |         |         |         |         |
| Gross revenue per farm (USD)                                                         | 320 321 | 312 931 | 293 686 | 305 835 | 336 414 |
| Net cash income per farm (USD)                                                       | 77 105  | 82 943  | 81 585  | 86 282  | 98 729  |
| <i>Financial ratios</i>                                                              |         |         |         |         |         |
| Current liabilities to current assets                                                | 0.47    | 0.33    | 0.36    | 0.42    | 0.40    |
| Current liabilities to current financial assets                                      | 1.72    | 1.04    | 1.23    | 2.52    | 1.62    |
| Current liabilities per hectare (USD)                                                | 315     | 252     | 248     | 254     | 264     |
| Current liabilities per employee (USD)                                               | 71 895  | 57 922  | 59 429  | 61 499  | 64 185  |

**Notes for Table 2:**

For Ukrainian farms, net cash income to sales ratio is balance profit plus amortisation divided by total sales.

For US Heartland farms, land per farm is for farms with sales over USD 100 000.

For US Heartland farms current liabilities to sales ratio is current liabilities divided by gross cash income.

Ukrainian currency values are converted to US dollars at the auction exchange rate.

**Sources:**

Ukrainian large farms: Ukrainian farm annual financial reports.

US Heartland farms: USDA, Agricultural Resource Management Study. Labour and land are estimates based on BEA Agricultural Census and USDA NASS figures.

Table 2 compares Ukrainian large farm indicators with similar indicators for a sample of farms in the Heartland region of the United States with gross sales revenue of USD 250 000 to USD 500 000 for the period 1994 to 1998.<sup>4</sup> This sample of US farms constitutes a reasonable comparison for Ukrainian farms, because they are of similar economic size. An average Ukrainian large farm sold USD 313 544 worth of agricultural and other products in 1998, whereas an average Heartland farm in this category had sales of around USD 300 000. Heartland farms also make a good comparison with Ukrainian large farms because these farms grow field crops such as wheat, soybeans and corn on large plains. Ukrainian large farms typically grow wheat, barley and sunflower seeds on large plains.

There is a very substantial difference between Ukrainian and US farms in the level of farm net cash income (Table 2, line 2) and in the behaviour of this indicator over time. For Ukrainian farms this statistic turned negative (losses) in 1997, indicating that an average Ukrainian farm was unable to service any level of debt. This indicates that Ukrainian farms actually subtracted nearly 600 million US dollars in value from the economy in 1998, rather than added. For US farms this indicator remained positive throughout these years. Moreover, in Ukrainian farms this indicator fell rather dramatically over the five years covered in the table. In US farms net income remained relatively stable over the entire period.

The next two ratios of Table 2 (lines 3 and 4) are indicators of the liquidity of an average farm. Judgements as to whether a debt load is large or small depend on the ability of the enterprise to repay the debt from cash and liquid assets either at a moment in time (through liquidation) or over a longer period (through debt service). Thus, in the short run there are two concerns that determine whether a debt load is sustainable. The first is whether the enterprise has sufficient cash and liquid assets to repay its debts immediately and the second is whether an enterprise can service its debt obligations through generation of profits over time. The first concern is that of the solvency of the enterprise, the second of its liquidity.

Normally, the issue of solvency relates to the farm's total structure of assets, liabilities and equity capital and the ability of the farm to meet total claims. That is, when a banker assesses the solvency of a farm business in the United States, for example, he compares the total market value of fixed assets, inventories and current assets and compares them with the total claims on the farm. A common measure of solvency is the debt to asset ratio. The debt to asset ratio addresses the question, if the farm sold off all its assets at their listed value, how much of the debt would it be able to pay off? For a US farm the debt to asset ratio would include fixed assets (such as land, housing and agricultural machinery) as well as non-fixed assets (such as inventories, cash and other liquid assets). It would also include debt related to fixed assets, the largest of which is land. In 1998 real estate debt of US farms comprised 51% of total debt.<sup>5</sup>

---

4. Gross sales are the standard measure of farm size in US farm statistics. US data is taken from the USDA Agricultural Resource Management Survey published by the Economic Research Service of USDA. For the purposes of this survey the US heartland is defined as farms in the states of Iowa, Illinois, Indiana and parts of Ohio, Kentucky, Minnesota, Wisconsin, South Dakota and Montana. For US farms "gross revenues" in Table 2 refer to gross cash income. Gross cash income includes cash receipts from farm sales, farm related income and government payments. It does not include the value of other elements that are not cash based, such as home consumption, imputed rental value of owner dwellings or inventory adjustment. For Ukrainian farms, the indicator in this table includes total sales revenue from farm and non-farm goods and services plus government support payments. The Ukrainian monetary value was converted to US dollars at the annual auction exchange rate for the years in question.

5. From Appendix Table 6 of Economic Research Service, *Agricultural Income and Finance Situation and Outlook Report* (1998).



In the Ukrainian case it is impossible to measure solvency accurately. This is because Ukrainian farm financial balances do not contain land as an asset, there is no developed market for farm machinery and there are no liabilities connected with land. The absence of working markets means that the valuations of fixed assets in farm balances are relatively meaningless for this issue.

Absent an accurate measure of solvency, we must do with a measure of the liquidity of the farm. For this purpose there are two ratios which offer an indication of the liquidity of the farm. The first is the current liabilities to current assets ratio (line 3).<sup>6</sup> This measures the ability of a farm to cover its short-term liabilities with its current (and presumably somewhat liquid) assets.<sup>7</sup> However, the current debt to current asset ratio is only a rough indicator of farm liquidity with many limitations. It should be viewed as such an indicator only under very opportune circumstances for the farm. This is because the accuracy of the current liability to current asset ratio in reflecting the actual ability of farms to cover their current debt with current assets depends vitally on the liquidity of inventories. A typical Ukrainian large farm was unlikely to be able to sell its inventories at their listed price. This is partly because of the absence of developed markets for such assets and partly because book values of inventories reflect costs of production rather than market prices. Since nearly all large farms run losses, costs of production offer an exaggerated value of inventories. A better indication of the ability of Ukrainian farms to cover their debts with current assets is the current liability to current financial asset ratio. In the ratio of current liabilities to current financial assets, the latter excludes potentially illiquid inventories of Ukrainian farms. Instead, only cash, accounts receivable and other liquid assets are counted.

The current liabilities to current financial asset ratio in Table 2 (line 4) shows that the most visible change in the financial state of Ukrainian farms is a steep drop in financial liquidity after 1994. Ukrainian farms are extremely illiquid (*i.e.*, short of "working capital") compared with similar financially healthy farms. Farms with such low levels of liquidity in a market economy would have probably been forced into bankruptcy long ago.

The last two financial ratios give an indication of the burden of debt on the factors employed on similarly sized farms in the US and Ukraine. This comparison shows that, compared to US farms of similar economic size, debt levels on Ukrainian farms are quite small. In 1998 US farms carried 35 more times debt per employee and nearly twice as much debt per hectare. This is perhaps one of the most significant comparisons of Table 2. It indicates that debt levels on Ukrainian farms are really quite manageable, if only factors were used more efficiently. Evidence on labour and land per farm in the following section confirms this conclusion. To sell a similar value of products, Ukrainian farms use 8 times more land and 147 times more labour than US farms. With such low value of output per factor, it is not surprising that these farms run losses.

---

6. For a more complete examination of the correspondence between the Ukrainian farm balance sheet and the accounting concepts used here see Sedik, *et al.* (2000), particularly Appendix III.

7. For US Heartland farms current assets exclude real estate assets (such as land and buildings, operator dwelling), as well as farm equipment, breeding animals and investments in co-operatives. For liabilities, Heartland farm current liabilities exclude both real estate and non-real estate long-term liabilities. For Ukrainian farms neither current assets nor current liabilities cover land. In addition, short-term assets exclude buildings, breeding animals and farm machinery. The Ukrainian ratios are therefore quite comparable to the Heartland ratios.

## **B. Farm profitability in Ukraine**

Low profits, then, appear to be the underlying problem behind Ukrainian farms' inability to service their debt. The present section attempts to shed light on why Ukrainian farms appear to be so financially unsuccessful. However, just as there are problems with the interpretation of Ukrainian farm financial balances, there are also problems with the interpretation of revenue and expenditure accounts. The chief of these is their lack of transparency and accuracy. There are many reasons to believe that Ukrainian large farm financial accounts are biased toward worse financial results than is the case in reality. Financial accounts may deliberately leave out profitable portions of farm activity, in order to avoid taxes.

The problem of a lack of transparency and accuracy of farm accounts may not be as important for our purposes as might be assumed. The real problem for private banks and other lenders is the great uncertainty as to actual farm accounts and the risk associated with this. It may be that many farms are financially well off, but conceal this fact to avoid taxes. Or it may be that the poor financial results shown in farm accounts reflect the actual situation. The end result in both cases is the same. Private banks and other lenders either do not lend or lend only at quite high interest rates to compensate for risk. Lack of private sector lending leaves an inroad for the state to claim that intervention in input and output markets is required.

There are at least three interrelated reasons for low profits of Ukrainian farms. First, the agricultural and land policies of the Ukrainian government have centred around the goal of preserving Ukrainian large farms irrespective of performance. Policies to address farm repayment problems have amounted to financial relief for large farms without attention to their financial performance, addressing symptoms rather than causes. The second reason for farm losses is connected more with farm management, though this is not entirely unconnected with government policies. This is the continued production of livestock products by Ukrainian farms. In 1998 Ukrainian large farms lost UAH 2.8 billion in the production of livestock products, four-fifths of total large farm losses. The third reason for low profits in Ukrainian farms is their lack of internal restructuring. The structure of Ukrainian farms, despite the reforms of the past 10 years, remains little changed from the collective and state farms of old. This is most evident in the excess land and labour they employ. Ukrainian farms are far larger (in hectares), employ far more people and have significantly worse financial results than US farms of a similar economic size. Financial data from Ukrainian farm financial reports show that more profitable farms tend to have less land and workers.

### ***Government policies***

There is little agreement between policy makers in Ukraine on what should be the basic tenets of agricultural and rural policy. Rather, policies, either by default, habit or design, are very much an inheritance of the Soviet period. Government agricultural and land policies in Ukraine have *de facto* centred around preserving Ukrainian large farms irrespective of performance. These policies never addressed the underlying problems of the rural economy, because they were based on the presumption that Ukrainian large farms were not truly independent, entrepreneurial farmers, but collective enterprises and agents of state policy, whose function was to produce agricultural commodities, first and foremost. The main government policies aimed at preserving former state and collective farms have been (1) the absence of land markets, (2) the absence of adequate bankruptcy legislation, (3) unconditional government debt relief for farms and (4) government sponsored financing of agricultural inputs.

In economist's terms, government agricultural policies have created an immense moral hazard problem. Policies aimed at supporting farms have severely limited incentives for sound financial performance. The lack of adequate penalties for poor financial performance has allowed Ukrainian farm management to perform quite miserably and accumulate unsustainable levels of debt.

Despite recent changes in farm ownership and governance, land markets in Ukraine are still undeveloped. The main problem is that land shares of large farms are not easily convertible into land plots which can be easily withdrawn from large farms (Csaki and Lerman, 1997). Prior to May 2000 most Ukrainian farms were "collective agricultural enterprises". The collective ownership of land in collective agricultural enterprises effectively paralysed the development of a land market in Ukraine, because "owners" of land could not dispose of their property as they saw fit. Provisions of the Land Code and the Law "On collective agricultural enterprise" stated that land in collective property had two simultaneous owners, namely agricultural enterprises as legal entities and individual members of the enterprise as shareholders. The enterprise had the preferential right to manage the land, but its ownership is collective. Since members of the collective farm enterprise were not accountable for the debts of the farm, land can neither be used as collateral, nor as payment for debts of the enterprise.

Since May 2000 most Ukrainian farms are privately owned corporate farms (e.g., joint stock companies, limited liability companies, partnerships, etc.). This change, the main result of Presidential Decree 1529 of December 1999, has not significantly eased the convertibility of land shares of large farms into actual plots that could be withdrawn from the large farm.

The most important government policy designed to "resolve" the debt problem by eliminating its significance is the absence of a court-adjudicated mechanism for the settlement of debt or for the liquidation of farms in the event that they are unable to pay their debts to creditors. Without such a procedure, the ability of creditors to collect on debts is severely restricted. The 1992 Ukrainian law on bankruptcy in principle provided a way for creditors to collect on debt through initiating bankruptcy procedures. However, the procedure outlined was so complex and oriented against creditor interests that it was seldom used. Creditors preferred to deal directly with farms, lobby the government or work through the Gore-Kuchma Commission. A new law on bankruptcy was adopted in June 1999, but included a 5 year moratorium on bankruptcy of farms.<sup>8</sup>

Further policies aimed at eliminating the debt problem through addressing symptoms rather than causes are debt relief measures. These include routine (in 1992, 1993, 1997, 1998 and 1999) and unconditional writing off, extension and restructuring of debt obligations of farms to the government. This statement may seem contradictory, since writing off actually reduces debt loads. However, interviews with large farm directors indicate that such habitual actions have had the effect of convincing farms that they need only wait and debt forgiveness will be forthcoming. For instance, one farm director and local administration official in Odessa oblast sympathetically described the fate of another director who made the mistake of paying off his tax debts only to find that that debt was written off for other farms in the country shortly afterwards. The lesson of such debt relief is clear. Many farm directors in our 1999-2000 farm interviews stated their confidence that the government would soon write off their debt obligations (they were right). In such an atmosphere it is difficult to see why farms should make strenuous efforts to pay back debt to the state, if such obligations are to be forgiven anyway.

Figure 2 illustrates the structure of creditors for Ukrainian farm debt. Since 1995 the allocation of debt has been nearly constant at 45-50% to the government, 20% to workers, and about 30% to other

---

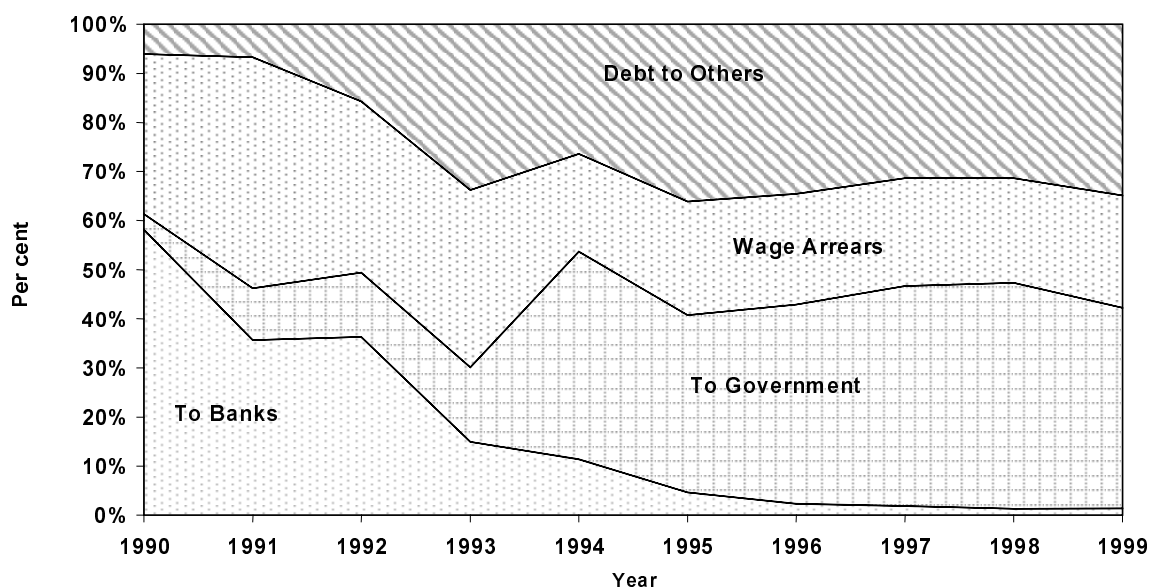
8. Law of Ukraine no. 2343-XII, "On Bankruptcy," May 14, 1992 and Law of Ukraine no. 784-XIV, "On Changes to the Law of Ukraine 'On Bankruptcy,'" June 30, 1999.

enterprises. Repayment of government debt has been de facto on relatively soft terms. This is illustrated in Figure 1, which shows that 80% of government and bank debt had been restructured, deferred, written off or was overdue. The second largest category of debt in 1998 was that to other organisations. This was primarily to private enterprises for input purchases, a significant portion of which was owed to distributors of foreign farm inputs. Much of this debt is thought to be in arrears. Overdue wage debt, the third largest debt category, also does not present a significant threat to the survival of the enterprise. In 1999 an average farm owed approximately 7.5 months of wage arrears to its employees.

The tradition of debt write-off continued in 2000. The Rada passed a law on March 16, 2000 which ordered the write-off of all tax and off-budget fund debt, including penalty payment debt as of May 1, 2000 for agricultural enterprises reformed in accordance with Presidential Decree 1529 of December 3, 1999. The law ordered that tax debt, penalty payment debt and debt for input purchases (advanced by the government) for processors be written off as well. Moreover, the law called for additional legislation in order to write off debt for government credits advanced to agricultural enterprises through processors and procurement organisations.

Finally, government sponsored financing of agricultural inputs has significantly added to debt accumulation. In Ukraine significant portions of markets for farm inputs are financed through government programs under which the state finances and distributes inputs to farms without regard to debt repayment capacity. This practice contributes to the accumulation of farm debt beyond the limits imposed by the necessity in market economies to demonstrate repayment capacity. When farms are not required to demonstrate repayment capacity to a bank or input supplier which has the authority to place a lien on the farm's harvest in order to collect debt, they naturally incur imprudent amounts of debt. It is not surprising that only 41% of state loans to large farms in 1998-99 were repaid (Cabinet of Ministers Resolution 2147, November 26, 1999).

**Figure 2. Farm debt in Ukraine, 1990-1999 (end of year)**



### ***Livestock production and financial losses***

In 1998 Ukrainian large farms lost UAH 2.8 billion in the production of livestock products. This was four-fifths of total losses in agriculture. If farms had not produced any livestock products at all sectoral losses would have been only 10% of total sales. As it was, losses were 35% of total sales in 1998.

In farm level interviews conducted in 1999-2000, managers noted two important reasons for the continued production of livestock products, which demonstrate the pre-eminence of concerns outside of profitability. First, there is direct local administration pressure on directors to preserve livestock herds. Second, directors themselves continue to produce unprofitable livestock products in order to provide for a constant income flow in order to pay in-kind wages or other monthly expenses. In addition, farms preserve livestock herds to maintain employment and provide organic fertiliser for crops.

Despite official pressure and internal incentives to support livestock herds, farms have reduced their livestock herds rather dramatically in the past 10 years. The question is only one of the pace of reduction. The fact that most directors interviewed cited official pressure to maintain livestock herds as one reason for decreased profits indicates that they themselves might have reduced herds faster, had they sufficient freedom.

The problem of a constant flow of income is solved in Western crop raising farms, first, by being profitable, second, by selling stocks throughout the year and, third, by earning income from non-farm sources. About half of farm income in the US is from non-farm sources. In Ukraine, however, the avenues for holding stocks and non-farm income are quite limited. Typically, the Ukrainian large farm must sell all its production in the fall, in order to pay off debt both from the current year and from previous years. Moreover, since Soviet times the business of Ukrainian farms has been farming. Though farms have made some efforts to develop non-farm income sources, there is little incentive for farm managers or farm workers to engage in risky, entrepreneurial activities.

### ***Lack of internal restructuring of Ukrainian large farms***

Lack of farm restructuring is most evident in the excess land and labour employed by Ukrainian farms. Ukrainian farms are far larger (in hectares), employ far more people and have significantly worse financial results than US farms of a similar economic size. The striking differences in size, employment and net farm income can be seen in Table 3.

**Table 3. Land, employment and net cash income per farm in  
US and Ukraine, 1994, 1998**

| Year                        | 1994                                  | 1998    |
|-----------------------------|---------------------------------------|---------|
|                             | <b>Land per farm (ha)</b>             |         |
| US Heartland 250-500K Farms | 311                                   | 320     |
| Ukrainian Large Farms       | 2 571                                 | 2 522   |
|                             | <b>Labour per farm</b>                |         |
| US Heartland 250-500K Farms | 1.36                                  | 1.32    |
| Ukrainian Large Farms       | 256                                   | 195     |
|                             | <b>Net cash income per farm (USD)</b> |         |
| US Heartland 250-500K Farms | 77 105                                | 98 729  |
| Ukrainian Large Farms       | 94 607                                | -49 053 |

*Sources:*

Ukrainian large farms: Ukrainian farm annual financial reports.

Heartland farms: USDA, Agricultural Resource Management Study. Labour and land are estimates based on BEA Agricultural Census and USDA NASS figures.

The juxtaposition of figures in Table 3 is interesting for two reasons. First, it illustrates that Ukrainian farms have been significantly larger (in terms of hectares and number of employees) than US farms of similar economic size over the entire period from 1994 to 1998. Second, it indicates that, though their size hardly changed between 1994 and 1998, the financial results of Ukrainian farms changed drastically. Large farms seemed to have large profits in 1994, but losses in 1998.

What makes this pattern particularly meaningful is that a similar pattern is observed in comparing farms within Ukraine. Table 4 shows such a comparison. This table is based on a data set containing the annual financial reports of all Ukrainian large farms subordinate to the Ministry of Agrarian Policy in these years. We restricted the data set to only those farms that were in existence in both 1994 and 1998. Of 11 980 farms in 1994 and 12 296 farms in 1998, only 10 279 could be followed through all of the intervening years. We also cleaned the data, reducing the sample size to 9 224 observations

Table 4 illustrates that in 1994, large farms were in fact the most successful. They had the highest absolute level of profits, the highest profitability (profits per unit of revenue) and the highest price to cost ratios. In other words, Ukrainian managers seem to have been behaving rationally in keeping large, rather than small, farms in Ukraine in 1994. However, by 1998, all that had changed. First, the average overall performance of Ukrainian farms deteriorated between these two years. In our sample, the median Ukrainian farm lost UAH 281 000 in 1998. Second, the most successful farms (by profits and profitability) were those with smaller staff and smaller landholdings.

**Table 4. Median performance indicators for Ukrainian farms arranged in profit quintiles, 1994 and 1998**

| Indicator                                  | Quintiles by median profit |        |        |       |        |        |
|--------------------------------------------|----------------------------|--------|--------|-------|--------|--------|
|                                            | Highest                    | 2      | 3      | 4     | Lowest | Total  |
| <b>1994</b>                                |                            |        |        |       |        |        |
| Profit (mln krb)                           | 10 516                     | 5 447  | 2 974  | 1 390 | 316    | 2 973  |
| Revenue (mln krb)                          | 24 372                     | 14 383 | 10 119 | 7 143 | 5 735  | 11 662 |
| Profit per unit of revenue                 | 0.47                       | 0.38   | 0.29   | 0.19  | 0.05   | 0.29   |
| Average number of farm workers during year | 351                        | 275    | 242    | 210   | 198    | 251    |
| Total land area, ha (selkhozugodiia)       | 3 263                      | 2 443  | 2 167  | 1 737 | 1 691  | 2 213  |
| <b>1998</b>                                |                            |        |        |       |        |        |
| Profit (UAH 1 000)                         | -58                        | -180   | -282   | -417  | -680   | -281   |
| Revenue (UAH 1 000)                        | 502                        | 386    | 490    | 616   | 879    | 577    |
| Profit per unit of revenue                 | -0.11                      | -0.47  | -0.58  | -0.68 | -0.82  | -0.56  |
| Average number of farm workers during year | 137                        | 147    | 172    | 201   | 255    | 182    |
| Total land area, ha (selkhozugodiia)       | 1 522                      | 1 666  | 2 056  | 2 575 | 3 682  | 2 204  |

Source: Ukrainian farm database (see text for description).

Tables 5 and 6 by and large support these conclusions. Table 5 shows profits and profitability by farmland area quintiles in 1994 and 1998. In 1994 the largest farms had the largest profits, though not always the largest profitability. By 1998, the smallest farms had the lowest losses. Table 6 shows profits and profitability of farms grouped by average number of farm employees over the year. These data indicate the same reversal in profits for large and small farms.

Why this dramatic change? The most obvious and important changes during these years concerned the stabilisation of the Ukrainian currency, liberalisation of agricultural market prices and the near elimination of agricultural subsidies, *i.e.*, those policy changes commonly associated with the transition. But despite the overall drop in profits usually cited, the transition brought a truly impressive turnaround in the fortunes of large and small farms.

**Table 5. Median performance indicators for Ukrainian farms arranged by total land area quintiles, 1994 and 1998**

| Indicator                | Quintiles by total land area |       |       |       |        |
|--------------------------|------------------------------|-------|-------|-------|--------|
|                          | Highest                      | 2     | 3     | 4     | Lowest |
| <b>1994</b>              |                              |       |       |       |        |
| Land Area (ha)           | 4 935                        | 3 127 | 2 213 | 1 573 | 867    |
| Number of farm employees | 360                          | 303   | 254   | 209   | 159    |
| Profit (million krb.)    | 5 250                        | 4 209 | 3 363 | 2 209 | 1 390  |
| Profit/Revenue           | 0.30                         | 0.31  | 0.30  | 0.28  | 0.24   |
| <b>1998</b>              |                              |       |       |       |        |
| Land Area (ha)           | 4 782                        | 3 108 | 2 204 | 1 582 | 922    |
| Number of farm employees | 263                          | 214   | 192   | 157   | 108    |
| Profit (UAH 1 000)       | -499                         | -354  | -287  | -234  | -154   |
| Profit/Revenue           | -0.52                        | -0.52 | -0.53 | -0.56 | -0.67  |

Source: Ukrainian farm database (see text for description).

**Table 6. Median performance indicators for Ukrainian farms arranged by employee number quintiles, 1994 and 1998**

| Indicator                | Quintiles by average number of employees over year |       |       |       |        |
|--------------------------|----------------------------------------------------|-------|-------|-------|--------|
|                          | Highest                                            | 2     | 3     | 4     | Lowest |
| <b>1994</b>              |                                                    |       |       |       |        |
| Number of farm employees | 434                                                | 312   | 251   | 200   | 134    |
| Land Area (ha)           | 3 868                                              | 2 806 | 2 097 | 1 802 | 1 173  |
| Profit (million krb.)    | 6 881                                              | 4 178 | 2 991 | 2 191 | 1 218  |
| Profit/Revenue           | 0.32                                               | 0.30  | 0.28  | 0.28  | 0.25   |
| <b>1998</b>              |                                                    |       |       |       |        |
| Number of farm employees | 325                                                | 234   | 183   | 138   | 87     |
| Land Area (ha)           | 3 586                                              | 2 680 | 2 257 | 1 777 | 1 172  |
| Profit (UAH 1 000)       | -457                                               | -351  | -306  | -240  | -155   |
| Profit/Revenue           | -0.37                                              | -0.48 | -0.57 | -0.65 | -0.92  |

Source: Ukrainian farm database (see text for description).

### C. Conclusions

The main conclusion of this paper is that the "farm debt problem" is largely a chimera in the following sense: The underlying problem of Ukrainian farms appears to be not debt but lack of profits. Table 1 illustrates that by 1994 an average Ukrainian large farm was not capable of servicing its debts, even if they were rescheduled on generous terms (over two years). By 1996 an average Ukrainian large farm was not able to service *any* debt. The comparative analysis of financial ratios in Table 2 for large Ukrainian farms and similarly sized US farms indicates that Ukrainian debt loads (on average) would be quite manageable for normally profitable farms with an efficiency considerably less than in the US.

The main reasons for low profits of Ukrainian large farms appear to be public policies that diminish incentives for good financial performance, continued production of livestock products by farms and considerably more labour and land employed in Ukrainian farms than in comparable market oriented farms.

The apparent inability of Ukrainian farms to service debt and their resulting inability to utilise market instruments to secure seasonal financing is the primary justification for the presence of the Ukrainian government in financing seasonal input supplies. Such financing creates a substantial burden on the state budget, and ultimately on taxpayers. A suggestion of the cost of input financing for the Ukrainian government can be seen in calculations concluded for spring sowing 2000 (Kobuta, Noga, 2000). For spring sowing 2000, the value of inputs (mineral fertilisers and oil products) supplied to farms in accordance with government resolutions was UAH 296 million (USD 53.6 million). However, the cost to the Ukrainian budget in order to interest banks, distributors, processors and others in working with agricultural enterprises was much larger, UAH 922 million (USD 167 million). These economic incentives included central bank subsidies to the sectoral bank responsible for agriculture, interest rate subsidies, local budget funds, government losses from oil import tariff discounts, milk and meat subsidies for input purchases, VAT discounts to farms for input purchases and discounted sales of oil by government enterprises to distributors.



The government role in agricultural input markets in Ukraine and accumulated farm debt related to government loans and taxes give the Ukrainian government a substantial claim on agricultural commodities (particularly grain, since it has become the primary numeraire) produced in Ukraine. For the past three years these claims have been far greater than farms have met.<sup>9</sup> It is not the ex post amount of grain the state has collected, but the effects of the claims on grain markets that is most important. State claims on commodity markets are similar to a continuation of the state order system for grain that was discontinued after 1997. Oblast governments have utilised the traffic police, the secret police and other state instruments to ensure priority of payment before private companies. Such efforts effectively make sales to private purchasers illegal before the state satisfies its claims on the market.

---

9. See Centre for Privatisation and Economic Reform (May, June and July, 1998).

## BIBLIOGRAPHY

- British Know How Fund (1997),  
*Comprehensive Report on Ukrainian Farm Debt Project* (Kiev, November 1997).
- Centre for Privatisation and Economic Reform (CPER) (1998),  
*How Much Grain has the Ukrainian Government Promised?* Issue 1 (Kiev, April 1998).
- Centre for Privatisation and Economic Reform (CPER) (1998),  
*How Much Grain has the Ukrainian Government Claimed?* Issue 2 (Kiev, June 1998).
- Centre for Privatisation and Economic Reform (CPER) (1998),  
*How Much Grain has the Ukrainian Government Claimed?* Issue 3 (Kiev, July 1998).
- Csaki, C. and Z. Lerman (1997),  
*Land Reform in Ukraine: The First Five Years*, World Bank Discussion Paper no. 371 (Washington, DC, 1997).
- Economic Research Service, United States Department of Agriculture (1998),  
*Agricultural Income and Finance Situation and Outlook Report*, AIS-70 (Washington, DC, 1998).
- German Advisory Group (1999),  
*The Next 1 000 Days: An Economic Reform Agenda for Ukraine* (Kiev).
- Jolly, R., D. Smith and A. Vontalge (2000),  
"Assessing the Financial Condition of Iowa's Commercial Farm Businesses, 1999-2001"  
FM-1868, Iowa State University Extension, Iowa State University, Ames, Iowa.
- Kobuta, I. and Noga, V. (2000),  
"Rol' gosudarstva v obespechenii sel'skogo khoziaistva material'no-tekhnicheskimi resursami",  
*Iowa State University Ukraine Agricultural Policy Project Discussion Paper* no. 8 (Kiev, 2000).
- Lerman, Z., K. Brooks and C. Csaki (1994),  
*Land Reform and Farm Restructuring in Ukraine*, World Bank Discussion Paper no. 270 (Washington, DC, 1994).
- Lerman, Z. and C. Csaki (2000),  
*Ukraine: Review of Farm Restructuring Experiences*, World Bank Technical Paper no. 459 (Washington, DC, 2000).
- Sablouk, P. and A. Fesina (1999),  
"Agrarian Policy" in *Economic Growth with Equity: Ukrainian Perspective* (Kiev, 1999), pp. 1-23.

Sedik, D., N. Seperovich, N. Pugachev, I. Chapko, I. Kobuta, V. Noga and V. Zhygadlo (2000), *Farm Debt in the CIS: A Multi Country Study of Major Causes and Proposed Solutions: Ukraine Country Study*, The World Bank, ECSSD Environmentally and Socially Sustainable Development Working Paper no. 28, September 26, 2000.

United States Department of Agriculture, National Agricultural Statistics Service (1999a), *Farms and Land in Farms* (July 30, 1996; February 12, 1998; February 26, 1999).

United States Department of Agriculture, National Agricultural Statistics Service (1999b), *Farms and Land in Farms: Final Estimates 1993-97*, Statistical Bulletin Number 955 (October 1999).

**SESSION II. PRIVATE AND CO-OPERATIVE BANKING FOR THE  
AGRICULTURAL SECTOR AND RURAL AREAS**



# **AGRICULTURAL AND RURAL CO-OPERATIVE BANKING: EU EXPERIENCE AND LESSONS FOR EMERGING MARKETS**

**By Mr. Gerard van Empel**

## **Abstract**

*A well functioning rural financial system, preferably on a co-operative basis, is an essential pre-condition for the development of a diversified, prosperous rural economy. A conducive policy environment with specific policy instruments (risk or cost sharing instruments) plays an important role in stimulating the desired developments. Some of the main lessons learned from EU co-operative banking are applicable for emerging markets. (1) Financial institutions that operate in the rural areas need a banking license and the ability to adapt their financial services in line with the development of their client members. (2) Ability also to tap the savings market from non-members is crucial. (3) Operating in a large-scale network of rural financial institutions has been an important factor in the success of co-operative banks. There is very little scope for stand-alone retail financial institutions. (4) Rural finance needs to be based on economic criteria. Payment capacity was and is the most important factor in assessing a loan. (5) High loan recovery rate is more important than low transaction cost. (6) Rural finance institutions need to be "all finance based". (7) Consolidation of the current fragmented rural finance systems and/or transformation of existing "State" structures are the preferred options for developing an effective rural banking system in emerging markets. Taking these lessons into account, options for the development of a sustainable rural finance structure are presented.*

## **1. Introduction**

Poor access to financial services is considered one of the main stumbling blocks for the development of the rural economy and a prosperous small- and medium-size enterprise (SME) sector in emerging markets. The many years of involvement of bilateral and multilateral donors and NGOs in stimulating the financial sector in developing countries have not produced the expected result. This is partly due to poor policy environments, macroeconomic imbalances and poor co-ordination in the development effort by the various actors.

The intention of this paper is not to present in-depth analyses of past failures, but to make some recommendations based on experience in these markets while drawing on the "lessons learned" from the development history in Western European countries.

It is well understood that no recipe can be duplicated under different circumstances, but a mixture of the ingredients, local knowledge and lessons learned, if properly adapted and applied, can lead to a successful recipe in a particular market.

## **2. Markets and market environment**

The financial markets in emerging market economies are increasingly becoming a part of the global financial market. It is expected that this trend will continue strongly in the coming years, taking into account technological developments and the consolidation of cross-border trends in the financial sector. This is further strengthened by the harmonisation of legislation and financial sector

restructuring, which is an on-going process in many countries. This trend is also enhanced by institutions like the International Monetary Fund (IMF) and World Bank, both of which are heavily involved in the restructuring of the financial sector in many countries, the World Trade Organisation (WTO), etc.

In most emerging markets the influence of the state on the economy in general and the financial sector in particular has been greatly reduced.

Large financial institutions from Western countries want to become global players and are interested in taking over financial institutions in emerging markets. At the same time the financial sector in these markets is going through a consolidation process, in many cases after an initial restructuring of existing institutions. The privatisation of state banks is also an important contributing factor in this process.

The trends described above will greatly affect many smaller local financial institutions operating in such markets. In most emerging markets, the financial sector is still very fragmented, varying from stand-alone credit unions, credit co-operatives, and micro-finance institutions to state banks and small commercial banks. In many situations urban areas are over-banked while the rural areas are under-banked.

In order to survive and/or to become competitive it will be necessary that small stand-alone financial institutions unite in a more or less institutionalised or consolidated structure and/or form alliances with other existing institutions. The expected speed of these developments depends on the specific market conditions. This process is already taking place in Asia and Central and Eastern Europe. Central and South America shows a mixed picture, while in Africa this process has only just started.

The access to financial services in many of these markets is still limited to a relatively small (and predominantly urban) part of the population. Broader access to financial services is considered an important tool to develop the economy. It is considered an essential pre-condition to stimulating economic growth. In the past, financial institutions associated with a development role in emerging markets were mostly directed and/or owned by the state. Experience has shown that in many cases this resulted in poor loan recovery rates, non-transparent institutions, favouritism, etc. These days the developmental financing role is increasingly being taken over by private institutions like micro-finance institutions, co-operative banks, etc. In some cases they have developed into sustainable organisations. In most cases, however, these institutions are still strongly subsidy dependent; they lack the scale and financial discipline to become truly sustainable.

Micro-finance involves mostly small transactions, therefore efficient delivery mechanisms and high recovery rates on loans are crucial in order to enable the institutions that offer these services to become sustainable. At the same time they need to have the ability to grow in terms of product range, systems, etc., in line with the developing needs of their successful clients. In practice this means that they need a banking license, in order to be able to offer the services required.

Rural development in many countries is still synonymous with agricultural development. In most markets it is not feasible to transform all subsistence agricultural producers into market oriented agricultural entrepreneurs. Therefore, much more attention needs to be given to creating non-agricultural employment in the rural areas. This will ultimately also result in a better income earning capacity for the people remaining in agriculture. At the same time a more diversified rural economy will make investments in an appropriate infrastructure more viable, and this in turn will stimulate agricultural development. An adequate rural financial system, dealing with both agricultural and non-agricultural financial services, can play an important role in this development.

### 3. Principles for rural finance

Based on lessons learned from various developing countries and emerging markets, the following primary "do's and don'ts" can be mentioned in relation to the establishment of an effective rural finance delivery mechanism:

- A state is never effective in credit delivery, as it lacks the infrastructure and in most cases the expertise to provide financial services. The most important aspect of credit delivery is credit recovery. End users in general consider state credits as a form of subsidy and the last to be repaid, resulting in a poor recovery rate for loans.
- Debt forgiveness schemes give the wrong signals to the market and have a negative long-term effect on loan recovery for all financial intermediaries operating in the market. At the same time, debt forgiveness schemes benefit larger producers much more than small producers. Debt restructuring needs to be carried out on a case by case basis and on the principal of maximum recovery.
- Sector-based retail financial institutions like agricultural banks show limited sustainability and continuity, due to the fact that they have too high a level of risk exposure in a single sector. They have high transaction costs as their facilities/branches are insufficiently utilised. World-wide experience has shown that most of these types of institutions needed to be rescued by the state at one stage and some are in need of constant subsidisation. If one considers this type of institution to be like a grocery shop for financial services, it does not make any sense to sell only to one particular client group, while there are plenty of similar clients in the vicinity. The above applies not only to agricultural banks but also to other sectoral or target group based retail banks. Only in corporate banking is this aspect of less importance, as an extensive financial services delivery system is not required.
- A financial intermediary dealing with medium and small enterprises, including farmers, should preferably be based on an "all finance" concept. In other words, it needs to be able to provide all the financial services that these types of clients require. This will enable the financial intermediary to carry out effective client risk management, while at the same time reducing transaction and account management costs.
- Loan purpose and loan conditions need to be properly matched. Poor loan recovery is partly caused by a mismatch between type of investment and loan duration.
- A high loan recovery rate is more important than low transaction costs. Enforcement of the discipline to repay loans is essential for the development of sustainable financial institutions.
- Supply or marketing co-operatives should not be engaged in banking for their members. Many of these organisations have failed because of the fact that they tended to be insufficiently prudent about financing their members. It somehow conflicts with their objective to have a high turnover from their members. A banking activity of this nature also has a high sector-based risk, as most of the members are involved in just one agricultural sub-sector. Each activity of a multi-purpose co-operative organisation, including banking, needs its own economy of scale, expertise, etc. Experience has shown that these fundamentally different activities are difficult to combine into one organisation. At the same time it limits their possibility to merge, which is the most



effective way to create economies of scale. Therefore the single purpose co-operative is the preferred model.

- Agriculture, although with specific characteristics, is an economic activity. Economic principles therefore have to be applied, meaning that financing can only be based on sufficient payment capacity and farmers will have to obtain their income from the market. Agricultural policy instruments need to be based on this principle.
- Improved access to financial services cannot replace income support, as credit is based on payment capacity. Income support is a social instrument, which in some cases is needed. However, it cannot be provided by financial institutions like micro-finance institutions, co-operative banks or credit unions, but only directly by the state and not in the form of a credit.
- Government financial policy instruments should only be used to ensure and/or improve access to financial services, especially credit to farmers and other rural entrepreneurs. This means that entrepreneurs who already have relatively easy access to these services are not eligible. These instruments, based on the principle of achieving particular development goals, need to be specific and clear with respect to eligibility criteria, target grouping, indicators to be monitored, etc.

Essential for the development of rural financial services is that the state must be a reliable partner in terms of consistency and transparency with respect to policy actions, legislation, etc. Governments should not direct the development of these services, but should facilitate the development towards sustainable institutions in different ways. There is never one instrument or one policy action that will substantially improve access to financial services for the rural economy. There is a need for an integrated approach and action plan to overcome the largest deficiencies. Consistency and reliability of related policies, the establishment of appropriate laws and regulations, and a stable monetary environment are the biggest enabling factors in improving rural finance.

#### **4. Lessons learned in Europe**

Many of the aspects associated with the development of co-operative banks in Europe are time and location determined and cannot be repeated as such in developing countries and emerging markets. However, there are some specific aspects that are applicable to many of these markets in one form or another.

Without any attempt at completeness, the following lessons can be mentioned which can be taken into account for the establishment of sustainable rural finance structures in emerging markets:

- Co-operative banks and similar institutions have played a very important role in the development of a diversified rural economy, more so than any other specific institution in Western Europe. Proximity to clients, peer pressure, knowledge of local circumstances and a large degree of self-governance have been important factors in this development. The fact that they were embedded in the local community and that they were considered by the members as their institution have greatly contributed to the success of the co-operative banks in EU countries.
- The co-operative banks' ability to adapt their services simultaneously with the development of their client/members and the development of the overall economy has

been another important factor in their success. Co-operative banks have adjusted their product range and operations according to the needs of their client/members. The legal environment in which they operate has allowed them the same flexibility as commercial competitors. In the initial stages of their development they faced very little competition in general, as the commercial banks were not interested in the rural areas in general, nor in the target group for co-operative banks, being farmers and SMEs in particular.

- The ability (including legally) to tap the savings market, also from non-members, has been very important for the development of co-operative banks in Europe. One essential factor was that co-operative banks were dynamic in terms of member policy. At the initial stage when the rural population was mainly engaged in agriculture, the members were predominantly farmers. When other economic activities were started, especially in the SME sector, these entrepreneurs were also welcomed as members. When financial services also became more important among other rural citizens, co-operative banks started to offer these types of services and became "all finance" institutions. Through this dynamic entrepreneurial approach, they have been able to compete on an equal footing with commercial banks, while still maintaining local roots. Contrary to this, in emerging countries, many financial institutions are created for a specific target group and with limited flexibility to become a locally based financial service provider. Also, the legal environment often constrains their development.
- Right from the earliest stages of their development the co-operative banks saw the benefits of doing those things together for which economies of scale apply, and that can enhance efficiency, while maintaining local autonomy for those aspects that require local knowledge. They therefore created central organisations (apex structure) at a very early stage, to take care of product development, standardisation of systems and procedures, treasury operations, wholesale banking, control and monitoring activities. The interaction between the apex and the local units became even stronger when the whole system was consolidated and when cross-guarantee systems were established, etc. Even today determining the right balance between local autonomy (bottom up) and top steering and services (top down) is constantly being debated and adjusted to fit prevailing market conditions. In order to guide this process it is crucial that a democratic governing structure be in place. It is clear that if this willingness to operate in a network and or institutional structure had not been there from the start, the co-operative banks would not have been able to develop this far and to compete with commercial banks. Co-operative local banks as stand alone individual retail banks would not be able to survive under the market conditions currently prevailing in Europe. An important factor to foster the above process of co-operating in a network was that the local co-operative banks were all established on the same principles, mainly Raiffeisen or Schultze-Delitsch (Volksbanken). In many developing countries and emerging markets, local financial institutions are developed on a stand-alone basis according to the principles of the individual constituting organisations, in many cases a non-governmental organisation (NGO). Insufficient account is taken of the fact that they can only become sustainable, competing with commercial banks, when some type of organisational or institutional network is formed. The formation of a network structure, at a later stage, will become much more difficult when the individual institutions are based on different principles, procedures, capitalisation structure, etc.
- A primary objective of co-operative banks is to provide credit to the members at reasonable prices and in a sustainable way. Savings mobilisation was considered an instrument for achieving this objective. The main reason why they have been able to

develop into sustainable financial institutions was that they achieved a high recovery rate on loans provided. A sufficient payment capacity ratio was and still is the most important criterion on which to assess the risk of a loan, while at the same time some form of management risk scoring was and is used to assess the capabilities of an individual borrower. Besides the cost of funding and the efficiency of the loan delivery system, the cost of a loan is determined to a large extent by the loan recovery rate. Membership did not provide a right to credit; each application was and is evaluated based on the earlier described criteria. Co-operative banks did not finance the poorest of the poor, who did not have sufficient repayment capacity, but only "bankable" members based on the above criteria. They used economic principles in providing financial services and not social criteria, although they played a very important role in providing access to financial services for a large part of the population that had no previous access. Indirectly they played an important role in the social development of the rural population. In many ways the co-operative banks were initially what is currently called a micro-finance institution (MFI). There are some successful MFIs in developing countries and emerging markets that operate according to the same principles as described above. However, many still mix social and economic criteria in their daily banking operations, resulting in poor loan recovery rates. These latter institutions are strongly subsidy dependent and their long-term viability is questionable.

- Co-operative banks practised individual lending based not only on the borrowing capacity of the borrower but also on the characteristics and capabilities of the individual borrower. Group lending, as practised in many markets, can be a useful method to provide initial access to financial services. However, after this initial period and once some form of track record has been built up, it should be changed to individual lending in order to "reward" the proven capabilities of the individual borrower.

The success factors given above are not specifically related to the circumstances in Europe, but can be applied in general terms to other parts of the world as well.

Aspects such as institutional structure, capitalisation, product range, financial services delivery mechanisms, initial target grouping, etc. need to be tailor-made to the specific circumstances for individual cases. Mixing the relevant ingredients that made co-operative banking in Europe successful with ingredients based on the prevailing local circumstances, in order to create the optimal recipe, is a big challenge for emerging markets in order to create a viable rural banking system.

## **5. Rural finance structure in emerging markets**

In this chapter we shall briefly analyse a few options for the development of a sustainable rural finance structure, taking into account the earlier mentioned lessons learned from the European experience and developments in the international financial market. In general terms there are four options for creating a viable private rural banking system: transformation of an existing mostly state institution, consolidation of existing stand-alone institutions into a network, starting a new rural finance banking system from scratch, and commercial banks that create rural finance outlets. This does not imply that in any given country just one specific option needs to be chosen, as different options can be developed simultaneously.

### **5.1. *Transformation of existing structure***

Mainly in countries of transition, but also in some developing countries, there are already state banks or financial institutions that were created in the past to provide rural finance - especially agricultural finance - or that were especially focussed on collecting savings. These institutions range from the Agricultural Bank in China, to Vietnam Agricultural Bank, to Agroprombank in Russia, to Banco do Brasil, to Nabard and the co-operative banking structure in India, to BAAC in Thailand, to Landbank in South Africa, to Savings banks and Post Office banks in many different countries. The common denominator for most of these institutions is that they were, and most still are, single purpose, being a policy tool for the government, usually with a large non-performing loan portfolio, mostly bureaucratic in their operations, with a large network in the rural areas, etc. Many of these institutions will be privatised after restructuring.

The biggest advantage for these institutions when considering them as a solution for creating a viable private rural banking structure is that they already have a large network in the rural areas. They can be transformed into an "all finance" based rural bank in a relatively short period, compared to the other mentioned options.

Essential preconditions are: that they will need to be restructured first, including taking out the non-performing portfolio; that they will need to be sufficiently capitalised; that agreement must be reached about their institutional structure; that they be de-bureaucratized; and that a transparent governance structure be established.

In principle, many of these institutions can be transformed into a co-operative bank with the right balance between local autonomy and central governance and services. This requires, among other things, that specific instruments be developed to ensure sufficient initial capitalisation, since in most cases rural entrepreneurs - taking their liquidity situation into account - will not be able to come up with the required capital. In Western Europe some co-operative banks were started on a member liability bases; this is not a viable option anymore in emerging markets. A more likely form is that entrepreneurs who apply for a credit need to buy a share of approximately 5% of the loan amount. Special regulations need to be developed concerning exit scenarios for members, division of profits (mixture of general reserves and increase of share value ), etc.

Although the starting position for these types of institution vary from case to case, it is important that strong consideration be given to the transformation option described above, as in many countries there is only a one-off chance to transform an existing state institution into a true co-operative bank. The time path, the possible structure - taking into account specific market conditions and target groups, etc. - need to be designed on a case by case basis. It is recommended that this option be given much more attention than is currently the case when privatising state banks with a large rural network.

### **5.2. *Consolidation of existing institutions into a network***

A large number of stand-alone financial institutions have been created in developing countries, mainly by NGOs. Most of these institutions have no banking licence, and therefore they are restricted in the scope of services that can be supplied and the target group that can be served. They rely on the commercial banks, with which they generally have an account, for matters such as payment clearing, treasury, etc. Due to legal restrictions and size, in most cases they are not able to develop alongside their better clients, which means that after they develop a client, there is a big chance that this client

will shift to a commercial bank. As a result of poor performance, legal restrictions, etc., they have no access to capital markets for funding nor even full access to the savings market.

Their target group is generally the poorest section of the population. They usually have relatively high transaction costs and low loan recovery rates, which makes them heavily dependent on subsidies. Many of these institutions have little or no long-term sustainability. They can be considered "graduation institutions" towards commercial banks for client/ members who become successful.

This is only a generalised picture as there are exceptions to this rule. A survey in South America has shown that the five most profitable MFIs had only a 4.9% subsidy dependency, compared to a 19% average for the total sample of the survey (source: Seed Capital Development Fund). This tends to lead to the conclusion that financial institutions with a high subsidy level pay insufficient attention to profitability, risk management, selection of clients etc. Subsidies are certainly needed in the start-up phase, but there should be an agreed time path for "weaning" a financial institution off subsidies.

The most logical way to overcome the earlier described situation is to combine a number of these stand-alone institutions into a two-tier network organisation. At the local level they can go on providing the financial services with a large degree of autonomy. In terms of operations and products they can be fully standardised, as their market does not require complex financial products. This will reduce transaction costs and increase transparency, and it requires only limited banking skills on the part of the local banking staff. The apex organisation in this structure can provide services such as product development, information technology (IT) services, credit inspection and internal auditing services, operation of payment clearing systems, treasury function, etc.

Based on the specific situation and preference of the participants in the network, the institutional structure can initially vary from local organisations that remain fully independent and agree to co-operate on a limited basis, to a fully consolidated system. However, in all cases the medium term objective, based on a previously agreed time path, should be to create a fully consolidated system. That commitment - based on consensus about the rules that will govern the network, including a capitalisation policy - should be made at the start of any network. There should also be an agreed time path within which the network must fulfil the requirements to obtain a full banking license. A full banking license will provide the flexibility to operate competitively in the market.

The preferred option for such a network is that the local institutions are the shareholders of the apex structure. This will ensure a more balanced organisation in which the strong points of a local unit - such as self-reliance, self-government, member participation and empowerment - are guaranteed. A co-operative banking format, based on the specific prevailing circumstances, would be the most preferred model for such a network. It is essential that the operational format, the capitalisation structure, governance issues, time path, etc., be worked out and agreed upon before the network is actually formed.

It is, of course, realised that tailor made solutions need to be developed for each specific case, as market conditions and the number of rural financial institutions vary greatly from country to country. Nonetheless, there is the potential to create a viable network of rural financial institutions in most countries.

### **5.3. *Starting a new rural finance banking system from scratch***

This option should only be used in cases where there is no financial institution involved in the delivery of rural financial services, including savings, on any scale at all. This is the case in only a very few countries.

Under current market conditions, contrary to the situation in Europe in the middle or at the end of the nineteenth century, it will be relatively costly and time consuming to establish a system from scratch, if it is to have a sufficient out-reach and impact. Some initial grant funding will need to be available to capitalise the institution, which under a certain formula can be transferred to general reserves when members provide additional capital.

In nearly all countries there are financial institutions involved in rural financial services delivery, although many have insufficient out-reach. Before a new initiative is started it should be investigated how and under what conditions the out-reach of existing entities can be extended. An appropriate weighing needs to take place with respect to cost efficiency versus proximity to the potential clients. Much attention will have to be paid to the delivery mechanisms used. This can range from fully-fledged offices to mobile units, part time service windows at grocery shops, etc.

Initiators of a completely new structure often argue that existing structures cannot be transformed (option 1) due to their ingrained lack of interest for this sector and political "meddling", or that existing stand-alone institutions - due to their different sponsors and structure (option 2) - cannot be transformed into a viable network. However, these initiators, frequently backed by some major donor, generally insufficiently investigate options 1 and 2, and underestimate the cost - in terms of funds and time - of establishing a completely new, viable, rural banking system.

It is therefore always to be recommended that the existing deficiencies in rural banking in a given situation be thoroughly analysed, including the options for improvement of existing systems and/or privatisation of state financial institutions, before any new initiatives are taken to create new financial institutions from scratch. The establishment of an appropriate policy environment and putting some new policy instruments into the market can in many cases mitigate the problems associated with restructuring/privatisation of existing institutions. This recommendation should also be viewed in the light of the issues discussed in the chapters about market environment, principles for rural finance and lessons learned from the European experience.

### **5.4. *Commercial banks in rural finance***

Just as they did in the European situation in the nineteenth century, commercial banks in emerging markets, countries in transition and developing countries are focussing their banking activities on the so-called top market segment in the urban areas. The reasons given for this approach are the high "perceived" risk in rural and SME financing, high transaction costs for rural financial service delivery, lack of credit track record of new clients, etc. These arguments are further fuelled by the difference in banking culture between urban-based commercial banking and rural-based banking.

Now that a number of MFIs have proved to be highly profitable, some commercial banks are reviewing their strategy towards rural and SME financing. It is expected that commercial banks in some emerging markets will become more active in this segment of the economy.

The preferred approach for commercial banks would be to establish a separate vehicle, possibly a separate legal entity, for rural and SME financing, with its own low cost financial service delivery

system, its own staff, etc. The reason for this is that taking the culture of a commercial bank and the staff attitude to clients in this market segment into account, it will be very difficult to combine the two. Also their regular branch concept is usually very costly and their credit evaluation and risk management systems are not really suitable for rural and SME financing. New IT developments might mitigate some of these disadvantages. The added advantages of a special vehicle or institution are that through the parent bank they have access to the financial markets, to a payment clearing system, etc. For the parent bank the advantage, besides a profitable undertaking, is that it will enlarge their future customer base (clients can graduate fairly easily from one system to the other).

Government policy can enhance this development through specific policy actions such as preferential tax treatment for these institutions and the establishment of some risk sharing, risk mitigation policy instruments. It is anticipated that option 4 is especially relevant for emerging markets, which have an established financial sector in the urban areas and a good and functional legal and policy environment.

## **6. Governance issues**

It is essential that rural finance institutions have a proper governance system that ensures an equilibrium between local decision making and adequate financial discipline. This applies both to the internal mechanisms and to the external controls designed to safeguard depositors.

With respect to the internal mechanism a distinction needs to be made between institutional guidance and control, through the board that acts on behalf of members/shareholders, and the management's responsibility for daily operations. In many (often smaller) institutions there is insufficient separation between these two functions. Board members are too involved in operational practices, including the credit granting process, and this can lead to favouritism, breaches of confidentiality, etc.

In a network organisation it is crucial that local decision making be adequately matched with appropriate control and monitoring exercised by the apex structure, especially with respect to loan granting, operational practices and financial ratios.

In general terms the right balance will have to be established between bottom-up self-determination and responsibility and top-down control and monitoring. The specifics of such an arrangement vary from case to case, depending on factors such as the prevailing legal environment, availability of professional management, etc.

The preferred option for the institutional arrangement is the bottom-up option in which the local boards elect the central governing body, or local advisory committees.

External control and monitoring of rural finance network organisations should preferably be carried out by the National Bank, similar to the situation for other financial institutions that operate in that market. In most countries, the experience with alternative control and monitoring solutions through organisations other than National Banks has not proven satisfactory, as they generally lack the knowledge and experience.

This recommendation also fits in with the earlier conclusion, that rural financial institutions should be preferably governed by national banking laws and have a banking licence.

## **7. Conclusions**

Within the context of this paper it is not possible to elaborate in detail on all the aspects of rural financing, institutional organisational structures, etc., taking into account the widely differing conditions which prevail in different parts of the world. But even so there are a great many similarities in terms of problems, issues, solutions and opportunities.

This paper, based on experience and observations drawn from working in more than 30 countries, tries to find some common denominators in terms of principles for rural finance, solutions for developing sustainable systems of rural finance service delivery systems, trends in the market, etc. With respect to the European experience in co-operative banking, only those elements have been highlighted which are determined to only a limited extent by time and location.

A well functioning rural financial system is a pre-condition for the development of a diversified prosperous rural economy, which is essential for poverty alleviation both in rural and urban areas. A co-operative banking system can play an important role in this development. From a practical point of view this can be best achieved through restructuring/privatisation of existing state institutions and development of a network of existing stand-alone institutions. In some cases the role of commercial banks can also be increased. In each situation a tailor-made solution based on one of the earlier mentioned options and/or a combination of these options needs to be worked out.



# MULTI-SERVICE CO-OPERATIVE FINANCING AND OTHER FACILITIES OF AGRI-FINANCING: JAPAN'S EXPERIENCE

By Mr. Tamotsu Kawamura

## Abstract

*Agricultural co-operatives in Japan are predominantly multi-service, with credit services interacting with other services within the co-operative. This paper discusses the advantages of multi-service co-operative institutions by analysing the characteristics of Japanese agricultural co-operatives, and the key factors for the success of their credit business. The following four factors are noteworthy: a) Sharing agricultural financing among the appropriate financial institutions according to the different financial risks involved; b) Making agricultural finance policy coherent with other agricultural policies, such as price support for agricultural products; c) Pooling and sharing information with other services within the co-operative; d) Establishing trust by members and local communities. This paper also compares finance provided through agricultural co-operatives and through government agricultural credit institutions.*

## 1. Introduction

### 1.1. Focus and objectives of this paper

An economy in transition is in the process of transformation from a socialist to a market-based system. However, even in market economies, the economic situation is constantly evolving. People, companies, governments, and other economic entities are also continuously changing. In that sense, we all are in a situation of transition. From this perspective, the Japanese experience with agricultural co-operatives and their credit operations can be relevant to experts on agricultural finance from so-called transition countries.

In Japan, as well as in many other countries, agricultural co-operatives play a vital role in agriculture and the rural economy. Most people involved in agriculture know what agricultural co-operatives are, how they are organised, and how they work. But the functioning of agricultural co-operatives can vary from country to country depending on the socio-economic conditions that prevail. International experience of agricultural co-operatives can provide useful lessons. This paper discusses the functioning of agricultural co-operatives in Japan. It focuses mainly on the credit (financial) services provided by Japan's multi-service co-operatives and the interactions with other services within the co-operative.

The first section gives some general facts on agricultural investments and their financing in Japan. In the second section, the characteristics of Japan's multi-service type co-operatives are discussed. Section 3 focuses on the credit services of agricultural co-operatives in Japan. And section 4 discusses some important aspects of the Japanese experience that may be relevant for transition economies.

### **1.2.      *The agricultural finance structure in Japan***

In Japan, two main institutions are involved in agricultural finance: agricultural co-operatives and the Agricultural, Forestry, and Fishery Finance Corporation (AFFFC)<sup>1</sup>. Table 1 gives a brief overview of agricultural investment in Japan. The total value of agricultural investment increased in 1950-1970s. But the growth rate has been slowing down since the 1980s, reflecting the declining terms of trade for agriculture in Japan.

The main investment area has been land improvement which is considered a public investment in Japan and is financed by the central and/or local governments. Agricultural machines, farm buildings, animals and permanent plantations are the other major investment area.

As shown in Table 2a and 2b, the largest share of these investments comes from public grants. The second largest item is “Other”, which is mostly self-financing. Government loan programmes, which account for 10% of loans, play an important role. The large share of public grants is a reflection of the substantial investment in land improvement. Land improvement is considered a public investment in Japan in view of the strong national consensus on the need to increase food production.

Table 3 shows the outstanding loans of each financial institution. Agricultural co-operatives account for more than 70% of outstanding loans to agriculture (including loans for farming and non-farming purposes). The agricultural co-operative credit system as a whole, including agricultural co-operatives, the Prefectural Credit Federations of Agricultural Co-operatives, and The Norinchukin Bank<sup>2</sup>, supplies more than 80% of loans for agriculture. The share of loans for purely agricultural purposes has not been reported, but it is certain that agricultural co-operatives are important lenders of funds for agricultural investments.

The Agriculture, Forestry and Fishery Finance Corporation (AFFFC), is another principal creditor. AFFFC is a governmental agricultural finance institution, providing more than 10% of loans for agriculture. The AFFFC loans are mainly for agricultural production.

### **1.3.      *Comparison of the AFFFC and agricultural co-operatives***

The nature of the two principal agricultural finance institutions in Japan is different. The AFFFC is a government financial institution. It concentrates on supplying loans and does not accumulate deposits. The main source of AFFFC funds is the Fund Trust Bureau of the Ministry of Finance. The funds are originally accumulated as postal savings deposits. The government provides capital and subsidies to the AFFFC which implements government policies<sup>3</sup>.

Agricultural co-operatives are legally independent institutions. While the government oversees and regulates their activities, they are independent and self-governed. The credit services of agricultural co-operatives cover collecting deposits and making loans, as well as buying bonds and securities.

- 
1. Madane (1990) provides a useful overview of agricultural co-operatives in Japan in English. Izumida (1988) discusses the Agricultural, Forestry, and Fishery Finance Corporation (AFFFC).
  2. The Norinchukin Bank could be considered as the central bank for agricultural and fishery co-operatives.
  3. See Izumida (1988).

As mentioned above, the AFFFC is a policy-oriented agricultural credit institution. One of its functions is to make loans to promote land improvement. Enhancing land productivity is high on the national policy agenda, as Japan is a small island country where farmland is scarce and food self-sufficiency is unfeasible. Another major agricultural policy objective is to produce farm entrepreneurs whose productivity and competitiveness are comparable with their counterparts in other countries. To achieve this goal, the AFFFC lends to farmers who are expanding their farms.

Table 4 shows the breakdown of AFFFC loans by use. The item “Improvement of Basic Conditions for Agriculture” consists mainly of loans for land improvement. “Structural Improvement of Agricultural Management” represents loans for farm development. As the table shows, these two categories account for the largest share of AFFFC credit, with the predominance of land improvement and other public investment related loans.

Agricultural co-operatives play an important role in the implementation of agricultural policies. The Agriculture Modernisation Loan (AML)<sup>4</sup> is one example. AML loans are provided from the funds of agricultural co-operatives. Central and local government partly reimburse the interest rates on these loans if the activity funded complies with policy objectives. Many farmers have had recourse to the Agriculture Modernisation Loan, which has contributed substantially to the improvement of farm productivity in Japan.

There are several important differences between AFFFC loans and the Agriculture Modernisation Loan, as shown in Table 5 and Table 6. Table 5 summarises the use of the “Super L Loan”. This is one AFFFC scheme for entrepreneurial farmers willing to develop their farms in order to establish efficient and stable farming. Large-scale farmers and/or farmers involved in livestock production are the main beneficiaries of the “Super L loan” and other AFFFC loans. The livestock sector is capital-intensive and investments in this sector are considered to be high-risk. The support provided to target farmers through the AFFFC has contributed to achieving agricultural policy goals. The AFFFC loans have thus worked for the “creative destruction” of Japanese agriculture in the *Schumpeterian* sense.

As shown in Table 6, the beneficiaries of the AML are more diverse. They represent almost all types of farming, including average size farms. Agricultural co-operatives are independent and in principle have to be self-sufficient. Therefore, they are more risk-averse in their lending operations. Also, as agricultural co-operatives are organised by members, they have to serve all their members equally. Even in allocating the AML, which is a government programme credit, agricultural co-operatives tend to spread the loans widely among their members. The same holds for other loans which are not government supported.

In summary, the AFFFC lending activity is strictly policy-based and aimed at supporting innovative and rather risky investments, and loans are larger. Agricultural co-operative loans, including the Agriculture Modernisation Loan, are smaller, member-oriented, and directed to conventional, rather than innovative, investments that carry relatively low risk.

The activity of the AFFFC and agricultural co-operatives is an example of the effective joint effort of government and co-operative banking institutions in implementing the two main objectives of Japanese agricultural policy: developing entrepreneurial farmers with high productivity and managerial skills; and raising agricultural productivity by encouraging investment.

---

4. Egaitsu and Kawamura (1985) analysed the AML.

## **2. Characteristics of multi-service co-operatives in Japan**

This section briefly outlines the main characteristics of agricultural co-operatives<sup>5</sup> in Japan.

### **2.1. *Multi-service agricultural co-operatives***

Two types of agricultural co-operatives can be distinguished in Japan. This paper focuses on multi-service agricultural co-operatives or “*Nokyo*”, in Japanese which means “Agri-Coop”. This type of co-operative renders financial services to its members. The other group, not involved in credit services, consists of smaller co-operatives, whose activities are limited to specific types of farming. They are numerous, but not as influential as the multi-service co-operatives.

### **2.2. *Membership***

There are two categories of memberships in Japanese agricultural co-operatives; regular, and associate or semi-regular. Farmers have the status of regular members. The criteria for granting regular membership are flexible. This category includes many part-time farmers and is quite similar to the membership structure of agricultural co-operatives in other countries. Associate membership, however, does not seem to be common in other countries. The term applies to non-farming residents in rural areas. They join agricultural co-operatives to benefit from services, such as saving deposits, life insurance, purchasing groceries in co-operative stores, etc. While the two forms of membership enjoy similar benefits, regular members have the right to vote at General Meetings, while associate members do not.

According to Figure 1, the total membership of agricultural co-operatives has been increasing. However, the number of regular members has been declining, while that of associate members has been rising. It is interesting that agricultural co-operatives, which are often called farmers’ co-operatives in other countries, include non-farmers as their members in Japan. Due to the membership system, Japanese agricultural co-operatives have very close links with rural communities as a whole and not just with farming.

### **2.3. *Operations***

Japan’s multi-service agricultural co-operatives undertake several services within a common structure. The four main functions are: credit (financial) services; mutual insurance; purchasing (supply); and marketing. In addition to this, multi-service co-operatives are involved in processing; warehousing; advisory services; real estate; day-care services for the elderly; petrol stations; and others. Some even operate bridal and funeral services, and run nursery schools.

The co-operatives also deal in multiple commodities, encompassing almost all commodities produced in Japan. Rice is the major commodity but agricultural co-operatives also deal with other grains, as well as vegetables, fruits, and livestock products.

---

5. See also Madane (1990).

## 2.4. *Three-tier structure*

The agricultural co-operative system in Japan has a three-tier structure: local co-operatives; prefectural federations; and national federations or unions (see Figure 2). The main role of the prefectural federations is to support local co-operatives by providing centralised services that cannot be efficiently organised at the local level. For example, there is a clear economy of scale for the prefectural federations to undertake market research to find the best markets for local co-operatives that then collect the agricultural products and ship them to destinations identified by the prefectural federation. The concept of national federations is the same. They play a support role for member co-operatives and/or the prefectural federations. The functions of the prefectural federations of credit agricultural co-operatives and the Norinchukin Bank are discussed in the next section.

## 2.5. *Scale of operations*

The following quotes from “Agricultural Co-operatives in Japan” illustrate the scale of operations of agricultural co-operatives in Japan. The figures refer to consolidated data on agricultural co-operatives.

*Credit Services:* “Savings at JA<sup>6</sup> at the end of March 1999 are about 69 trillion yen, accounting for about 10% of the total balance of personal deposits in Japan.” Additional information on the scale of the credit business of Japanese agricultural co-operatives is also presented in Table 7.

*Mutual Insurance:* “The share of the total amount of insurance in Japan held by JA insurance at the end of March 1998 is 13% of life insurance, and 14% of damage insurance” *Purchasing (Supply):* “The foundation of the system is made up of warehouses at each JA. As of the end of March 1998, there were 5 678 JA warehouses.”

*Marketing:* “96% of rice and other grains, 56% of vegetables, and 47% of livestock products, are marketed through JA.”

## 2.6. *Financial performance*

Multi-service agricultural co-operatives perform a number of services and it is sometimes difficult to capture the business results separately for each activity. Most Japanese agricultural co-operatives report the surplus-deficit (or profit-loss) by each type of service. This indicator is calculated as:

$$\text{Receipts} - [(\text{Direct costs of the activity}) + (\text{Indirect or Overhead Costs allocated to the activity})]$$

Table 8 illustrates the financial performance of Japanese agricultural co-operatives since 1965, which is confirmed by research<sup>7</sup>. It should be noted, however, that the data on surplus-deficit for each sector to some extent reflect assumptions used in allocating indirect costs.

Since the 1960s, we can observe that credit and mutual insurance services have been constantly in surplus while supply, marketing and other activities have shown a deficit. This is unlikely to have been the case if Japanese agricultural co-operatives had been organised as single-purpose institutions.

---

6. JA stands for “Japanese Agricultural Co-operative”. It is used as a nickname of Agricultural Co-operatives.

7. See Kawamura and Yurugi (1995).

This situation represents a typical cross-subsidising that is often referred to in the literature on industrial organisation. When a multi-product firm supplies the products of one sector at such low prices that the revenue of the products cannot cover a fair share of the cost, cross-subsidy is said to exist<sup>8</sup>. When a cross-subsidy exists, one product sector is setting its product price higher than it should be, and other product sector is setting the price lower than it should be.

Credit and mutual insurance services in Japanese co-operatives are in surplus. This means that these two activities subsidise other services such as supply and marketing. It is interesting to know that lending services are yielding a surplus. And it is also important to understand why agricultural co-operatives set lower prices for supply and marketing services. These questions are discussed in the next section.

## **2.7 Regulation and government support**

Agricultural co-operatives in Japan have maintained good relationships with the government and politicians. Soon after World War II, when there was a real menace of hunger, a consensus was established that agriculture and food production are the most important sectors in Japan. Since then, the government has been implementing policies aimed at supporting agriculture.

For example, the government set the price of rice. Consequently, the producer price for rice was higher than the equilibrium price. The distribution system for rice was strictly regulated from wartime until the 1970s. After the 1970s, the system was gradually deregulated, and in 1995, it was deregulated further by legislation under the New Staple Food Law. Agricultural co-operatives acted as the main players in rice distribution; they could make profits or receive a quasi-rent from rice marketing. Even after deregulation of the system, agricultural co-operatives remained dominant in rice distribution.

Farmers and agricultural co-operatives also enjoy tax benefits. The tax on farmland is quite low and it is often considered that income tax rates are favourable for farmers. The income tax rate for agricultural co-operatives is lower than that for business corporations<sup>9</sup>.

As discussed earlier, the government implements many public investment projects to improve agricultural productivity and/or the living standards of farmers. In addition to these public investments, there are subsidised credit programmes, such as the AFFFC loans and the AML. The government also provides financial support for mergers of agricultural co-operatives in order to increase their size and efficiency.

The government considers co-operatives as important vehicles for the implementation of agricultural policies. Agricultural co-operatives bring together not just farmers but most of the rural community. They are therefore an ideal structure for the government and administrators to communicate policies and projects to farmers and the rural community, and sometimes to persuade them of the usefulness of these policies and projects. From the viewpoint of politicians, agricultural co-operatives are considered to be an effective tool for ensuring votes. Politicians sometimes offer attractive policy packages to farmers and agricultural co-operatives. When considering the characteristics of credit services of Japanese agricultural co-operatives, it is important to understand the close relationship between agricultural co-operatives and politics.

---

8. In literature on industrial organisation, we can find detailed explanations of cross-subsidy. See, for example, Braeutigam (1989) pp. 1337-1342.

9. Kawamura and Yurugi (1995) analysed preferential taxation system for agricultural co-operatives.

### 3. Credit services in multi-service agricultural co-operatives

#### 3.1. Overview of the credit services of agricultural co-operatives

Figure 3 gives a brief overview of the current functioning of credit services in Japan's agricultural co-operative system. The basic functions of credit services are to collect deposits from members and to disburse loans in response to members' needs<sup>10</sup>.

While these functions are undoubtedly filled, there is an imbalance between deposits and loans. As Figure 3 shows, at the local co-operative level, the value of loans (22.1 trillion yen) is much smaller than the value of deposits (72.3 trillion yen). The Loan/Deposit ratio (L/D ratio) was only 30% at the end of March 2000.

There are two reasons for the low L/D ratio. Firstly, members' incomes are strong enough to ensure a high level of savings. Most Japanese farmers are part-time farmers who work in offices or factories as well as in the rice paddy fields. Farmers can sell their land to developers at a high price. So, they have farm income, off-farm income, and sales of farmland as sources of deposits. The substantial market share of agricultural co-operatives in financial services in rural areas, and members' trust in co-operatives ensure a high deposit collection. Secondly, the demand for agricultural investments and loans is quite low among member farmers due to the worsening of agriculture's terms of trade. Although some farmers take out loans and make large-scale investments, the majority of farmers do not, as they are just part-timers. Some large agricultural co-operatives are allowed to invest in securities, but for smaller ones this type of investment is restricted as the value of securities is subject to high variations. Therefore, the only option for many agricultural co-operatives is to deposit the surplus in the prefectural credit federations. The situation is pretty much the same in prefectural credit federations. While they are allowed to invest in securities as they can bear the risks, most of their deposits are transferred to the co-operative Norinchukin Bank. The Norinchukin Bank makes loans not only for farming but also to such industries as food processing, distribution and retailing. The Norinchukin Bank invests in securities, mainly in low-risk ones, for example, Japanese government bonds.

Table 7 gives additional information on co-operative credit. The L/D ratio for the agricultural co-operative system as a whole at around 55% is much lower than that of other financial institutions. The average size of deposits and loans per agricultural co-operative is smaller than for other financing institutions; the average deposit and loan per federation of agricultural co-operatives is comparable with those of credit associations or regional banks in the Second Association; and the average deposit and loan of the Norinchukin Bank is comparable with those of City Banks. The average local agricultural co-operative is a small financial institution, but the prefectural credit federations and the Norinchukin Bank are quite large.

The co-operative credit system and the general co-operative system have a three-tier structure. The system performed particularly well during the period of rapid economic growth, when farmers' incomes were growing and the demand for capital from the industrial sectors was strong. Credit channelled to industry from the agricultural co-operative system was mutually beneficial for farmers and industries. Farmers received income from interest payments and industrial sectors had access to credit for investments.

---

10. Matsuhiro (1988) provides a detailed overview of the credit business of Japanese agricultural co-operatives.

Table 9 shows outstanding farmers' savings and loans. The financial status of Japanese farmers is quite sound. Farmers of every category have much larger savings than loans outstanding. The table does not show the share of deposits in agricultural co-operatives, but it was around 50% in the early 1990s, and is likely to be currently at almost the same level. The share of loans in agricultural co-operatives is around 40% on average, varying from 25% to 60% depending on the farm size. Co-operative credit is an important source of credit for farmers.

### 3.2. Scope economy

Multi-service co-operatives appear to benefit from cost advantages by running plural businesses. This kind of cost saving represents a scope economy. This concept was put forward by Dr. Baumol and his colleagues<sup>11</sup>. Scope economy occurs when a multi-product firm supplies products at a lower cost than the sum of the costs of sole product firms that supply the same products<sup>12</sup>. So, if a scope economy exists, the multi-product firm is more efficient than a sole product firm. In empirical analyses, researchers prefer to use the term "cost complement" rather than economies of scope<sup>13</sup>.

In the early 1990s, I analysed the cost functions of multi-service agricultural co-operatives, and found that economies of scope existed in Japanese multi-service co-operatives in the 1980s. The cost complement occurred between credit business and supply business<sup>14</sup>. But more recent analysis undertaken in the 1990s<sup>15</sup>, does not indicate a clear cost complement. This could be the result of difficulties faced by Japanese agricultural co-operatives in the 1990s, which resulted in organisational changes and mergers.

My analysis of the situation is as follows. Undoubtedly, the scope economy (cost saving effect) of multi-service agricultural co-operatives existed in 1980s when the Japanese economy, agriculture, and agricultural co-operatives enjoyed favourable conditions. But the scope of economy has been lost due to changes in economic conditions in the 1990s. To learn something from the Japanese experience, we need to examine carefully why the scope economy existed.

---

11. See Baumol *et. al.* (1982).

12. Suppose one multi-product is producing  $X_1$  and  $X_2$  jointly, and two single product firms are producing  $X_1$  and  $X_2$ , respectively. The cost function of these firms can be written as:  $C = C(X_1, X_2)$ . When the quantity of one of these products is zero, this cost function can be regarded as the cost function of a single product firm. And we can define the economies of scope as the case where  $C(X_1, 0) + C(0, X_2) - C(X_1, X_2) > 0$  holds. The first two terms represent the cost of producing  $X_1$  and  $X_2$  by two single product firms and the last one represents the cost of producing  $X_1$  and  $X_2$  by one multi-product firm.

13. The cost complement between the 1st and 2nd production sectors ( $CC_{12}$ ) is defined as  $CC_{12} = \frac{\partial^2 C}{\partial X_1 \partial X_2}$ . When  $CC_{12} < 0$ , producing both products jointly is cost effective than producing both products separately.

14. Kawamura (1991).

15. Kawamura (1999).



Theoretical economists argue that the sources of the scope economy were mainly the factors of production that could be used in different business sectors and that were not used to the full extent possible. They often refer to information as the key factor of production. This is discussed further in the next section.

### **3.3. *Factors influencing the credit services of multi-service agricultural co-operatives***

Of the factors of production that are widely used in different activities and not fully utilised, there are several that are important for the credit operations of multi-service agricultural co-operatives. I would like to discuss six of these factors.

#### *A: Transferring receipts from sales of agricultural products through members' accounts in the credit service*

Agricultural co-operatives usually transfer receipts from the sales of agricultural products to member farmers through members' accounts in the credit service. This involves low transaction costs for both member farmers and the co-operative. It also secures a steady flow of cash into the credit business. After the transfer, at least some portion of the deposits is left on the account. This transfer helps agricultural co-operatives to collect savings at low costs.

Table 10 shows the sources of deposit money in 1975 and in 1999. In 1975 when conditions for the agricultural sector were favourable, revenues from sales of rice were an important source of deposits (21.1%). This is clear evidence that the multi-service role of co-operatives worked. In 1999 agricultural conditions were unfavourable, gross sales of rice were falling and net receipts from rice sales were negative. The decline in rice sales and receipts largely contributed to the reduction in co-operatives' deposits in 1999.

#### *B: Internal financing*

The second factor is internal financing. Internal financing means financing within an entity, or re-allocating funds from a surplus sector to a deficit sector within an entity. In Japanese agricultural co-operatives, internal financing implies re-allocating funds from credit and mutual insurance operations to supply and marketing services. Credit and mutual insurance are surplus-generating operations where income exceeds expenditure. The surplus funds are used to offset deficit sectors where funds are insufficient for current operations. The agricultural supply industry is always short of funds as it needs money to pay in advance and goods are often sold on trust. The situation is almost the same in the marketing sector, which needs large funds to be successful. The internal financing arrangement meets the needs of both sides. The credit sector lends to the supply and marketing sectors and earns interests.

#### *C: Information on members*

The scope economy is based on factors of production that are commonly used in different business sectors but not fully utilised. Information is often referred to as an example. The third factor discussed here is the common use of information on member farmers by all the sectors within a co-operative. Information on member farmers is a very important intangible asset of co-operatives.

For example, an employee working in the marketing service may obtain information that a member farmer is planning to introduce a new crop or variety. This information can be transferred to other services to pool their resources to meet the member's needs. The supply service can provide seeds, fertilisers, and chemicals for the new crop, while the credit service can offer a loan for the purchase of a new tractor. Information can be used by all sectors in a multi-service agricultural co-operative. Another example is given in the next section on regulation and protection.

#### *D: Government regulations and support*

Government regulations usually favour agricultural co-operatives. Farmers and farmers' groups, such as agricultural co-operatives, are considered to have a very strong political influence in Japan. Politicians are deeply concerned about the views of the agricultural and rural electorate. All policies concerning agriculture and agricultural co-operatives in Japan, including price policies, marketing regulations, fertiliser price regulation, etc. are quite protective. One of the most important areas of support is financial markets and the financial sector. During the 1950s through the 1970s, money demand was strong. Industry was so bullish that more than 30% of GNP was invested in gross capital formation during this period. Under this situation, the financial sector and financial markets were strictly regulated by the Ministry of Finance and barriers to entry were extremely high. This regulation resulted in excess profits for the financial sector and financial markets especially for city banks. The Norinchukin Bank received interest through call loans to city banks in that situation.

Another example of policies favouring agricultural co-operatives is the fact that only agricultural co-operatives in Japan are allowed to combine credit and insurance operations within the same entity. As far as the insurance services are concerned, it is generally prohibited to operate life and damage insurance in the same company. Although the regulation was abolished in 1996, before that, only agricultural co-operatives were allowed to combine the two types of insurance. As agricultural co-operatives run pluri business, credit and insurance, or life insurance and damage insurance, at the same time, they can exploit the advantages of information sharing.

#### *E: Cross-subsidy*

The importance of cross-subsidy within a multi-service co-operative has already been underlined in section 2. However, the question of why co-operatives have higher profitability in credit services and low profitability in supply and marketing services, has not been addressed yet.

Following on what was said above about government support, it is obvious that protective financial policies were essential to ensuring the high profitability of the credit services of agricultural co-operatives in Japan. Under the strong demand for money, agricultural co-operatives could make profits by collecting members' savings and placing them with the Norinchukin Bank which could in turn make profits by lending these funds to big corporations in industry, buying bonds and securities, or lending money in the call money market.

All the local agricultural co-operatives had to do was to collect savings. They did this by attracting clients through their supply and marketing services. The fees for such services were quite low. For example the margin in the co-operative marketing sector was 2.2%, compared to 8.3% in the wholesale sector and 26.8% in the retailing sector<sup>16</sup>. Multi-service agricultural co-operatives

---

16. See Kawamura and Yurugi (1995) pp. 162-163.

successfully attracted members through their low supply and marketing margins, collected members' savings, and made profits by lending them to industry or buying securities.

#### *F: Members' trust in agricultural co-operatives*

The last factor to be discussed is members' trust in co-operatives. Agricultural co-operatives are embedded in rural communities in Japan, and there are many factors that contribute to members' trust. A co-operative's employees usually come from the local community; employees and member farmers know each other, sometimes they are related. Besides interacting within a co-operative, they participate together in community activities.

As multi-service agricultural co-operatives cover a very wide range of operations, farmers have many opportunities to meet, talk, interact, and work together. When they have a technical problem in agricultural production, they consult the co-operative's farm advisor. When they buy agricultural machines, they seek advice from the co-operative's supply service. Through this process, farmers and co-operative staff understand each other and build strong relations. This trust has naturally contributed to promoting the businesses of multi-service agricultural co-operatives.

### **3.4. Side effects of multi-services**

As mentioned above, multi-service co-operatives have obvious advantages. According to a survey, the managers of credit service of agricultural co-operatives evaluate the principle of multi-services very highly, with about 20% indicating that it is advantageous for credit operations (see Table 11).

But the spin-off effects of multi-services have to be considered as well.

In Japan, the advantages stemming from the multi-service character of a co-operative are based on the regulation/protection of financial markets. Protection often weakens the protected industry. This problem seems to exist in Japanese agricultural co-operatives. One example is stagnating or declining productivity. Table 12 gives an estimate of the total factor productivity of Japanese agricultural co-operatives<sup>17</sup>. There was an upward trend before 1990s, but since then, factor productivity has been stagnant or decreasing. There are numerous reasons for this trend, but it is certain that government regulation and protection are linked to stagnant productivity. Another problem is bad loans that result from a lack of proper evaluation and management.

Multi-service operations can generate difficulties for management and governance. Multi-service agricultural co-operatives certainly have more complex organisation than single-purpose ones and need more sophisticated management to remain efficient.

## **4. Suggestions from Japan's experience**

Agricultural finance institutions have their own history and their own relationships with farmers. It may be pointless to advocate the establishment of multi-service agricultural co-operatives everywhere. The Japanese experience might be based on country-specific factors, and be difficult to generalise. But there must be something that can be transferred to other countries even where the economic conditions are different from those in Japan.

---

17. Kawamura (2000a) and Kawamura (2000b).

#### **4.1. *Appropriate financial system and organisation to cope with risk***

In Japan, two major agricultural finance systems the AFFFC and credit services of agricultural co-operatives, share the tasks of agricultural financing. The AFFFC provides rather risky agricultural loans to larger farmers, while agricultural co-operatives make more regular loans with smaller risks.

The credit services of agricultural co-operatives are also organised on the basis of sharing functions. Agricultural co-operatives at the local (municipal) level collect members' savings, while prefectural credit federations and the Norinchukin Bank concentrate on lending to agriculture related industries and invest in securities. If agricultural co-operatives at the local level had to be responsible for meeting all the money demands of their members, they would be unable to cope with the lending risks and would cease to be viable.

#### **4.2. *Linkage with other agricultural policies***

Agricultural finance is influenced by agricultural finance policies. However, policy goals cannot be achieved through financial measures only. The government has to establish a coherent policy package.

Government policies for rice production and distribution had a very important influence on multi-service agricultural co-operatives in Japan. The pricing policy for rice, regulations on rice trade, and land improvement investments, were all supportive of rice farmers, and had positive implications for agricultural co-operatives. Regulations on the trade and distribution of rice helped agricultural co-operatives to collect rice from farmers to receive fees for marketing rice. The high fixed price for rice increased farmers' gross receipts, which were transferred to members' through their accounts in the credit business. All this favoured the financial performance of the credit services of agricultural co-operatives.

It is important to implement policy measures in a package. Neither agricultural finance nor agricultural finance policy could have worked well without other agricultural policies.

#### **4.3. *Interaction with other agricultural related businesses and common use of information***

Multi-service agricultural co-operatives in Japan exploit the advantages of interaction between various services. In particular, the role of information is important. Multi-service agricultural co-operatives pool information on members, thus reducing the cost of obtaining information. In many countries where agricultural co-operatives are single-purpose, it is difficult to organise them into a multi-service structure. But if these single-purpose co-operatives can form a network or a consortium, the advantages characteristic of multi-service co-operatives can be exploited, such as the common use of information, mutual financing, etc. In this respect, the experience of the Mondragon Co-operatives in Basque, Spain is interesting<sup>18</sup>.

---

18. See Thomas, H. and C. Logan (1982).

#### **4.4.      *Trust by members and communities***

Agricultural co-operatives in Japan bring together not only large farmers, but also small part-time farmers and the non-farming population in rural areas. Agricultural co-operatives deal equitably with all members. They do not discriminate between members according to size or wealth. Co-operatives maintain good relations with the rural communities where they operate and offer many services that meet the needs of the local population.

All these factors create members' trust. Trusting members prefer to operate through their co-operative, even if other types of banks, trading companies, and merchants offer competitive services.

Finally, it is down to the basics. Agricultural co-operatives are organised for members, and by members. Without members, the co-operative is not a co-operative. Members' trust in the agricultural co-operative is the most important factor for their successful business operations.

## **Appendix: Historical outline of multi-service agricultural co-operatives in Japan<sup>19</sup>**

I would like to present a brief history of Japanese agricultural co-operation, which helps to explain the origin of its most important present-day features.

Japanese agricultural co-operatives, as well as other types of co-operatives, have their origin in credit unions, which appeared in the first half of the 19<sup>th</sup> century when Japan was still a feudal monarchy. One such union, “Houtoku-sha”, was established in 1843 by a farmer leader and philosopher Sontoku Ninomiya. The early credit unions evolved from informal local mutual financing groups. They were rather weak and it took several decades for the formal co-operatives and institutional co-operative banking system to emerge.

In 1868, Japan experienced a major transition from feudal to imperial monarchy. The Japanese government opened the country’s borders after 300 years of isolation policy. The government and the Japanese people imported not only new products from Europe or America but also new institutions and new ideas of social, economic and government systems. In 1873, the first institutional bank was established, and in 1882, the central Bank of Japan. In 1889, a Constitution was adopted for the first time in Japanese history.

During this transition period, several co-operatives were established to promote production and sales of members’ products, such as silk and tea.

The Japanese government also promoted industries and agriculture in order to establish a modern economy and society. A Co-operative Society Law was enacted in 1900 authorising the establishment of modern co-operatives in Japan. This law was intended to stimulate the development of “Industrial Co-operatives” (“Sangyo-kumiai”). These co-operatives included not only those set up by the producers in heavy and light industry, but also by farmers, as agriculture was the main sector of Japanese economy at that time.

Under the Co-operative Society Law, single-purpose co-operatives were established, to provide credit, marketing, purchasing services, and for joint use of processing machinery and equipment.

Soon after their establishment, the need for a strong financial foundation to underpin the co-operatives became apparent. Consequently, the Co-operative Society Law was amended to allow industrial co-operatives to run diversified operations. For example, an industrial co-operative with a credit function merged with another industrial co-operative involved in marketing to become a multi-service institution. Another important amendment to the Law concerned the establishment of prefectural and national Federations (or Union) of the industrial co-operatives. These features are maintained in the present-day agricultural co-operation in Japan.

After the World War I and during the 1930s, Japan underwent agricultural slumps. In order to cope with the difficulties, the co-operatives adjusted in two ways. One was to set up prefectural and national federations to support the co-operative operations. The other was to establish a co-operative in every

---

19. The author is heavily indebted to Takeuchi *et al.* (1999) and Agricultural Division, MAFF (2000) to write this appendix. And these two publications present details of the Japanese agricultural co-operatives’ history.

town and village all over Japan by encouraging every farm household to join a co-operative to help the farming population to overcome the economic difficulties. Both adjustments were successful. The National Supply Federation of Co-operatives and the Central Bank for Co-operatives were established in 1923, and at the end of 1937, 76.5% of Japanese farm households participated in co-operatives. Co-operatives existed in 10 618 out of 11 350 administrative units (cities, towns or villages) in Japan. Therefore, co-operatives spread all over Japan during this period and the tradition of high participation of farm households in co-operation began.

During the World War II and the orientation of the economy to the war, the government reorganised industrial co-operatives as well as other agriculture-related organisations and established Agricultural Societies ('Noukai'). During the wartime, every economic activity was under the control of the government; Agricultural Societies served as institutions for the control and distribution of agricultural products and agricultural inputs.

After World War II, the Japanese government faced the crucial problems of how to feed the population facing the real threat of hunger, and how to establish a new democratic society in the country. The government implemented land reform and promoted the establishment of agricultural co-operatives. Under land reform, the landlords had to sell their cultivated lands to the former tenant farmers at low real prices. Consequently, many small private farmers emerged in Japan.

In 1947, the new co-operative law, the Agricultural Co-operative Society Law was enacted. Soon after this agricultural co-operatives were established all over the Japanese Islands, and the Agricultural Societies of the wartime period were abolished. Prefectural and national federations were also re-established in this period. At the beginning, agricultural co-operatives faced financial difficulties. Some of them went bankrupt and were dissolved, but many have survived by merger and/or the efforts of their leaders.

New agricultural co-operatives had some similar features but also some differences compared to the industrial co-operatives of the pre-war period. One of the similarities was that the new co-operatives were multi-service, operating credit, supply, marketing, and other business. As for the differences, the democratic governance system was introduced and co-operatives were not under the landlords' control any more. The new agricultural co-operatives also began mutual insurance business, which has been a profitable activity until present time.

**Table 1. Real Gross Agricultural Capital Formation**

1 000 million Yen, 1995 FY constant; %

| Fiscal Year                          | 1960    | 1970    | 1980    | 1990    | 1998    |
|--------------------------------------|---------|---------|---------|---------|---------|
| Gross Agricultural Capital Formation | 1 321.2 | 3 044.5 | 4 500.6 | 4 186.7 | 4 808.6 |
| Land Improvements                    | 611.0   | 1 325.1 | 2 215.7 | 2 247.9 | 2 974.6 |
| Agricultural Buildings               | 128.0   | 608.8   | 785.2   | 444.4   | 600.9   |
| Agricultural Machines and Implements | 203.6   | 805.6   | 1 276.3 | 1 294.2 | 1 096.7 |
| Plants                               | 97.6    | 159.0   | 108.3   | 81.0    | 47.5    |
| Animals                              | 91.0    | 146.0   | 115.1   | 119.2   | 88.9    |
| Gross Agricultural Capital Formation | 100.0   | 100.0   | 100.0   | 100.0   | 100.0   |
| Land Improvements                    | 46.2    | 43.5    | 49.2    | 53.7    | 61.9    |
| Agricultural Buildings               | 9.7     | 20.0    | 17.4    | 10.6    | 12.5    |
| Agricultural Machines and Implements | 15.4    | 26.5    | 28.4    | 30.9    | 22.8    |
| Plants                               | 7.4     | 5.2     | 2.4     | 1.9     | 1.0     |
| Animals                              | 6.9     | 4.8     | 2.6     | 2.8     | 1.8     |

Source: MAFF, *Economic Accounts for Agriculture and Food Industry 1998, 2000*.

**Table 2a. Agricultural Investment (Nominal Value)**

1 000 million Yen; %

| Fiscal Year                                  | 1970    | 1980    | 1990    | 1998    |
|----------------------------------------------|---------|---------|---------|---------|
| Gross Agricultural Capital Formation         | 1 091.7 | 3 674.4 | 3 910.1 | 4 879.8 |
| Capital Trade within the Agricultural Sector | 284.9   | 404.3   | 378.2   | 293.5   |
| Buying Farm Land                             | 168.6   | 285.3   | 306.1   | 253.4   |
| Total                                        | 1 376.6 | 4 078.8 | 4 288.3 | 5 173.3 |
| Gross Agricultural Capital Formation         | 79.3    | 90.1    | 91.2    | 94.3    |
| Capital Trade within the Agricultural Sector | 20.7    | 9.9     | 8.8     | 5.7     |
| Buying Farm Land                             | 12.2    | 7.0     | 7.1     | 4.9     |
| Total                                        | 100.0   | 100.0   | 100.0   | 100.0   |



Table 2b. **Source of Agricultural Investment (Nominal Value)**

1 000 million Yen; %

| Fiscal Year                    | 1970    | 1980    | 1990    | 1998    |
|--------------------------------|---------|---------|---------|---------|
| Public Grants                  | 300.9   | 1 492.2 | 1 711.1 | 2 592.5 |
| Trust Fund Bureau Fund         | 12.6    | 61.1    | 137.0   | 77.1    |
| Government Programme Loans     | 300.2   | 793.0   | 644.3   | 446.1   |
| AFFFC                          | 152.8   | 462.1   | 325.7   | 270.2   |
| Agriculture Modernisation Loan | 135.2   | 304.3   | 270.2   | 155.8   |
| Other                          | 12.2    | 26.6    | 48.4    | 20.1    |
| Other                          | 762.9   | 1 732.4 | 1 796.0 | 2 057.6 |
| Total                          | 1 376.6 | 4 078.7 | 4 288.3 | 5 173.3 |
| Public Grants                  | 21.9    | 36.6    | 39.9    | 50.1    |
| Trust Fund Bureau Fund         | 0.9     | 1.5     | 3.2     | 1.5     |
| Government Programme Loan      | 21.8    | 19.4    | 15.0    | 8.6     |
| AFFFC                          | 11.1    | 11.3    | 7.6     | 5.2     |
| Agriculture Modernisation Loan | 9.8     | 7.5     | 6.3     | 3.0     |
| Other                          | 0.9     | 0.7     | 1.1     | 0.4     |
| Other                          | 55.4    | 42.5    | 41.9    | 39.8    |
| Total                          | 100.0   | 100.0   | 100.0   | 100.0   |

Source: MAFF, *Economic Accounts for Agriculture and Food Industry 1998, 2000*.

Table 3. Outstanding Loans and Discounts for Agriculture, Forestry and Fisheries by Financial Institution, March 2000

100 million Yen; %

| Financial Institutions                    |                                                              | Outstanding Loan & Discounts |       |                 |             |              |
|-------------------------------------------|--------------------------------------------------------------|------------------------------|-------|-----------------|-------------|--------------|
|                                           |                                                              | Grand Total                  |       | For Agriculture |             | (B)/(A)<br>% |
|                                           |                                                              | Value<br>(A)                 | %     | Value<br>(B)    | %           |              |
| Private<br>Financial<br>Institutions      | Domestically Licensed Banks                                  | 4 616 799                    | 68.3  | 9 646           | 4.1         | 0.2          |
|                                           | City Banks                                                   | 2 141 530                    | 31.7  | 3 511           | 1.5         | 0.2          |
|                                           | Regional Banks                                               | 1 340 163                    | 19.8  | 4 423           | 1.9         | 0.3          |
|                                           | The Second Association of Regional Banks                     | 505 519                      | 7.5   | 1 519           | 0.6         | 0.3          |
|                                           | Trust Banks                                                  | 312 775                      | 4.6   | 59              | 0.0         | 0.0          |
|                                           | Long-Term Credit Banks                                       | 316 811                      | 4.7   | 132             | 0.1         | 0.0          |
|                                           | Credit Associations                                          | 687 157                      | 10.2  | 3 602           | 1.5         | 0.5          |
|                                           | Other                                                        | 234 497                      | 3.5   | 39              | 0.0         | 0.0          |
| Sub-Total                                 |                                                              | 5 538 453                    | 81.9  | 13 287          | 5.7         | 0.2          |
| Co-operative<br>Financial<br>Institutions | <b><i>The Norinchukin Bank</i></b>                           | 209 224                      | 3.1   | 10 382          | <b>4.4</b>  | <b>5.0</b>   |
|                                           | <b><i>Prefectural Credit Federations of Agri. Co-ops</i></b> | 59 533                       | 0.9   | 16 218          | <b>6.9</b>  | <b>27.2</b>  |
|                                           | <b><i>Agri. Co-ops</i></b>                                   | 212 880                      | 3.1   | 169 708         | <b>72.5</b> | <b>79.7</b>  |
|                                           | Prefectural Credit Federations of Fishery Co-ops             | 8 293                        | 0.1   | 0               | 0.0         | 0.0          |
|                                           | Fishery Co-ops                                               | 2 079                        | 0.0   | 0               | 0.0         | 0.0          |
| Sub-Total                                 |                                                              | 492 009                      | 7.3   | 196 308         | 83.8        | 39.9         |
| Governmental<br>Financial Institutions    | <b><i>Agri. Forest. Fish. Finance Corp. (AFFFC)</i></b>      | 40 810                       | 0.6   | 23 802          | <b>10.2</b> | <b>58.3</b>  |
|                                           | Other                                                        | 691 714                      | 10.2  | 769             | 0.3         | 0.1          |
| Sub-Total                                 |                                                              | 732 524                      | 10.8  | 24 571          | 10.5        | 3.4          |
| Grand Total                               |                                                              | 6 762 986                    | 100.0 | 234 166         | 100.0       | 3.5          |

Source: Norinchukin Research Co. Ltd. (ed.), *Financial Statistics of Agriculture, Forestry and Fisheries in Japan*, 2000, pp.38-39.

**Table 4. Outstanding Loans of the AFFFC by Use, March 2000**

Million Yen; %

|                                                 | Amount    | share (1) | share (2) |
|-------------------------------------------------|-----------|-----------|-----------|
| Agriculture Sub-Total                           | 2 380 171 | 58.3      | 100.0     |
| Structural Improvement of Agri. Management      | 766 730   | 18.8      | 32.2      |
| Improvement of Basic Conditions for Agriculture | 1 209 012 | 29.6      | 50.8      |
| Joint Use Facilities                            | 192 922   | 4.7       | 8.1       |
| Facilities Authorised by Competent Minister     | 87 888    | 2.2       | 3.7       |
| Maintenance Farming with Ownership of Land      | 123 555   | 3.0       | 5.2       |
| Forestry Sub-Total                              | 1 026 529 | 25.2      | -         |
| Fishery Sub-Total                               | 170 873   | 4.2       | -         |
| Processing & Distribution Sub-Total             | 503 458   | 12.3      | -         |
| Grand Total                                     | 4 081 031 | 100.0     | -         |

*Source: Annual Statistics of Business, AFFFC.*

**Table 5. Comprehensive Loan Programme for Development of Enterprises (“Super L” Loan) by Types of Farming, 1999 Fiscal Year**

Million Yen; %

|                            | Amount | Share |
|----------------------------|--------|-------|
| Crop Cultivation Sub-Total | 22 108 | 43.6  |
| Rice                       | 7 591  | 15.0  |
| Upland farming             | 3 535  | 7.0   |
| Vegetables                 | 1 738  | 3.4   |
| Tea                        | 2 015  | 4.0   |
| Fruit                      | 700    | 1.4   |
| Greenhouse Vegetables      | 3 325  | 6.6   |
| Greenhouse Flowers         | 2 411  | 4.8   |
| Other                      | 793    | 1.6   |
| Livestock Sub-Total        | 27 378 | 54.1  |
| Dairy                      | 11 779 | 23.3  |
| Beef                       | 3 265  | 6.4   |
| Pigmeat                    | 5 689  | 11.2  |
| Eggs                       | 3 594  | 7.1   |
| Other                      | 3 051  | 6.0   |
| Mushrooms                  | 1 165  | 2.3   |
| Grand Total                | 50 651 | 100.0 |

*Source: Trend in Agricultural, Forestry and Fisheries Finance, 2000.*

**Table 6. Agriculture Modernisation Loan (AML) by Types of Farming, 1999 Fiscal Year**

%

|                           |       |       |
|---------------------------|-------|-------|
| Crop Cultivation Subtotal |       | 78.8  |
|                           | Rice  | 23.4  |
|                           | Fruit | 6.3   |
|                           | Other | 49.1  |
| Livestock Subtotal        |       | 15.2  |
| Fixed Investment          |       | 6.0   |
| Grand Total               |       | 100.0 |

*Source: Trend in Agricultural, Forestry and Fisheries Finance, 2000.*

**Figure 1. Membership of Agricultural Co-operatives**

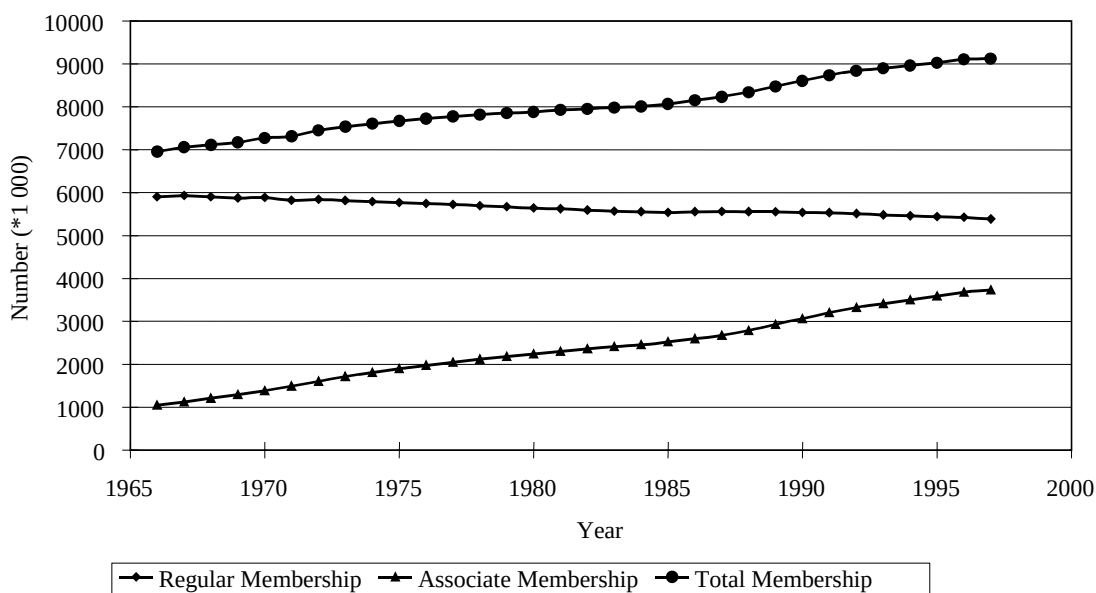


**Figure 2. Organisation of the Agricultural Co-operative System in Japan**

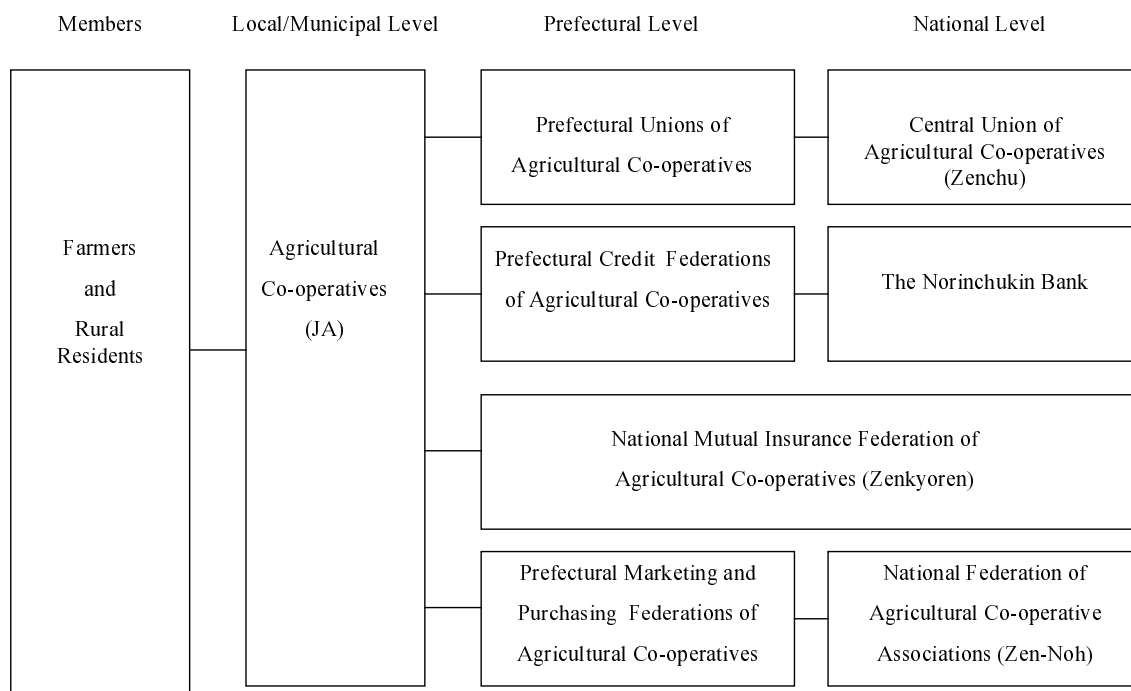


**Table 7. Size and Efficiency of Credit Institutions by Types  
(As of end March 1999)**

1 000 million Yen; %

|                                          | Number<br>A | Deposits<br>B   | Loans<br>C      | Offices<br>D  | Employees<br>E | L/D ratio<br>C/B |
|------------------------------------------|-------------|-----------------|-----------------|---------------|----------------|------------------|
| <b><i>Agricultural Co-operatives</i></b> | <b>1736</b> | <b>68 996.3</b> | <b>22 026.0</b> | <b>14 390</b> | <b>69 034</b>  | <b>31.9</b>      |
| Pref. Credit Federations of Agri. Co-ops | 47          | 47 108.8        | 6 555.2         | 112           | 7 806          | 13.9             |
| The Norinchukin Bank                     | 1           | 34 967.1        | 17 257.4        | 40            | 2 858          | 49.4             |
| Sum of Agri. Co-ops Credit System        | 1784        | 83 073.6        | 45 364.1        | 14 542        | 79 698         | 54.6             |
| Credit Cooperatives                      | 322         | 20 219.0        | 15 420.4        | 2 432         | 30 600         | 76.3             |
| Credit Associations                      | 396         | 100 592.3       | 71 206.0        | 8 673         | 145 573        | 70.8             |
| The Second Assoc. of Regional Banks      | 57          | 63 532.3        | 52 720.6        | 4 020         | 71 004         | 83.0             |
| Regional Banks                           | 64          | 173 305.6       | 138 243.9       | 7 078         | 155 350        | 79.8             |
| City Banks                               | 9           | 246 229.8       | 211 003.8       | 2 641         | 124 525        | 85.7             |

|                                          | per institution |             |            |             |
|------------------------------------------|-----------------|-------------|------------|-------------|
|                                          | Deposits        | Loans       | Offices    | Employees   |
|                                          | B/A             | C/A         | D/A        | E/A         |
| <b><i>Agricultural Co-operatives</i></b> | <b>39.7</b>     | <b>12.7</b> | <b>8.3</b> | <b>39.8</b> |
| Pref. Credit Federations of Agri. Co-ops | 1 002.3         | 139.5       | 2.4        | 166.1       |
| The Norinchukin Bank                     | 34 967.1        | 17 257.4    | 40.0       | 2 858.0     |
| Credit Co-operatives                     | 62.8            | 47.9        | 7.6        | 95.0        |
| Credit Associations                      | 254.0           | 179.8       | 21.9       | 367.6       |
| The Second Assoc. of Regional Banks      | 1 114.6         | 924.9       | 70.5       | 1 245.7     |
| Regional Banks                           | 2 707.9         | 2 160.1     | 110.6      | 2 427.3     |
| City Banks                               | 27 358.9        | 23 444.9    | 293.4      | 13 836.1    |

Source: MAFF, *Present State of Agricultural Finance 2000*, 2001.

**Table 8. Net Profit and Loss of the Co-operatives' Business Sectors**

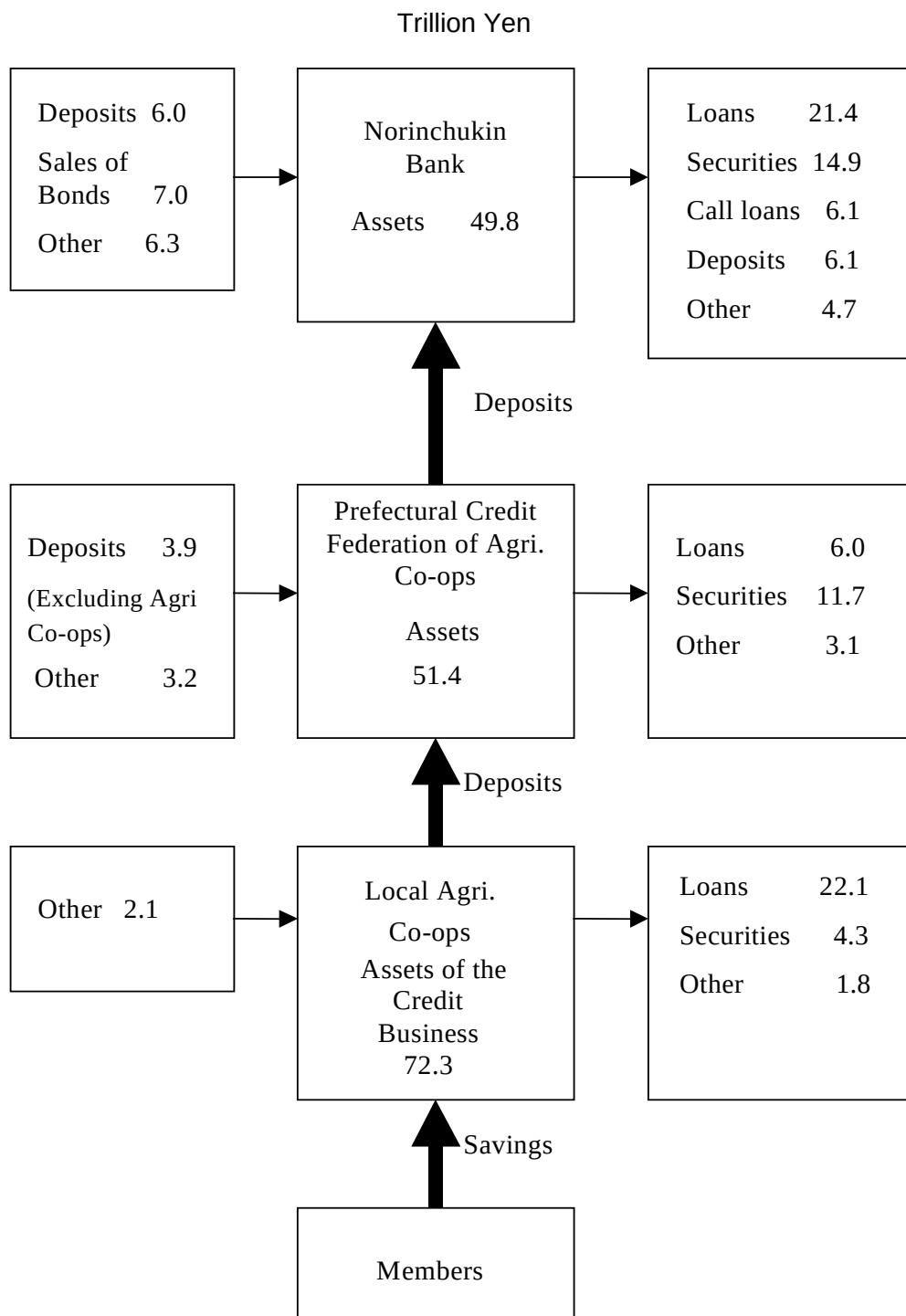
1 000 Yen; %

| Year | Credit<br>Insurance | Mutual  | Supply<br>(Purchasing) | Marketing | Other   | Total   |
|------|---------------------|---------|------------------------|-----------|---------|---------|
| 1965 | 8 417               | 716     | -1 653                 | -1 552    | -3 509  | 2 419   |
| 1970 | 18 340              | 1 456   | -4 954                 | -4 676    | 329     | 10 495  |
| 1975 | 54 484              | 13 636  | -13 059                | -7 654    | -17 697 | 29 710  |
| 1980 | 65 879              | 37 595  | -13 259                | -14 030   | -21 515 | 54 670  |
| 1985 | 101 687             | 58 941  | -23 746                | -13 025   | -23 348 | 100 509 |
| 1990 | 120 753             | 88 240  | -36 130                | -22 398   | -27 574 | 122 891 |
| 1995 | 128 605             | 150 707 | -80 268                | -38 226   | -41 979 | 118 839 |
| 1998 | 160 195             | 226 535 | -118 443               | -54 650   | -73 980 | 139 657 |
| 1965 | 348.0               | 29.6    | -68.3                  | -64.2     | -145.1  | 100.0   |
| 1970 | 174.7               | 13.9    | -47.2                  | -44.6     | 3.1     | 100.0   |
| 1975 | 183.4               | 45.9    | -44.0                  | -25.8     | -59.6   | 100.0   |
| 1980 | 120.5               | 68.8    | -24.3                  | -25.7     | -39.4   | 100.0   |
| 1985 | 101.2               | 58.6    | -23.6                  | -13.0     | -23.2   | 100.0   |
| 1990 | 98.3                | 71.8    | -29.4                  | -18.2     | -22.4   | 100.0   |
| 1995 | 108.2               | 126.8   | -67.5                  | -32.2     | -35.3   | 100.0   |
| 1998 | 114.7               | 162.2   | -84.8                  | -39.1     | -53.0   | 100.0   |

Source: MAFF, Zenchu, *Management Analysis of Agricultural Co-operatives*.

Note: Numbers are averages (per agricultural co-operative).

Figure 3. Flow of Funds, end of March 2000



Source: MAFF, *Present State of Agricultural Finance*, 2001.



Table 9. **Farm Households' Outstanding Savings and Loans, 31 March 1999**

1 000 Yen per Farm Household; %

|                                |              | Average  | Size of Cultivated Land |           |           |           |           |           |           |                      |
|--------------------------------|--------------|----------|-------------------------|-----------|-----------|-----------|-----------|-----------|-----------|----------------------|
|                                |              |          | <0.5 ha                 | 0.5 - 1.0 | 1.0 - 1.5 | 1.5 - 2.0 | 2.0 - 3.0 | 3.0 - 5.0 | 5.0 - 7.0 | 7.0 - 10.0 10.0 ha < |
| Cash                           | (1)          | 232.5    | 297.3                   | 245.4     | 251.6     | 224.4     | 216.1     | 194.6     | 220.7     | 174.0 306.5          |
| Savings Sub-Total              | (2)          | 29 672.4 | 33 259.9                | 30 975.4  | 30 639.3  | 26 989.3  | 25 201.4  | 24 459.9  | 29 432.4  | 23 475.7 26 080.6    |
| Savings                        | (3)          | 18 779.8 | 22 060.5                | 19 947.6  | 19 442.2  | 16 133.3  | 15 075.5  | 14 458.2  | 20 130.0  | 13 486.9 13 939.0    |
| Securities                     | (4)          | 624.3    | 715.4                   | 673.5     | 633.1     | 590.6     | 459.6     | 515.2     | 471.7     | 359.4 565.9          |
| Other                          | (5)          | 10 268.3 | 10 484.0                | 10 354.3  | 10 564.0  | 10 265.4  | 9 666.3   | 9 486.5   | 8 830.7   | 9 629.4 11 575.7     |
| Loans Sub-Total                | (6)          | 2 933.8  | 2 954.2                 | 2 249.4   | 2 454.3   | 2 823.5   | 4 305.3   | 4 350.7   | 7 457.1   | 7 923.0 13 917.1     |
| Governmental Banks             | (7)          | 284.0    | 133.5                   | 161.3     | 261.8     | 110.6     | 295.0     | 839.7     | 1 440.3   | 3 141.4 6 468.3      |
| Agricultural Co-operatives     | (8)          | 1 165.7  | 749.7                   | 897.2     | 840.5     | 1 470.9   | 1 664.7   | 2 140.5   | 4 568.9   | 3 880.6 4 866.9      |
| Other                          | (9)          | 1 484.1  | 2 071.0                 | 1 190.9   | 1 352.0   | 1 242.0   | 2 345.6   | 1 370.5   | 1 447.9   | 901.0 2 581.9        |
| Debt/Savings Ratio             | (10)=(6)/(2) | 9.9      | 8.9                     | 7.3       | 8.0       | 10.5      | 17.1      | 17.8      | 25.3      | 33.7 53.4            |
| Share of Govenmental Bank Loan | (11)=(7)/(6) | 9.7      | 4.5                     | 7.2       | 10.7      | 3.9       | 6.9       | 19.3      | 19.3      | 39.6 46.5            |
| Share of Agri. Co-ops Loan     | (12)=(8)/(6) | 39.7     | 25.4                    | 39.9      | 34.2      | 52.1      | 38.7      | 49.2      | 61.3      | 49.0 35.0            |
| Share of Other Loan            | (13)=(9)/(6) | 50.6     | 70.1                    | 52.9      | 55.1      | 44.0      | 54.5      | 31.5      | 19.4      | 11.4 18.6            |

Source: MAFF, *Farm Household Survey*, 1998.

Note: The data are for commercial farm households, cultivating over 0.3 ha of farm land or with sales over 500 thousand yen (Hokkaido Island not included).

Table 10. **Deposits in Agricultural Co-operatives by Source**

%

| Year                                        | 1975  | 1999  |
|---------------------------------------------|-------|-------|
| Sample Size                                 | 468   | 306   |
| Agricultural Revenue Sub-Total              | 39.7  | -5.8  |
| Sales of Rice                               | 21.1  | -4.1  |
| Sales of Other Products                     | 18.6  | -1.7  |
| Non-Agricultural Revenue Sub-Total          | 40.8  | 59.6  |
| Off-Farm Income                             | 26.3  | 16.5  |
| Pensions                                    | -     | 20.1  |
| Other                                       | 14.5  | 22.9  |
| Transfers from Other Financial Institutions | -     | 18.4  |
| Sales of Farm Land                          | 19.5  | 24.4  |
| Other                                       | -     | 3.4   |
| Total                                       | 100.0 | 100.0 |

Source: *The Norin Kinyu Monthly Review of Agriculture, Forestry and Fishery Finance*, Dec., 2000, p. 29.  
*Facts on Agricultural and Fishery Finance 1976*,  
The Norinchukin Bank, 1976, p. 98.

**Table 11. Strengths of Agricultural Co-operative Finance**

Number of Co-ops; %

|                                                        | Number of<br>Answers | Share |
|--------------------------------------------------------|----------------------|-------|
| Credit Business within a Multi-purpose Co-op           | 58                   | 18.3  |
| Close Relationship with Members                        | 50                   | 15.8  |
| Visiting Members by Co-op Employees                    | 47                   | 14.8  |
| Close Relationship with Local Community                | 39                   | 12.3  |
| Soundness of Management                                | 32                   | 10.1  |
| Relationship with the Local Government/ Administration | 26                   | 8.2   |
| Being a regional Financial Institution                 | 25                   | 7.9   |
| Reliability                                            | 24                   | 7.6   |
| Availability of Branch Offices                         | 22                   | 6.9   |
| Ways of Operating Credit Business                      | 19                   | 6.0   |
| Bank Account for Pension Payment                       | 18                   | 5.7   |
| Strong Demand for Loans                                | 14                   | 4.4   |
| High Quality and Morale of the Employees               | 9                    | 2.8   |
| No Merits                                              | 3                    | 0.9   |

*Source: The Norin Kinyu: Monthly Review of Agriculture, Forestry and Fishery Finance, Jan., 2001, p. 74.*

*Note:* Answers from a sample of 317 agricultural co-operatives.  
Multiple answers.

**Table 12. Average Annual Productivity Indexes**

%

| Period    | Labor<br>Productivity | Capital<br>Productivity | Total Factor<br>Productivity |
|-----------|-----------------------|-------------------------|------------------------------|
| 1966-1973 | 7.83                  | 8.06                    | 7.77                         |
| 1973-1990 | 2.03                  | -2.18                   | 0.92                         |
| 1990-1996 | 1.63                  | -1.91                   | 0.64                         |
| 1966-1996 | 3.27                  | 0.17                    | 2.42                         |

*Source:* Kawamura (2000), p. 368.

## BIBLIOGRAPHY

- AFFFC,  
*Annual Statistics of Business*, AFFFC (in Japanese).
- Agricultural Co-operatives Division, Ministry of Agriculture, Forestry and Fisheries (ed.),  
*Agricultural Co-operatives in Japan*.
- Baumol, W.J., J.C. Panzar, and R.D. Willig (1982),  
*Contestable Market and the Theory of Industrial Structure*, Harcourt Brace Jovanovich.
- Braeutingham, R.R. (1989),  
Optimal Policy for Natural Monopolies, in R. Schmalensee and R.D. Willig (eds.), *Handbook of Industrial Organisation, Volume II*, Elsevier Science Publishers, pp. 1337-1342.
- Egaitsu, Fumio, and Tamotsu Kawamura (1985),  
Significance and Roles of the Agriculture Modernisation Loan, in Henmi, K. and Y. Kato (eds.), *Economic Analysis of Agricultural Fundamental Policies*, Meibun-shobo, pp. 556-568 (in Japanese).
- Higuchi, Teizo, and Tamotsu Kawamura (1988),  
Savings Behaviour and Debt Problems in Farm Households, in *Farm Finance and Agricultural Development*, Asian Productivity Organisation, pp. 173-200.
- Izumida, Yoichi (1988),  
Status of Government-Programmed Agricultural Loans (GPALs) in Japan, in *Farm Finance and Agricultural Development*, Asian Productivity Organisation, pp. 315-331.
- Kawamura, Tamotsu (1991),  
Economies of Scale and Scope in Multipurpose Agricultural Co-operatives: Multiproduct Cost Function Approach, *Journal of Rural Economics*, Vol. 63, No. 1, pp. 22-31 (in Japanese).
- Kawamura, Tamotsu, and Takao Yurugi (1995),  
“Profit-Loss Structure of Multipurpose Agricultural Co-operatives by Business Sector”, in Egaitsu, Fumio, and Teizo Higuchi (eds.), *Industrial Organisation of Japanese Agribusiness*, University of Tokyo Press, pp. 149-170 (in Japanese).
- Kawamura, Tamotsu (1991),  
A Reconsideration of Cost Function Analysis of Multipurpose Agricultural Co-operatives, *Journal of Rural Economics (Special Issue)*, pp. 231-236 (in Japanese).
- Kawamura, Tamotsu (2000a),  
Empirical Study on the Measurement and Factors of Total Factor Productivity of Agricultural Co-operatives, in *Reports on Granted Studies on Co-operatives*, No. 25, pp. 343-380 (in Japanese).

- Kawamura, Tamotsu (2000b),  
*What Caused Ups and Downs of Japanese Agricultural Co-operatives?: A TFP Approach*,  
 Paper presented at the IAMA Food and Agribusiness Forum in Chicago.
- Madane, M.V. (1990),  
*Agricultural Co-operatives in Japan: The Dynamics of Their Development*, International  
 Co-operative Alliance Regional Office for Asia & the Pacific.
- MAFF (2000),  
*Economic Accounting of Agriculture and Food related Industry 1998* (in Japanese).
- MAFF (1998),  
*Farm Household Survey* (in Japanese).
- MAFF, Zenchu,  
*Management Analysis of Agricultural Co-operatives* (in Japanese).
- MAFF (2001),  
*Present State of Agricultural Finance 2000* (in Japanese).
- MAFF (2000),  
*Trend in Agricultural, Forestry and Fisheries Finance* (in Japanese).
- Matsuhiro, Midori (1988),  
 Agricultural Co-operative Banking, in *Farm Finance and Agricultural Development*, Asian  
 Productivity Organisation, pp. 139-153.
- The Norinchukin Bank (1976),  
*The Facts of Agricultural and Fishery Finance 1976* (in Japanese).
- Norinchukin Research Co. Ltd. (ed.) (2000),  
*Financial Statistics of Agriculture, Forestry and Fisheries in Japan*, The Norinchukin Bank.
- Norinchukin Research Co. Ltd. (2000),  
*The Norin Kinyu: Monthly Review of agriculture, Forestry and Fishery Finance*,  
 December 2000 (in Japanese).
- Norinchukin Research Co. Ltd. (2001),  
*The Norin Kinyu: Monthly Review of Agriculture, Forestry and Fishery Finance*, January 2001  
 (in Japanese).
- Takeuchi, Tetsuo, *et. al.* (1999),  
*Agricultural Co-operatives (New edition)*, Central Union of Agricultural Co-operatives of Japan  
 (in Japanese).
- Thomas, H. and C. Logan (1982),  
*MONDRAGON: An Economic Analysis*, George Allen & Unwin.

# ROMANIAN BANCA AGRICOLA: AGONY AND ECSTASY

By Mr. Eugen Radulescu

## Abstract

*Born in the 19<sup>th</sup> century, Banca Agricola (BA) experienced wide and abrupt swings across time, and the last decade was one of the most agitated; from rapid expansion and actively traded shares in the stock exchange market in early '90s, to the brink of a failure starting, in 1997, and a new fresh start, in 2001, along with its privatisation. The paper discusses the main features of each period during the decade, and tries to draw lessons from that experience.*

*The governmental policy to channel huge amounts to agriculture – rather untransparently, through subsidised credits, using BA's network – favoured the bank's rapid advance in the first part of the decade; however, disequilibria and unsustainable features were accumulated, primarily because long term policies were based on short term developments. Against this background, the authorities' decision to launch the largest-ever subsidised credit to agriculture, in 1996, brought BA to a "technically bankrupt" situation.*

*Three years of half-hearted restructuring followed, a period plagued by piece-meal approach, half measures and diluted responsibilities for the individuals involved in managing that process. Therefore, sensible measures to downsize the bank and to reorganise its functions were accompanied by eccentric investments and, in fact, no clear direction for the bank's future.*

*Towards end-1999, the last attempt to restructure and privatise the bank was launched. This time, with crystal-clear and very tough rules of the game, precise responsibilities and better support. The paper discusses the main direction of the bank's restructuring: measures aimed at maintaining public confidence; sharp reduction in overall costs and in employment; special focus on the bank's strengths, which directed it towards retail banking; and the most important of all, constant efforts for a deep cultural change among the bank's staff. Encouraging results in the restructuring process, together with more favourable externalities led to a successful privatisation. Together with its new major shareholder, Raiffeisen Zentralbank AG, Banca Agricola is prepared for a fresh start.*

## I. A touch of history

In the last quarter of the 19<sup>th</sup> century, Romania had gained its independence and had launched a dramatic race to catch up with western civilisation. Banking was among the front running industries. The National Bank (NBR) was born in 1880, and the bank's palace, a stately building, was erected a few years later, in the very heart of Bucharest, on Lipscani Street. Banking was booming and a genuine "city" was built around the central bank, at the beginning of the 20<sup>th</sup> century. Before World War II, some 400 banks were operational in Romania, and the most eminent had their headquarters in the proximity of the NBR.

Most of those buildings are still there, and some have remained bank premises. One is the NBR, whose palace was extended with the so-called "new wing" (actually, built in the 1930s), and a smaller building, once owned by a bank, which had gone under. Across the street, there is the Romanian

Development Bank, which is now a part of “Société Générale Groupe”. On the other side of the same square is Banca Agricola’s (BA) building, which witnesses a tradition born in the 19<sup>th</sup> century.

The bank was born in 1896 – one of the oldest Romanian banks which still operates in its original premises. In fact, the history was not particularly “lean and mean”. The bank began with great promise - the baroque building of its headquarters is a living proof - and developed quite a wide network. However, it went under during the Great Depression, before re-launching its activities in the mid 1930s, when its business success was materialised, among others, in erecting two more stories to the original building of its headquarters.

In 1948 the communist regime discontinued the activity of all banks, but one (the NBR). Only in the '60s, duplicating the soviet system, Romania’s rulers decided to reopen a few “specialised” banks, among which was BA (in its traditional premises, but under a new name: Bank for Agriculture and Food Industry). Soon after the collapse of that regime and immediately after the relevant legislation was passed, in 1990, Banca Agricola was registered as a stock company. A new start, which, once again, was the beginning of a decade of swings and full of lessons, that I think deserve to be shared.

## **II. Macroeconomic conditions in the '90s**

The collapse of communism found Romania in a terrible condition: exhausted after the full repayment of its external debt, with the economy plagued by huge imbalances and one of the lowest GDP per capita in Europe. The banking system was represented by 4 commercial banks (emerging from the formerly “specialised banks”) and the central bank (whose commercial activity was taken over by a newly created entity). I will not elaborate on that period more than it may be useful for the purpose of this paper. Therefore, I will limit myself to a number of events, or policy decisions that had an impact on BA’s development.

- The NBR set stringent rules to authorise the creation of a bank (among which, minimum capital requirements in excess of USD 5 million to be fully disbursed in cash). Consequently, the country did not face the problems created by mushrooming small (and weak) banks, with all the inconveniences associated to such practices - very well known in some neighbouring countries. But the system imposed by the NBR had its own drawbacks - among which, a somewhat slower penetration of banking into smaller cities, and hence additional incentives for existing banks to rapidly expand both in the territory and with the range of services that they provided. All in all, it is obviously better to have fewer and - arguably - stronger banks, than (too) many small and probably weaker banks. However, the existing large banks were weakened by an expansion, which they had not enough means and incentives to carry out properly.
- Throughout the past decade, rampant inflation plagued the Romanian economy. While it never crossed the hyperinflation threshold, triple digit annual price increases in 1990-1993, and around 50% per year during 1994-2000 constitute one of the weakest performances among transition economies. I will not discuss causes, but one of the most significant effects has been a severe burden for investors across the economy, and particularly for those industries whose “raw material” is money. Obviously, real balances sharply eroded and investment decisions had little support from a well-founded cost-benefit analysis; long-term credits almost disappeared and real value of short-term credit tumbled. Banks were weakened by their capital erosion and insufficient means to assess their customers’ credit worthiness.

- The main source for inflation was provided by the central bank through preferential credits to support “privileged industries”, according to governmental policies. There were three main fields of activity (energy, export, and agriculture) that were subsidised via soft loans, and two state-owned banks, which acted as governmental agencies in disguise (Bancorex and BA). Again, I will not elaborate on the success of such policies for the above-mentioned fields. It is well known that the road to hell is paved with good intentions, and governments’ attempts to regulate any particular industry by denying market-forces is exactly that<sup>1</sup>. The banks involved in that process were in perfect shape as long as cheap money kept coming, but they paid dearly afterwards: one did not survive (Bancorex) and BA was also almost there.

### **III. The first half-decade: the roots of evil**

Favoured by the conditions outlined above, BA experienced a period of rapid expansion from 1991. The number of outlets, of clients, staff and, quite surprisingly, real profits, all expanded sharply, year after year (Chart 1: BA indicators, 1991-1996). The main trigger - that eventually proved to be the most significant weakness of BA - was a high level of resources devoted to agriculture by the government. During that period, the bank developed a number of appealing features. Thus, BA was among the first publicly traded companies, starting as early as 1992. In 1993, when the first subscription was completed, more than 15 000 natural and legal persons had subscribed more than 1 million new shares, thus diluting the state-owned part to 57.4% of the total.

At end-1994, EBRD granted BA a 7-year loan to finance (in part) the newly launched information technology (IT) programme for the bank. The loan also had a share purchase option, which eventually was not exerted. As far as the IT is concerned, its implementation was severely delayed, and the total costs exceeded by far the initial programme. The flaws of the programme notwithstanding, IT eventually became one of the main strengths of the bank for its privatisation.

In 1995 a second wave of new shares was launched, that time including an incredibly high premium (*i.e.*, 448%), which partially deterred investors; however, more than 4 300 natural and juridical persons subscribed almost 280 000 new shares, thus further diluting the state-owned part, to 56.5% of the total. The same year, BA launched debit and credit cards, among the first Romanian banks which entered that business. High hopes for a bright future were about to materialise – or, at least, it seemed so. In fact, the bank was a few months away from a deep crisis.

Unfortunately, the mechanism under which the government supported agriculture was dramatically inadequate. Instead of transparently promoting output (steady) growth and market driven resource allocation, the authorities remained stuck to hopeless soft credits injected mainly to dying (state-owned) farms, using the central bank’s printing machine and BA’s territorial network. That system is responsible in part for both poor performance in controlling inflation and weakening BA as far as its development as a commercial bank was concerned.

Thus, during 1992-1996 BA got the bulk of refinancing granted by the NBR to the whole banking system (on average, 56.8%). Even higher levels mark the weight of BA in the total net position of the

---

1. A recent – and, I must say, unexpected - example was offered by the energy industry in California, which proved poorly equipped to face the stubbornness of local authorities to decide what is best for everyone.



banking system against the NBR<sup>2</sup>; on average, 73.5% of the total net debtor position of the banking system against the NBR represented the net debt of BA (Chart 2: Financing and refinancing agriculture). In other words, the NBR had become the bank for refinancing agriculture; sterilising that liquidity injection proved to be an overwhelming task for the central bank. It is worth mentioning that agriculture hovered around 19% of GDP throughout that period, thus pointing out a sizeable discrepancy between effort and effect.

From a macroeconomic perspective, the worst year was 1993. Inflation peaked at a terrible 295% (CPI based, at end year), at the same time with a sharp increase of BA's dependence on the central bank refinancing. In the first half of that year BA's weight in the total net position of the banking system against the NBR averaged an incredible 113% (which shows that BA was practically the single bank in the system which received credits from the central bank). Not quite surprisingly, that particular year brought BA to its peak position in the banking system, with as much as 39% of total credit, and 24% of total assets. Profit after tax exceeded USD 51 million – probably the best in the bank's history<sup>3</sup>.

At first glance - very good. But only at first glance. Any serious analysis would have pointed out that the bank was accumulating unsustainable features:

- Its expansion was primarily based on the government's stubbornness to pump money into agriculture. The bank launched itself into a costly investment programme. Impressive buildings were erected everywhere, across the country, in big cities as well as in remote regions, with little, if any, consideration for the overall outcome of such policy. One single excuse may be formulated to defend that policy: inflation was very high, and interest rates low, thus eroding the bank's liquid capital. However, it is more than questionable if investing in severely oversized bank premises could be considered as a valid defence for the value of money. The more so, when investment projects launched in 1992 or 1993 kept pulling out money in 1997 or 1998 – under totally different conditions, and eventually became an additional burden for an impoverished bank.
- The central bank's benevolence eased the pain for BA - at least, for a while. BA did not need to focus on attracting resources from the public, but mainly on exerting pressure for an indefinite extension of easy money policy from the central bank. In fact, during 1991-1995, non-government deposits attracted by BA covered only 18-35% of the total credits extended by the bank, with the balance generously provided by the central bank, usually at lower than the market rates. Not bad, but how long could such a policy last?
- BA had become a rather huge bank, which had old-fashioned procedures, high costs and quite limited overall control for its day-to-day transactions. There was little, if any, concern for some sort of a strategic plan for the bank's future in terms of products, target structure of customers, or position in the banking system. It appeared fashionable to be as close as possible to a "universal bank", that is, to do everything for everybody. The bank expanded from its traditional range of services - *i.e.*, financing both operational costs and investments in agriculture and the food-processing industry – to foreign trade

---

2. The net position of a bank against the NBR consists of net refinancing credit minus reserves of banks to the NBR. Most banks did not receive credits from the central bank, thus they recorded a net creditor position.

3. However, those numbers are drastically distorted by inflation, and have subsequently been eroded by it.

transactions, all types of SME operations, deposits and credits for individuals and other services. Certainly, that was easy to understand in the given economic environment, but hard to sustain in the long run. Only in 1995 did the bank start to contemplate the possibility to build a comprehensive IT system, but its implementation was delayed year after year, through 2000.

The first clear sign that glorious days were gone appeared as early as end-1993. The NBR decided seriously to fight inflation using traditional instruments: tight control of money supply and high interest rates. In order to avoid an open dispute with the government, the central bank forged a mechanism under which directed credits were maintained (less generously defined, though), but any other liquidity injection was made at prohibitive interest - the so called Lombard rate, set at 250% p.a. and paid daily, which blew the yield up to an unprecedented 1 100% p.a. – well beyond any past or expected inflation rate.

In the given market conditions, BA was the most important “customer” for both - directed and Lombard credits. The immediate impact was severe - in terms of a squeeze on liquidity and hiking the cost of funds. Fortunately, BA found an adequate response to the problem: it aggressively launched savings investments for individuals. At that moment, only the old Savings Bank offered something similar (in fact, it was only one type of deposit - one year, at fixed interest rate – and a type of sight account). BA launched various instruments (deposits for various maturities, with different options for interest payment) at attractive interest rates. The outcome exceeded expectations, and BA became one of the most important players in the retail market (Chart 3: Household deposits in BA, 1992-1997). Other banks followed that path, and competition increased. However, BA has remained very well positioned and, quite likely, after privatisation, it will return to its leader position.

All in all, BA’s development was not particularly well designed, but the public image exceeded reality. Against this background the Parliament launched, in March 1996, a controversial act, to support agriculture. It was not the first time the authorities did that, but it was Parliament’s first initiative in that field, and it turned out to be a terrible illustration that the road to hell is paved with good intentions. The law, approved with an overwhelming majority, stipulated that the NBR would extend an enormous credit, equivalent to USD 380 million in March 1996, mainly through BA, at a heavily subsidised rate for the final user. So far, so good. Unfortunately, the law stipulated also that all past overdue credits were rescheduled for one year or more, and debtors were entitled to receive new loans. Thus, all BA’s insolvent clients were practically bailed out – and that, not via a transparent budgetary subsidy, but again using central bank’s printing machine first, and BA’s financial position later.

This time though, the burden was simply too huge for BA’s means. Obviously, the amount of that directed credit was enormous: more than 30 times the bank’s share capital in March 1996. Even a “normal” rate of default would have seriously impaired the bank’s position. But it was much more than that. First, because the decision to reschedule all the past loans dried up most repayments due and deteriorated the bank’s cash flow; second, because soft money is always an invitation to unsound spending, thus increasing the likelihood of default; third, because a new abrupt change in macroeconomic policies, decided by the new centrist government at the beginning of 1997, dearly affected must of the imprudent borrowers, among which, BA’s clients were included anyway.

The outcome was clear: by mid 1997 BA was technically bankrupt.

#### **IV. 1997-1999: half-hearted restructuring**

Probably, the natural solution when a bank is “technically” bankrupt would be to let it fall. It appears though that this is easier to say than to do. For instance, we saw that the French government did not leave Credit Lyonnais to go under. Why should one reasonably expect the Romanian government to act differently in BA’s case?

Unfortunately, the political decision to rescue BA was not followed by an adequate strategy to do it fast and effectively. In fact, BA experienced a long period of contradictory policies, lack of leadership, and the perpetual threat that the end would be bankruptcy. As far as the tax-payer was concerned, such restructuring represented mostly a deeper hole in the pocket; from October 1997, when the first round of bail-out took place, through April 2001, when the privatisation agreement was signed, the government pumped USD 933 million into BA’s accounts (without including any quasi-fiscal subsidies provided by the central bank, via soft credits, to cover liquidity gaps, or via exemptions to reserve requirements).

The worst thing was a kind of piece-meal approach, with half measures and - probably, most importantly – half responsibilities among those involved in the process. Thus, in 1997 some 60% of losses were bailed out, and that action before any kind of restructuring plan. A new supervisory body was created, to oversee decisions taken by the bank’s management. Double fault: the supervisory body was not able (and, quite likely, not motivated) to effectively control the management’s decisions and it was not a clear break with the past, which offered a good excuse for deteriorating overall results. Three management teams came and went in two and a half years; one of the presidents serviced twice; another is being prosecuted for fraud during his mandate. So much for the ownership of the restructuring programme.

In such circumstances, actions performed in the bank became contradictory. On the one hand, costs were curtailed, the number of staff and branches was reduced. In the early stages, it was not all that difficult to perform such operations, since useless costs were huge, overstaffed levels – incredible, and meaningless territorial expansion – alike. There was constant pressure from the supervisory body to persevere on that path, and measures taken became more and more stringent over time. The number of staff, which had peaked at 12 000 by mid 1996, reached 6 900 three years later<sup>4</sup>, and wage increases represented a small fraction of inflation over the period. The most dramatic move in this respect took place in September 1999, when wages were seriously curtailed in nominal terms, via discontinuing all kind of bonuses and premia, which had been previously generously granted. Thus, in September 1999, total costs for payroll were USD 2.4 million per month, compared to USD 6.6 million in September 1996. This was the first time that a loss-making state-owned entity experienced a severe compression in both overall payroll costs and individual nominal wage. The trade union proved flexible and sensible, and has remained so since. Probably, that attitude was in part due to factors outside BA, such as a weaker demand for staff in the banking industry, and the demonstration effect of the fall of Bancorex (once a glamorous state-owned bank, whose disappearance proved that there is no such thing as “too big to fail”).

---

4. Not all staff reductions were genuine lay-offs. Some represented merely externalisation of services, with little, if any, impact on either actual bank costs or overall employment. However, in time such practices proved beneficial, as soon as externalisation of more bank services started to bring natural benefits, well known in the world.

Meanwhile, other sensible measures were taken. Thus, work-out units were established, in most outlets across the country and in the headquarters. Over time, their performance in collecting non-performing loans has improved<sup>5</sup>.

During that period, the restructuring process benefited from thorough support from Bank of Ireland International Services (BIIS), which contributed to discontinuing some of old bad practices, to modernising procedures and structures in the bank, and to improving the flow of information within the bank.

On the other hand, though, some of the management decisions remained highly controversial. New eccentric investments were launched, in which tens of million of dollars were thrown away: additional bank premises, which needed serious refurbishing works, other real estate and equipment investments, far from necessary at that particular moment, based on contracts in which the bank was systematically disadvantaged. The same applied in respect of a number of investments in the capital market. I will not enter into details, which are in fact relevant for criminal justice, where they belong. It is relevant, though, that owners of BA proved totally unable to exert adequate corporate governance, even when they were aware that the bank was on the brink of failure, several supervisory bodies were established, and the bank had a reputable external auditor.

How was this possible? I questioned several people on this matter. Two of their replies deserve mentioning. One refers to investments; most were approved as such by the general assembly of shareholders, based on distorted information provided by the bank's management; therefore, the supervisory body was legally covered, and did not decide to act to reverse those approvals. Another refers to the external auditor role; it was bound by its confidentiality agreement with the bank's management, to whom it reported; moreover, such cases were either perfectly legal or had little "material" impact on the bank's overall situation. Good excuses, bad corporate governance.

## **V. The last attempt: November 1999-end 2000**

### **1. *New rules of the game***

By mid-1999 the bank was practically crumbling. Its credit activity declined; some clients chose to move their business to other, more secure, banks; therefore, income declined faster than expenditure, and the bank's negative net worth started its snow-ball effect. However, closing down the bank would still have cost more than saving it – provided that a genuine restructuring programme was put in place. Obviously, there was a distinct risk that after pumping in new money, the outcome would still be the same. Nevertheless, the authorities decided to launch the last attempt to restructure and privatise BA. The first step was to appoint the privatisation adviser. The winner in an international tender was a consortium led by Lazard Frères, which eventually succeeded in its mission.

---

5. The Romanian judiciary system proved poorly equipped to address dishonesty in economic activities. A long list of reasons – that I will not elaborate on here – have led to quite widespread cases when the debtor is overly protected against the creditor. Since banks are creditors by definition, the outcome is that they incurred significantly more losses than if courts had protected their interests against fraudulent debtors. Therefore, various mechanisms tested over time – such as specialised agencies, or collection of debts during bankruptcy procedures – proved rather ineffective. That is particularly important for a bank whose loans had become non-performing at a rate in excess of 80%.

An important decision was to radically change the bank's management, which had developed, in time, a shaggy structure, consisting of two separate executive bodies, totalling 11 people. All that was replaced in November 1999 by a single management committee (MC), consisting of three individuals (one president and two vice presidents, out of which the president and one vice president came from the central bank). They took the full responsibility for the bank's restructuring, based on a clear mandate. The main lines of that mandate were drawn up in an Emergency Ordinance<sup>6</sup> – which emphasised the political importance attached to BA restructuring. Such a level of regulation was helpful in deterring, down the road, any interference in the decision-making process. However, the whole process lasted significantly longer than initially expected, and tight regulation became too much of a straightjacket.

The new rules of the game were very clear. All non-performing loans (doubtful or loss) were immediately transferred to an independent agency, in exchange for T-bills. A classical bail-out, which should have been performed at least two years earlier<sup>7</sup>. All new investments were formally prohibited. The same applied to all credits, before restoring the bank's liquidity. All other decisions were the MC's responsibility.

The hardship of the situation was increased by a terrible – though unconfessed – lack of confidence in the bank's perspective. The authorities at the same time did not want to close the bank, but did not really think that privatisation was achievable. In turn, the international financial institutions (IFIs) were concerned that any new re-capitalisation performed before privatisation would risk keeping the bank in the same old pattern of actions. That was the line of reasoning behind the decision to drastically limit BA's activities starting at end-1999, and particularly to freeze any new lending. Such a decision was well founded theoretically, as well, since a drastic compression of the balance sheet is an unavoidable part of a cure for any bank in distress.

Having said that though, such a cure cannot be applied too long. After 4-6 months of strong actions to restructure the bank, which obviously should include an assessment of the bank's credit procedures, the decision-makers should make up their mind: either to prudently start to "release the belt" (and check the outcome after a few more months) or simply close the bank. Neither of the two was applied as far as BA was concerned. The bank continued to act under the same straightjacket for as long as 18 months, in fact proving an incredible resilience. During this period, it survived based in part on income from other banking services, and from recovering past bad loans.

But that became apparent and increasingly painful, long after the process had been launched. At the beginning it was clear only that time was running out, and decisions should be expeditiously adopted. The fact that MC consisted of only three people helped that process<sup>8</sup>. A number of issues were both very urgent and important.

---

6. An Emergency Ordinance is approved by the government, but is subsequently endorsed by the Parliament in a law.

7. The bank's net worth remained negative, though, since the T-bills covered the net value of loans, after provisioning. The government promised to cover "past losses" only when privatisation is completed. Such a strategy was in fact imposed by the international financial institutions (IFIs), which wanted to be assured that unless privatised, the bank would not continue its activity.

8. A few months after, the second vice president got another appointment. Two people have managed BA since then.

## **2. *Maintaining public confidence***

The main concern was to maintain as much as possible the public's confidence in the future of the bank. On the one hand, because liquidity was scarce, and a run on the bank would have exhausted it rather quickly. On the other hand, because quite a wide deposit base, with more than one million clients (mostly individuals), was one of the few attractions of the bank for a potential buyer. However, it was not all that simple to keep the public's confidence, after the fall of Bancorex and several other bankruptcies, which had shaken the banking system. The more so, when the alternative to privatisation (*i.e.* closure) was well known to the public.

Several actions were taken in order to counteract that unfavourable public image. The first was to carefully avoid any similarity with Bancorex. Thus, BA was not managed by a special administrator, appointed by the NBR, as had happened with Bancorex, in its last months, but by the MC, appointed as a consequence of a special piece of legislation. A number of symbolic gestures suggested that difference, such as a press conference held by the governor of the central bank together with the newly appointed MC and several public statements from high officials. Subsequently, the MC systematically maintained an optimistic discourse, both for the public and the bank's staff, and was in continuous search of favourable signals. Thus, at times, BA acted as agent of the government, for various foreign exchange bonds issued for the public. The profit of the bank, if any, was minimal. Improving the image was what mattered. With this goal in mind, public relations (PR) was constantly a matter dealt with by the top management of the bank.

The outcome was reasonably good, in the given circumstances. It was impossible to avoid a continuous decline in the deposit base, particularly in periods when the bank was scaling down its territorial network. However, a run on the bank was avoided, and a slight recovery in the value of deposits has been felt since November 2000, long before the privatisation.

## **3. *Sharp reduction in overall costs and in employment***

Reducing functional costs is an obvious target in any restructuring plan, and BA continued to follow that path, more and more aggressively, with measures meant to take advantage of every possible way to reduce costs. It was a very difficult job, since there were natural limits, which had already been attained; moreover, there were growing taxes, as well as contracts whose termination would have cost the bank more than their continuation. Nevertheless, results exceeded expectations in many respects (Chart 4: Monthly operating expenses, 1999 – 2001). Below I will elaborate on one of the most painful ways to cut costs: sharply reducing employment.

In October 1999 the payroll cost the bank USD 2.5 million, while the total loss had reached a frightening USD 10 million per month<sup>9</sup>. Nonetheless, the MC attached special importance to significantly reducing employment. In the eight months starting November 1999, three waves of collective lay-offs took place, totalling some 3 000 persons (*i.e.*, 45% of total staff). The first had been decided by the former management, and was endorsed by the MC, before end-1999. To ease the process, the bank applied for a severance mechanism financed by the government in certain collective lay-offs. This mechanism was used for the second and the third waves of lay-offs.

Why the emphasis on such a painful decision? There were strong considerations in this respect. Probably, the most important was the signalling effect, for both the bank staff and the outside world.

---

9. Again, those numbers are heavily distorted by inflation. In International Accounting Standards (IAS) terms, monthly losses were USD 3 – 4 million.

When restructuring goes directly to the most sensitive of the existing problems, then that is a sign of genuine commitment. For the outside world, quantitative data sufficed; for the bank, it was extremely important to perform that operation in a manner consistent with the bank's future development, while giving a solid proof that deep cultural change was on its way.

A few principles were constantly applied during staff lay-offs, the first being the rules, no discretion in establishing who goes and who stays. The MC imposed to others (and to itself!) the "zero tolerance principle", knowing that any "favour" would ruin the credibility and would undermine the very heart of the cultural change intended. Another rule (which also made the difference with the past) was to avoid proportional reductions in employment, in favour of performance-based ones. The second and especially the last waves of lay-offs were based on indicators such as number of transactions and of accounts per employee; for larger branches, distinct evaluations of workload had been performed by the WASP (work and service planning) team. Critical importance was attached to keeping young professionals, who had been victims of previous waves of lay-offs, due to the common practice "last in, first out". A specific clause was included in this respect. Another principle was to withdraw all directors who were close to retirement age; most of them got the message and decided to leave the bank (and to take advantage of severance payments).

Another consideration, part of the "cultural change package", was to put the MC's deeds where its mouth was. From day one, the MC stated that the bank's goal was to become a western-style bank, profit-oriented, and able to face challenges in the 21<sup>st</sup> century. It was a long way to go to achieve such an ambitious goal. However, rapidly increasing productivity, to reduce the existing gap against other Romanian banks (let alone western standards in that field), represented a natural immediate step.

There was also another consideration, which has never been admitted so far. In the case that restructuring had failed and the bank had been eventually closed down, it would have been preferable to do it with a smaller bank and fewer staff.

A few months from the start of that process, a piece of anecdotal evidence dramatically confirmed the management's position. One of the potential investors, which had thoroughly analysed the bank's activity, came up with an implacable verdict: "too little balance sheet, too much staff". He was right and the MC was supposed to do something in this respect. Fast.

#### **4.        *Focus on the bank's strengths!***

The main goal that MC had was to privatise the bank. Curtailing costs and containing losses were obviously a must, but far from sufficient. The buyer needed to detect something really valuable in the bank - at least in a medium term perspective. Investing in an "ongoing concern" – as BA was presented – represented a risky decision, which should have a correspondent in the expected profit. Therefore, the MC's most important job was to spot – and then to support the development of – areas of interest in the bank's activity. Fortunately, there was an obvious candidate in this respect: retail services. BA benefited from its wide network and a good experience in working with individuals and, to a certain extent, with SMEs. Moreover, the bank had developed a good plastic money division, and was at work on a state-of-the-art IT system – both a perfect match with its retail business development.

Unfortunately, such an assessment had not been made by previous management teams, which actually disregarded the enormous potential represented by cards and IT combined. Thus, the card department had been “exiled” to a separate building, a few kilometres away from the bank’s headquarters, while its staff “enjoyed” the lowest wages in the bank. Below are listed some of the measures taken by the MC to correct that situation:

- A symbolic gesture took place on the first day in the MC’s activity: the president paid a visit to the card department, met all staff and depicted the emphasis that the new management attached to their activity.
- To the extent possible in the given situation, more resources have been devoted to the card development in terms of staff, investments, etc. Extra-hours worked have been fully paid, and wages were subsequently corrected.
- Directors of the territorial network were instructed to focus on developing the card activity, which became one of the performance criteria used, among others, for their wage level.
- In time, when the IT made it possible, the bank started to offer corporate customers wage payments via debit cards, and additional services such as direct debit.

The outcome was favourable, but not spectacular, since other banks devoted by far more resources to the same field, and were not undermined by an overall bad image. However, the card activity was the single one that continued to grow in that difficult period, and the bank managed to preserve its share in the market (*i.e.*, some 10%).

As far as the IT system was concerned, the situation at end-1999 was more than worrisome. The project had been launched more than 4 years before, some USD 30 million had been spent, and the bank was supposed to have in place a modern, and highly effective IT system. Unfortunately, before even proving its capabilities, the whole project had stalled. The bank had entered into disputes with the supplier of the system (a reputable European company, whose system was successfully used in other banks, in a comparable situation). Each party had claims on the other, and the system did not work. Sustained efforts and substantial resources were needed to address all the problems accumulated over years of half-hearted co-operation between the bank and the IT supplier. A new person, young and very enthusiastic, was appointed as IT manager, and the MC closely monitored every development in that particular area. A couple of months later, the pilot units were able to function flawlessly. Subsequently, the system was implemented in more and more units, which have started to operate, live. However, BA is a large entity, and the completion of the programme is scheduled for this fall. Currently, more than 80% of the activity is performed live, through the IT system, which has already proven its capabilities.

The emphasis in exploiting the card business and in implementing the IT system, as part of retail oriented activity proved correct, at the end of the day. Representatives of the new major shareholder admitted that it was precisely those features of BA that weighed most favourably in their decision to buy the bank.



## 5. *About the cultural change*

Throughout this paper, I have underlined more than once that a deep cultural change in the bank was perceived by the MC as critically important for the success of the restructuring. In this case, though, it was not quite an immediate objective, but a long lasting process, in which every single action should add something in the same direction. The task was considerably complicated by two factors: a dramatic lack of resources to reward performance and legal restrictions in the bank's activity, which could be used as an excuse for weak results.

Several principles were used to achieve the desired goal:

- I have already mentioned rules rather than discretion in the decision-making process. It was valid not only for lay-offs, but in every possible matter. One of the important decisions was to evaluate the performance of each unit based on a set of indicators, well known by all local managers and staff. Once the performance indicators were established, most decisions regarding the activity in branches were taken based on the “stocks” and the “flows” recorded by each unit. For instance, when a branch was constantly in the bottom of the classification or recorded noticeable deterioration, local managers incurred a serious risk of being removed; decisions to increase nominal wages were also based on the position of each unit in the overall classification. In time, the system proved extremely effective in generating competition among units to improve their performance (particularly in controlling costs and recovering overdue credits).
- Transparency in the decision-making process was seen as part of a new relationship in the bank. While a certain centralisation of the final decision was unavoidable during the restructuring, the MC made efforts to make clear the reasoning behind all decisions, when a formal procedure was not already in place. The same was valid for both day-to-day decisions, and also longer perspective plans.
- Strict observance of rules was also severely enforced. This was particularly important in a company where rules and regulations had been perceived as “optional”; the situation had worsened when top managers of the bank had repeatedly acted well beyond any rule – to put it mildly. Two objectives were followed: to have a clear connection between any infringement of a rule and a prompt penalty; to make necessary corrections in the procedures, in order to reduce the likelihood of similar situations.

Deep cultural change is a matter of time. Some individuals simply are not able to adhere to the new rules of the game. Others will need a push for a longer period. Critically important is to gather the right persons to support and induce the process across the bank and to make sure that the critical mass to achieve the goal is attained in a reasonably short period of time.

Unquestionably, much remains to be done from now on.

## VI. Conclusions

BA's long ordeal is over, now. In April 2001 the government increased the bank's share capital from some USD 5 to 155 million. Thus, BA's net worth became positive, the government's weight in total capital jumped to almost 99%, and all those shares were sold to a consortium consisting of Raiffeisen Zentralbank AG (as strategic investor and majority shareholder) and the Romanian-American Enterprise Fund (an investment fund with American capital). By August 2001, the consortium will inject USD 37 million as an additional increase in BA's capital. There are good reasons to state that the goal to return to a position among the top three banks in Romania over the next few years, though ambitious, is quite achievable.

The conclusion of privatisation and a new beginning for the bank was favoured by the combined action of several factors.

- BA had a number of valuable intrinsic features, which needed to be enlightened and (fully) exploited. Had they not existed in the bank, the restructuring would not have succeeded. In fact, BA had experienced quite a schizophrenic development: on the one hand, old (minded) structures, remains of the late regime, extended their existence particularly because they were nourished by outdated practices, such as directed credits with subsidised interest; on the other hand, forward looking segments succeeded to implant themselves in the same bank, which tries to find its place in a new world. It was the managers' role to support the latter and inhibit the former.
- Several failures in restructuring BA, before and after closing down Bancorex, brought the bank to the edge and offered strong evidence that half-measure policies do not achieve anything but increase the overall cost and reduces the chance to succeed. Had the government acted more forcefully earlier (in terms of both procedures and allotted resources), we would not have this topic to discuss here. Most likely, the overall cost would have been significantly lower, and BA would have recovered by now, and would have started to bring in - rather than pull out – money from the budget. However, when the authorities decided to perform a text-book restructuring, they got exactly what they had paid for.
- While restructuring was on its way, overall economic as well as political conditions improved in Romania. Moreover, neighbouring countries exerted a somewhat lower attraction for investors chasing favourable opportunities. In other words, the internal and external environment was riper for success in privatising a bank like BA.
- Last, but not least, the success of privatisation was possible because a number of individuals, in their official capacities, seized the enormous potential of BA and decided to launch a bid and subsequently to push the deal forward. As a matter of fact, the bank's balance sheet did not look too good, and very prudent businessmen could have refrained from entering that game in the first place. BA was fortunate enough to meet those businessmen who were able to correctly assess the risk, and had the perseverance to follow the deal to its completion.

All these factors, put together, contributed to a success story. Or, as a matter of fact, to the prologue of a success story. Which is yet to be written, together with Raiffeisen Zentralbank AG, the new major shareholder.

Chart 1: BA INDICATORS, 1991-1996

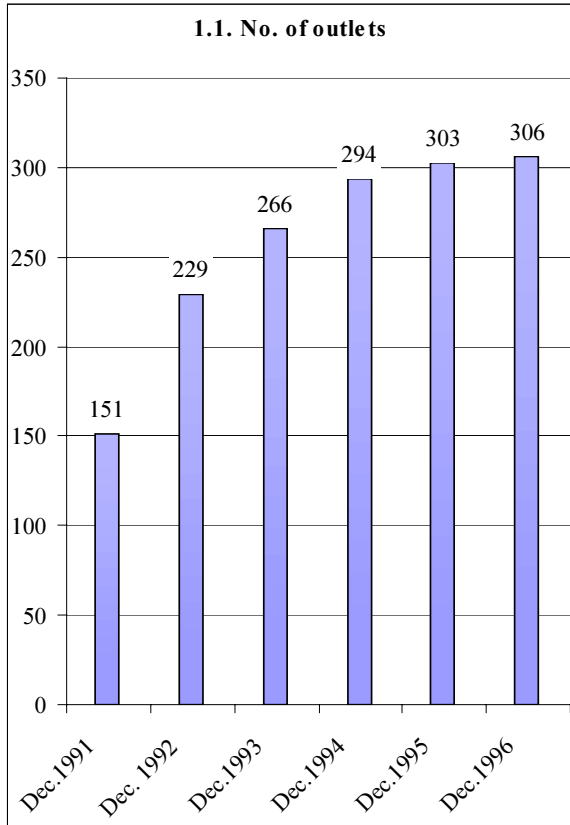
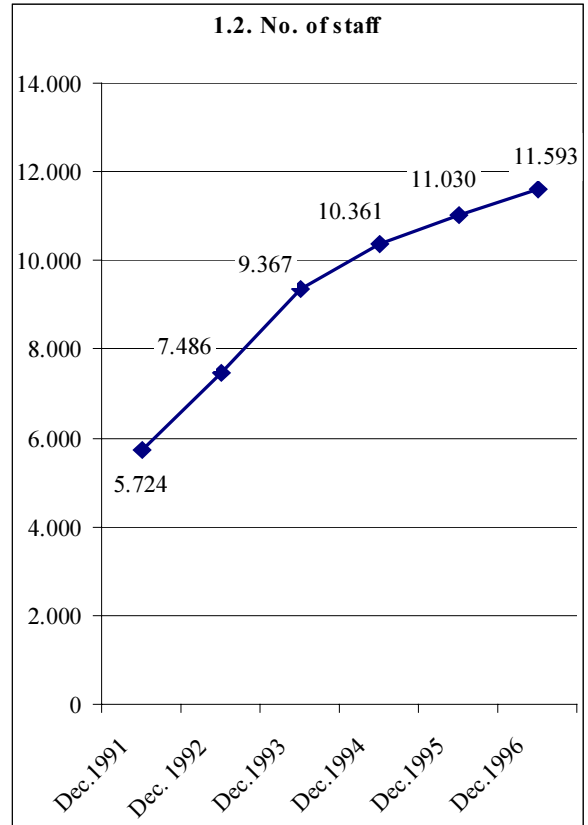
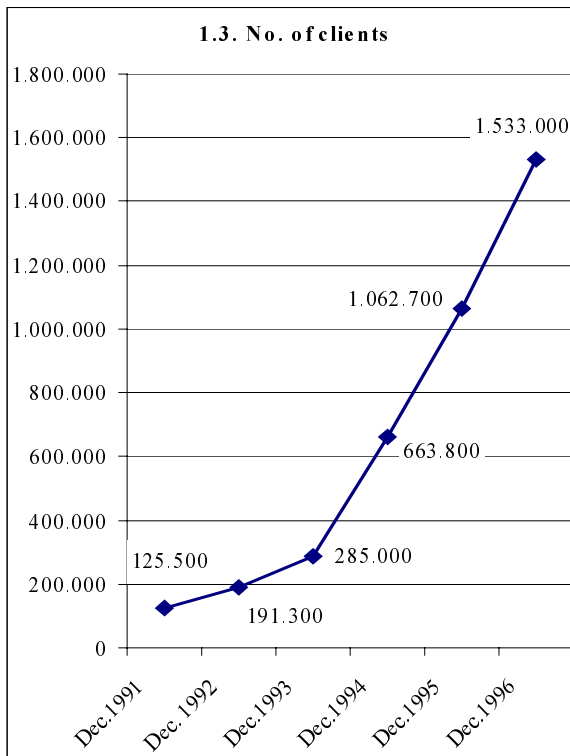
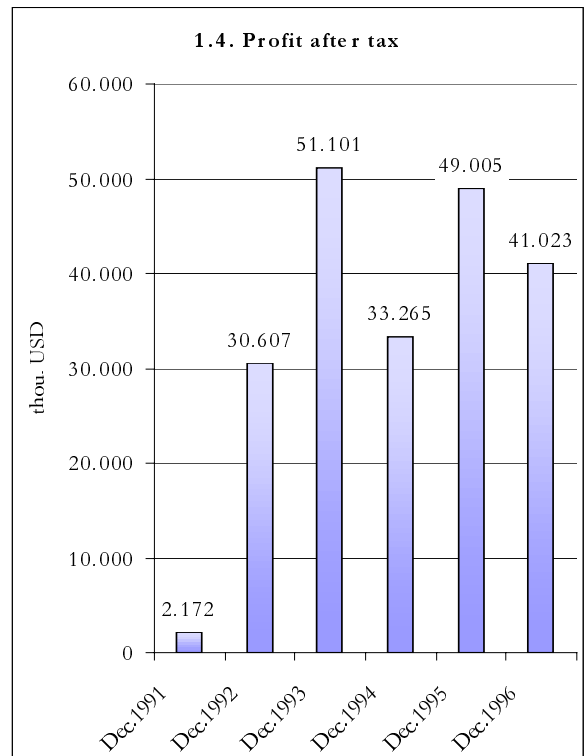
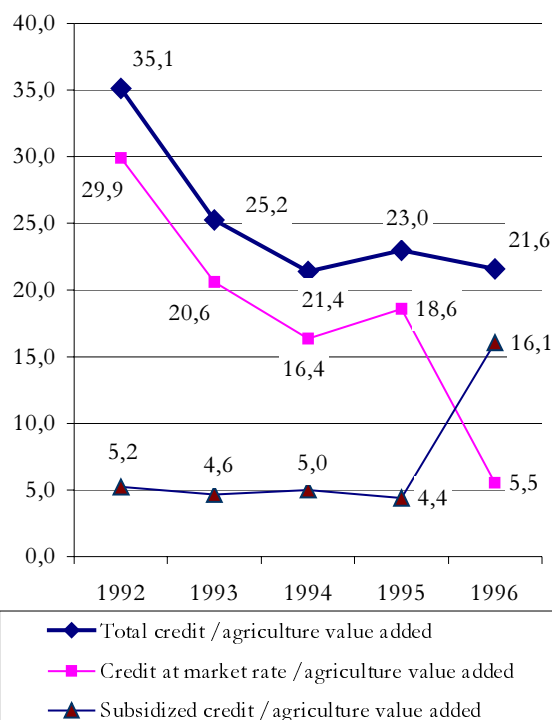
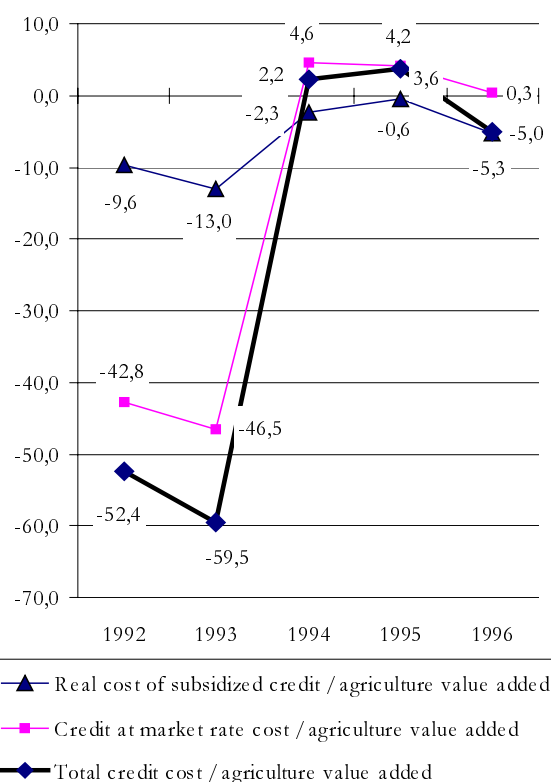


Chart 2: FINANCING AND REFINANCING AGRICULTURE, 1992-1996

2.1. Average credit level /value added in agriculture (%)



2.2. Average real cost of credit /value added in agriculture (%)



2.3. The BA weight in refinancing the banking system and its net position in relation to the NBR (%)

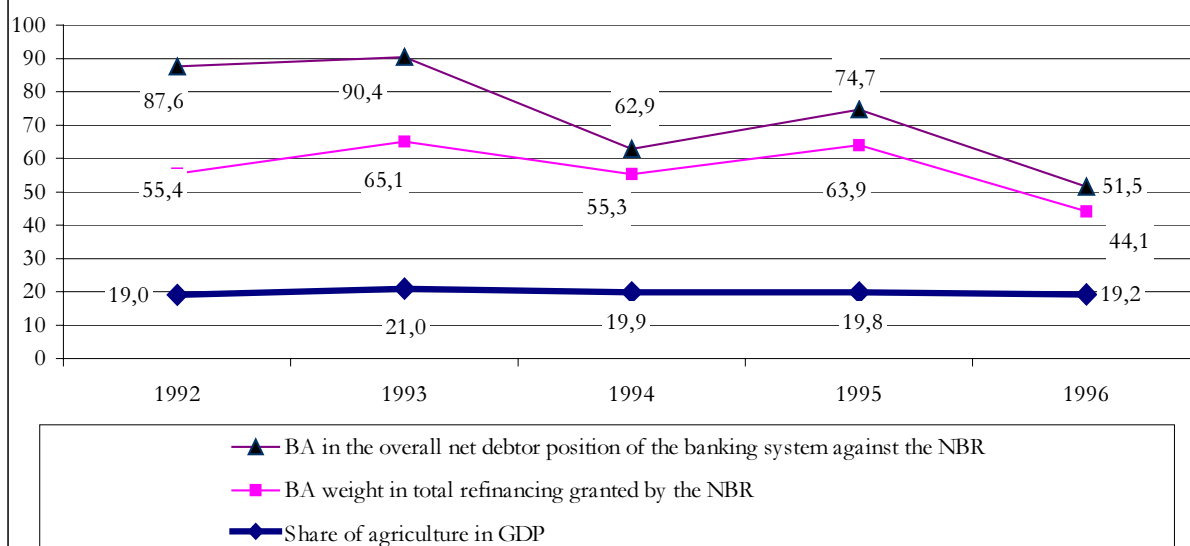


Chart 3: **HOUSEHOLDS DEPOSITS IN BA, 1992-1997**

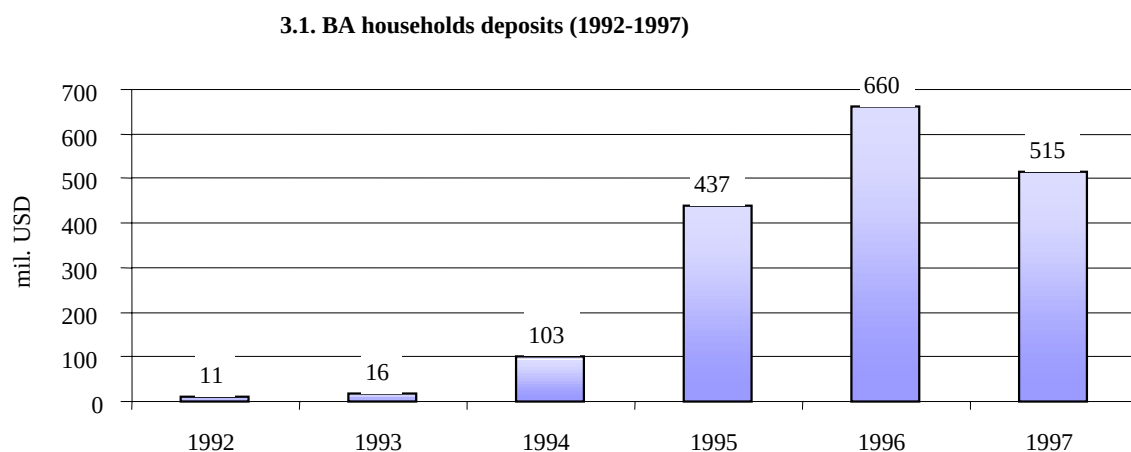
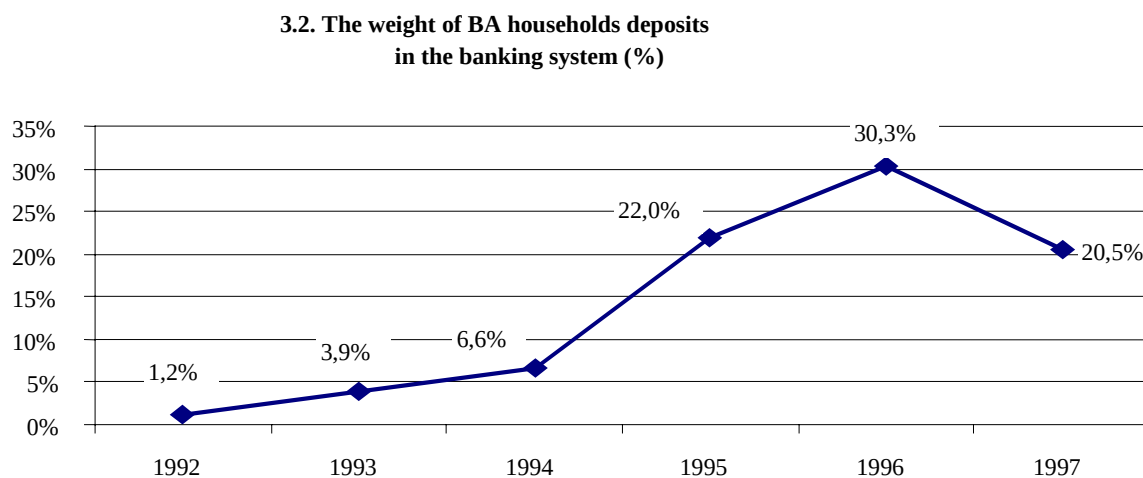
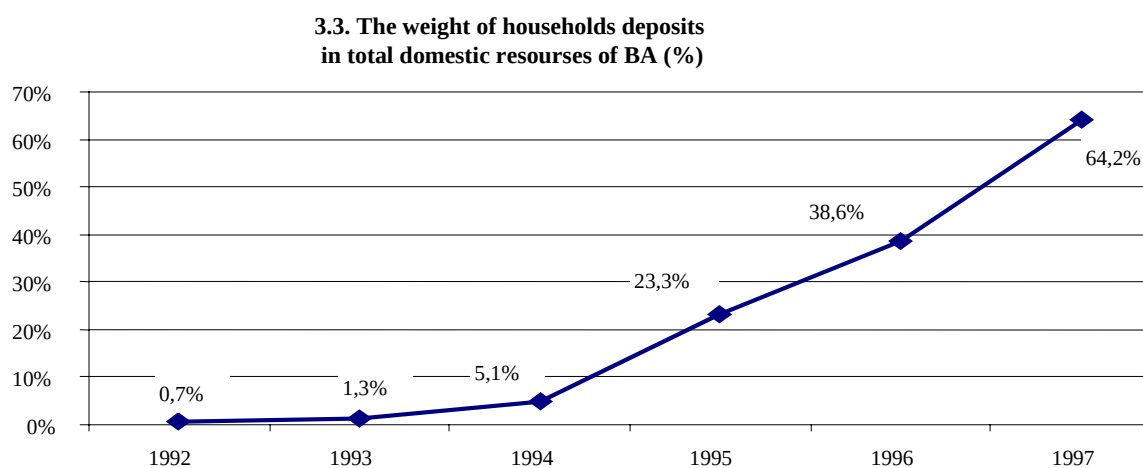
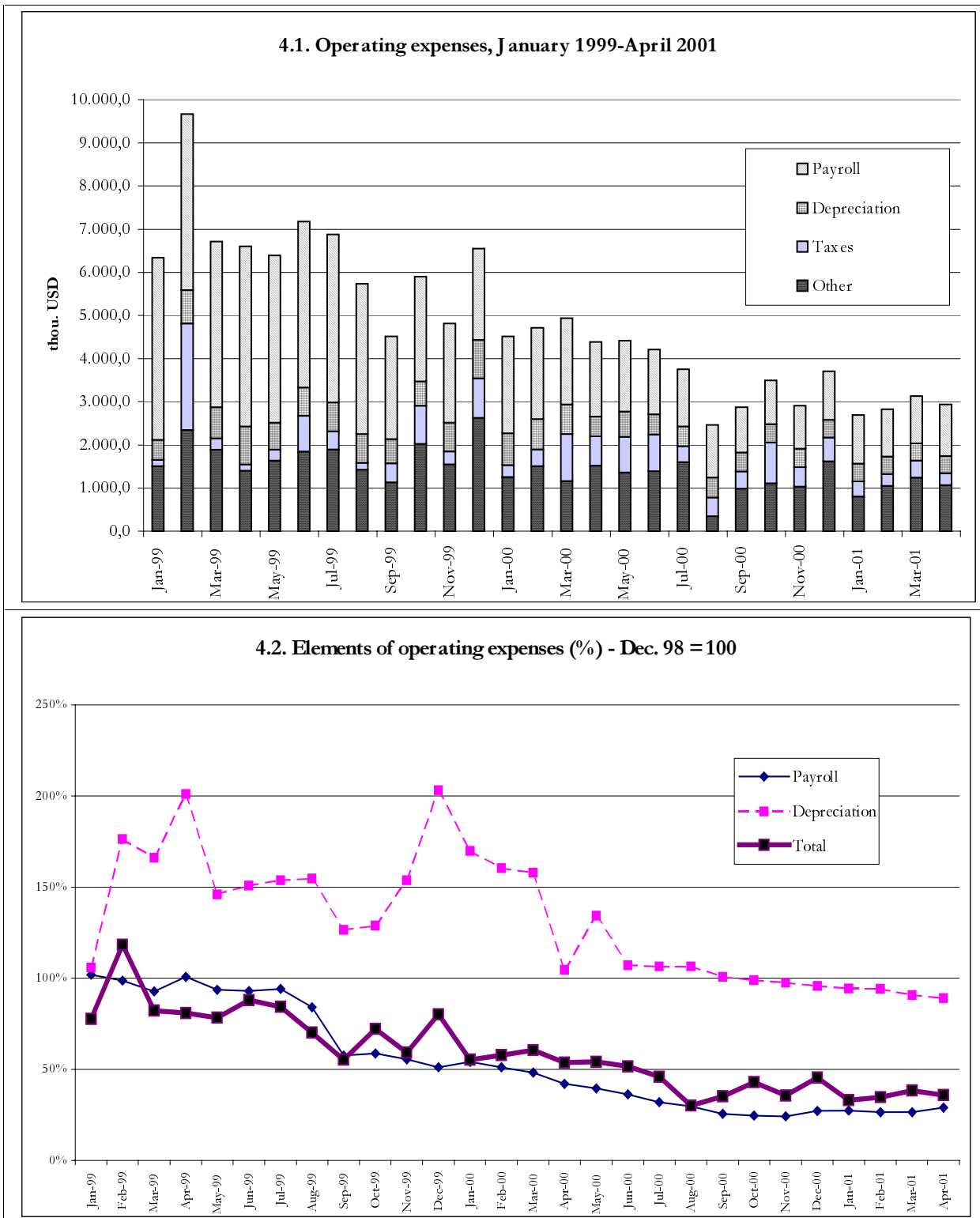


Chart 4: **BA MONTHLY OPERATING EXPENSES**  
(JANUARY 1999 - APRIL 2001)



# AGRICULTURAL CREDIT CO-OPERATION IN SLOVENIA: LESSONS FROM THE PAST AND STRATEGY FOR THE FUTURE

By Mr. Franci Avsec and Mr. Tomaž Sila  
(Paper presented by Mr. Sila)

## Abstract

*The Slovenian tradition of private farming and market and supply systems has enabled the development of credit co-operation. There are currently 59 Savings and Loans Services (SLS) in operation in Slovenia, providing financial services for farmers and agricultural co-operatives. However, the need to comply with new banking legislation, and to conform to European Union requirements, is posing a number of challenges. This report examines the development of credit co-operation in Slovenia, looks at the current structure, functioning and role of SLS, and discusses the adjustments needed in order for the SLS to remain competitive and to retain their comparative advantage.*

## Credit co-operation in Slovenia: a historical overview

Credit co-operation in Slovenia has a very rich and colourful history. Its development can be broken down into three stages. The **first period** began in the second half of the 19<sup>th</sup> century and lasted until the end of the Second World War. The development of credit co-operatives was triggered by legislation allowing the division of farm households among heirs (land discharge) and rapid progress in market-oriented economic reform. Following land discharge, the farmers' need for financial resources increased. On one hand, they lost revenue from transport and home industry activities due to the development of the industrial and railway systems. On the other hand, they needed money to pay taxes, and compensation for land discharge, in particular hereditary indemnities due to the recent introduction of the free division of land. Many usurers took advantage of the demand for loans. Due to the high expenses involved, city banks and savings banks did not provide loans for farmers.

The emergence of credit co-operatives made it possible for farmers to get loans. Many credit co-operatives were established in the 1870s and 1880s when the problem of farmer borrowings reached its peak. After Dr. Josip Vošnjak (1834-1911) had got acquainted with loan co-operatives in Bohemia, several credit co-operatives were established in Slovenia. By the beginning of 1883 there were 14 credit co-operatives in business and a year later there were already 25. The engineer Mihael Vošnjak (1837-1920) established the first association of credit co-operatives in the Slovenian territory in January 23, 1883 (the Association of Slovenian Savings Co-operative Banks in Celje). The association offered assistance to its members for transactions, and in 1888, 15 years prior to the Co-operative Auditing Act, began to perform regular audits.<sup>1</sup> During this period the Slovene co-operative movement had a strong national focus and was underpinned by the belief that political freedom required an effective economic framework.

By the turn of the century, credit co-operation in Slovenia had acquired an important social dimension. A severe economic recession triggered the failure of many farms as well as massive migration. In response to this situation numerous credit and other types of co-operatives emerged with a low share

---

1. Dolfé Schauer, Prva doba našega združništva (The First Period of Our Co-operative Movement), Ljubljana 1945, p. 113.

base, and joint and common liability. The initiator was Dr. Janez Evangelist Krek (1865-1917), the leader of the Christian Social movement, who was influenced by Raiffeisen's principles. The co-operatives contributed to an almost complete disappearance of usury and in many ways improved farmers' economic position. However, they could not completely prevent the failure of farms and halt the emigration flow.

Credit co-operatives were an institutional innovation in the field of financial intermediation in Slovenia. By accumulating investors' savings and drawing on their in-depth knowledge of local conditions, credit co-operatives were able to make a realistic assessment of borrowers' loan capacity and reduce the associated risks. By the mid-1890s, co-operatives had reduced the interest rate from approximately 20% to around 6%<sup>2</sup>, due to the increased availability of credit. The introduction of liquidity balances and the establishment of co-operative auditing associations further reduced risk.

After the First World War, the first co-operative banks were founded, which resulted in a further concentration of the financial reserves of loan co-operatives and their associations. During the Second World War, co-operative activity came to a halt. In 1947, all credit co-operatives in Slovenia were liquidated by the government and the assets of many co-operative institutions were confiscated.<sup>3</sup>

The **second period** was characterised by a short revival of co-operative savings banks in the second half of the 1950s. The *1954 Regulation on Banks and Savings Banks*<sup>4</sup> allowed city committees and agricultural co-operatives to establish savings banks to accumulate deposits and give loans. Although savings banks were not credit co-operatives, they enabled agricultural co-operatives to expand their activities to the area of finance. However, under the provisions of the *1961 Banking Act*, co-operative savings banks had to cease their transactions and transfer their dealings to public utility banks.

The **third period** began in 1969 when Slovenia adopted an Act providing for the establishment of Savings and Loan Services (hereinafter SLS) within agricultural co-operatives and forestry organisations (see Box 1). Two years later the *Association of Savings and Loan Services* of Slovenia was established as a voluntary association of these organisations. In the 1970s the SLS contributed to the modernisation of private farms through extensive credit activity. Farmers were purchasing machines, constructing and restoring production premises, planting and renovating orchards, vineyards and gardens. The main reason for this increased investment was the abolition of administrative restrictions on the purchase of agricultural machinery by private farmers. The low inflation rate and subsidised interest rates also made repayment easier. As of 1980, the SLS became independent legal entities, managed by the founders: agricultural or other co-operatives.

In 1990, the *Slovenian Co-operative Agricultural Bank* was established. However, even after a third Act on SLS was passed in 1990 and despite their gradual expansion, the SLS activities were restricted to accumulating savings deposits from farmers and other individuals and giving loans to the founders and other individuals. When inflation slowed down in the first half of the 1990s, confidence in the Slovene currency strengthened. After a few years of stagnation in agricultural and forestry production,

---

2. Tossaint Hočevar, Slovensko poslovno bančništvo kot inovacijski dejavnik (The Slovenian Commercial Banking as an Innovative Factor), 1900-1930, in: *Zgodovina denarništva in bančništva na Slovenskem* (The History of Monetary and Banking Institutions in Slovenia), Ljubljana: Zveza zgodovinskih društev Slovenije, 1987, p. 61-74.

3. Uredba o likvidaciji kreditnih zadrug (Regulation on Winding up of the Credit Co-operatives), Uradni list (Official Journal) LRS, 16-81/1947.

4. Zakon o bankah (The Act on Banks), Uradni list FLRJ, 10-118/1961, Article 156, Paragraph 1.



the output of private farms started to increase. And concomitantly, savings deposits in SLS started to grow.

**Box 1. Evolution of the regulatory framework of rural credit co-operation in Slovenia in the 1960s - 1990s**

**The Slovenian Act of 1969**<sup>5</sup>, stipulated the establishment and business of savings and loan services (SLS) of agricultural and forestry organisations. Under this Act, the SLS operated as special organisational units within agricultural co-operative and non-co-operative organisations dealing with agricultural production and forest cultivation. The SLS activity included accumulating deposits in the form of savings and granting loans. The SLS were allowed to give loans from the deposits accumulated and the SLS's funds, with the exception of the reserve fund. In principle, total loans were not supposed to exceed half of the total deposits and loans were not allowed to be given to the founder under more favourable conditions than those to ordinary citizens.

**The Act on Savings and Loan Services and Mutual Relief Funds (1980)**<sup>6</sup>. SLS became independent entities (autonomous financial organisations) that could be founded either by one or more co-operative organisations, or by other legal entities in conjunction with co-operative organisations. The right to establish a SLS was extended to all co-operatives. However, while SLS were created by some handicraft and other non-agricultural co-operatives, the majority were still established by agricultural and forestry co-operative organisations. In order to safeguard liquidity, the SLS had to set up a reserve fund consisting of at least 1% of the financial assets according to the annual accounts. While the reserve fund was being constituted, the SLS had to accumulate resources into the reserve fund representing at least 0.1% of the financial assets of the SLS.

**The Savings and Loan Services Act (1990)** stipulated that the founder of the SLS could either be co-operatives or companies co-ordinating agricultural co-operative production. SLS could also be established by other legal persons. All founders were jointly and individually liable for the SLS. The activities of SLS were extended to the following areas: accumulating citizens' and legal persons' savings deposits, keeping giro and current accounts, providing payment transactions for citizens and civil legal persons (*i.e.* legal persons without any social capital or social property), financial and loan transactions on behalf of the founders, of banks and other financial organisations, and other transactions in compliance with the appropriate regulations. Conditions for state guarantees became more rigorous. The State had subsidiary liability for savings deposits only if the savings and loan service had a bank guarantee. The Act maintained the framework under the former law, providing that SLS can only operate within available accumulated resources of savings deposits, deposits and granted loans. However, it also added one restriction: an SLS is allowed to invest a maximum of 50% of its resources in long-term financial assets. The Act reiterated the provision that the SLS has to convert at least 0.1% of its financial assets into reserves until the reserve fund amounts to 1% of the SLS's financial assets.

**The Co-operatives Act (1992)**<sup>7</sup> provided, *inter alia*, for the restitution of the nationalised property of co-operatives.

**The Banking Act (1999)**<sup>8</sup> and **the Decree on Savings and Loan Services Adjustment to the Banking Act (1999)** laid down a 5-year transition period (until 20 February 2004) during which the SLS have to comply with certain requirements such as minimum share capital (equivalent to 1 million EUR), capital adequacy, risk management, bank accounts and reports, internal and external audits and deposits liability.

---

5. Zakon o ustanavljanju hranilno kreditnih služb kmetijskih in gozdnogospodarskih delovnih organizacij (The Act on Establishment of Savings and Loans Services of Agricultural and Forestry Labour Organisations), Uradni list (Official Gazette) SRS, 22-170/1969.

6. Zakon o hranilno kreditnih službah in blagajnah vzajemne pomoči (The Act on Savings and Loan Services and Mutual Relief Funds), Uradni list SRS, No. 4-233/80.

7. Uradni list RS, No. 13-675/92, 7-291/93, 13-587/93, 22-955/94 and 35-2282/96.

8. Uradni list RS, No. 7-286/99.

## **Savings and Loan Services: current status, functions, and structure**

Savings and Loans Services (SLS) are financial organisations, which have a special status defined in the 1990 Savings and Loans Services Act. They operate mainly in the field of agriculture in close collaboration with agricultural co-operatives, which are the founders and the owners of SLS. In organisational and financial terms, they are similar to European loan co-operatives, especially to those in Austria. The fundamental purpose of SLS is to provide financial services for farmers and SLS founders, in particular agricultural co-operatives. SLS ensure that the money generated through agriculture is returned to farmers in the form of easily accessible and low-interest loans. This provides economic independence and safeguards further development.

As of 31 December 2000, there were 59 Savings and Loans Services in operation in Slovenia, all members of the Association of Savings and Loans Services (Figure 1). Savings deposits in the SLS amount to SIT 31.8 billion<sup>9</sup> (1 EUR = SIT 210), which represent 4.4% of the national currency savings in Slovenia. Half are sight deposits and the rest are time deposits for periods ranging from one month to one year. The volume of long-term deposits is very low. The balance sheet amounts to SIT 43.5 billion (excluding the Association of SLS) which represents 1.5% of the total assets of the Slovene banking system. SLS have approximately 200 000 clients, mainly farmers, but also people employed in co-operatives, pensioners and other rural residents. SLS employ 250 workers who provide services in over 200 cash register units.

The 1990 Savings and Loans Services Act laid down the current legal framework for SLS. It defined SLS as independent legal entities and stipulated the conditions under which they should operate:

- SLS can be founded by co-operatives and companies that organise co-operative production;
- the founders adopt a statute defining: the organisation and terms of operating; the administrative bodies and their competence; the conditions for representation and other organisational issues;
- SLS activities include: collecting savings deposits and deposits of citizens and legal persons; managing giro and current accounts; performing payment transactions; raising and giving loans to citizens, civil legal persons and the founders; undertaking financial dealings for the benefit of the founders, banks and other financial organisations; other activities in accordance with specific regulations;
- the savings deposits and assets of the SLS are guaranteed by founders through a sovereign loan guarantee and by the Republic of Slovenia through a subsidy;
- SLS can operate within the limits of the funds accumulated from savings deposits and interest from loans;
- SLS can invest a maximum of 50% of the funds accumulated from savings deposits in long-term funds, while 5% of deposits must be invested in liquidity reserves;
- if the SLS establishes a loss, the founders must cover it; part of the profits (up to 1% of the SLS's funds) must be set aside as reserves.

---

9. SIT - the Slovenian tolar.

The basic activity of SLS is collecting savings deposits from individuals (farmers). Assets are mostly in the form of money orders from agricultural co-operatives and other purchasers of agricultural products and wood, as well as the salaries of the co-operative employees, pensions and other types of income.

SLS manage giro and current accounts and payment transactions. Clients can pay with the “Magna” credit card and an automated teller and debit card are soon going to be introduced, in collaboration with the Slovene Farm Co-operation Bank.

The loans can only be taken up by farmers, citizens and founders. There are no restrictions on the purpose of the loans, most of which are to finance investment in agricultural production and for co-operative activities. A large share of loans is also for additional farm activities, building apartments and for consumer goods. SLS also serve as a channel for the transfer of government funds (subsidies, loans from the Regional Development Fund and other government assistance).

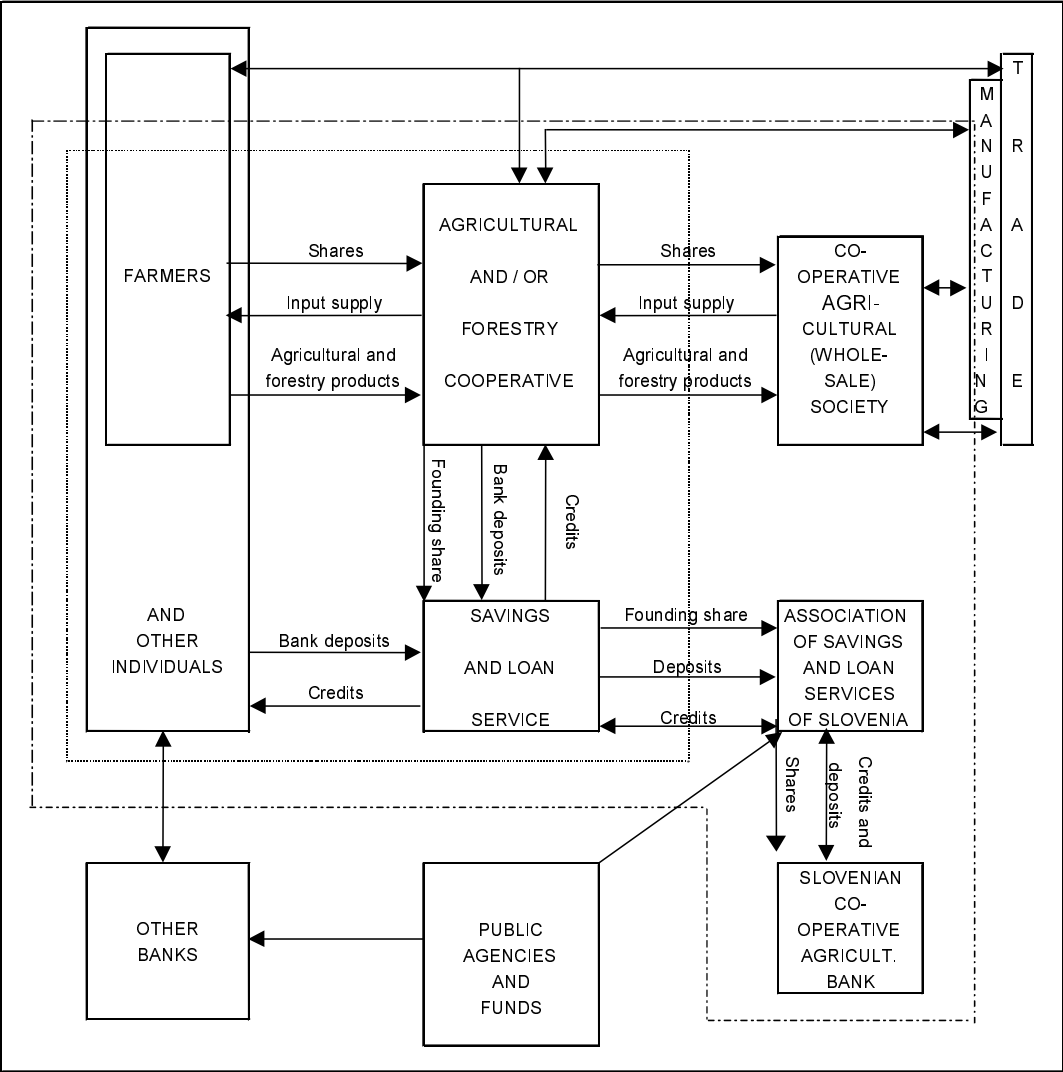
The SLS provide brokerage services and collect ownership certificates in co-operation with the Agricultural Company. SLS also undertake foreign currency and exchange transactions for the Slovene Farm Co-operation Bank. The SLS’s advisory role is very important as they provide farmers with financial and related information that is hard to obtain from conventional commercial banks.

SLS activities as a whole have been highly successful. In the last thirty years, no SLS has failed, none has needed to use a bank or state guarantee to meet its obligations, none has had assistance from the national budget and SLS have therefore not been a burden on taxpayers. This testifies to the successful farmer and co-operative management.

### **Association of Savings and Loans Services of Slovenia**

The Association of SLS is the central organisation of co-operative SLS in Slovenia. Its main responsibility is to safeguard SLS operations and supervise their development. The Association of SLS has the necessary expertise to manage and supervise the work of services, to harmonise the administration policy for accumulating deposits and evaluating lending conditions (interest rates and other conditions for savings deposits and loans). The ASLS is also responsible for the introduction of new products offering a full range of financial services for farmers. Its role in providing advisory and consulting services is also very important. The ASLS represents the SLS in consultations with domestic and foreign monetary and other institutions with the primary objective of introducing foreign know-how into Slovenia. It is also responsible for the promotion of credit co-operation and the introduction of modern data processing. The Association of SLS also manages the procedures for recovering the property of former loan co-operatives. Besides regulating the settlement of financial resources, the Association of SLS also supervises liquidity reserves. It transfers funds to SLS with insufficient resources for daily liquidity, the surplus is used for other purposes in the co-operative agriculture sector and as deposits in the Slovene Co-operative Agricultural Bank.

Figure 1. Saving and loan services in the agricultural co-operative system of Slovenia



Legend:  
----- Local or regional level  
..... Regional or national level

## Challenges faced by SLS

### *Gaps in legislation*

As was noted above, the legal framework for SLS operations was defined in 1990 in the *Savings and Loans Services Act*. However, this Act left some serious legislative gaps; combined with the important economic developments that have taken place in Slovenia during the past decade, this has created impediments for the successful operations of SLS.

The basic problems are:

- ❖ ***Uncertain legal status.*** Under the current Savings and Loans Services Act, SLS are recorded in the register of companies as legal entities with full responsibility. The law does not stipulate whether the SLS should be regarded as co-operative, enterprise, or commercial companies. While the current legal framework for SLS complies with the repealed Enterprise Act, it is not harmonised with the Commercial Company Act, the Banking Act or the Co-operative Act.
- ❖ ***Founders' liability.*** A particular problem for the future of SLS activities is the issue of liability. While the Banking Act introduced regulations on minimum share capital, the founders of SLS still have sovereign and joint liability for obligations arising from the SLS. Under the new law, the SLS will be the only organisation subject to a minimum share capital and the founder's sovereign guarantee. If all the founders' assets are subject to sovereign and joint liability, they will have no interest in share or capital payments. Capital and personal responsibility are precluded in all companies, therefore the same should apply for SLS. If this is not the case, SLS will be placed in an extremely unfair position with regard to other banks, savings banks and other commercial entities.
- ❖ ***Permits.*** Under European Union Directives, financial institutions have to adhere to a compulsory system regulating the issuance of operational permits. The section of the Banking Act that regulates permits does not apply to Savings and Loans Services. This means that in compliance with the EU directives the Bank of Slovenia has no legal foundation to issue a permit for SLS operations. Without a formal permit issued by the central bank, the performance of financial services is extremely difficult or even impossible. This again puts the SLS in a disadvantaged position with regard to other banks and savings banks.
- ❖ ***SLS activities and clients.*** The SLS Act stipulates that the Savings and Loans Services can operate with physical persons and the founders, whereas the Banking Act regulates transactions with small legal entities but prohibits dealings with medium and large enterprises. Because of the intrinsic link between the SLS and its founders, the majority of which are in fact medium and large enterprises (agricultural and forestry co-operatives), the discontinuation of transactions with founders would put the SLS's future into question, since the SLS would no longer remain an interesting business partner. This would also exacerbate the SLS investment policy.
- ❖ ***Changes in SLS status.*** Another major disadvantage is the lack of legislation concerning changes in SLS status following take-overs, mergers, restructuring, etc. The SLS Act has regulations only on the cessation of SLS dealings. There is also no meaningful application of the terms of the Banking Act, Commercial Company Act or Co-operative Act to SLS operations. This is a serious topical issue that became apparent during the process of SLS compliance with the provisions of

the Banking Act. The registration courts favour different viewpoints, and there is no case law that would apply to this field.

In order to guarantee the consistent development of savings operations and above all to ensure the successful adjustment of SLS operations to the provisions of the new Banking Act, it is imperative to clarify the major questions on SLS operations raised above. A new Loan Co-operative Act could successfully contribute to solving these issues in the following way:

- *Savings and Loans Services should be transformed into loan co-operatives, regulated by the provisions of the Co-operative Act; some issues, could also be resolved through compliance with the Banking Act;*
- *liability for SLS or loan co-operatives should be the same as that applying to limited companies and co-operatives;*
- *the procedures and conditions for issuing operating permits should be clearly defined;*
- *the client base of loan co-operatives should be expanded to include physical persons, founders and civil legal persons, as well as small and medium-sized commercial companies, all agricultural and forestry co-operatives and related commercial companies from the food-processing industry;*
- *the law should regulate the manner and procedure for SLS harmonisation with the provisions of the Banking Act, it should also contain legislation on changes in SLS status.*

### ***Conforming to the Banking Act and EU financial legislation***

The new banking legislation (the 1999 *Banking Act* and the *Decree on SLS Adjustment to the Banking Act*) has major implications for SLS operations. *The Banking Act* requires SLS to implement a number of organisational and financial changes by the end of February 2004. The *Decree* lays down the adjustment procedures. The *Act* and *Decree* impose the same criteria and requirements for SLS operations as for commercial banks, *i.e.* to fulfil requirements regarding minimum share capital (equivalent to Euro 1 million); capital adequacy; risk management, bank accounts and reports internal and external audit; and liability for deposits.

There are also requirements to adapt to EU financial legislation, including the obligation to have at least two members in the management board; consolidated supervision; and qualified holdings. SLS and their founders are unable to fulfil these requirements on an individual basis. The majority of SLS are unable to ensure the required minimum capital. And even if the founders succeed in amassing the required capital, the other legal provisions still represent a huge obstacle. Therefore the only solution is for SLS to organise themselves on a regional level, or to form a pan-Slovene association of Savings and Loans Services. The proposal for a joint SLS was put forward by the Association of SLS (see Box 2). The proposal is for the majority of SLS to integrate with the head office in Ljubljana (into the Association of SLS). A structure of local offices and cash register units would be maintained. In this way, former business procedures and methods would be maintained, while complying with the new legal and structural framework.

## **Box 2. Rationale for creating a pan-Slovene SLS under co-operative (and farmers) ownership**

In order to maintain financial independence, the co-operative system needs its own financial institution. While there is certainly some justification for integrating the SLS into a commercial bank, the Slovene Co-operative Agricultural Bank, and setting up a joint financial and banking system within the Co-operative Business System, there are many reasons why it is important and reasonable to establish a pan-Slovene SLS:

- Closed ownership structure – the founders choose and admit new members at community meetings or assemblies; similarly, the resignation procedure is regulated by the board of founders.
- Founders, as owners, would have a strong influence on the overall operations of the pan-Slovene SLS.
- Ensurance of an appropriate financial foundation for financial transactions within the agro-food sector.
- A coherent business flow from farmer to agricultural co-operative to SLS.
- The SLS' unique approach to clients: individual appointments, information provision, consultations, and commitment would be maintained.
- Decentralisation of decision making: the founders (co-operatives) influence business policy on their territory.
- More flexibility within the market sector which is controlled by SLS (in this case, smallness can be an advantage), more acute perception of the financial needs of the rural population.
- The preservation of co-operative principles in savings operations: voluntary nature; economic solidarity; democratic principles (one share per vote or restrictions against dominance); covering outlays (profit in business operations, but not as the underlying basis); identity (founders or members are also business partners).
- Different approach of government institutions towards SLS compared to other financial institutions (banks), and maintenance of previous benefits: no profit tax if profits are distributed into reserves; no tax on total assets; no expenses incurred for central bank surveillance.
- Certain criteria still have to be met: clear management structure; regular external audit every two years rather than annually; fulfilment of the minimum reserve requirement: partly in government or central bank securities, the inclusion of transaction accounts into the base for the calculation of the minimum reserve.
- Other services performed by SLS of benefit to clients: channelling support from the Regional Development Fund; channelling subsidies, state funds and other funds to the claimants.
- Links with similar non-profit institutions in the fields of trade, housing, consumer organisations, etc., and similar co-operatives and institutions.

## Summary and conclusions

Savings and Loans Services are co-operative organisations, which operate in accordance with co-operative principles and banking legislation. Their aim is to promote economic benefits for all their members, both the founders and their co-operative clients. Savings banks have been an important factor in the alleviation of economic crises in Slovenia that led to the failure of farms and the fragmentation of society. The financial policies practised by the SLS ensured that no farm fell into ruin. Savings banks or rather loan co-operatives have been traditionally perceived by the Slovene population as being strongly linked to economic independence, political equality and sense of identity. To a great extent this perception persists today.

Due to their decentralised and regional structure, co-operatives are well placed to perceive local needs and conditions and to adapt their dealings accordingly. The advantages for the future development of credit co-operatives in Slovenia are this good knowledge of local conditions (constant monitoring of loan capability) and the strong links with farmers who represent a significant part of SLS management. On the other hand, the low profitability of agricultural production is a drawback to the development of credit co-operation. Agricultural prices are steadily falling, and the problem is aggravated in Slovenia by the dispersed agricultural structure and higher production costs. However, compliance of Slovene farms, co-operatives and the food processing industry with EU requirements in the areas of veterinary medicine, plant protection, food safety, and environmental protection will call for extensive investment. Another potential growth area for SLS is rural development programmes, especially the introduction of additional, subsidiary activities on farms.

The main problem faced by SLS is the lack of adequate legislation. The SLS Act poorly defines the legal status of SLS, the relation between the founders and the SLS, the activities and customers of SLS, operating permits and changes in status. The Association of Savings and Loans Services is therefore pressing for a new law that would define SLS as loan co-operatives and formally introduce co-operative principles into savings services. Legislation was passed in 1999 that laid down some radical changes in the structure of the SLS. By 2004 it is expected that this legislation will result in the integration of most SLS into a single Slovene SLS – the Association of Savings and Loans Services.

Establishment of a pan-Slovene SLS would also ensure an appropriate financial foundation for financial transactions within the agro-food sector. It is clear that the services offered and charges would have to remain competitive vis-à-vis other financial institutions. The banking sector in Slovenia is highly concentrated. The four largest banks currently have 56% of the market share. The Slovene Co-operative Agricultural Bank is in 15<sup>th</sup> position with 1.5%.<sup>10</sup> This structure should ensure that competition for savings and loan services remains keen.

In conclusion, the savings operations sector in Slovenia has a number of very important issues to tackle. In order to achieve the necessary adjustments, the sector will need the support of the broader community in the following areas:

- *a positive government attitude towards the savings operations sector;*
- *consolidation of the SLS under the Association of SLS; if this is not possible, the SLS should remain under co-operative ownership;*

---

10. The Bank of Slovenia, Report on Supervision of Banking Operations, Ljubljana 2000, p. 74.



- *establishing a structure that allows the maintenance of operational procedures, while complying with operational and legal banking procedures;*
- *legal ruling on SLS status as a loan co-operative;*
- *to obtain some benefits that would foster and stimulate SLS development – at least in the transition period and the medium-term;*
- *changes in tax legislation concerning co-operative operations (the issue of related persons);*
- *a guarantee that the majority of funds for agriculture will be transferred through the SLS (subsidies, state support, SAPARD funds and other state funds, local community resources);*
- *financial support (grants) to restructure - integrate savings operations in particular for SLS which are in a critical situation (due to bad investments by farmers, co-operatives and other legal bodies); additional finance to increase the capital base of the integrated pan-Slovenia SLS; support from institutions such as the PHARE programme, EBRD, SAPARD for developing information systems, financial consultation and education, etc.*

**SESSION III. INFORMAL CREDIT FOR THE AGRICULTURAL SECTOR AND  
RURAL AREAS**



# THE ROLE OF TRADE CREDIT AND FOREIGN DIRECT INVESTMENT IN IMPROVING THE AGRICULTURAL FINANCE SITUATION IN TRANSITION COUNTRIES

By Mr. Johan F.M. Swinnen and Mr. Hamish R. Gow  
(Paper presented by Mr. Swinnen)

## Abstract

*Agricultural credit and rural finance problems are important constraints on restructuring, investment, and thus on recovery and growth in transition countries. This paper discusses which role trade and industry credit can play in reducing these constraints. Based on empirical evidence, the paper emphasises the role of foreign direct investment. The paper shows that companies have overcome institutional constraints by introducing contract innovations and programmes including trade credit throughout the agri-food chain. While empirical evidence on the impact is limited, the paper discusses several case studies which suggest that these innovations can be very important. Still, our case studies show that not all financial programmes and contract innovations were successful. More research is needed in this area to better understand the precise causes of success and failure of the trade credit, finance assistance, and contract innovations in the agri-food chain, and to identify the impact of the programmes, and the potential role of public policy.*

## Introduction

Agricultural credit and rural finance problems are important constraints on restructuring, investment, and thus on recovery and growth in transition countries. The problems are due to a combination of “normal” imperfections of rural credit and risk markets and specific transition problems such as macroeconomic instability, institutional reforms of the financial system, low profitability in agriculture, accumulated debts, high risk and uncertainty, and general contract enforcement problems (OECD, 1999; Swinnen and Gow, 1999).

This paper discusses which role trade and industry credit can play in reducing these credit and finance constraints for the agri-food enterprises. Based on empirical evidence, the paper emphasises the role of foreign direct investment.

## Financing problems in transition agriculture

Financing working capital requirements and investments<sup>1</sup> can come both from own resources and from (formal or informal) loans. Transition has constrained both sources of credit.

Own financial resources are constrained because hyperinflation wiped out many savings in early transition, and low profitability and cash flow problems have complicated building up own resources during transition.

- 
1. The discussion in this paper focuses primarily on working capital and short and medium-term investments. Those were the main constraints in (early stages of) transition; and these are the main areas where industry and trade credit played an important role. For these reasons there is little discussion of factors such as land property rights and markets for collateral purposes, since this plays little or no role for short-to-medium term credit.

Access to external credit has suffered from the same, and other, problems. Financial institutions are less likely to lend to enterprises with low profitability, outstanding debts, and cash flow problems. In addition, institutional problems such as ongoing reforms of the banking systems and the farms, a lack of credit history, high monitoring costs, etc. contribute to these problems.

While early discussions of the finance problems focused mostly on the institutional problems, recent empirical studies seem to emphasise the profitability and cash flow problems. For example, Pederson *et al.* (1997) emphasise the importance of profitability and cash flow problems in the perceived “excessive debt burden” of Russian farms. Another example is a recent Romanian survey, in which farmers identify insufficient income as the key reason for their loan application being rejected -- 52% of the cases, much more than lack of collateral (18%) or outstanding debts (11%) (Davis *et al.* 1998).

Throughout transition countries an important factor in the cash flow and profitability problems are contract enforcement problems throughout the agri-food chain. A widespread effect is delayed payments for product deliveries. A survey of food companies in Central Europe identified payment delays as their number one constraint to growth (Gorton *et al.* 2000). Data from Slovakian farms show that payment delays are strongly correlated with profitability problems (Slovak Ministry of Agriculture, 1996). A 1997 survey of Hungarian agricultural enterprises shows that for 61% of the farms contract breaches in the form of delayed payments is an important impediment to expanding profits (Cungu, Gow, and Swinnen, 2001).

### **Transition and contract enforcement**

Under the Communist regime, production and processing were centrally planned and vertically integrated. Industries were composed of large state-owned firms. The central authority provided contract enforcement and transacting parties were certain that the contracts were honoured.

Reforms caused several institutional changes which led to contract breaches. First, economic reforms split the vertically integrated chains into autonomous enterprises. Second, privatisation and restructuring of the companies in the agri-food chain created many independent enterprises. Third, the previous legal system or the central planning authority was no longer able to enforce the contractual terms and a new legal enforcement mechanism was absent or ineffective. Fourth, macroeconomic reforms and price and trade liberalisation caused dramatic changes in both nominal and relative prices. After many years of near price stability, inflation jumped to several hundreds of per cent while, for example, in agriculture the terms of trade declined dramatically during the beginning of the 1990s.

It is not difficult to imagine that these shocks caused widespread contract breaches throughout the economy. In the agri-food chain, food processors delayed payments to farms for delivered product. The effects were important. The payment delays caused additional financial strain, worsening the farms’ already severe cash flow and profitability problems. Furthermore, given these financial problems of farms and in the absence of enforcement mechanisms, financial institutions were not willing to loan to farms, and neither were input suppliers willing to provide inputs based on the promise of future payments.

Furthermore, the contract breaches and payment delays are self-reinforcing. First, as the payment delays worsen the financial situation of enterprises, their incentives to breach contracts themselves increase. Second, once such contract breaches have occurred, the companies or farms no longer have to worry about their reputation, making contract breach in the future more likely.

These problems obviously negatively affected farms, but also the other companies in the agri-food chain suffered. The input supplying companies saw their markets and revenues dwindle. Moreover, the processors themselves were worse off. They saw the quality and quantity of supplies fall. As farms no longer trusted the processors to pay them for their products in a reasonable time schedule, they either shifted their products to other crops, or invested less in the production of the commodity, thereby reducing their losses if payments came late.

In summary, finance constraints and contract enforcement problems made everybody worse off in the agri-food chain.

### **Restructuring and innovation in the supply chain**

What we observed in several case studies in transition countries was that these finance and payment problems have been overcome as the result of initiatives taken by a company up- or downstream from the farms. The initiatives include company programmes to provide farm assistance with accessing inputs (directly or indirectly providing trade credit) and innovations in contracting with farms.

Such programmes and innovations typically only follow a significant restructuring of the companies, often following foreign investment. The companies that introduced these innovations were typically restructured processing companies or input suppliers. Their motives are entirely private but the effects of the programmes have important spill-over effects throughout the chain. For example, processing companies, in order to produce higher quality products and reduce costs, need to access a guaranteed supply of high quality produce. These companies asked: how can we solve the problem of the poor quality supplies and uncertain deliveries by farms? How can we make sure that farms deliver guaranteed and quality supply?

The answer is straightforward: farms will only supply such products (a) if they are certain the processor pays according to the contract (amount and timing), and (b) if they have access to the necessary working capital and inputs for producing high quality commodities. In addition, as most of the restructured companies required higher quality product than the farms were used to deliver, the farms further needed to upgrade their equipment, technology, and management. This requires even more financial means, and of a longer duration.

However, even if the restructured companies would start paying the farms on time, it was unlikely that the farms would quickly adjust their strategies because (a) it takes a while to restore/build a better reputation, (b) their own resources were too low to make the investments themselves, and (c) the financial institutions were unwilling to lend to them because of the absence of good collateral or because of their poor profitability and cash flow history.

Hence, the conclusion for the up- and downstream companies was that if they wanted a secure supply and high quality supply base (processors) or if they wanted a viable market (input suppliers) then they (a) needed to assist the farms in making these investments and in accessing inputs and (b) needed to change the farms' incentives such that the farms would deliver good quality product (processors) or purchase and pay for their inputs (input suppliers).

## Contract innovations and trade credit

Here we summarise insights from several of our case studies, and refer to Gow and Swinnen (2001) and Gow *et al.* (2000) for details and for a conceptual analysis.

Successful companies investing in food processing introduced input provision and investment facilitation programmes for farms that deliver products to them and guaranteed timely payments based on pre-specified quality. The input provision programme indirectly provided farms with inputs, such as seeds, fertiliser, chemicals, credit, etc.

The most straightforward approach is pre-payment of farms' inputs and direct loans to them. For example, in several countries processors of oilseeds and grains provide advanced payments for chemical inputs and fertilisers. Dairy subsidiaries of western companies pre-finance feed for farms delivering milk to them and provide loans for milking equipment. Another approach, followed, for example, by Juhocukor, the largest Slovakian sugar processor, is to provide payment guarantees for farm input purchases with input supplying companies. The same approach was used in Juhosucor's finance and investment facilitation programme which provided Polnobanka, the main Slovakian agricultural bank, with a payment guarantee for contract-related loans by farms.

Through accepting the residual claim on farms' contract-related investments via input pre-payment or loan and payment guarantees, processors effectively increase their own costs of contractual breach, thereby making their honouring of the contract more likely, and their promises to do so more credible. At the same time the programmes reduce the farms' losses of delayed payments by processors. Hence, by simultaneously reducing the likelihood of a contract breach by processors and limiting the costs of it for farms, the programmes induce farms to increase contract-specific investments.

However, the financial assistance and input programmes introduced by processing companies may give farms an incentive to cheat. For example, in crop production farms may use the pre-financed fertiliser and pesticides for other crops, or just sell them. In fact, in one case we studied the company ended up cancelling the input pre-finance programme as farms continuously diverted the inputs for other uses. Another example is dairy farms which benefited from pre-financed feed and investment support from a dairy processor and then sold their milk to other dairy processors for a higher price, or ended up diverting some of their assistance to other uses.

Typically, the processors combine their input and finance programmes with technical support and extension programmes. These programmes serve three purposes: they provide the farms with management and technical support; they signal more commitments by processors; and they also serve as a monitoring device for the processors to control whether the farms are using their pre-financed inputs and guaranteed loans for contract-specific investments and whether they are committing the effort needed to produce high quality output.<sup>2</sup>

Another example of contract breach is when farms do not pay their input suppliers. To ensure payments by farms, input suppliers have engaged in a variety of, sometimes quite unconventional, forms of contracting. For example, in one case in Ukraine, described by Foster (1999), a US farm

---

2. Our case studies show that processors in transition countries have severe problems in enforcing quality and securing guaranteed quantity of supplies. This is difficult in general with agricultural production affected by unobservable factors, and even more problematic in transition countries. Changes in property rights, restructuring, macro-economic reforms, etc. all affect the farms' operation, and hence the volume and quality of their output.

equipment manufacturer partnered with local farm equipment distributors to sell combines and tractors to farms. The US company provided a large inventory of equipment for the distributor to sell on credit and to service. The farms received the equipment for a 25% down payment (in cash or kind) and after three additional payments received ownership. The equipment dealer, to ensure payment, was given the rights to a certain agreed upon grain area as repayment; moreover, the equipment dealer was given the rights to harvest, transport, store and sell the grain himself. Further, as part of the arrangement, the equipment dealer and the transactions themselves provided the farms with training and skill development.

Similarly, in Bulgaria, a US pharmaceutical subsidiary, in order to ensure payments for inputs delivered to farms, engaged, in collaboration with a specialised company, in downstream marketing of the grain of the farms to which they delivered inputs.

### **Vertical integration and contract enforcement**

As these case studies illustrate, both processors and input suppliers have vertically integrated “around” the farms. Processors introduced programmes to improve farms’ access to inputs as part of enforcing contracts on the downstream side of the farms. Inversely, input suppliers got involved in harvesting and marketing farms’ output to enforce contracts on the upstream side of the farms.

An even more complex example of such vertical integration “around” the farms is the use of so-called “special purpose vehicles (SPVs)” by international banks, such as Rabobank, in collaboration with agribusiness partners. An SPV is a stand-alone company jointly owned by the processor, input providers, and a project financed by the bank. The contract between the SPV and the farms includes all provisions on output, inputs, and credit.

An important advantage of such institutions is that the partners in the SPV now share the risk of contract breach. With the previously implemented input and investment facilitation programmes, processors carried the entire risk of farms’ breaching contracts, although both the input suppliers and the financial institutions benefit from these contract innovations. Institutions such as SPVs allow sharing of the risk between various agents, and hence, will stimulate investments by companies who otherwise may be deterred by the risk.

Interestingly, in some cases we observe farms participating in such structures. For example, in Eastern Hungary, we studied a group of sheep farmers who set up a producers’ co-operative through which they participated in an SPV-like joint company. This gave them more bargaining power *vis-à-vis* the other partners, much in the same line as a marketing or input purchasing co-operative does in a normal environment.

### **Contracts, trade credit, and farm organisation**

So far we have discussed the contracting and credit assistance as between homogenous agents in one specific, albeit uncertain and changing, environment. However, in most transition countries, farms vary widely in size and organisation, *e.g.* from small household plots or family farms, to large co-operatives or farming companies.

Intuitively one would expect companies to prefer larger farms with which to contract. However, our observations suggest that most companies contract with a variety of farms. Contracting with both small and large farms may be due to both necessity and preferences. The existing farm structure may



require companies to deal with small farms. For example, in Romania 90% of dairy cows are now in 1-2 cow “farms” (USDA). Hence any dairy processor needs to deal with small farms by necessity, focusing for example on investments in collection points etc. rather than on-farm equipment.

However, our case studies suggest also that company preferences for contracting with large farms are not as obvious as one may think. While processors may prefer to deal with large farms because of lower transaction costs in *e.g.* collection and administration, contract enforcement may be more problematic, and hence costly, with larger farms. In several interviews company managers indicated that (smaller) family farms were less likely to breach contracts or to divert company investments than large co-operatives or farming companies.

The company programmes differ to address the characteristics of these varying farms. For example, in case studies of dairy processors in Moldova and Poland, investment support for larger farms include leasing arrangements for on-farm equipment, while assistance programmes for smaller dairy farms include investments in collection units with micro-refrigeration units.

A large Slovakian oilseed processor we studied has three different contract types. In west and east Slovakia it contracts directly with farms. However, as it experienced more severe problems of diverting company-assisted credit to other uses on farms in eastern Slovakia, the company only provides them inputs in physical form (seeds, chemicals, and fertilisers), instead of credit assistance as in western Slovakia. In central and north Slovakia, the company contracts with so-called integrators, who then in turn contract with the farms. Similarly, Interbrew’s<sup>3</sup> Hungarian brewery/malting facility also contracts through integrators with smaller farms and directly with the larger farms, because of differences in transaction costs.

## **Transition and programme adjustments**

These programmes and contract innovations have been quite successful in a number of cases we studied in transition economies, though not always. In most cases it took considerable fine-tuning of the programmes and contracts to increase their effectiveness. In addition, circumstances change so rapidly in transition that contracts and programmes required continuous adjustments.

For example, Interbrew has different contracting and programme strategies in various countries and varying over time, depending on the local market structures, farm structures, and trade regimes. For example, in Hungary in the early 1990s it acquired its malting barley in the spot market. However as transition progressed the spot market quality was insufficient and contracts were introduced in order to secure high quality barley and/or malt.

More generally, it seems that as transition progresses, part of the role that trade credit and the input and financial assistance programmes play is reduced *vis-à-vis* formal credit sources and public enforcement mechanisms. For example in a 2000 study of investment on dairy farms delivering to a Polish dairy processor we found that access to credit for financing milking equipment was not restricted to those with contracts to dairy companies, but could also be obtained through the banks. However, pre-financed feed was restricted to the farms delivering to the company.

---

3. Interbrew, the Belgian brewing multinational with investments in many east European countries.

## Effects

The impact of these forms of trade credit and contract innovations is difficult to quantify as several other factors affect output simultaneously (Macours and Swinnen). Yet, while ‘hard’ empirical evidence is limited, what is available suggests that they can be very important.

First, in the case of Juhosucor, the largest Slovakian sugar company and the contracting farms, we have indicators which suggest a remarkable impact of the programmes (see Gow, Streeter and Swinnen). Transition contract disruptions caused a decline of sugar beet deliveries and contracted hectares of around 30% between 1990 and 1993. However, after the restructured company introduced the contract innovations and finance assistance programmes, contracted hectares more than doubled and farm yields increased significantly. As a result Juhocukor’s output more than tripled between 1993 and 1997.

Second, an analysis based on a survey of 371 Hungarian farming enterprises, of which 318 were contracting with processors, shows that there is a significant negative effect of the perceived likelihood of contract breaches on the farms’ investments in capital assets. Furthermore, 90% of the farms with contracts quoted security of outlets and prices as the main reasons for entering into contracts with processing companies (Cungu, Gow, and Swinnen, 2001).

That said, our case studies show that not all financial programmes and contract innovations were successful. For example, Interbrew quit its input support programme in Croatia since it could not enforce proper use of the inputs by its suppliers. In other cases, foreign investors left after they failed to obtain sufficient quality of raw materials from their supplying farms, despite extension, training, and support programmes.

A further important issue is the role of foreign investment. While conceptually there is no need for foreign direct investment (FDI) to implement the successful programmes and trade credit systems, empirically we observe that FDI has been the most important driving factor behind these programmes. One could think of reasons why that is the case: they have easier access to financial resources needed to get the system going and come in with a long term strategy in which upgrading of technology and quality standards throughout the chain is a key ingredient.

However, we do observe important instances of domestic companies implementing similar programmes. One could broadly distinguish two strategies of domestic companies introducing trade credit programmes and contracting strategies. The first is where domestic companies are forced to imitate programmes implemented by FDI-companies because of competitive pressures. Farms may no longer want to deliver to the domestic companies unless they get the same conditions as they get from the FDI-companies. This is what we observe in many east European countries, and these spillover effects occur not only within a certain commodity sector, but even across commodities through the competition for land use (for example, when oilseed farmers shift to sugar beet to get the benefits from the programmes provided by sugar companies).

A second strategy is where domestic companies autonomously introduce such programmes for much the same reason as the FDI companies. This seems to occur mostly when they can access financial sources from outside the agri-food sector. For example, in Russia the so-called financial industrial groups (FIGs) have started investing in the agri-food sector in recent years and have provided a much needed source of finance, resulting in vertical contracting and trade credit, similar to the programmes described above (see *e.g.* Melyukhina and Khramova (2000) and Wandel (2000) for discussions).

Finally, it is clear that more research is needed in this area to better understand the precise causes of success and failure of the trade credit, finance assistance, and contract innovations in the agri-food chain, and to identify the impact of the programmes.

An important issue therein is the potential role of public policy and regulation in stimulating the desirable effects of these innovations and in preventing potential harmful impacts. Much in this paper has addressed the benefits of contracting, FDI, and vertical integration. However, obviously there are potential dangers in terms of imperfect competition, unequal distribution of bargaining power in the chain, etc. This is illustrated, for example, in countries such as Hungary where FDI has led to a major inflow of finance and technology in the agri-food chain, but recently also to strong industry concentration in *e.g.* the food retailing sector, where the competitive pressures and industrial restructuring are providing major benefits for consumers but also causing major pressures on farms and food processors. Such issues need to be integrated to obtain a more comprehensive assessment of the aggregate effects, and to assess the role for government policy in this area.

Table 1. **FDI-induced vertical contracting and support to producers by agribusiness's in central and eastern Europe**

| <b>Foreign Investor</b>              | British/French<br>Sugar Processor     | British Sugar Processor | Belgian Beer Producer | Belgian Malter      | European<br>Seed Merchant     | ---                      |
|--------------------------------------|---------------------------------------|-------------------------|-----------------------|---------------------|-------------------------------|--------------------------|
| <b>Local Firm or Partners</b>        | Local Sugar Processor                 | Local Sugar Processor   | Local Brewery         | Local Malting Plant | Foreign Food<br>Manufacturers | Oilseed Producer         |
| <b>Activity</b>                      | Sugar Production                      | Sugar Production        | Malting               | Malting             | Seed Merchandising            | Vegetable oil production |
| <b>Countries of Investment</b>       | Hungary<br>Czech Republic<br>Slovakia | Poland                  | Romania<br>Hungary    | Croatia             | Central and<br>Eastern Europe | Slovakia                 |
| <b>Producer Type</b>                 | Sugar Beets                           | Sugar Beets             | Barley                | Barley              | Crops                         | Rape and Sunflower       |
| <b>Types of Support to Producers</b> |                                       |                         |                       |                     |                               |                          |
| Production and Equip. Training       | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Credit Access Programmes             | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Input Provision and Facilitation     | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Machinery Procurement                | Yes                                   | Yes                     | ---                   | ---                 | Sometimes                     | ---                      |
| Agronomical Support                  | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Veterinary Support                   | ---                                   | ---                     | ---                   | ---                 | ---                           | ---                      |
| Harvest and Handling Support         | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Quality Control                      | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Transportation                       | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Specialized Storage                  | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Bus. And Fin. Mgmt Support           | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Market Access                        | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |
| Timely Payments                      | Yes                                   | Yes                     | Yes                   | Yes                 | Yes                           | Yes                      |

Source: Gow and Swinnen (2001b).

Table 2. **FDI-induced vertical contracting and support to producers by agribusiness's in the former Soviet Union**

|                                      |                             |                              |                                  |                          |                    |                                 |
|--------------------------------------|-----------------------------|------------------------------|----------------------------------|--------------------------|--------------------|---------------------------------|
| <b>Western Investor</b>              | U.S. Combine Producer       | Swiss Confectionary Producer | U.S. Dairy Processor             | U.S. Food Catering Firm  | U.S. Nut Processor | U.S. Agri-Chemical Manufacturer |
| <b>Foreign Partner</b>               | Ag. Equipment Dealer        | Dairy Plant                  | Dairy Plants                     | Food Catering Enterprise | Facilities Owners  | Ag. Input Distributors          |
| <b>Activity</b>                      | Ag Equip. Leasing and Sales | Confectionary                | Dairy products                   | Fast Food Service        | Walnut processing  | Fertilizer and Pesticide Sales  |
| <b>Countries of Investment</b>       | Ukraine                     | Russia                       | Ukraine<br>Moldova<br>Kazakhstan | Russia<br>Ukraine        | Moldova            | Ukraine<br>Russia               |
| <b>Producer Type</b>                 | Grain and Oilseed           | Dairy Producers              | Dairy producers                  | Vegetable producers      | Walnut Growers     | Crop Producers                  |
| <b>Types of Support to Producers</b> |                             |                              |                                  |                          |                    |                                 |
| Production and Equip. Training       | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Credit Access Programs               | Yes                         | ---                          | ---                              | ---                      | Yes                | Yes                             |
| Input Provision and Facilitation     | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Machinery Procurement                | ---                         | ---                          | Yes                              | Yes                      | Yes                | Yes                             |
| Agronomical Support                  | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Veterinary Support                   | ---                         | Yes                          | Yes                              | ---                      | ---                | ---                             |
| Harvest and Handling Support         | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Quality Control                      | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Transportation                       | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Specialized Storage                  | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Bus. And Fin. Mgmt Support           | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Market Access                        | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |
| Timely Payments                      | Yes                         | Yes                          | Yes                              | Yes                      | Yes                | Yes                             |

Source: Gow and Swinnen (2001b) based on Foster (1999).

## BIBLIOGRAPHY

- Cungu, A., Gow, H. and J. Swinnen (2001),  
*Investment, Contracts, and Incentive Constraints in the Agri-food sector in Transition*, Policy Research Group Working Paper, Department of Agricultural and Environmental Economics, Katholieke Universiteit Leuven.
- Davis, J.R., Gaburici, A., and Hare, P.G. (1998),  
"What's Wrong with Romanian Rural Finance? Understanding the Determinants of Private Farmers' Access to Credit", Centre for Economic Reform and Transformation discussion paper 98/08, Department of Economics, Herriot-Watt University, Edinburgh, 44 pp.
- Foster, C. (1999),  
"The Impact of FDI in the Upstream and Downstream Sectors on Investment in Agriculture in the NIS", *Agricultural Finance and Credit Infrastructure in Transition Economies*, OECD, ed., pp. 198-211, Paris France: OECD Publications.
- Gorton, M., Buckwell, A., and S. Davidova (2000),  
"Transfers and distortions along the CEEC food supply chains" in Tangermann, S., and M. Banse (eds.), *Central and Eastern European Agriculture in an Expanding European Union*, CAB International.
- Gow, H. and J. Swinnen (1998),  
"Agribusiness Restructuring, Foreign Direct Investment, and Hold-Up Problems in Agricultural Transition", *European Review of Agricultural Economics*, 25(4):331-350.
- Gow, H., Streeter, D. and J. Swinnen (2000),  
"How Private Contract Enforcement Mechanisms Can Succeed Where Public Institutions Fail: The Case of Juhosucor A.S.", *Agricultural Economics*, 23(3):253-265.
- Gow, H. and J. Swinnen (2001),  
"Private Enforcement Capital and Contract Enforcement in Transition Countries", *American Journal of Agricultural Economics*, forthcoming.
- Gow, H. and J. Swinnen (2001b),  
"Foreign Direct Investment and Vertical Contracting in the Agro-Food Sector of Transition Countries", in A. Schmitz (ed.), *Agricultural Globalisation, Trade and the Environment*, Kluwer Academic Press, forthcoming.
- Macours, K. and J. Swinnen (2000),  
"Causes of Output Decline during Transition: The Case of Central and Eastern European Agriculture", *Journal of Comparative Economics*, 28(March):172-206.

- Melyukhina and Khramova (2000),  
“New Players in the Food Marketing Chain in Russia”, in Wehrheim P. and J. Von Braun (eds.),  
*Russia’s Food Economy: Towards Truly Functioning Markets*, forthcoming.
- OECD (1999),  
*Agricultural Finance and Credit Infrastructure in Transition Economies*, Paris.
- Pederson, G. D., K. Brooks, O. Lektman, and Z. Lerman (1997),  
“Russian Farm Finance Performance and Restructuring: A Debt or Profitability Problem?”  
World Bank Discussion Paper (Draft), The World Bank, Washington, DC.
- Pederson, G. D., and T. Khitarishvili (1997),  
“Challengers of Agricultural and Rural Finance in CEE, NIS and Baltic Countries,” Working  
paper WP97-5, Centre for International Food and Agricultural Policy, University of Minnesota,  
St. Paul, MN.
- Swinnen J. and H. Gow (1999),  
“Agricultural Credit Problems and Policies during the Transition to a Market Economy in  
Central and Eastern Europe”, *Food Policy*, 21(1):21-47.
- Wandel (2000),  
“Vertical integration in the Russian Agro-Food Sector”, in Wehrheim P. and J. Von Braun  
(eds.), *Russia’s Food Economy: Towards Truly Functioning Markets*, forthcoming.

# EQUITY FINANCING FOR WOMEN

By Ms. Astra Michels

## Abstract

*Equity capital should become a more important source of finance for women-owned businesses. Women business owners' access to finance and capital is severely constrained. This constraint results from a combination of factors with the effect that women business-owners generally do not seek out the range of institutional financing options and conversely, the financial sector typically does not target women's business for lending and/or investing. In the US, women own about 40% of the small and medium enterprises yet receive less than 5% of the nation's private venture capital. In the emerging markets, the proportion is even more minute. This paper describes how a venture capital fund, specifically targeting women-owned enterprises in the emerging markets, can assist these businesses and help them grow. Although equity funds generally invest in agri-processing versus primary agricultural production, the paper also discusses how fund investment in agri-processing can directly benefit primary producers by including them in the ownership mix.*

## Introduction

Women own at least a fourth of the world's businesses, but their share of business financing world-wide is disproportionately small. In the emerging market economies, women's businesses are an important untapped opportunity not only for commercial gain but also for economic and social development. Therefore, the Women's Emerging Markets Equity Fund (the Women's Fund) is being formed with the goal of obtaining significant capital appreciation for its shareholders through private equity and quasi-equity investments in women's businesses in emerging market countries.

In the United States, women own about 40% of the small businesses, including high-tech, biotech, and pharmaceutical research enterprises. A recent study by the National Foundation for Women Business Owners finds that women's businesses are just as financially sound and creditworthy as the typical US firm, and they have a higher survival rate. But thus far, women's enterprises have received only a minute share (less than 5%) of the nation's private venture capital. Recognising this financing gap, within the last five years, various organisations and funds have been formed to improve US women's access to capital and business skills.

In the emerging market economies, financing for women's businesses has further to go. Most women's formal businesses in the emerging markets are small and medium-sized enterprises (SMEs). Access to capital for SMEs in general, and women-owned SMEs in particular, is especially difficult. Moreover, cultural and societal factors have traditionally excluded women from the business relationships, financing, and information networks that they need to build skills and expand their businesses. Many women business owners don't have enough knowledge about financing options and therefore do not actively seek commercial credit or investment capital. The reverse side of the coin is that still relatively few women work in venture capital, most financial institutions don't collect data on women's businesses, and existing emerging markets funds do not specifically target women-owned enterprises. Yet emerging market women have proven to be a good business risk. Experience from micro-financing institutions shows that women repay more than 95% of the loans they receive.



All of these factors create a promising niche market opportunity. The Women's Emerging Markets Equity Fund will invest in individual women's businesses in the emerging markets and in financial intermediaries that serve them. The Fund plans to raise USD 50 million for investment initially focused on five to six countries, concentrating on three to four key sectors where women-owned/managed businesses prevail (e.g. agro-processing, health care, information technology). Once invested, the Fund would raise new money for additional investment markets. Market studies are underway in 15 countries.

Money alone, however, is not enough to sustain women's businesses and help them grow. Besides investment capital, added value needs to be provided by: closely monitoring investee companies' performance and participating on their boards; directing and co-ordinating technical assistance to investees; partnering and working with existing networks to help investees market their products, obtain business skills, and exchange information.

### **Investment capital for women's businesses in the United States**

In the United States where research is most developed, according to the National Foundation of Women Business Owners (NFWBO), over 9 million businesses are owned and managed by women and provide one out of every five private sector jobs. These businesses account for approximately 40% of the country's small businesses, generate USD 3.6 trillion per annum in sales, employ 27 million people, and are present in every industrial sector. Moreover, over the last ten years, the number of firms created and managed by women has grown twice as fast as those set up and managed by men. It is astounding however that, even though the venture capital industry is one of the drivers of growth and development in the US, women-owned businesses receive less than 5% of the institutional venture capital.

It is this scenario that inspired the establishment of one of the first US women's investment funds in 1997 – the Women's Growth Capital Fund (WGCF). The Fund raised USD 29 million as a licensed SBIC - Small Business Investment Company – under the US Government's SBIC programme (**Table 1**) which has been instrumental in the creation and growth of various women's investment funds. Investors in WGCF include Bank of America, FleetBoston Financial, State Street Bank, Silicon Valley Bank and about 70 individual investors. The Fund's goals are to invest in women-owned/managed businesses, encourage women to invest in private equity, and to achieve a 25-30% return for the Fund's shareholders.

After a little over three years, the Women's Growth Capital Fund is nearly fully invested with eighteen investments and is in the process of raising USD 75 million for a second Fund. Performance to date has been typical to that of traditional venture capital funds of similar size: over a 30% return on investments exited so far, one company has gone public, and two have failed. Seventy-five per cent of the portfolio is in the technology sector, the rest is in health care, telecommunications, education and retail.

Currently, just three years after closing the Women's Growth Capital Fund, there are eight US venture capital funds specifically dedicated towards providing women with private equity capital (**Table 2**). However, in spite of this dynamic growth of women-dedicated investments funds in the United States, the total capitalisation of these eight funds amounts to less than USD 200 million, a drop in the bucket when compared to the more than USD 12 billion invested annually by institutional venture capital funds. This highlights the fact that even in the United States, there is still very little risk-taking capital available for women entrepreneurs.

**Table 1. SBIC programme**

A number of governments support entrepreneurship by promoting venture capital through financial incentive programmes and also by directly investing in venture capital funds in their countries. In the United States, the Small Business Investment Companies (SBIC) programme, in place since 1958, is perhaps the best-known example of a hybrid programme of private and government equity investment.

SBICs, licensed and regulated by the Small Business Administration (SBA), are privately owned and managed investment firms that invest their own capital and borrowed funds (“leverage”) in qualifying small businesses. SBICs can supplement their private capital with SBA funds (“leverage”) at a ratio of up to 3:1. This “leverage” comes from debentures or participating securities issued by the SBICs and sold in the public markets through underwriters. The SBA guarantees the repayment of the principal and interest with the full faith and credit of the US government. Two types of “leverage” are available for SBICs:

*Debenture Leverage*

- Up to 3 times private equity capital
- 10 year term, lump sum principal payment at maturity
- Interest rate: 75-95 basis points over 10 year Treasury Rate
- Semi-annual interest payments

*Participating Securities Leverage*

- Preferred equity instrument – up to 2 times private equity capital
- 10 year term
- Similar interest spread
- Dividends paid only when the SBIC has positive retained earnings.

In the meantime, the SBA makes payments to investors on behalf of the SBIC, and in return, SBA receives about a 10% profit-sharing in the SBIC’s earnings

The Programme has had many successes; for example, SBICs provided initial funding for a number of well-known US companies such as: America on Line, Apple Computer, Federal Express, Intel Corporation, and Staples.

Table 2. US funds investing in women-owned/managed businesses

| <b><u>Fund name</u></b>            | <b><u>Fund objective</u></b>                                                                                                                                                                                                                                                                                    |
|------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Blue Chip Opportunity Fund</b>  | Making equity investments (USD 200 000 - USD 1 000 000) in companies that are substantially owned by women.                                                                                                                                                                                                     |
| <b>Capital Across America</b>      | Making equity investments (USD 250 000 - USD 800 000) in companies that are substantially owned by women and specialising in “dequity” or debt that works like equity (USD 25 million).                                                                                                                         |
| <b>Inroads Capital Partners</b>    | Providing growth and acquisition capital for minority and women-owned small and medium enterprises (USD 50 million).                                                                                                                                                                                            |
| <b>Isabella Fund</b>               | Making early-stage investments (USD 200 000 - USD 2 000 000) in female owned businesses, targeting technology enabled, market driven companies with a concentration on the Internet, and focusing on the following industries: information technology, healthcare, retail/consumer product, and communications. |
| <b>Milepost Ventures</b>           | Investing in women-owned businesses that are engaged in the following target markets: early-stage life science, healthcare, information technology, and communications. Investments range from USD 100 000 to USD 1 000 000.                                                                                    |
| <b>The Women’s Equity Fund</b>     | Providing start-up capital, loans, and technical assistance for women-owned businesses in the state of Colorado (USD 1.6 million).                                                                                                                                                                              |
| <b>Women First Capital Fund</b>    | Currently in formation, with plans to focus on providing equity investments and debt securities with convertibility features and warrants to businesses that have a women-focused product, are majority owned by women, or have significant female senior management.                                           |
| <b>Women’s Growth Capital Fund</b> | Making equity investments (USD 500 000 - USD 2 000 000) in companies that are substantially owned by women, with no specific industry focus but with a regional focus on the eastern coastline of the United States (USD 29 million).                                                                           |

### **Investment capital for women’s businesses in the emerging markets - The opportunity**

Despite the scarcity of international data on women-owned SMEs, a number of observations show the substantial importance of women-owned SMEs and the increase in the number of women entrepreneurs. For example, the 1991 census in India indicated that female entrepreneurs represented 10% of all companies. In the transition economies of Eastern Europe (Poland, Romania, Russia),

although statistical data broken down by gender are scarce, evidence there suggests that women (who were particularly affected by privatisation of State-owned industries and the structural unemployment resulting from transformation to market economies) are increasingly turning to entrepreneurship.

**Table 3. Ownership facts**

- In China – women founded 25% of the businesses since 1978.
- In Europe and Newly Independent States (NIS) transition economies – women are 25% of the business owners.
- In Hungary – women started more than 40% of all businesses since 1990.
- In Poland – women own 38% of all businesses.
- In Mexico – 32% of women-owned businesses were started less than 5 years ago.
- In Swaziland - women account for about 70% of micro, small and medium enterprises.
- In Russia – women own 64% of firms employing 10 people or more.

In emerging markets, women's enterprises and their needs for capital are growing. More liberal economic policies have opened doors for the establishment of private businesses, including small and medium-sized companies owned and managed by women. And the success of micro-finance has created a group of women entrepreneurs who need capital to grow their businesses further.

Thus far, women's businesses have attracted only a minute share of private capital. Most women's enterprises in the formal sector are small and medium-sized (SMEs). Although enterprises in this size range are vital to the economic and social advancement of the emerging market economies, SMEs have been largely overlooked by loan financing, equity capital, and technical assistance. And the women's businesses are even more under-served.

The majority of women business owners rely on family relationships to meet their financing needs. A number of specialised institutions have been created to focus on micro-lending to women, but no international emerging market equity fund specifically targets women's businesses. Young growing enterprises need access to both equity and debt financing. Many women's businesses lack sufficient equity capital to enable them to borrow from financial institutions. Investment from equity funds can increase a company's capital base thereby increasing chances for loan financing and opportunities for enterprise growth.

Beyond financing, emerging markets women's businesses also need access to business networks to help improve business skills, marketing, planning, and financial management. Investment funds, as equity partners, induce and help business owners/managers to receive training and technical assistance, and thereby further increase their chances of business success.

## **Investment strategy - Aim global, go local**

The Women's Emerging Markets Equity Fund would be the first investment vehicle to target international equity investment in companies owned and managed by women in the emerging market economies (**Table 4** shows the Fund's key features). The Fund will invest equity and quasi-equity (generally on a minority basis) in growth-oriented enterprises that are:

- majority-owned by women, or
- managed by women at the executive level, or
- staffed predominantly by women, offering them career development and ownership opportunities.

The Fund will also invest in financial intermediaries that specifically target or have programmes for women's businesses (up to USD 5 million). As most individual women's enterprises are small and medium-size, the Fund will target opportunities with a minimum size of USD 300 000 and an average investment of USD 1 million (5-10 investments per country). The Fund will also invest in larger enterprises as opportunities arise.

The Fund will seek equity holdings that enable the Fund Manager to:

- exercise substantial influence over investee companies;
- become actively involved in the management of investees to add value to these companies; and
- exit through sales formulas prearranged with existing shareholders or through sales to strategic investors.

The Women's Fund strategy is to invest opportunistically throughout its markets in a range of sectors. However women's businesses are heavily represented in the following sectors: agro-processing, information technology, fashion (manufacturing/wholesale & retail, textiles, beauty products), and healthcare (including medical clinics, pharmaceuticals, spas, health insurance). Accordingly, the Fund will concentrate investment and develop advisory expertise in these sectors as well as accumulate a portfolio of investments that could offer an interesting package-sale opportunity to strategic investors.

The Fund Manager will help to earn commercial returns for investors by:

- building, training, and supervising local management teams;
- professionally selecting and evaluating companies with promising growth prospects and low asset prices;
- providing comprehensive advice to investees in order to ensure sustainability and to maximise potential capital gains;
- sourcing technical assistance and assisting investees directly in crucial areas such as marketing, productivity, and financial management.

Table 4. **The Women's Fund**

**The Women's Emerging Markets Equity Fund**

|                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|--------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Investment objective:</b>   | To obtain significant long-term capital appreciation for its shareholders through private equity and quasi-equity investments in enterprises in emerging markets that are growth oriented and (a) are majority-owned by women; (b) are managed by women; or (c) predominantly employ women and offer them career advancement and ownership opportunities. The Fund will also invest in financial intermediaries that serve women's businesses.                |
| <b>Investment instruments:</b> | <p>Primarily minority equity participation (up to 49% of share capital), with significant approval rights and often in combination with subordinated debt and other quasi-equity instruments.</p> <p>To minimise investment risks, the Fund will: (a) invest no more than 10% of its net assets in any one company or business group; (b) co-invest with strong and reputable local partners; and (c) diversify the portfolio across a number of sectors.</p> |
| <b>Investment size:</b>        | Individual enterprises: minimum investment - USD 300 000; average target investment size - USD 1 million for individual enterprises, USD 1-5 million for financial intermediaries.                                                                                                                                                                                                                                                                            |
| <b>Target return:</b>          | Pre-tax 20%, net of fees and expenses.                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Committed capital:</b>      | The Fund intends to obtain aggregate commitments of USD 50 million.                                                                                                                                                                                                                                                                                                                                                                                           |
| <b>Committed period:</b>       | Three years.                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Term:</b>                   | The Fund is expected to terminate 10 years from the closing.                                                                                                                                                                                                                                                                                                                                                                                                  |
| <b>Exit strategy:</b>          | Given the level of capital markets development in emerging market countries, the Fund is expected to rely primarily on pre-negotiated exit formulas.                                                                                                                                                                                                                                                                                                          |

**Fund manager - The pioneers**

To manage the Women's Fund, a world-class core of investment professionals will be headquartered in Washington and supported by local teams in key markets. The Fund management has a successful track record of investing in emerging markets, specialisation in SMEs, and thorough practical understanding of issues facing women's enterprises in the emerging markets. To optimise and leverage its own resources and have a cost-effective local presence, the Fund Manager will also form exclusive partnering arrangements with several successful private equity investment firms (country/regional partners) that have operations and staff in the Fund's markets of interest.

The management company, headquartered in Washington DC, will manage the Women's Fund, set up each of the local offices, and provide comprehensive support and guidance to the local teams, source and co-ordinate technical and marketing assistance to investee companies. The Fund management will also participate on the boards of directors of investee companies. The Fund's Investment Committee

will approve each investment recommendation. The Fund investors and Fund management will appoint representatives to the Investment Committee.

### **Local management and investment partners - The front line**

The local team, supported by the Fund's country/regional partners, will be responsible for identifying, evaluating, structuring, negotiating, closing, monitoring, and reporting on each investment. The local teams will receive formal training and ongoing support from the headquarters team and from institutions specialising in equity investment, such as the Institute of SME Financing in Washington. The local managers will also represent the Women's Fund on the boards of directors and managing committees of investee companies.

The Fund's country/regional partners will support the Fund's local management teams in identifying, evaluating, closing, and monitoring transactions over a broader base than the Fund could achieve by itself. This dual strategy of leveraging and optimising the Fund's own equity investing skills with the country/regional partners local knowledge and experience is designed to give the Fund broader access to investment opportunities throughout its target markets. Sharing the country/regional partners' offices and already existing infrastructure also will help to keep operating costs low.

### **Business advisory services - Adding value**

Equity investment in SMEs, and particularly women's enterprises, is still in its infancy, and the Fund Manager will need to provide a significant amount of advice to its portfolio companies. In conventional private equity and venture capital investing, the major activity of a fund manager is to select a small number of investments from a much larger number of business plans. At the SME level, however, reliable business plans are rarely available, and thus the core activity of a fund manager is more to build businesses rather than to pick them.

Women's businesses need more than money; business support — especially during the first two to three years of an investment — is crucial if the portfolio companies are to achieve a solid financial record and growth trajectory. According to UNCTAD, in addition to lack of capital, the main obstacles to the development of women's enterprises are lack of access to technical assistance, information/technology, training and networking. Advisory services typically needed by small and medium-size enterprises include financial management, marketing, improvement of terms/conditions of sales and purchasing agreements, growth management, and restructuring and negotiating bank debt.

The Fund's trained local staff will be the first providers of advice, augmented by outside technical assistance services affordable to investees. The Fund will seek cost-effective business support through its country/regional partnership arrangements, sourcing technical assistance grants whenever possible, drawing on business women's networks and specialised agencies, service of retired technical experts, and mentoring by successful business executives from industrialised markets.

### **Investment in agri-processing - Benefits to primary producers**

As noted above, the agri-processing sector will be an important source of investment for the Women's Emerging Markets Equity Fund. Without women the world would go hungry. Women are responsible for producing between 60-80% of the food in emerging market economies. In regions such as Sub-Saharan Africa, women provide approximately 80% of the staple foods and in Asia, women perform 90% of the work in the rice fields. Yet the magnitude of these numbers is underscored by the

irony that women's access to financial and other resources is still severely limited. The traditional pattern in agrarian societies has focused on giving men control over agricultural resources, which in turn, led to men becoming the recipients of training and investment in the agricultural sector.

Venture capital rarely invests equity in primary agricultural production. The commercial banking sector is the customary supplier of financing to agriculture and will probably continue to be so. Agri-processing, rather than agriculture, is the more likely beneficiary of equity fund investment. There is evidence, however, that investment in agri-business can also benefit the primary agricultural producer in a variety of ways. Gow and Swinnen in their paper entitled: "The Impact of FDI in the Downstream Sector on Agricultural Finance, Investment and Production: Evidence from the CEEC", discuss some of the spillover benefits of foreign direct investment in agri-processing to primary agricultural producers. These positive spillover effects include: increased access to external financial resources through trade credit, leasing and other financial instruments; as well as increased availability of technical assistance and managerial assistance.

An additional spillover effect of venture capital investment in agri-processing on agricultural producers also warrants a closer look. It is a fact that equity funds invest in agri-processing versus primary agricultural production. However, if you can't bring Mohamed to the mountain, then bring the mountain to Mohamed, i.e. give the primary agricultural producers an opportunity to share in the ownership of agri-processing concerns. One such example is a cashew processing plant in Tapachula, Mexico.

Fondo Chiapas, a small equity fund investing in Mexico's southernmost State, decided to invest in a greenfield cashew nut processing facility led by Grupo Agros, a Mexican agri-business group. Mexico imports over 95% of its cashew nut consumption. Cashew trees are being cultivated in Chiapas as a result of a state sponsored programme initiated a number of years ago, however, there are no cashew processing facilities in Chiapas or other parts of Mexico.

Grupo Agros, the lead investor, decided to make available a portion of the processing plant's shares to the surrounding cashew growers. A formula was devised whereby the growers could elect to take part of the payment for their cashew crop in shares of the processing plant. Bringing in the cashew growers into the ownership mix of the processing facility results in a win-win situation for both sides.

Cashew growers reap a number of benefits by participating in plant ownership such as sharing in the income of higher value-added product thereby supplementing their own farm income. Moreover, the growers also mitigate risk by diversifying their sources of income. For example, in the event of crop failure, the farmer suffers, however the plant can import and continue to process raw material (in this case from Guatemala) and still produce income. Additionally, growers benefit from long-term employment opportunities for their families (in this case wives and daughters as most employees are female) in an area with little employment opportunity, especially for women. Growers also benefit from easier access to credit, training and technical assistance, as well as gaining knowledge about the processing business.

The owners of the processing plant also benefit. The inclusion of cashew growers in the ownership mix provides the plant with a more reliable supply of raw material. With a stake in the income of the processing plant, the grower is less likely to abandon cashew cultivation or switch to another crop. Cashew growers' families in the surrounding cultivation area provide a steady source of employment for the processing plant. Intangible benefits such as goodwill also should not be discounted; everyone having something at stake contributes to everyone pulling together and better working relationships.



## BIBLIOGRAPHY

- FleetBoston Financial, The Edward Lowe Foundation, The Kauffman Centre for Entrepreneurial Leadership (2001),  
*Entrepreneurial Vision in Action: Exploring Growth Among Women- and Men-Owned Firms*, The National Foundation for Women Business Owners, February 2001.
- Foster, Christian (1999),  
“The Impact of FDI in the Upstream and Downstream Sectors on Investment in Agriculture in the NIS”, *Proceedings, OECD Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies*, Moscow, February 1999.
- Foundation for Entrepreneurship Development (2000),  
*Survey on Women Entrepreneurs and Their Role in the Economic Transformation of Bulgaria*, Sofia.
- Future Harvest (2001),  
*Women Feed the World*, [www.futureharvest.org](http://www.futureharvest.org), 9 April 2001.
- Gow, Hamish and Johan Swinnen (1999),  
“The Impact of FDI in the Downstream Sector on Agricultural Finance, Investment and Production: Evidence from the CEEC”, *Proceedings, OECD Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies*, Moscow, February 1999.
- “Investing in Agriculture and Food Production”, *Food for All*, 1995.
- Jalbert, Susanne E., Ph.D. (2000),  
*Women Entrepreneurs in the Global Economy*, March 17, 2000, pp. 3-9, 14-16, 24-27.
- Koreen, Miriam (2000),  
“Financing for Women-owned Businesses”, Background paper, The 2<sup>nd</sup> OECD Conference on Women Entrepreneurs in SMEs: Realising the Benefits of Globalisation and the Knowledge-based Economy, Paris, France, 29-30 November 2000.
- Lisowska, Ewa, Richard T. Bliss and June Lavelle (2001),  
*Polish Women Managers 2000*, Survey report, February 2001.
- Miller, Saunders (1999),  
“Small Business Investment Company Programme: Outline of Comments”, *US Small Business Administration*, January 1999.
- The National Foundation for Women Business Owners (2001),  
“Survey shows traits of women owners of fast-growth firms”, *NFMBO News*, Issue No. 1.

- OECD (2000a),  
Abstracts, *Women Entrepreneurs in SMEs: Realising the Benefits of Globalisation and the Knowledge-based Economy*, Paris, France, 29-30 November 2000.
- OECD (2000b),  
“Fostering Entrepreneurial Culture for Women: Education, Management Training and Societal Values”, Issue Paper No. 1, *Women Entrepreneurs in SMEs: Realising the Benefits of Globalisation and the Knowledge-based Economy*, Paris, France, 29-30 November 2000.
- “People in Food Production”, *Food for All*, 1995.
- Rural Women (1999),  
“World Rural Women’s Day 15 October: Give Credit to Rural Women”,  
[www.rural-womens-day.org](http://www.rural-womens-day.org).
- US Small Business Administration (2000),  
“The SBIC Programme: Overview”, [www.sba.gov](http://www.sba.gov), July 13, 2000.
- Wells Fargo & Co., NFMBO (2000),  
“Women Entrepreneurs in the Equity Capital Markets: The New Frontier”, *The National Foundation for Women Business Owners*.

# **FINANCING AGRICULTURE THROUGH VERTICAL INTEGRATION: THE CASE OF HUNGARY**

**By Mr. Tamás Székelyhidi**

## **Abstract**

*This report discusses the role of vertical integration as a tool for stimulating the development and modernisation of SMEs in the agro-food chain in Hungary, in particular in underdeveloped regions. In addition to reviewing some general trends in Hungarian agriculture, the report looks at the Total Quality Management (TQM) model and discusses a case study that employs the integrator and TQM concepts. Resource mobilisation possibilities are revealed that provide agricultural SMEs with quality and financial support that help enterprises to be sustainable. The appearance of informal credit (investment from outside entrepreneurs) in agriculture is discussed in the study. Finally, the report emphasises the importance of a coherent and targeted flow of information, especially in underdeveloped regions, and underlines the key role to be played in this respect by agricultural extension and advisory services.*

## **General trends**

### ***Characteristics and structure of agriculture***

The importance of agriculture in the national Hungarian economy has gradually declined over the past decades. In 1994, agriculture represented 6% of GDP, while by 1998 this had dropped to 5%. In EU countries, except for Greece and Ireland, agriculture's share is between 1 and 5% of GDP. Agriculture and the food industry together account for 9-10% of GDP while the overall share of agro-business (including the production of fertiliser and plant protection chemicals, trade, education, etc.) is 15-18%.

The food industry is a significant sector in the national economy, producing an output value of HUF 1 300 billion yearly, that is 4% of GDP. Its importance is due to the fact that the sector processes 75% of agricultural products and thus influences the financial situation of hundreds of thousands of families working in agriculture. Three to four per cent of active workers are employed by the food industry. Most processing plants are situated in the countryside.

Food, drinks and tobacco products accounted for 12% of exports and 3.7% of imports in 1998, thus the trade balance is positive. Exports could be further increased through investment and improved marketing. These adjustments are becoming urgent to take account of changes, since 1998, in the sales system, as well as the increasing prevalence of multinational trading companies and shifts in the trade balance (it is still positive, but imports of processed products have increased). The habits and expectations of consumers have also changed considerably, representing a further challenge for the sector. Ninety-five per cent of the 8 700 operating enterprises employ less than 50 people and belong to the small- and medium-sized category, and only 108 enterprises (1.3%) employ more than 300 people.

Food processing has developed unevenly over the recent past. The situation of some sub-sectors such as mineral water, soft drinks, confectionery and alcoholic beverages, has improved due to structural changes and the modernisation of privatised companies and, in these sectors, processing plants already

meet EU standards in technology, quality and profitability. However, in other areas, mainly in basic agricultural production, structural changes are still underway and products are less competitive. Above all, in particular for local SMEs producing for the domestic market, the lack of capital is the main obstacle to technological development and to meeting hygiene, environmental and animal protection standards. Inability to meet these standards puts the future of these operations into question and there is a real danger that they will be ousted from the market. The sectors concerned are the primary processing of agricultural and fishery products (agro-food sector), mainly meat, fish, poultry, eggs, milk, fruit and vegetables and wine production. The agro-food sector accounts for 14 of the 34 sub-sectors. It includes 2 860 enterprises, only 80 of which employ more than 250 people.

Many aspects of the privatisation process of the Hungarian food industry carried out in the 1990s were widely criticised. However, the fast privatisation and modernisation of strategically important, large enterprises definitely had positive effects as it ensured the continuity of agricultural production and opened up new opportunities. Due to these trends, production started to grow again after a sharp decrease following changes in the political system. There were several reasons for the earlier decrease, such as political changes, privatisation, changes in the distribution and ownership of land, market loss, etc. It has been claimed that that the expansion of multinational companies in Hungary served only to obtain market share. It has also been said that in this competitive situation the outlook for Hungarian SMEs declined sharply. However, multinational companies triggered a fast shift in the way of thinking and responded to consumers' requirements. To reach this goal, quality systems and new marketing strategies have been introduced and a positive attitude is being established among entrepreneurs, resulting in an increase in vertical co-ordination, the introduction of quality systems and the production of internationally competitive products.

Hungary's state of economic development makes it possible for agricultural SMEs to obtain special support from state development programmes. EU resources and these state programmes will hopefully generate further development. Although strategic goals such as regional development and modernisation are very important in determining the allocation of resources, entrepreneurs can influence decisions by submitting effective proposals. Vertical, strategic, finance programmes can provide customised solutions by sector and by region.

SMEs in the Hungarian food industry lag behind the EU in the following areas:

- productivity is lower than Western countries;
- a lack of capital and difficult conditions for obtaining credit makes investments and quality improvement a challenge;
- co-operation between producers and processors are being established through stable contract conditions, but the building up of a market-oriented quality raw material base has just started;
- in domestic food processing, specialisation that is characteristic in the EU, has just started to develop and conditions for the effective size of processing plants do not prevail.

Possibilities:

- Favourable natural conditions and good arable land make additional investments in agriculture effective.
- Effective use of state support (special technological development).
- State support for the production of high quality products to increase choice on domestic and foreign markets.
- Introduction of agri-environmental measures (support) helps the establishment of a balanced land-use structure and the regeneration of extensive technologies that meet the demand of health-conscious consumers. This also keeps more people in the countryside.
- Modern education methods and more effective extension services help to disseminate specialised knowledge.

### **Importance of the links between vertical integration and TQM in development programmes**

Vertical integration takes place automatically in product lines, because there is the producer on one side and the consumers' demand and the end product on the other side. The essence of a development strategy in an enterprise, sector or regional programme is the relationships inside the system and the added value of the product at the different levels. By simplifying this even more, we can say that the question is whether the system and its end-product is able to meet consumers' demand and thus ensure income for the workers in the system.

The philosophy behind TQM is that quality assurance is required at every level of the system. It also asserts that one end is the market where continuous analysis is needed, the other end is the person participating in the system for whom continuous training is required. The efficiency and sustainability of vertical programmes are of high importance especially in countries that have only recently changed to a market economy system. The only guarantee for this is the application of TQM methods and means to the management of vertical systems. When there is sufficient and adequate information it is possible to provide assistance and subsidies at the optimal place and time, which will have a positive effect on the whole system.

I was leading the ACIDI/VOCA Programme (Agricultural Co-operative Development International / Volunteers in Overseas Co-operative Assistance) between 1995 and 1999 in Hungary, financed by the United States Government. In the framework of this programme we participated in several sectoral development projects. Our biggest achievement was the establishment of regional (in underdeveloped regions of Hungary) vertical integration systems and training to manage them. The methodology used consisted of the following elements:

- market analysis;
- product development;
- working out the elements and the parameters of the TQM system;
- feasibility study;

- preparation of business plans for enterprises at different levels of the integration;
- preparation of educational materials and organising training courses;
- co-ordination of financial resources;
- monitoring.

As a result of the programme 264 new, marketable products have been developed (meat, milk, fruit, vegetables), but the most important achievement is that sustainable co-operation was established between the producers and the processing plants. Seventy-four regional integrations were built up based on the newly developed products and the involvement of small- and medium-size enterprises. The amount invested in these programmes was more than USD 5 million, including state, bank and private capital. The establishment of alternative rural enterprises was one of the priorities of the programme.

When designing the TQM system, the following issues were taken into consideration:

- providing quality control;
- conditions for quality assurance;
- conditions for profitability;
- sustainability of the system;
- stable markets for the products.

Figure 1. shows the structure of the TQM system that was used for the development of regional goat and sheep production systems.

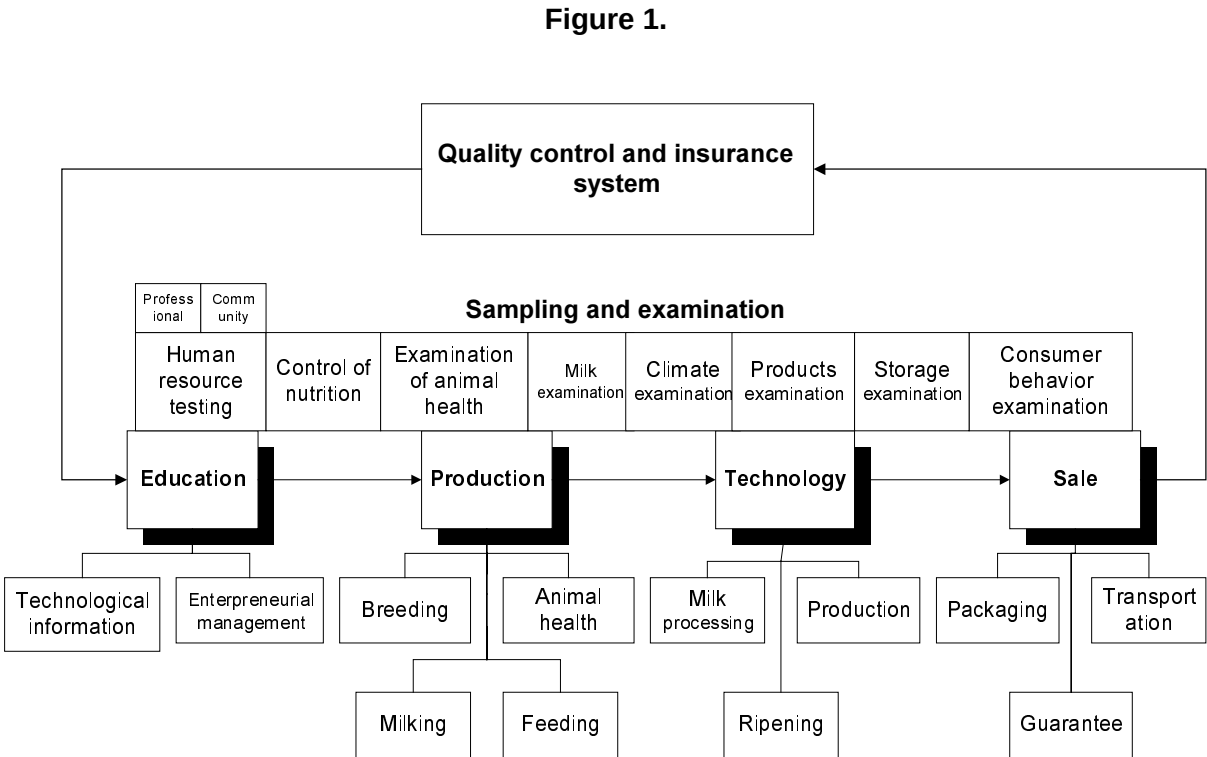
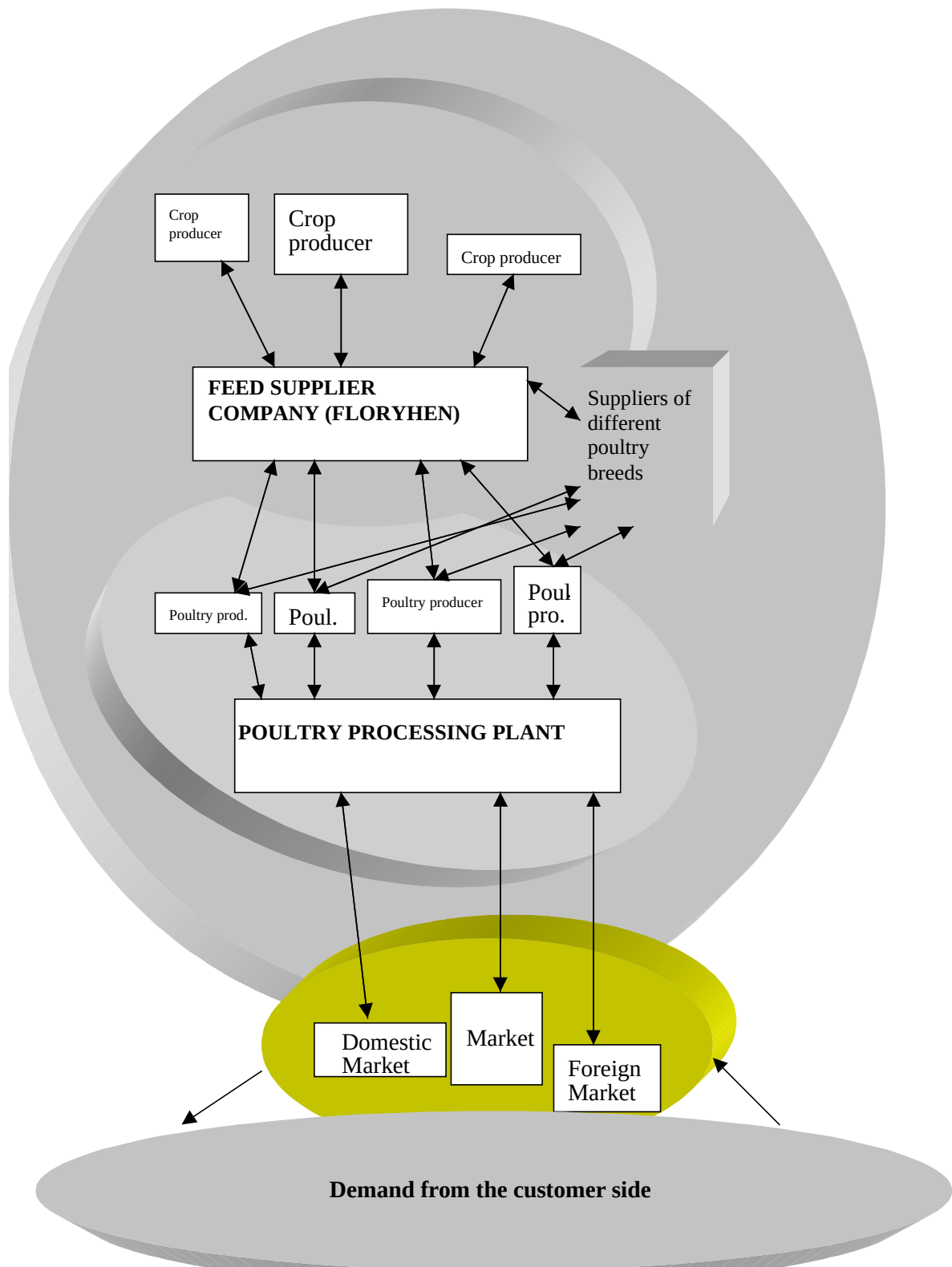


Figure 2. shows a poultry sector development model, in which internal integration is emphasised. While these relationships could be managed individually, sustainable results cannot be achieved without an understanding of the overall system.

Figure 2. Poultry industry





Possibilities for the use of the model:

- enhances marketing opportunities;
- the network owner obtains extra profit without additional investment;
- promotes the establishment of private businesses;
- creation of new jobs at the family level;
- improvement of the economy in underdeveloped regions;
- the quality control system provides protection for producers and buyers;
- promotes introduction of modern management techniques;
- solicits outside resources;
- gives an example for regional co-operation.

Adaptation of the model:

- Operational mechanisms among the various organisations involved in the model have been elaborated. Various patterns of co-operation have been outlined. These patterns provide information on how much investment is needed as well as on opportunities for marketing goods and the relationship with banks.
- A developed integration and co-operation system based on family farms:
  - franchise;
  - franchise model with credit construction;
  - co-operative (production, marketing, supply);
  - Vertical and horizontal integration with shared capital investment.

### **Appearance of informal credit (outside investors) in agriculture**

Well-structured vertical integrations are transparent systems where players are known, processes can be planned and the capital security can be guaranteed. Every system that meets these criteria provides its own stability. The quantity of informal capital appearing in agriculture demonstrates the stability and sustainability of the sector.

Vertical integration can take the following forms:

- Multinational foreign capital: existing systems with traditions and market position introduce their own vertical system. Many times its aim is to obtain more market share and this is important for the free movement of capital, so it can be regarded as a positive step from the country's point of view. Naturally it is necessary for the country to have a

strategy for the protection of domestic enterprises in order to sustain a healthy and competitive environment for formal and informal capital.

- Joint state and individual capital: The appearance of this type of capital is probably the most important in transition economies, because risk-taking by the state means that the country has a long term strategy. The injection of state capital is also very important as often the level of investment from entrepreneurs is not enough to ensure the production of high quality, competitive products. The appearance of state capital in the verticum is a guarantee of quality improvement.

Private enterprise capital introduces management skills that transition economies in Eastern Europe are in great need of. I would like to emphasise these topics in this paper. After focusing on extension services, strategies for development programmes in micro-regions are discussed.

### **Resources of underdeveloped regions**

The new structures of regional integration are not present in most of the underdeveloped regions in Hungary. The main reason for this is that the former integration, co-operative structures and products are no longer competitive under the new conditions of ownership and subsidy systems. So these products are not an option for enterprises. The market for industrial activities has declined and there is little likelihood for regenerating these activities in the underdeveloped regions. In general, these regions do not have marketable products that could form a base for building up new production systems. In the case of the few positive examples new enterprises were immediately established, but due to their limited external resources these new enterprises cannot generate significant employment and profit in the region.

Agricultural consultants should be aware of the three main goals that influence the entrepreneur when starting a new business:

- Minimising the inputs.
- Maximising the outputs (the first two points strongly depend on the capital available, the product, the technology, the market, etc.).
- Reducing management costs. Minimising the opportunity cost (“what I spend and what I gain”).

There are four basic types of free resources that are available for the business consultant or the regional manager during the development and management of enterprises and regional processes:

- land (depending on quality, situation, climate, etc);
- labour force;
- financial capital;
- knowledge and information (management skills).

While the first three have significant direct costs (*e.g.*: rent, interest, wages), the mobilisation or ‘import’ of the fourth element can produce profit with relatively low costs in underdeveloped regions.

At the same time, the lack of knowledge and management skills is a risk for the effective operation of the first three elements even in developed regions. Extension services have an important role in providing knowledge for the efficient management of land, labour and capital.

Some of the basic factors determining the work of advisers in underdeveloped regions:

- Big numbers of small enterprises. Unemployed family members usually try to start a family business using their own resources. Often they try to replace missing resources with labour intensive technologies.
- Available free land, buildings, etc, relative abundance of capital goods. However, without supplementary resources (new technology, machinery, equipment) the presence of these resources rather reinforces the survival of old systems than the introduction of new, mobile and marketable technologies.
- Lack of capital. The lack of mobile capital is typical both in the private, local governmental and bank sector. Presumably, favourable loan terms and other financial resources will also pass by these regions as there are no marketable products produced in marketable quantities.
- Lack of information. This is one of the most important factors in underdeveloped regions. This not only means that important information does not reach the region but also that the best information can be redundant without a sensitive receptor. “Money is mobile information”. Both may lose their value if they do not reach their optimal receptor. Besides ensuring information transfer it is also the responsibility of extension services to establish the places where information is understood.

To summarise: there are relatively few individual initiatives for starting new businesses due to the lack of resources, families cannot afford the necessary resources, they do not have information about the market (the product and the technology) and they do not have the management skills that help reduce the risks in decision making.

So today, the most important tasks of regional development managers and advisers are:

- on external markets: introduction of regional resources;
- in the region: development of management skills;
- transferring information in and out of the region.

### **New type of integration**

The development activities mentioned above may contribute to the starting of new integration among consumers, producers, investors in the region and from other regions.

The most important factors for regional integration are:

- A market niche: lack of a product on the market encourages producers and customers to mobilise regional resources. From the experiences of ACIDI/VOCA the production of goat and sheep dairy products or herb production in family size enterprises or

co-operatives can be cited as positive examples of channelling such market signals to local investments.

- A technology that can generate processing and delivery integration in a region. Dairy, fruit, meat and other food industry technologies can be good examples. Medium size processing plants may wish to participate in these new integration systems that have good quality products but because they do not have enough capital to make investments for improvements, they tend to chose franchises or know-how transfer.
- Market position that ensures its position by the integration built up under the integrator. *E.g.:* integration around large enterprises.

In all three cases, the market position of the product originating from the region generates internal and external capital investment to the regional enterprises. The opportunities of the regional management depend on the information they have about the region. The regional management should link the following elements:

|                |      |                    |
|----------------|------|--------------------|
| Producer group | with | the customer       |
| Producer group | with | the technology     |
| Technology     | with | the producer group |
| Technology     | with | the technology     |
| Product        | with | the product        |
| Market         | with | the market         |

In order to link these elements the different business structures and management techniques must be known and applied. The most frequently used forms are:

| <b>Type</b>       | <b>System co-ordinator</b>   |
|-------------------|------------------------------|
| Franchise         | franchise deliverer          |
| Co-operative      | co-operative                 |
| Volunteer network | distributor                  |
| Producer system   | owner of the producer system |

### **Extension, rural development and integration**

Integration can take different forms. Basically everything function as an integration, if it connects the actors of the production cycle from raw material production to selling of the final product. In this structure no enterprises should be more or less important. If one is privileged over the other, that decreases the possibility of developing an integration. According to our concept, local resources, the local market, quality, market demand and the organisation among the actors will influence the final structure of the integration.

The classical integration from the point of view of regional development strategies such as co-operative and producer systems are important but are only one solution. Under the new market conditions, integration means the connection of resources to the market. And the integration means quality control both the quality of products and the quality of information. No isolated information units concerning local resources should go from the region to the market. The role of extension services is to integrate such information.

For this reason micro-regional strategies are developed that include all the information about natural and human resources, markets, existing products, production capacity, potential integration and development ideas. This information is compiled into a complex and flexible structure that:

- offers the resources of the micro-region to the market;
- links market information and signals to the micro-region;
- offers alternative types of integration to entrepreneurs;
- combines the resources of a wide variety of actors in the integration including the resources from tenders and subsidies.

A SWOT analysis that examines the strengths, weakness, risks, and opportunities underpins the strategies. The strategies can offer alternative marketing programmes. The important factor is that the integration programme is harmonised with the regional strategy. Once the link between the various actors in the market has been established then depending on the capacity of the integration system and the available capital, the development of integration can be speeded up with different supports. For example, continuous information on local trends can be supported through finance monitoring (if the monitoring includes the continuous enterprise and enterprise niche monitoring).

In summary: integration in development programmes cannot be established without harmonised information and without the operation of an advisory service. The only way management or advisory services can succeed in regional development programmes is to introduce marketable products and programmes to the participants. This means nothing else but integration, *i.e.*, the integration of economic activities and information about economic trends. The greatest database in the world is useless without the integration of the information.

### **Case study of the ACIDI/VOCA A-Integrator concept**

The A-integrator concept is a variation on the A-sub-sector approach, where assistance efforts are focused on one industry or a commodity sub-sector. In the case of an A-integrator project though, there is a central unit B, usually a processing business, which becomes the integrator for all parts of the system. The assistance process works with this unit, and integrates the production, processing and marketing functions around this unit.

Once the sub-sector or commodity has been chosen, the process starts with a thorough examination of the market and reviews the needs of the customers and the competition. In the case of ACIDI/VOCA's sheep integration project in Hungary, the market targeted was the cheese market B both internally and externally. Before providing any assistance ACIDI/VOCA needed to understand what the market was looking for, and what the processor would have to do to be competitive in the market. One interesting factor in the sheep cheese market was that Hungary was not fulfilling its EC quotas for sheep cheese, and this represented a significant marketing opportunity.

The next step in the process was to examine the producer side of the problem, and determine how best to address the raw material supply issue. The objective of the programme from the outset was to create opportunities for small- and medium-scale producers to remain in the business, and to make a living out of their farming activities. Much effort was put into this part of the programme, as ACIDI/VOCA staff wanted to fully understand the situation at the farm level, and wanted to know with certainty what the costs and yields were for farmers under various conditions. Having a thorough knowledge of the

farm situation is the key to gaining the trust of the farmers themselves, and developing a working relationship.

The next step was to focus on the A-integrator itself, and in the case of the sheep integration this was a dairy processing plant producing sheep cheese. ACDI/VOCA staff wanted to have a thorough understanding of the situation at the plant to know what was needed to make the products from this plant competitive. The analysis also needed to determine the relationship between the A-integrator and the individual farmers, and what support and technical assistance the integrator would provide to the farmers. In the sheep integrator project, the individual farmers – via their association – became the main suppliers of raw material to the processing plant, and they must be fully involved in the project.

The ACDI/VOCA staff created A models for the various types of farming operations that the individual farmers could possibly have. These models, which incorporate a tremendous number of variables, are then used to help the farmer understand how each decision he makes has an impact on productivity, and thus on income from the project. The models encompass a wide array of different sizes of farms, and in the case of sheep, they incorporated many assumptions regarding investment, feed use, animal health, and other factors. This model is then used by the integrator to assist the individual farmers to make decisions regarding their operations.

The integrator concept can include the provision of credit, directly from a bank or via the integrator or the farmer association, but this credit is usually provided in the form of inputs for the farmers involved. Because there are accurate models for all circumstances, accurate predictions can be made as to the impact of the use of feed additives (and other similar factors), and the integrator can determine quickly (via the quality & quantity of milk delivered) if the farmer is or is not using these additives for his animals. Should there be a problem, the integrator can work with the farmer immediately to resolve any issues that come up. This in-depth knowledge of the farm situation also serves to increase the trust between the farmer and the integrator, as the farmer knows that the integrator can provide good advice and information.

Another important element of the integrator concept is the Total Quality Management system B or TQM. The ACDI/VOCA staff has integrated this concept throughout the system, and it provides a method for controlling the quality of both the milk produced on the farm, and the cheese produced in the integrating plant. The TQM system is a set of detailed specifications for all the factors that go into producing quality products at each step of the process. The staff at the A-integrator plant provides training to individual farmers on TQM methods, and similarly TQM methods are integrated into the production activities at the processing plant.

For sheep integration in Hungary, the ACDI/VOCA staff has developed a CD-ROM for use by the integrator. This CD-ROM has all the information needed to analyse the activities of the integration from the smallest individual farmer producer, right up to the integration plant itself. The CD-ROM is an interactive set of programmes, which allows the user to enter data on the actual factors existing in the integration, and the programme puts out extensive quantitative and financial projections on the operation.

## **Summary**

In this study I have tried to demonstrate the methods used in development programmes in Hungary that have been successfully managed and financed through vertical integration. After reading this study it might seem that since the introduction of such financing, there has been a series of success stories. This is not exactly true.

An unexpectedly quick change has taken place in a short period of time in Hungary similar to developments in other countries of the region. The network of Western style multinational storehouses and malls was built at a dramatically fast pace (3-4 years), and today customers buy 70% of products in this type of shop. The demands these store chains impose on their suppliers in terms of logistics and distribution are well known. The small- and medium-size enterprises cannot keep up, even though their products satisfy all the quality parameters. Since they cannot meet the quantity and logistical demands, the majority of small- and medium-size enterprises lose their market share.

In this situation it is essential that entrepreneurs learn how to apply integrated marketing methods and that the state supports domestic producers. These marketing methods are detailed in another study. Here I would only like to introduce the House of Hungarian Tastes Programme that I represent, and which is developed and managed by HHT Ltd. The principle of this programme is to develop a network of exhibition and marketing centres in every large city with the same image focusing on typical domestic and Hungarian food. The network is a permanent showcase for the supply side, provides a venue for integrated marketing events, and the wholesaling system operating in the background selling the special products.

The results since the programme has been launched proves that the system is viable. This emphasises again the importance of learning and applying the philosophy of TQM in vertical integration. This method allows quick adjustments to market changes and helps identify the optimal time and place for investment.

# THE ROLE AND DEVELOPMENT OF INFORMAL AND CO-OPERATIVE FINANCIAL CHANNELS IN ALBANIAN AGRICULTURE

By Mr. Hamish R. Gow, Mr. Zef Preçi, and Mr. Drini Salko  
(Paper presented by Mr. Gow)

## Abstract

*This paper discusses the recent development of informal and co-operatively based rural financial markets and institutions in Albania. The paper begins by outlining the development and restructuring process that has occurred within Albania's financial markets over the past decade. Specifically, it focuses on the processes that have led to the recent establishment of Savings and Credit Associations (SCAs) in Albania. The paper concludes with a discussion of the initial results of a recent comparative survey of 100 Albanian farmers in two villages that attempts to measure the impact that the introduction of an SCA into one of the villages is having on farmers' borrowing and investment practices.<sup>1</sup>*

## Introduction

The objective of this paper is to survey the development of Albania's rural financial markets over the past decade, identifying the critical problems and constraints within the market and analysing the possible role that micro-lending institutions, such as Savings and Credit Associations (SCAs), may play in rectifying these problems. The results of a recent survey of farmers in two Albanian villages will be used to provide comparative indications of what impact these financial institutional innovations are having on the borrowing and investment decisions of Albanian farmers.

The paper begins with a brief discussion of land reform in Albania. This is important, as the land reform process has been an important driving force behind the break up of the co-operative and state farming system into a highly fragmented production system based upon numerous small farmers. The second section reviews the general banking reforms that have occurred in Albania over the past decade. The next section discusses the specific reforms and problems encountered in Albania's rural financial markets. The fourth section addresses an important financial innovation currently occurring within the Albanian financial system: the establishment and development of Savings and Credit Associations. The fifth section draws on a recent survey of 100 Albanian farmers to discuss and draw implications about the impact of SCAs on the availability and access to external financial resources.

---

1. This paper presents the initial results for Albania of a larger project analysing the constraints to the development of sustainable rural financial markets and micro-lending institutions in the Balkan region. The research project was structured to provide policy makers and advisors a better theoretical and empirical understanding of the financial problems facing financially distressed small rural enterprises and households within the region, the possible role that micro and group based lending institutions may play in correcting these problems, and any specific regional requirements and constraints that may need to be overcome for the development of sustainable rural financial markets. The specific countries studied in the research project are Albania, Bulgaria, Macedonia and Romania.



## **Agricultural land reform**

Preçi and Salko (2000) classify Albanian agricultural land reform into three phases. The first phase ran from the fall of communism to the approval of the “Law on Land” and was characterised by the introduction of numerous minor and often contradictory reform measures. The reforms were generally aimed at protecting the “co-operatives” and state farms. However, due to a range of factors these reforms were ineffective and could not stop the eventual decline of these organisational forms in Albania. The second phase of land reform corresponded with the implementation of the “Law on Land” of August 1991. This legislation constituted the basis for agricultural land reform in Albania, since through its enactment ownership of land could be transferred from collectives to individuals on the basis of a pre-specified proportional criterion.<sup>2</sup> This was shortly afterwards followed by the distribution of approximately 120 000 hectares of former state farm land to approximately 80 000 households in about 400 000 plots (according to decree No. 452 dated 17 October 1992). As a result, by 1995, approximately 380 000 households had gained control of over 426 000 hectares of agricultural land broken into over 1.5 million small plots that had previously been controlled by agricultural co-operatives or state farms. Consequently, the hallmark of Albania’s agricultural land reform was the sudden creation of a highly fragmented land ownership system spread over numerous small farmers: the “average” Albanian farmer controls just over one hectare of agricultural land divided into five separate plots, of which approximately 0.85 ha is cultivated. The third, and current, phase can be characterised by a series of attempts by government to consolidate farmland and develop and expand the agricultural market for Albanian producers.

## **Banking sector reform**

The Albanian banking reform process can be divided into two periods. The first period ran from 1990 to 1996 and was characterised by the creation of the necessary legislative, judicial, and institutional framework required for the development of a two-tier banking system. The end of the first period coincided directly with the period when the pyramid schemes began flourishing in Albania.<sup>3</sup> The second period ran from 1997 to 2000 and was characterised by the restructuring and expansion of the private banking sector. During this period the Rural Commercial Bank was liquidated, the National Commercial Bank was privatised, and a new legislative and judicial framework was prepared.

During the period following the Second World War, the Albanian banking system functioned as a one-tier system, under which the Bank of Albania (BA) simultaneously performed all central bank as well as commercial bank functions. Those functions included money printing, enforcement of monetary policies, relationships with other countries, and deposits and loan issuance services to state owned enterprises and private individuals. After 1969, the Agricultural Bank (AB) was established. Its primary role was to provide credit to agricultural enterprises and co-operatives. This bank never operated independently and was to all intents and purposes just an extension of the Bank of Albania. The credit or lending plans of the AB were included in that of BA and were fully funded from the state budget.

The creation of a private agriculture sector in 1991 necessitated the reform of the financial system to support the whole economy, including the agricultural and rural sectors. The judicial foundations for

---

2. See Swinnen 1999 for further elaboration of the different mechanisms used in central and eastern Europe for the distribution of land ownership and property rights.

3. The development of pyramid schemes provides a useful ad hoc indication of how slowly the speed of reform within the financial sector was actually occurring.

the creation of a two-tier commercial banking system were established, in April and May 1992, when the “Law on Banking in Albania” was enacted. The law established the Bank of Albania as the country’s highest banking regulatory and monetary authority and determined the rules for the organisation and establishment of commercial banks. In accordance with those laws a two-tier banking system was established, which included the Bank of Albania (BA) as the central bank and the commercial banks under its supervision.

By 1993 the Albanian banking system, apart from BA, consisted of a series of state owned commercial banks, the National Commercial Bank (NCB), Saving Bank (SB), and Rural Commercial Bank (RCB), as well as two joint venture banks, the Italian Albanian Bank (IAB) and Arab Albanian Islamic Bank (AAIB). All these banks were officially licensed to operate as universal commercial banks, receiving deposits from and issuing loans to individuals as well as state and private entities.

By 1996-1997, however, lax regulation, volatile economic policies, and the development of an unstable investment system based upon pyramid schemes had combined to destabilise the financial sector. The amount of non-performing loans within the three State-owned banks had reached 33% of all outstanding loans by 1996. The 1997 financial crisis further inflated the non-performing loan rate, which reached 45% by the end of the year. These factors combined forced the Albanian government in 1997 to undertake steps to reform the entire financial system and in particular, the banking system, including privatisation of the state owned banks, introduction of new legislation to increase competition in the banking market, restrict ownership of banks and enforce minimum capital requirements for financial institutions. The start of this reform period was marked by closure of the RCB, a shift to more secure investment practices by the SB, and the establishment of a specialised institution, the Bank Asset Resolution Trust, whose role was to restructure the non-performing loan portfolios of the RCB and other state owned banks.

As a result of the reforms, the number of new private commercial banks within the market has increased substantially (see Table 1). They all operate under standard commercial practices with the exception of the Arab Albanian Islamic Bank, which operates on Islamic banking principles and does not accept term deposits or issue interest-bearing loans. The Albanian banking system, however, remains highly segmented. The Savings Bank still holds the greatest share of deposits (about 80% of them) and is the only bank that has branches in all the districts. However, private banks are making progress and quickly attracting deposits as domestic confidence grows in the contemporary payment system.

### **Recent developments in the Albanian banking system**

Along with the expansion of private commercial bank activity, the economy in general has also observed a marked increase in the level of general economic activity. Macroeconomic stability, increased political security, and a generally more stable business and investment environment have all contributed to increasing the availability of financial resources, hence increasing economic activity. For example, during the period January-November 2000 new loans reached Lek 21.2 billion. Although the majority of loans are short-term loans, a positive upward trend in the issuance of medium and long-term loans can be observed. In terms of sectors, bank lending is mainly concentrated in the construction, trade, and processing industries. Recent banking data indicates that 26% of loans have been allocated to construction, about 26% to trade, about 16% to the processing industry, 5% to

tourism activities (hotels and restaurants), 6% to real estate, with the remainder to transport, communications, and agriculture<sup>4</sup>.

The increase in bank numbers has however not alleviated the potential supply problems that the agricultural sector faces, as most of these banks, according to their publicly stated policies, are only interested in providing credit to medium and large sized commercial enterprises. Obviously, Albanian agricultural producers do not fit within this group. Those banks that explicitly provide credit to small businesses (*i.e.* FEFAD bank) focus primarily on urban clientele. The few, rare loans allocated to agriculture are issued for activities like agro-food processing and setting up greenhouses.

## **Rural finance and credit**

The condition of Albania's rural financial system during the past ten years has been strongly impacted by the general economic, political, and regulatory environment operating at that time. During the period 1990-1991 the government used rural credit as a social policy instrument, distributing numerous small loans to support "new" farmers to whom land had just been distributed, so that they could purchase livestock and seeds and meet other operational needs. These loans are *de facto* grants, as farmers accepted these government loans based upon the old mentality that "any credit provided by the government should be forgiven by the government as well." Thus, the policy had the effect of creating of a group of clients who never had any intention of paying back their loans, as they never realised that they were actually required to do so.

During 1991-1993 rural credit policy shifted to supporting agricultural mechanisation. The traditional agricultural production systems inherited from the previous system were inadequate, given the substantial structural change to small fragmented production systems, which necessitated an upgrading of the production techniques. This was primarily achieved through internal sources; however, aid agencies from Germany, Greece, Italy, China, and the EU PHARE programme provided important technical and financial support.

During 1994-1996, the agribusiness and agri-food industry began providing financial support for agricultural investment linked to the provision of inputs.<sup>5</sup> This was in addition to the financial support provided by the ACB, NCB, and other NGOs and donor organisations. The International Fertiliser Development Centre (IFDC) played an important role in the development of these activities by channelling American government aid through their newly established system of dealers and traders to the Albanian agricultural sector. This programme became the seed for further programmes, such as one developed by the Albanian government that assisted farmers with the purchase of pesticides through short-term credits allocated to merchants from commercial banks and mainly ACB and NCB.<sup>6</sup> Another was the rural credit project implemented by the Albanian Development Fund.

---

4. Bank of Albania – "Monetary Policy Declaration" February 2001.

5. See Gow and Swinnen (1998) and Gow *et al.* (2000) for an elaboration of the reasoning behind this development. Cungu *et al.* (2001) shows empirically the significant positive impact that the provision of financial resources through this channel can have on farm level investment.

6. This process of innovation and replication closely matches the convergence processes that Gow and Swinnen (1998) observed in Slovakia, where the State Agricultural Bank quickly started providing general lines of credit to all processors following the success of a similar scheme that was developed with one individual sugar processor.

Agricultural credit policy during this period was inadvertently linked with the development of the Albanian banking system. Private farmers' demand for credit to finance the purchase of inputs (fertilisers, seeds, pesticides, etc.) and investment in mechanised equipment increased as market opportunities developed. However, the Rural Commercial Bank (RCB) was unable to respond, as it was required to meet not only increasingly more stringent commercial lending practices, thereby reducing the number of suitable borrowers, but was also faced with increasingly more profitable lending opportunities outside of agriculture where financial resources could be diverted. This is exactly what occurred, as Table 2 indicates. By the end of 1996 commercial activities plus construction consumed 64% of the bank's outstanding loan portfolio. However, the financial crisis of 1997 brought about the demise of RCB. During this period, the percentage of non-performing loans soared and the government was forced not only to close RCB and shift its non-performing loan portfolio to a specialist institution, but it was also forced to reform and restructure the entire financial system.

As part of the reform process introduced by the government following the 1997 financial crisis, the government introduced new legislative and judicial foundations for the establishment and development of group based rural financial institutions. Two key laws were approved during this period:

- The **“Law on Associations of Mutual Co-operation”**, which provided the legal framework for the establishment of relatively loose member owned groups and co-operatives with few obligations for its members. The model was not specific to the financial sector, as no bank supervision of the associations was foreseen. Some rural banking sector policy specialists favour the model, as outside control would be kept to a minimum. This law also constituted the judicial foundation for the development of “modern” co-operative agriculture.
- The **“Law on Savings and Credit Associations”**, which is aimed directly at the financial issue of group based borrowing and lending. This law provides the judicial foundation for the establishment of financial institutions specialising in delivering financial services to rural areas. There are a number of savings and crediting associations currently being set up but most have not yet started providing client services. A range of donors provided assistance in the establishment and initial financing of these institutions, including the Rural Finance Fund (RFF); the Albanian Credit Union Development Project; GTZ (German Agency for Technical Co-operation), and IFDC (International Fertiliser Development Centre).

During this same period, surveys conducted by the Rural Finance Fund indicated that the informal sector, which included moneylenders, merchants, friends, and family members, became an important source of funds for many Albanian farmers. According to a survey conducted in 1993-1995 sampling some 648 farmers in 25 out of Albania's 36 districts, only 2% of farmers borrowed credit through the formal banking system (Table 3). High interest rates, bureaucratic procedures, and short pay back periods were among the primary constraints stressed by farmers regarding difficulties in accessing credit from banks.

In another survey the Rural Finance Fund found that only a very small percentage of 89 households surveyed in their operational regions borrowed from commercial banks (Table 4). About 60% of farming households declared that they had received some type of credit during 1998. Of this group, two thirds received an average USD 390 per household from the RFF, whereas 5% received larger loans from the Agricultural Bank, and 16% borrowed from people in village or family on interest free terms. The smaller RFF loans were mainly used to finance husbandry activities and animal purchases,

whereas the larger loans from the ACB were used to purchase farm machinery and equipment. Finally, it was also common for households to borrow from individuals with whom they had close personal relationships. These funds primarily contributed to financing livestock purchases and supporting specific or emergency household needs (sickness, feasts). What these survey results seem to indicate is a high propensity for rural Albanian farming households to use informal, group borrowing and micro-finance institutions for a majority of their borrowing requirements.

## **Albanian Development Fund**

The rural credit project implemented by the Albanian Development Fund (ADF) is the oldest in Albania. The programme initially started as a rural poverty eradication project with the goal of facilitating the transition for poor farmers but later developed into a micro-financing programme. The idea was to provide credit to small farmers who could not access external credit through normal channels, as well as provide financial management training for farmers and the Village Credit Council (VCC).

Credit was delivered through an approval system based upon co-operation between two groups: the VCC and the local credit officer. Both of these groups were administered and supervised by the Village Credit Fund (VCF). The credit approval process was based on clear-cut, transparent, and well-understood criteria, including the capacity of the borrower to repay the loan, satisfactory investment opportunity, client trustworthiness, etc. The project developed credit schemes and payment schedules that matched farmer's demand for small credits and time dynamics. A credit ceiling of a few hundreds dollars was imposed at the beginning; however, this has now been increased to USD 2 000 and borrowers are given up to a maximum of three years to repay the loan. In special cases loans can be given up to USD 5 000. Tables 6 and 7 provide summary statistics of the Funds activities

Traditionally, the loans provided through the scheme have been used primarily for animal husbandry purposes. However, the ratio of activities financed by the scheme is beginning to change as investment in other activities, such as trade, agricultural machinery, and crafts, take on greater importance. Important determinants in this process have been the creation of new villages around key cities, as well as decreasing interest rates. As a result, credit demand is changing in terms of amount, as well as repayment timing and activities financed. Since 1995 the size of loans and the repayment structure offered by the ADF have steadily changed as demand has changed. By 1998 the average amount of distributed credits had increased to Lek 78 940. In the beginning the amount lent was around USD 100-200; however, today loans can reach up to USD 5 000, with repayment schedules now stretching up to three years.

## **Financial institutional innovation and the development of SCAs**

The VCF programmes have been successful in penetrating rural areas and providing much needed financial resources to rural households. A problem with these institutions, however, is that they do not have any mechanisms available to mobilise savings or other discretionary household funds. The establishment of Savings and Credit Associations is one of the important financial institutional innovations<sup>7</sup> currently occurring in Albania to assist rural households in accessing and mobilising financial resources. There are two ways in which SCAs are being established in Albania: first, VCFs

---

7. Financial institutional innovation refers to changes in the organisational structure of an institution to overcome transaction costs or other economic or legal obstacles to the delivery of financial resources to a specific client group.

are being transformed into Savings and Credit Associations, and second, new SCAs are being established based upon new and previously formed farmer associations. Both of these initiatives seem to offer enormous potential for the establishment and development of a bottom-up financial network based upon small farmers with the hope that this network will eventually progressively evolve into a sustainable system of savings and credit associations.

Albania already has a strong co-operative movement, both financially and non-financially. On the financial side, as we have previously shown, farmers are already lending to each other on an informal basis. On the non-financial side, there are over 750 farmers associations currently operating in Albania, of which approximately 600 village based water user groups. The remaining associations are primarily agricultural marketing and agro-processing co-operatives. Both of these factors tend to indicate that the necessary conditions required for the potential development of such a system are present.

The RFF is co-ordinating this process and providing technical support for farmers attempting to establish new SCAs. Currently, 21 SCAs have been established with the support of the RFF, 18 of which were created through the transformation of VCFs, while the other three were created in areas where the RFF previously had not operated. Out of 21 existing SCAs, 13 started credit activities in 2001. All associations but two (Palas and Shilbater) have been operating since October 2000. Of the SCAs which have yet to start credit activities, some SCAs have voluntarily postponed new loan disbursements in order to ensure repayment of current outstanding loans disbursed under the previous VCF structure, whereas others have postponed the beginning of credit activities until their absent members return from seasonal migrant work. Table 8 shows the loan portfolio and disbursements of the VCFs and SCAs as of December 31, 2000. Specifically, the SCAs combined have disbursed 231 of the total outstanding loans, which amounted to approximately USD 300 000 with a loan repayment period varying between 24 and 36 months. The average SCA individual loan size was USD 1 300, which is considerably higher than previously with the VCFs. The registration of new members (who were not VCF clients) has also helped increase the average loan size. This trend has been encouraged by RFF even though it presents some additional risks.

Of the SCAs not created through the assistance of the RFF, 14 SCAs have been established with support and assistance from an Irish Project, and the Union of Commercial Credit for Chemical Pesticides and International Fertiliser Development Centre in collaboration with USAID. Under the Irish project six SCAs have been established. The amount of contribution from members is still modest (USD 7 000) and the number of members is small (on average 15-25 member per SCA). These 6 associations have also set up their union. The International Fertiliser Development Centre has begun the ambitious task of creating a SCA for merchants, particularly in fertilisers.

### **Initial results of comparative survey of the impact of SCAs in Albania**

During the Spring of 2001 a survey was conducted in Albania in an attempt to measure the impact of and opportunities for the development and use of micro-finance institutions. Due to budget limitations it was impossible to undertake a representative survey of the whole population; instead, a comparative study was designed which surveyed two similar villages from the same region: one where a micro-finance institution was present and the other where a micro-finance institution was not present. This design provided the best mechanism for conducting a comparative analysis of the differences between the two respective groups' responses, while controlling for as many common factors as possible, given the limited funds.

The survey was conducted in two villages, Mollas and Klos of Elbasan district. The district's topology is composed of about 35% hill country with the remaining 65% in flat arable plains. The combined population of the two villages was approximately 2 800 inhabitants with about 300 and 250 farm enterprises operating in the villages of Mollas and Klos, respectively. The main agricultural production activities undertaken in the villages are arable cropping, horticulture (grapes and fruit), and livestock. However, many farmers transport and trade their agricultural products in the city of Elbasan about 25 km away. Over the last 3-4 years many farmers within the village of Mollas have been able to access loans issued by the RFF.<sup>8</sup> Last year with the assistance of RFF, Mollas Savings and Credit Association was founded in the village. Whereas in the village of Klos no financial institution exists; a micro-finance project or savings credit association has yet to be established there.

The survey was conducted with heads of farm enterprises/households who were also the main farm owners. A total of 100 respondents were surveyed. They were equally divided between the two villages and selected on a random basis. The enumerators employed to conduct the interviewing process were knowledgeable of both the agricultural sector as well as rural finance, including the specific area of interest being surveyed.

Both villages surveyed were very similar. The "average" farm size in Klos was 8.83 dca<sup>9</sup> broken into 2.72 parcels of land, whereas the "average" farm in Mollas was slightly larger at 9.84 dca and 3.8 parcels of land. Interestingly, the range in the number of parcels of land per farm is wider in Mollas (1 to 7) than in Klos (1 to 4). Very little land was leased, on average only 0.17 dca per farm in both villages. Farmers in both villages indicated that land was available for purchase. However more farmers in Klos indicated that they would like to purchase land (80%) than in Mollas (40%). Interestingly, only 25% of the farmers in both villages were willing to lease land if it was available. This seems to indicate a propensity for farmers to own their own land, as opposed to just acquiring the operational rights to use the land.

The prices that farmers stated they would be willing to pay for land and their perception of the current market prices within the village were approximately the same, indicating that the land markets within each village are potentially clearing. All of the farmers indicated that they would be willing to use land as collateral. Interestingly however this conflicts with later responses indicating that farmers do not wish to use business assets as collateral.

Very few of the households had bank or savings accounts or alternative sources of income. Most households indicated that they had both borrowed and lent money to friends and family in times of need. When asked how much money they would be able to mobilise in the case of an emergency, the households in Klos indicated a substantially higher amount from both relatives (302 500 Lek) and friends (269 318 Lek) than the households in Mollas from relatives (218 586 Lek) and friends (233 369 Lek). The result changed, however, when access to external sources was included, as the Mollas villages all indicated that they would be able to access funds from the SCA (384 000 Lek on average), whereas the Klos villages did not have such an option.

96% and 94% of households in Klos and Mollas respectively indicated that they had borrowed money in the past twelve months. 24 farmers indicated that they currently had loans outstanding, 18 in Mollas and 6 in Klos. All of the loans in Mollas had been provided by the SCA, with 11 of the 18 loans being used for the development of new marketing enterprises and channels, 4 for the purchase of livestock,

---

8. The Rural Financial Fund established by Albanian government with the support of World Bank as a rural poverty eradication project (see earlier discussion).

9. Dca (deca) equals 100 square metres.

and the remainder for land, buildings and farm equipment. In Klos the source of funds was evenly split between friends and family and the use was primarily for building. No collateral was required for the loans in Klos, however collateral was provided for 17 of the 18 SCA loans. Land was used in 7 cases, livestock twice and cars or trucks for the final 8 cases. The collateral value averaged 164% of the value of the loan and ranged from 60% to 200%. For the SCA loans for the development of new marketing channels, an outside guarantee was required in five cases and business plans in all cases.

All of the farmers indicated that they have a fixed group of input providers whom they knew personally. All purchases were made in cash at time of delivery. Only 4 farmers indicated that their purchases were tied to production contracts. On average the farmers in Klos and Mollas spent 44 130 Lek and 52 587 Lek on inputs, with the most important purchases being fertiliser and seeds, respectively.

On the sales side, there is very little difference between the amounts of crop and livestock product sales for each village. Farms in Klos on average sell 67 947 Lek of crops and 94 678 Lek of livestock products, whereas farms in Mollas sell 72 333 Lek of crops and 75 560 Lek of livestock products. They all indicated that it was quite difficult to find buyers. The standard practice used by farmers to market their produce seems to be selling it for cash to whichever trader turns up on the day and offers the highest price. Interestingly only two farmers, one from each region, indicated that they sold their produce to a regular trader or client. Both of them sold between 80% and 100% of what they produced to one of three regular traders. All of the farmers indicated that they rarely felt that they were on equal negotiating terms with their respective trader partners. However, the survey results indicate that 58% of farmers in Klos have alternative marketing channels available, whereas in Mollas only 24% of farmers indicated this. This is a possible explanation why we earlier observed farmers in Mollas having a higher propensity to borrow funds for the development of alternative marketing and production channels.

When asked about conflicts with suppliers and customers, they all indicated that the major problem with suppliers was poor product quality. On the customer side, the most common problem was unexpected price renegotiations. They had no problems with payments as all transactions occurred in cash.

Looking at the key constraints to business growth, all of the farmers indicated that low and uncertain prices along with a lack of credible markets for their products were the key constraints. Interestingly, both groups of farmers also indicated that lack of access to a banking system constrained growth. However, only the farmers in Klos indicated that lack of a credit history was a constraint. Obviously, the SCA in Mollas is playing an important role of assisting farmers to develop credit histories, in addition to providing them access to investment funds. One odd result to come out of the survey was the unwillingness of farmers in both villages to pledge business assets as collateral in support of loans, but a general indifference about using personal assets. This may be due to risk aversion with farmers unwilling to lose their only source of income, but willing to lose more luxury personal items.

Access to external financial resources is obviously important for Albanian agricultural producers, as all of the survey farmers indicated that they had borrowed money in the past twelve months. The survey results also indicate that the SCA is having a large impact on where farmers are sourcing funds, as all of the outstanding loans in Mollas came from the SCA. The SCA also seems to be having an important impact on how farmers are investing their funds: 2/3 of the outstanding loans in Mollas were directed to projects that further developed markets for the farms. There are a couple of possible reasons for this. One is that these farmers were also more concerned about the power of traders and lack of credible markets and prices. Alternatively, it could be that most loans are seasonal short-term loans and due to the timing of the survey they were not picked up.



The result of Mollas farmers' sourcing all of their loans from the SCA, whereas farmers in Klos being forced to rely on friends and family, could be of concern to policy makers if Albania is hit by another economic shock. The survey results seem to indicate that as farmers develop a great reliance on external sources of funds other than on family and friends, they begin to lose the capacity to use the informal financing mechanisms as a safety net in times of need. This is not a concern as long as the SCA are financially viable; however, it may be a concern if they are not well managed and regulated.

## **Discussion**

The past decade has been very tumultuous and chaotic in Albania, as economic and political events have swiftly changed the structure of the whole economy, including the agricultural system, within which farmers operate. For many farmers an important challenge that they have faced relates to the ever-changing structure of rural financial markets and the resulting lack of access to external financial resources for many of them from the formal system. As result of this exclusion, many farmers and rural households have been forced to rely upon the development of mutual support systems whereby individuals borrow from their friends and family to meet their investment needs. However, as the data presented above indicates, the exclusion of farmers from the formal sector seems to constrain their options both with respect to the specific investment activities that they are willing to undertake and the speed with which they are required to pay back loans. Farmers who are constrained to borrowing from the informal system seem to invest primarily in production and rarely invest in developing alternative marketing channels, even though they regularly state that market access is one of the most serious constraints to the growth of their operations. They also rarely hold credit for more than 12 months. Whereas the opposite holds for individuals who can access credit through more formal channels. The data indicates that these individuals have a higher propensity to invest in the development of new marketing channels. The data also indicates that those having access to more formal credit are more likely to invest in larger and longer-term projects.

A recent financial innovation that is assisting individuals' access to external financial resources has been the establishment of Savings and Credit Associations. The data presented above tend to indicate that these associations seem to have helped alleviate many of the problems farmers faced with respect to access, timing, and amount. Loan sizes have increased, participation rates have increased, and so has the length of loan pay back periods. Additionally, credit history no longer seems to be of concern to individuals with access to SCAs. The establishment of SCAs, however, is not without potential problems, as their establishment may have created some new ones. Of particular concern is the fact that the farmers within the regions where SCAs operate indicated that they can only mobilise 80% of the total amount of financial resources that farmers can mobilise living in regions without an SCA. This should be of particular concern to policy makers, as it indicates that the development of these institutions may potentially be eroding the stability of an important emergency lifeline for rural households. For governments that provide a stable economic policy and business environment this may be of little concern, as these policies are likely to ensure the long-term economic and financial viability of these institutions. However, for governments that do not ensure this, the consequences could be dire, as many farmers may have lost a substantial portion of their lifeline.

Financial innovations such as the establishment of SCAs obviously seem to provide plenty of upside potential in Albania for both assisting rural households to access external financial resources as well as the development of long-term sustainable rural financial markets. However, as the data presented above indicate, future governments should be wary of pushing for the establishment of such institutions unless they are able to ensure a stable economic platform on which they can operate.

**Table 1. Selected indicators of the structure of the Albanian banking system**

July 2000

| Banks                                   | No. of branches | No. of agencies | Market share<br>(in %) |
|-----------------------------------------|-----------------|-----------------|------------------------|
| <b>STATE OWNED BANKS</b>                |                 |                 | <b>63.0</b>            |
| Savings Bank                            | 26              | 228             | 63.0                   |
| <b>Joint-Venture Banks</b>              |                 |                 | <b>6.8</b>             |
| Italian-Albanian Bank                   | 1               | 1               | 5.7                    |
| Albanian Arabic Islamic Bank            |                 |                 | 1.1                    |
| <b>Private Banks</b>                    |                 |                 | <b>30.2</b>            |
| National Commercial Bank                | 10              |                 | 13.3                   |
| Dardania Bank                           |                 |                 | 1.3                    |
| Tirana Bank                             | 2               |                 | 3.8                    |
| The Branch of National Bank of Greece   |                 | 2               | 2.1                    |
| International Commercial Bank           |                 |                 | 1.3                    |
| The Branch of Alpha Credit Bank         | 2               |                 | 2.7                    |
| American Bank of Albania                |                 |                 | 3.1                    |
| FEFAD Bank                              | 2               |                 | 1.8                    |
| The Branch of the First Investment Bank |                 |                 | 0.5                    |
| Inter-Commercial Bank <sup>1</sup>      |                 |                 | 0.3                    |

1. This bank is beginning its activities in Albania.

Source: Bank of Albania, *Economic Bulletin*, October 2000.

**Table 2. Credit portfolio structure of Rural Credit Bank, 1993-1996**

Per cent

| Sector                                                               | 1993 | 1994 | 1995 | 1996 |
|----------------------------------------------------------------------|------|------|------|------|
| Agriculture, animal husbandry, and input provision                   | 16   | 12   | 17   | 21   |
| Commercial value-added agricultural production and processing        | 8    | 9    | 10   | 7    |
| Tractors and agricultural equipment                                  | 20   | 20   | 12   | 8    |
| Commodity trade, construction, and other non-agricultural activities | 56   | 59   | 61   | 64   |
| Total loans                                                          | 100  | 100  | 100  | 100  |

Source: RCB Statistics, 1996.

**Table 3. Incidence and sources of credit in Albanian farm households**

Results of the survey of 648 households (1993-1995)

| Zone                                                                  | Source       | Number of farmers | Interest rates, % |
|-----------------------------------------------------------------------|--------------|-------------------|-------------------|
| A. Coastal regions with intensive agriculture                         | Bank         | 6                 | 27                |
|                                                                       | Friends      | 18                | 10                |
|                                                                       | Moneylenders | 10                | 24                |
| B. Hills, valleys, and mountainous regions with intensive agriculture | Bank         | 2                 | 26                |
|                                                                       | Friends      | 3                 | 10                |
| C. Mountainous regions with extensive agricultural production systems | Bank         | 2                 | 28                |
|                                                                       | Friends      | 4                 | 15                |

Source: Rural Finance Fund, 1998.

**Table 4. Incidence and sources of credit in Albanian farm households**

Results of 1998 survey of 89 households

| Credit source                             | Number of households | %  |
|-------------------------------------------|----------------------|----|
| Credit not taken                          | 37                   | 42 |
| Rural Finance Fund                        | 33                   | 38 |
| Banks and other sources                   | 5                    | 4  |
| Relatives, friends and village neighbours | 14                   | 16 |

Source: Rural Finance Fund, 1998.

**Table 5. Credit use by source of credit**

Per cent

| Credit use             | Rural Finance Fund | Other sources,<br>including banks | Individuals,<br>including relatives |
|------------------------|--------------------|-----------------------------------|-------------------------------------|
| Urgent household needs | 0                  | 0                                 | 37                                  |
| Crop production        | 2                  | 0                                 | 5                                   |
| Livestock production   | 67                 | 40                                | 21                                  |
| Draught animals        | 14                 | 0                                 | 0                                   |
| Trade                  | 5                  | 0                                 | 0                                   |
| Crafts                 | 2                  | 0                                 | 0                                   |
| Mechanisation          | 2                  | 60                                | 0                                   |
| Other                  | 8                  | 0                                 | 37                                  |

*Source:* Rural Finance Fund, 1998.

**Table 6. Selected indicators of Albanian Development Fund loans**

|                              | 1997   | 1998   | 1999   |
|------------------------------|--------|--------|--------|
| Repayment Rate, %            | 99.70  | 99.54  | 99.82  |
| Loan loss rate, in %         | 0.00   | 0.07   | 0.19   |
| Average loan per farmer, Lek | 44 389 | 51 620 | 59 701 |

*Source:* Rural Finance Fund Annual Report, 1999.

**Table 7. Loan portfolio indicators of Albanian Development Fund - Rural project**

1 000 Lek

| Years                  | 31.12.94 | 31.12.95 | 31.12. 96 | 31.12. 97 | 31.12. 98 | 31.12.99  |
|------------------------|----------|----------|-----------|-----------|-----------|-----------|
| Districts              | 7        | 9        | 11        | 11        | 11        | 11        |
| Villages               | 59       | 100      | 170       | 192       | 221       | 238       |
| Clients                | 2 662    | 4 750    | 8 097     | 11 202    | 13 623    | 15 621    |
| No. loans              | 2 751    | 5 143    | 8 996     | 13 092    | 16 557    | 20 034    |
| Amount disbursed       | 94 695   | 194 504  | 371 730   | 581 138   | 854 665   | 1 196 042 |
| Active loans (clients) | 2 408    | 4 171    | 6 859     | 8 634     | 9 255     | 8 269     |
| Outstanding loans      | 76 720.  | 138 875  | 243 231   | 313 052   | 421 088   | 505 099   |

Source: Rural Finance Fund Annual Report, 1999.

**Table 8. Outreach and performance indicators of SCAs**

USD

|                                           | End of 1999 | End of 2000 |
|-------------------------------------------|-------------|-------------|
| <b>Outreach</b>                           |             |             |
| SCA membership                            | 0           | 505         |
| Number of new SCAs and transformed VCFs   | 0           | 21          |
| Number of SCAs under creation process     | 0           | 3           |
| <b>Loan portfolio</b>                     |             |             |
| Balance of loans outstanding (VCF & SCAs) | 2 694 144   | 2 673 760   |
| Number of active loans (VCF & SCAs)       | 5 754       | 4 423       |
| Average loan outstanding (VCF & SCAs)     | 468         | 605         |
| Nominal interest rate (VCF - SCAs), %     | 21          | 17 - 11     |
| Portfolio at risk (loans over 60 days)    | 958         | 97 404      |

Note: 1 USD = 140 Lek.

Source: Rural Finance Fund Annual Report, 2000.

## BIBLIOGRAPHY

- Cungu, A. (2001),  
“Essays on AID, Investment, and Economic Growth in Transition Economies,” PhD  
Dissertation, Katholieke Universiteit Leuven, Belgium.
- Gow, H. R. and J. F. M. Swinnen (1998),  
“Up- and Downstream Restructuring, Foreign Direct Investment, and Hold-Up Problems in  
Agricultural Transition,” *European Review of Agricultural Economics*, 25(3): 331-350.
- Gow, H. R., D. Streeter, and J. F. M. Swinnen (2000),  
“How Private Contract Enforcement Mechanisms can succeed where Public Institutions Fail:  
The Case of Juhocukor a.s.,” *Agricultural Economics* 23:253-265.
- Swinnen, J. F. M. (1999),  
“The Political Economy of Land Reform Choices in Central and Eastern Europe,” *Economics of  
Transition*, 7(3): 637-664.

# THE EXPERIENCE OF RURAL MICRO-CREDIT IN NORTH-WEST RUSSIA

By Ms. Renata Yanbykh

## Abstract

*Rural employment and rural incomes are a crucial issue in the ongoing reform of Russia's agro-food sector. Unemployment and living below the subsistence level are the most acute problems to emerge from the transition. Before the break-up of the Soviet Union the large socialist farms fulfilled the role of main employer and social security guarantor. Today most of the large farms are insolvent and are unable to provide jobs. As a result, a substantial part of rural incomes now come from private household plots. The state should encourage the development of these private household plots through special programmes. Creating micro-credit schemes to provide start-up capital for activities generating alternative incomes would be one solution. The case study of the Lodeynoye Pole Rural Development Fund is one example of how this can work.*

## Introduction

Rural employment and rural incomes are a crucial issue in the ongoing reform of Russia's agro-food sector. The rural population, which amounted to 39.5 million in 2000 (or 27.0% of the total Russian population of 146.3 million) is beset by numerous difficulties arising from the transition process, with unemployment and below subsistence living the most acute ones to emerge.<sup>1</sup> (Table 1).

There are several reasons for this: a substantial share of agricultural enterprises are not viable; the rural population has no alternative sources of employment; the government has no programmes for small rural entrepreneurship development; state credits are directed only at large-scale farming; micro-credit schemes are not widely available.

Table 1. **Population employed in agriculture, millions**

|                                                    | 1985  | 1990  | 1995  | 1996  | 1998  | 2000  |
|----------------------------------------------------|-------|-------|-------|-------|-------|-------|
| Total population                                   | 142.8 | 148.0 | 148.3 | 147.6 | 146.7 | 146.3 |
| Rural population                                   | 40.0  | 38.8  | 40.0  | 39.9  | 39.7  | 39.5  |
| Share of rural population, %                       | 28    | 26    | 27    | 27    | 27    | 27    |
| National economy                                   | 74.9  | 75.3  | 66.4  | 66.0  | 64.6  | 64.0  |
| Agricultural sector                                | 11.0  | 10.3  | 9.7   | 9.3   | 8.6   | 8.5   |
| Employed in large farms                            | 10.3  | 9.3   | 5.8*  | 5.4*  | 5.3*  | 5.1*  |
| Employed in agriculture, share in national economy | 14.6  | 13.6  | 14.7  | 14.0  | 13.3  | 13.3  |

Source: Goskomstat: Agriculture in Russia, 1995, p. 28; 2000, p. 16.

\* Ministry of Agriculture and Food of the Russian Federation: Agro-industrial complex of Russia in 2000, p. 49.

1. According to Goskomstat (State Committee on Statistics of Russian Federation) 47% of rural population had incomes below the subsistence level in 1998. The official rural unemployment rate amounts 4.7% and the real one exceeds this figure in some regions 4-5 times (Working materials of SRLPP project, 1999).

## Insolvency and viability of large farms

During the Soviet Union period, large collective and state farms (*kolkhozi* and *sovkhozi*) provided employment, social services and incomes for most of the rural population. Since the reform, about 56% of large farms have become insolvent and have had to restructure their business and management. The cash receipts of large farms are equivalent to their debt overhang. The steady decline in production, has led to a shrinking demand for labour and millions of agricultural workers have already been made redundant or face losing their jobs.

From 1990-2000, the productivity of large farms fell 2.6 fold and numbers employed fell to 5.2 million. The average monthly salary in agricultural enterprises was 483 roubles (USD 16.8) in 2000 which represents 44.5% of the average salary in Russia<sup>2</sup>. It has become clear that agricultural enterprises need to shed surplus labour. Thus the collapse of the system of planned agriculture, resulting in the break-down of the large farms economy is the first reason for the rise in unemployment.

Table 2. Financial indicators for large farms, 1999

|                                   | Groups of Large Farms       |                                 |                                  |                                     |                |
|-----------------------------------|-----------------------------|---------------------------------|----------------------------------|-------------------------------------|----------------|
|                                   | I.<br>Financially<br>stable | II.<br>Temporarily<br>insolvent | III.<br>Chronically<br>insolvent | IV.<br>On the edge<br>of bankruptcy | V.<br>Bankrupt |
| Number of farms                   | 5 957                       | 4 607                           | 4 470                            | 4 849                               | 7 376          |
| % of total number                 | 22                          | 17                              | 16                               | 18                                  | 27             |
| Share, %                          |                             |                                 |                                  |                                     |                |
| In production                     | 53                          | 18                              | 13                               | 9                                   | 7              |
| In overdue debts                  | 9                           | 15                              | 19                               | 21                                  | 36             |
| Per 1 worker, thousand of roubles |                             |                                 |                                  |                                     |                |
| Sales                             | 58                          | 35                              | 28                               | 22                                  | 13             |
| Profit                            | 14                          | 3                               | 0                                | -5                                  | -9             |
| Debt, total                       | 15                          | 26                              | 35                               | 39                                  | 51             |
| Including overdue debt            | 5                           | 14                              | 20                               | 24                                  | 33             |

Source: Uzun, Shagaida, Agrarian Institute working papers (2000).

As one can see from Table 2 not all enterprises are homogeneous – some are quite profitable. Over the last 10 years, resources from insolvent enterprises have likely shifted to the viable ones.

2. Goskomstat: Russian Statistical Yearbook 1999, p. 351.



Table 3. Financially stable and bankrupt farms

|                             | Financially stable farms<br>(I group) |       |                    | Bankrupt<br>(V group) |       |                    |
|-----------------------------|---------------------------------------|-------|--------------------|-----------------------|-------|--------------------|
|                             | 1995                                  | 1999  | 1999 to<br>1995, % | 1995                  | 1999  | 1999 to<br>1995, % |
| Number of farms             | 4 815                                 | 4 815 | 100                | 6 544                 | 6 544 | 100                |
| Share in sales, %           | 42                                    | 53    | 126                | 14                    | 7     | 50                 |
| Number of workers per farm  | 344                                   | 304   | 88                 | 207                   | 133   | 64                 |
| Land per worker, ha         | 18                                    | 20    | 111                | 30                    | 40    | 133                |
| Funds per worker, th. Roub. | 72                                    | 159   | 221                | 75                    | 197   | 263                |
| Area per farm, ha           | 6 225                                 | 6 173 | 99                 | 6 204                 | 5 318 | 86                 |
| Area under crops, ha        | 4 000                                 | 3 837 | 96                 | 2 914                 | 1 808 | 62                 |
| Number of cows per farm     | 497                                   | 409   | 82                 | 345                   | 142   | 41                 |

Source: Ibid.

In the majority of cases, for farm workers who lose their jobs, their own household is the only alternative source of employment.

### Private household plots

The slow development of individual private farms (introduced in 1990 through the Federal Law “On private Farming in Russia”) is one of the reasons for the lack of progress in rural development. Before the reforms were introduced, it was considered that rural inhabitants would start individual farming at their own risk. However, this was not the case. Today individual private farms account for only 6.9% of total agricultural land use and produce 12.7% of sunflowers, 7.1% of grain, and 5.4% of sugar beets.<sup>3</sup> The number of individual private farms in 1999 amounted to 260 000, the average size was 55 ha.<sup>3</sup>

In the absence of traditional sources of employment, rural dwellers have begun to look for alternative opportunities and to develop their private household plots (*lichnye podsobnyye khozyaystva*). Private household plots (PHP) emerged in the early 1970s when rural residents, the workers of *kolkhozes* and *sovkhozes*, were allowed to work at their kitchen plots to provide food to support their families since food shortages had become widespread under the Soviet economy. The size of these PHP was strictly limited as was the time agricultural workers could spend on their “private” land.<sup>4</sup>

During the transition period the importance of PHPs has significantly increased. Today, PHPs do not only provide for household subsistence or supplementary earnings; in many cases they have become the sole reliable source of income for rural families. Today, 16 million PHP throughout Russia (of which 14 million in rural areas) account for more than 50% of total agricultural production (Table 4).

3. AKKOR (Russian Association of peasant farms and their co-operatives) statistics, 2000.

4. The PHP land was private only in the sense that nobody could cultivate it and use the results of production except the family members. Officially it was state land given to the rural families in temporary use.

**Table 4. The share of main types of agricultural producers in land-use and agricultural output, %**

|                          | 1990                             | 1995 | 2000 |
|--------------------------|----------------------------------|------|------|
|                          | Share in agricultural land use   |      |      |
| Large farms              | 98.1                             | 81.7 | 83.7 |
| Individual private farms | 0.1                              | 5.0  | 6.6  |
| Private Household Plots  | 1.8                              | 4.7* | 5.4* |
|                          | Share in agricultural production |      |      |
| Large farms              | 73.7                             | 50.2 | 43.1 |
| Individual private farms | 0                                | 1.9  | 3.0  |
| Private Household Plots  | 23.6                             | 47.9 | 53.9 |

Source: Goskomstat: Agricultural activity of rural households in Russia, 1999, pp. 16, 18.

\* The sum of columns is not equal to 100 % because there are other types of land-users (for example, northern tribes using polar pastures etc.)

Private household plots account for 92% of potato production; 77.1% of vegetables; 60% of poultry and meat; 48.8% of dairy production; 29.2% of eggs and 56.0% of wool.<sup>3</sup> The official average size is 0.4 ha (Goskomstat, 1999). However, some specialists estimate the average size at 1.7 ha (Uzun, 1999) taking into account municipal and collective enterprise land which PHPs also use.

Despite the new role of PHPs in the rural economy, government policy towards PHPs has not changed. PHPs are not subject to government regulations and are thus excluded from state support programmes. For example, funds from the State Subsidised Credit Fund for Agriculture are directed at large farms irrespective of their effectiveness. PHPs do not have access to state leasing, investments and guarantees.

PHP owners have no official status, they cannot be registered as self-employed and contribute to the Pension, Medical and other social funds. This means that private plot owners do not have the same social guarantees as other employees and cannot benefit from pension, social and medical insurance. Some PHP owners are obliged to take on a “fictitious” jobs in order to maintain their length of service rights and social security coverage but their major income comes from the PHP.

Some Russian academics and agrarian policymakers believe that the lack of a clear government policy towards PHP development is a major impediment to improving the income-generating potential of many rural households (Petrikov, 2000; Uzun, 1999; Shmelyov, 2000). Developing PHPs could solve many of the social security issues pertaining to the rural and urban population. Firstly, employment generated through PHPs will reduce the need for unemployment allowances (dole). Secondly, the new employment opportunities created would reduce migration from rural to urban areas, reducing the need for state investment in new building in the cities.

The introduction of a transparent agrarian policy for PHPs is therefore vital. The appropriate framework could be introduced through a special federal law “On the development of private household plots” which would clearly define the status and rights of PHP owners. Some regions (*Tyumen, Omsk oblasts*) have already passed regional laws and approved special programmes for PHPs. These include measures on PHP integration into local and regional markets; providing access for PHPs to input supplies, service provision, collective use of machinery and marketing; organisation of agricultural co-operatives; technological modernisation of the small farming sector; creation of financial funds to support PHPs; development of local governance and NGOs.

To stimulate rural economic activity, it is also necessary to expand PHPs. Land is not a scarce resource in Russia because large farms have insufficient inputs to use it all. Moreover through land privatisation in Russia every rural citizen received a land share (5-7 ha in average) to use as he/she wishes<sup>5</sup>. In March 1996 President Yeltsin issued a decree allowing the expansion of PHPs up to the land share size. But the legal and practical procedures associated with this land use are still in their infancy. And some regions such as Leningrad have limitations on the size of PHPs. PHP owners are increasingly expressing their desire to expand production and this necessitates the increased availability of all types of land: arable land for crop production and pastures and hayfields for the increase of livestock production.

Thus the 14 million PHPs in rural areas are a great potential engine for generating rural employment and enhancing rural incomes. They are also a guarantor for maintaining rural lifestyles and cultural and social traditions in Russia's vast rural territories. The vital role private household plots can play in the transition from a planned to a market economy must not be underestimated.

The creation of micro-credit schemes in rural areas is a crucial factor in support of small village entrepreneurs. In recognition of this, the Government of the Russian Federation has supported the *Sustainable Rural Livelihoods Pilot Project* that was begun in September 2000 under the umbrella of a bilateral Russian-British Development Programme<sup>6</sup>.

### **Sustainable Rural Livelihoods Pilot Project: Russia**

The *Sustainable Rural Livelihoods Pilot Project* (SRLPP) is the successor to several land privatisation and farm reorganisation projects in Russia. Its ultimate goal is to secure rural livelihoods through the creation of sustainable income generating activities for rural areas. In other words the main purpose is to create favourable conditions and mechanisms for employment creation and income enhancement for the rural population.

The following 8 areas need to be addressed:

- development of economically viable market-oriented collective enterprises;
- expansion of PHP size;
- increased productivity of family households;
- equipment of individual private farms and PHPs with modern small machinery and appliances;
- development of alternative off-farm employment;

---

5. Every land share owner could sell his land share, give it to lease, present, put it as a stock to the charter capital of large farm, withdraw land plot to start individual private farming, expand his PHP. Land could be used only for agricultural purposes.

6. The project was started in 2 counties (*raions*)– Lodeinoye Pole raion of Leningrad oblast and Novosilsky raion of Oryol oblast, but in this very paper we'll use mainly Lodeinoye Pole raion data. The main implementor of the project is RosAgroFond (Fund for Support of Agrarian Reform and Rural Development).

- micro-financing of family farms via locally created municipal funds and credit co-operatives;
- support of rural communal and social infrastructure;
- development of local governance in rural areas.

Information campaigns are an essential starting point because rural residents are often not aware of their constitutional rights concerning land and farm property. It has emerged that legal procedures need to be developed to transfer land shares from large-scale collective agricultural enterprises to private plot holders. The process of farm reorganisation must be continued. And the introduction of a Third Party Arbitration Court would help to explain procedures and to clarify local legal issues on land and farm assets.

PHP activity could be stimulated through improved service provision (*i.e.* input supply, access to farm machinery, transport and marketing) including:

- i) more effective co-operation between private plot holders and the remaining elements of the parent large farm;
- ii) creation of co-operatives among PHP owners;
- iii) establishment of reliable, transparent and fair trading arrangements with private market traders which meet the needs of PHP owners for marketing their commodity production.

Generating diversified rural income activities for small-scale rural producers includes identifying new farm and off-farm activities. Rural tourism and the development of local handicraft industries are among the possible sources of additional income.

Maintaining communal infrastructure is also a key problem for rural areas. In the Soviet Union the social infrastructure was managed by *kolkhozes* and *sovkhozes*. Now that they can no longer financially fulfil this responsibility, the social assets are transferred to the local municipalities. The problem arises when the local municipalities cannot support rural infrastructure because of a lack of resources. The SRLPP is trying to elaborate new approaches. Improved local support for maintaining rural infrastructure and social assets could be achieved through better co-ordination between farm businesses, private plot holders (or their co-operative structures) and local government structures (village councils, *volosts*, *rayon* administrations, and other *rayon* level service providers).

But the central part of the project is **micro-credit schemes**. The majority of people in rural areas do not have effective access to credit and are very appreciative of the service offered by the schemes. The clients see the loan systems as simple and straightforward, especially compared to the bureaucratic bank procedures. Most clients intend to use the loans to increase their income. Given the short time that the schemes have been operational, the evidence for their success is limited, although progress is very positive. Small-scale rural producers now have access to credit and to legal, taxation and business “start up” advice. One in ten rural families in the Lodeinoye Pole *raion* have benefited from the project.

## ***Description of credit scheme***

**The Lodeynoye Pole Fund for Rural Development (LPFRD)** is a very important component of the SRLPP. The LPFRD is the first micro-credit fund created for the needs of PHPs and small rural businesses in Russia. In one year of operations, the LPFRD has given 108 loans of an overall value of nearly of 1.5 million roubles (USD 52 300). Over 75% of clients are household plot owners, the main target group, and this is the first scheme in Russia to offer loans to these very small-scale farmers.

In September, before launching the credit scheme, *RosAgroFond* experimented by giving loans in kind in the form of 210 goslings to 8 families to be repaid in cash over six months. The loans were all successfully repaid, although two families had to repay the loan from other sources as the birds died. However, the successful repayment rate encouraged *RosAgroFond* to move to a more formal credit scheme.

The Lodeinoye Pole Rayon administration was anxious to improve small-scale farmers' access to finance. With the help of *RosAgroFond* it established the Lodeinoye Pole Fund for Rural Development in August 1999, initially with a view to using *rayon* funds from timber taxes as the basis for the credit scheme. The main principles of the LPFRD, as stated by the First Deputy in the *rayon* administration responsible for founding it, are:

- i) loans should be repaid;
- ii) interest is payable on all loans;
- iii) procedures should be transparent;
- iv) clients must produce appropriate documents before receiving a loan.

As *RosAgroFond* was developing plans for implementing the credit component of SRLPP, it was decided that LPFRD was an appropriate vehicle for the scheme.

The initial focus of the schemes has been to ensure repayments. And to a large extent they have been successful with an impressive repayment rate to date. Only two clients are in arrears and failing to make any attempt to repay. This is particularly important in the Russian context where historically loans have been given with low expectations of repayment.

The main governing body of LPFRD is the Board of Trustees. Its members consist of the *rayon* administration, *RosAgroFond*, agricultural producers and DFID<sup>7</sup> (as its money was used for credit). The board meets once a month to review credit applications and problems with existing loans, such as applications for rescheduling, and makes the final decision which must be agreed unanimously. The board is advised by specialists working for *RosAgroFond* who appraise the applications and make recommendations to the board. These recommendations are generally accepted, although the board may modify loan amounts or terms.

The staff of LPFRD currently consists of an acting director who was appointed by the *rayon* administration, and an accountant who also works as assistant to the project director of *RosAgroFond*. In the future, it is anticipated that LPFRD will become more autonomous and take over more of the work of *RosAgroFond*. *RosAgroFond* is based in Moscow and its key staff travel from Moscow each week. Staff recruited from Lodeinoye Pole will form the personnel base for LPFRD.

---

7. DFID - British Department for International Development.

The first cash loan of 150 000 roubles was given in November 1999 to a private family farm to expand its dairy herd. However, the main scheme was launched in February 2000. As funds have become available, notices have been sent out to villages inviting applications for credit, specifying the activities for which applications are invited. The decision to create credit schemes for specific activities is based on detailed business plans prepared by RosAgroFond specialists, which review production costs, anticipate yields and provide a market analysis. The first three months of the scheme's operation focused on cattle fattening and dairy and potato cultivation. In May the first loans were given for pig farming and in June the scheme was extended to off-farm businesses.

Following submission of the applications, the specialists meet with the applicants to develop a cash-flow projection for their enterprise. This is presented in tabular form and is largely based on a generic business plan for yields, costs and sales, although adjustments are made for the particular applicant's circumstances. For example, the cost of feed for pigs may be reduced for clients who have ready access to large quantities of household waste food. The initial shortfall in cash flow each month represents the client's investment in the enterprise and the later positive flow represents their profit. All costs are based on current prices. The net value is calculated applying a discount rate of 1.67% per month (~ 20% pa), as is the rate of return of the cash flow. This table and the calculations form the basis for the financial appraisal.

In nearly all cases a RosAgroFond specialist will visit the client to ensure that they have the required facilities for undertaking the activity, such as an appropriate building for livestock. Prior to approving the loan the client will have to present various papers including a letter of support from the local *rayon* or *volost* administration, an extract from the administration's records for the household, a certificate from the tax office (to show they are not in arrears), and agreements to use any additional land required. Applicants also have to complete a form detailing their educational background and experience.

The interest payable and the collateral required vary according to the amount of the loan (Table 5). Where collateral is required it must be in the form of liquid assets. Collateral and third party guarantees also require additional documentation. The loan terms and repayment schedule will vary according to the activity. Terms vary from 3 months (poultry) to 18 months (fattening cattle) and over a third of the loans are for more than 1 year. Depending on the activity and anticipated cash flow, capital repayments are either spread evenly throughout the loan term or are paid in lump sums at the end of the loan period. Nearly 50% of loans have large capital repayments scheduled for the last three months and, for many of the loans, there is a six month period when no capital repayments are due.

**Table 5. Lodeinoye pole micro-credit interest rates and collateral**

| Loan size                  | Interest rate                        | Collateral                              |
|----------------------------|--------------------------------------|-----------------------------------------|
| ≤ 5 000 R                  | $\frac{1}{4}$ Central bank rate + 3% | None                                    |
| >5 000 Rur, ≤ 25 000 Rur   | $\frac{1}{4}$ Central bank rate + 3% | Goods                                   |
| >25 000 Rur, ≤ 100 000 Rur | $\frac{1}{2}$ Central bank rate + 3% | Goods + 3 <sup>rd</sup> party guarantee |
| >100 000 Rur               | $\frac{3}{4}$ Central bank rate + 3% | Goods + 3 <sup>rd</sup> party guarantee |

The client base and range of activities is shown below. At least five clients have received more than one loan and one has received 4 loans. These loans have overlapped and in some cases were planned in order to match the cash flow of the fund to the needs of the client by giving credit in two tranches. Each loan is recorded separately, *i.e.*, the total number of clients is closer to 90. The average loan size is 15 000 Rur.

**Table 6. Distribution of loans by client**

| Type of clients         | Applications   | Loans granted |      |                   |           |
|-------------------------|----------------|---------------|------|-------------------|-----------|
|                         | Number         | Number        | %    | Loan volume – Rur | % of fund |
| Household plot owners   | 107            | 84            | 77%  | 498 000           | 33%       |
| Private family farm     | 45             | 20            | 19%  | 633 000           | 42%       |
| Individual entrepreneur | Incl. With PFF | 2             | 2%   | 60 000            | 5%        |
| Enterprises             | 3              | 2             | 2%   | 300 000           | 20%       |
| Totals                  | 155            | 108           | 100% | 1 491 000         | 100%      |

**Table 7. Distribution of loans by type of activity**

| Activity               | Number of loans | % of loans | Loan volume – Rur | % of fund |
|------------------------|-----------------|------------|-------------------|-----------|
| Fattening cattle       | 45              | 42%        | 184 500           | 12%       |
| Dairy farming          | 19              | 18%        | 639 000           | 43%       |
| Fattening pigs         | 18              | 17%        | 213 000           | 14%       |
| Off-farm business      | 7               | 6%         | 196 000           | 13%       |
| Potato cultivation     | 6               | 5%         | 50 000            | 5%        |
| Strawberry cultivation | 4               | 3%         | 80 000            | 6%        |
| Vegetable cultivation  | 2               | 2%         | 28 000            | 2%        |
| Rabbit farming         | 2               | 2%         | 20 000            | 1%        |
| Poultry                | 2               | 2%         | 21 000            | 1%        |
| Other                  | 2               | 2%         | 9 500             | 1%        |
| Sheep breeding         | 1               | 1%         | 50 000            | 3%        |
| Totals                 | 108             | 100%       | 1 491 000         | 100%      |

Once loans have been approved a specialist from RosAgroFond will visit the client within about 10 days of the loan being disbursed to ensure that the money has been spent on the specific activity. Thereafter clients visit the Lodeinoye Pole office each month to make their repayments. Six clients have run into difficulties, mostly due to the poor potato harvest, and have requested loan rescheduling which has been granted. One client failed to use the loan for the specified activity citing family problems, and is in arrears. Some of the larger loans have been given to clients who are starting up ventures which are important for the rest of SRLPP, for example setting up model farms and marketing systems. These clients have received considerable technical support from the RosAgroFond specialists and are visited regularly. Others have received support in the form of advice such as sources of animals, fodder and production techniques but are not visited regularly. At the end of loan a statement of the clients' repayments and the results of their activity is drawn up.

The start up capital of LPFRD was 1.15 million roubles of which 62% was provided by DFID and the balance from *rayon* funds. The fund has received additional income of 70 000 roubles from interest and fines and 30 000 roubles have been spent on administration costs and taxes, leaving a net increase in capital of 50 000 Rur or 4.3%. However, with an inflation rate of approximately 28% this represents a loss in real terms of 18% over one year. It should also be noted that RosAgroFond pays the salaries

of the staff involved in loan appraisal, transport, stationery and other scheme running costs. The project manager has estimated this to cost approximately 12 000-18 000 roubles per month.

**Table 8. Source and use of LPFRD funds**

| Income                                         | Rur       | Outgoing             | Rur       |
|------------------------------------------------|-----------|----------------------|-----------|
| DFID capital funds                             | 753 000   | Loans disbursed      | 1 491 000 |
| Rayon and oblast admin capital funds           | 445 000   | Administration costs | 25 250    |
| Principal repaid                               | 666 000   | Taxes                | 9 500     |
| Interest repaid                                | 94 000    |                      |           |
| Fines                                          | 4 000     |                      |           |
| Total                                          | 1 962 000 | Total                | 1 525 750 |
| Residual funds                                 | 436 250   |                      |           |
| Overdue debts                                  | 128 000   |                      |           |
| Percentage of overdue debts to loans disbursed | 8.5%      |                      |           |

The question on the minds of everyone involved with this credit scheme is how to ensure its sustainability, both in financial and institutional terms. Critics of the scheme state that it is currently operating with subsidised, below inflation interest rates, which mean that it is losing capital value in real terms.

There are several reasons for the use of subsidised interest rates at the beginning of the scheme. The first is that subsidising is necessary as the poorest clients are not able to pay higher rates and would be excluded from the scheme if market rates were charged (over 90% of households in Lodeinoye Pole Rayon are living below the poverty line, see ANNEX).

Another argument for low interest rates is that the government offers subsidised agricultural credit and if rates were too high farmers and private household plots would not take up the loans. Besides LPFRD could act as a channel for government subsidies to bring the benefits of low interest to household plot owners. In this case the credit scheme could be sustainable as the shortfall in interest would be paid by the government. However, this would expose the scheme to risk as it would have to lend in advance of receiving government payment.

Of course, even if interest rates are set at a level to maintain the capital value of the fund, the transaction costs will need to be subsidised until the schemes have grown to a sustainable size which would require a significant injection of capital.

We agree that if the scheme were to adopt a stronger interest rate regime, it would make it more attractive to other sources of capital. Another important potential source of capital would be the mobilisation of savings but this is currently highly unlikely. Since the financial crisis of 1998 people have been very nervous of any savings schemes and Russian law does not have a mechanism for allowing micro-finance institutions to accept savings. None of the other micro-finance organisations in Russia have a savings component to their schemes.

This project is the first externally funded programme that has extended credit to the smallest farmers in Russia, down to the level of those working on household plots. A remarkable and very impressive feature of this credit scheme is that it has achieved high repayment rates in the context of Russia where it has been common practice for loans to be taken as grants and repayment has not been enforced. This is a good base on which to build.



In its first year of operation, the credit scheme successfully focused on giving credit to small-scale farmers who do not have access to bank loans or subsidised government agricultural loans. In order to maintain this focus, some adjustments may be necessary to ensure that the scheme can continue to address the needs of this target groups. One method being considered by RosAgroFond is to use social capital to secure loans by giving loans in rotation to individuals in groups where new loans are only disbursed if all members of the group keep up their repayments. There are many variants on this group banking model. There is also scope for some experiment with different loan periods and repayment schedules to discover which is the most beneficial for clients, while minimising the risk for the scheme.

The current appraisal and monitoring system of the credit scheme will need to be strengthened in order to gain a fuller picture of the impact of the programme in building up sustainable livelihoods and reducing rural poverty. An assessment of different models of credit organisations would also be useful (one idea could be to transform the fund into a credit co-operative managed by its members). Currently there is little data on the clients beyond the strict minimum necessary to monitor loan repayments and there appears to be very limited understanding of the dynamics of poverty at the level of the household. For example, there is no routine information on the source of clients' contributions to their businesses. While the baseline data shows that the majority of clients live below the subsistence level it is not clear how they make ends meet, let alone have cash to invest. In the currently extensive non-cash economy in Russia much economic activity is likely not captured by local government statistics.

An appropriate monitoring system must balance the usefulness of the information to the stakeholders (clients, field staff, managers and specialists) against the cost of collection and analysis. Data such as the size of land holdings, regular source of household income (salaries, other farm activities), household structure (family size, number of dependants) may be useful indicators of poverty and its routine analysis may enable the credit schemes to monitor who they are reaching (see ANNEX).

### ***Social and economic impact of the credit scheme<sup>8</sup>***

Given that the programme is still in the early stage of implementation, and in view of the small number of loans completed to date, it is premature to assess the impact of the scheme. However, the following preliminary assessment has been made based on interviews with a selection of clients.

Five different reasons for taking a loan emerged during the client interviews:

- i) to expand an existing business – increasing number of animals or area cultivated;
- ii) to use a new technique – farming rabbits using heated hutches to accelerate growth, building a drying room for timber to add value to the product, launching strawberry production;
- iii) to build up household assets and income – restarting stock raising after loss of a farm;
- iv) to generate capital – investment in assets such as pigs which will yield a further cash lump sum on sale;

---

8. This material is based on the report of Oliver Bakewell, external consultant of SRLPP project (2001).

- v) to create an occupation – investing in small-scale farming activity such as rabbit breeding to create an occupation following loss of employment. Keeping busy is seen as a worthwhile outcome even if the venture will not noticeably increase household income.

For the most part the clients were very positive about the schemes as they offer credit which would not be otherwise available. Getting loans from banks was described as an extremely bureaucratic procedure with applicants required to have an adequate formal salary and to provide collateral such as land. The SRLPP credit schemes take into account income from agricultural production and accepts collateral such as motorbikes and other assets which would not be accepted by banks. One client had received a bank loan in the past for house construction at an interest rate of 100% and had struggled to repay. Another said they had been trying to get a bank loan since 1994 without success and had eventually launched their business with the proceeds from the sale of the client's parents' flat.

The exception was the one client who failed to buy the animals she borrowed money for and is now in arrears. She described taking the loan as a mistake and she would not want to touch credit again. She appeared to be the poorest of the clients visited in Lodeinoye Pole.

Although the clients see the scheme in a positive light, it is disturbing that few of them had a clear idea of whether and when their venture would return a profit. Those most experienced in the particular activity (such as larger private household farmers) were confident that they would have some return on the investment. The majority of clients were not aware of the progress made as measured against the initial business plan. While some clients are relying on the business plan that RosAgroFond had helped to develop, for example when new ventures such as large-scale pig farming and timber drying were being launched, it does not appear that the financial analysis follows up on the business progress. The relationship between the costs described by clients and those appearing in the financial analysis is unclear, and in the two cases which were cross-checked the former seemed to be higher.

In many cases, the client's major contribution to the venture is in the form of labour and materials, such as leftover food, which are not available free of charge. One client said that she would pay whatever it took to get her pigs fatter and the profit was not important. The crucial issue for her was that it gave an opportunity to build up a capital asset that could yield a lump sum on sale – literally a piggy-bank.

Although the client base in both schemes is dominated by household plot owners (75% in Lodeinoye Pole), the largest share of the loan capital (45%) has been disbursed to private family farms. The staff at RosAgroFond are anxious to ensure that they can support the development of farms and off-farm businesses which can provide employment and contribute to the wider goals of SRLPP. The credit fund is seen as a method of supporting such businesses and the RosAgroFond staff and some clients were keen to make larger loans over longer periods for this purpose. Their staged interest rates also make larger loans more attractive for the credit scheme as they bring in more interest and cost less to administer. As noted above, it is the larger clients whose businesses are followed more closely and who receive the most business advice. This may make sense within the larger SRLPP but it is likely to encourage a drift towards larger farmers and weaken the focus on the household plot owners. Half of the current capital (1 million Rur) still on loan with clients from LPFRD is owed by four clients.

Thus the LPFRD has tested new approaches.

*First*, LPFRD relies mainly on local sources of funding. Lodeinoye Pole *raion* has considerable timber resources and the Municipal administration is able to direct some of this money to LPFRD.

*Second*, LPFRD accords different interest rates according to the size and the social dimension of the business-project<sup>9</sup> making borrowing affordable for rural families.

*Third*, the local budget participates in LPFRD subsidising the difference between market and subsidised interest rate.

*Fourth*, there are no minimum limits for a loan so even small borrowers can obtain modest loans (for example, USD 20).

*Fifth*, the credit terms are also favourable since the cycle of agricultural production is taken into account in every case.

*Sixth*, LPFRD staff assists borrowers to prepare effective business plans.

And finally, the LPFRD often uses a system of collective responsibility for loans, grouping together several borrowers.

The importance of micro-credit schemes cannot be overestimated. Under conditions when small rural entrepreneurs have no access to credit, micro-credit can be the only source of funding for their activities.

---

9. The loans are given by  $\frac{1}{4}$ ,  $\frac{1}{2}$  and  $\frac{3}{4}$  of Central Bank interest rate.

## ANNEX

### **An overview of borrowers: employment and incomes of the rural population in the Lodeinoye Pole raion of Leningrad oblast<sup>10</sup>**

Lodeinoye Pole *raion* is one of the 17 *raions* of Leningrad *oblast* in the North-Western part of the Russian Federation. It is situated 250 km from the capital of Leningrad *oblast* – St.-Petersburg. The population is around 40 000 of which the rural population represents 10 500 or 26%.

The *raion* is one of the poorest in the region. The rural poverty level (the share of population whose aggregate income is below the subsistence level) in the *raion* is 92%. Rural families have very low incomes. The estimate of aggregate income is based on data from household records, official statistics and estimates by local residents of output costs on private household plots.

The aggregate income includes the following (Annex Table 1):

- wages;
- private household plot income;
- pensions;
- benefits/ allowances;
- income from entrepreneurial activities;
- property income: land share rent etc.;
- income from collecting and selling wild produce (berries, mushrooms and herbs).

**Annex Table 1. Rural residents income in the Lodeinoye Pole rayon**

| Source of income                                                 | Per person<br>rouble*/ month | %   |
|------------------------------------------------------------------|------------------------------|-----|
| Wages                                                            | 343                          | 51  |
| Pensions                                                         | 145                          | 22  |
| Income from private household plot farming and livestock keeping | 81                           | 12  |
| Collecting and sale of found wildlings                           | 83                           | 12  |
| Social benefits (childcare allowances, etc.)                     | 9                            | 1   |
| Dole                                                             | 6                            | 1   |
| Total                                                            | 667                          | 100 |

\*At the end of March 2001, the rouble / USD ratio is 27.8.

10. Case study is based on the implementation of methodical approaches elaborated for SRLPP realisation (2000) by research group. The most important contribution was made by Uzun, Petrikov, Shagaida, Ianbykh *et. al.* The calculations were made by Rodionova and Ovchintseva (2000).

The gross average monthly income per capita is obtained by dividing the sum of annual income from the sources mentioned by the number of local residents. It amounts to Roubles 669 per month, or 69% of the subsistence level<sup>11</sup>.

The average income per household in rural areas of the Lodeinoye Pole rayon is equal to RUR 1 736 a month and is calculated by dividing the aggregate income from all mentioned sources (on the basis of available data) by the number of households.

The Food security status of the Lodeinoye Pole rayon is estimated as the ratio of gross average monthly income per capita (RUR 669) to the portion of the subsistence level value relating to food stuffs (in other words the consumer basket) - RUR 542:  $\text{RUR } 669 : \text{RUR } 542 * 100\% = 123\%$ . This means that the aggregate income of the population is 23% higher than prices for food products comprising a subsistence level diet. Only 47% of the population live in families whose income is above the subsistence level required to spend on food.

The level of employment of the rural population is calculated as the ratio of the number of residents involved in economic activity to the total population of working age. The total population of working age is 5 311 persons. The number of residents involved in economic activity is 623 (number of workers of agricultural enterprises) + 1 397 (number of rural residents employed in other enterprises) + (registered self-employment: 65 private farmers + 100 individual entrepreneurs registered in the rural area) + not registered self-employment: 446 (estimated number of people employed on private household plots) + 243 (estimated number of people employed in collecting of found wildlings) = 2 874

The level of employment of the rural population is 2 874:  $5\,311 * 100\% = 54\%$  (including estimated self-employment). The level of employment excluding estimated self-employment is 41%.

Level of self-employment. The calculation of unregistered self-employment on private household plots is carried out by comparing the annual labour costs of output on private household plots to the labour norms (2004 hours per year with the norm of a 40-hours working week). As a result we have the estimated average annual number of workers on private household plots. Actually, unregistered self-employment pertains not only to the working age population, but to pensioners and children as well. For many, who have an official job, this is auxiliary employment, for those who do not, it is primary.

The value of self-employment in collecting wild produce is calculated as a ratio of the time spent by rural residents on collecting wild produce to the labour norms (2004 hours).

Registered self-employment (65 private farmers + 100 individual entrepreneurs = 165) plus unregistered self-employment (446 estimated number of people employed on private household plots + 243 estimated number of people employed in collecting of found wildlings = 689) = 854 :  $5\,311 * 100\% = 16\%$ .

Unemployment assessment. In the information provided by the Raion Employment Centre the unemployment rate as of early 1999 is over 9%. Information from household records shows that early

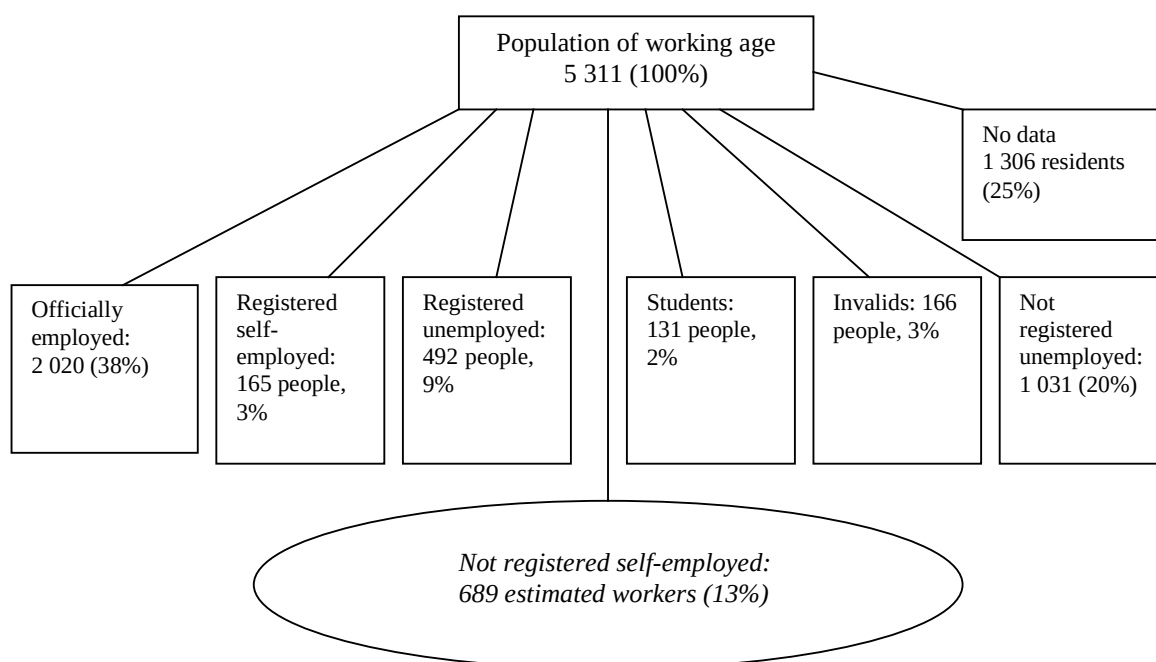
---

11. The subsistence level value for the Lodeinoye Pole rayon is calculated based on the consumer basket as fixed in the Leningrad oblast. The content of the consumer basket is multiplied by corresponding average prices in Lodeinoye Pole rayon. Monitoring of the prices is conducted by statistics of the Lodeinoye Pole rayon. The average subsistence level value of the rural population of the Lodeinoye Pole rayon in 1999 amounts to RUR 969.

1999, the number of people without jobs was three times the level of the number of people registered with the Employment Centre. The total number of formally unemployed was  $1\,031 + 492 = 1\,523$  people (29%).

Thus the rural unemployment level in Lodeinoye Pole *raion* is enormous. Taking into account that neither household records nor official statistics have information about the employment status of 25% of the rural population (with the high probability that those people are unemployed too) one can assume that the total unemployment level is more than 50 % of the working age population (Annex Figure 1).

Annex Figure 1. Rural employment in Lodeinoye Pole Raion



## Conclusions

The data from Lodeinoye Pole *raion* shows that rural unemployment and poverty are the two dominant problems of rural development in Russia's economically depressed regions. The State has to implement special programmes to solve these problems. One effective measure would be to stimulate the development of self-employment in private household plots through the creation of micro-credit schemes for rural dwellers.

Micro-credit schemes have both social and economic dimensions. On the one hand, they can encourage the start-up of small businesses and generate income for rural families. They can also mitigate the problems of rural unemployment and the social adjustment of the rural population. To have beneficial effects, the schemes should be supported by the creation of rural consultant centres, NGOs, and third party arbitration courts which can provide the rural population with the necessary economic, legal, social and technological advice and knowledge.

## BIBLIOGRAPHY

- Bakewell, Oliver (2001),  
Report on the micro-credit component of the Sustainable Rural Development Project.
- Decree of the President (1996),  
N 337, April.
- Goskomstat (State Statistical Committee of Russia) (1999a),  
*Agriculture in Russia in 1998*, Moscow.
- Goskomstat (State Statistical Committee of Russia) (1999b),  
*Agricultural activity of households in Russia*, Moscow.
- Goskomstat (State Statistical Committee of Russia) (1996),  
*Agriculture in Russia in 1995*, Moscow.
- Ministry of Agriculture and Food of the Russian Federation (1999),  
*Russian agro-industrial complex in 1998*, Moscow.
- Petrikov, Alexander (1999),  
“Big problems of small households”, (in Russian), *Agrarnaya reforma: ekonomika i pravo* (2), 2-5.
- Petrikov, Uzun, Rodionova, Ovchintseva, Ianbykh *et al.* (2000),  
“Providing employment and increasing income of rural population”, (in Russian), Materials of the manual for working groups, forthcoming.
- Rodionova and Ovchintseva (2000),  
“Estimation of the poverty level of rural population in Lodeinoye Pole raion of Leningrad oblast”, (in Russian), In: *Working materials of sustainable rural livelihood project* (not published).
- Shmelyov, Gelii (2000),  
“Role of households in Russian agrarian sector and their co-operation”, (in Russian), *Agrarnaya reforma: ekonomika i pravo* (3), 5-6.
- Uzun, V.Ya. (1999),  
“Land privatisation and farm reorganisation: ideas, mechanisms, results and problems”, (in Russian), In: *Farm reorganisation: their effectiveness and sustainable growth*, Golitsyno workshop materials, Moscow: 36-54.

# HIDDEN CREDITS IN THE AGRO-FOOD SYSTEM IN THE CZECH REPUBLIC: A FARMER'S POINT OF VIEW

By Mr. Michal Pospíšil

## Abstract

*The transition from a centrally managed to a market economy is a long term process and has many new aspects with which no one as yet has significant experience. This short case study illustrates the process from the farmers' point of view. The examples given show that farmers, as the primary producers, have little influence over the food chain as a whole.*

## Introduction

The transformation from a centrally managed to a market-oriented economy is accompanied by the emergence of non-traditional business practices. Before the fall of the communist system, the economy of the Czech Republic was managed centrally: one institution was responsible for a certain processing branch (dairy industry, slaughter houses and production of meat products, cereals storage, sugar refineries, etc.) and the branch was managed by one general directorship. Agricultural production was centrally planned and followed the Soviet model of state farms or so called co-operatives (*kolkhoz*). There were no private farmers and no farmer marketing organisations – co-operatives.

In the course of privatisation and the process of restitution there was a split between processing and the primary producers of agricultural commodities, with the former marketing chains integrated according to command principles, gradually broken down into individual segments. Through this process, a few agents managed to corner the limited Czech market. During the period of political reform, when new legislation was being enacted, there was strong pressure from people who had never undertaken farming under market economy conditions. Under the circumstances, it was quite easy to enforce hidden centralist and monopolistic interests, which has resulted in imbalances.

The entry of foreign capital brought in competition and led to the gradual collapse of most of these “pseudo – monopolies” although this was not the case for all sectors (*e.g.* sugar refineries). There has also been a gradual development and growth of successful market-oriented Czech firms. The relative openness of the Czech economy also acts as a check upon monopolisation by individual processors.

Given the very difficult financial situation of producer–farmers, the low capital yield of the sector, and the virtual inexistence of agricultural credits between 1993-1996, including the reluctance of banks to finance farmers, a number of non-traditional, non-transparent, non-bank, credit arrangements, have emerged. Even foreign owners have adapted to Czech conditions and have made full use of these non-bank credits when they are to their advantage (*e.g.* supermarkets).



## **Non-bank credits to agricultural primary producers**

In the chain from the customer back to the producer, “non-traditional credit” is provided in the following ways (this description applies only to the food chain).

1. The consumer always pays immediately. Nevertheless, supermarkets negotiate very different term of payments with suppliers (from 30 to 90 days). In 30 days, a supermarket is capable of accumulating up to 200 million Czech crowns, which is sufficient for further expansion of its trade turnover.
2. But the position of the supermarket supplier is complicated further.
  - Due to oversupply on the food market, the supplier is forced to pay the supermarket a so-called registration fee (for each kind of good).
  - The supplier is forced to accept the terms of payment.
  - The supplier is forced to take back unsold goods.
  - The terms of payment for the primary producer are extended even further.
3. The processor of raw materials takes advantage of his strong position relative to the producer of raw materials or animals in several other ways:
  - He extends the terms of payment (dairies up to 120 days, sugar refineries up to one year).
  - He reduces the price paid to the farmer to the maximum limit.
  - He uses his strong position to prevent new entrepreneurs from entering the market.

Example 1. Sugar beet – Eastern sugar and English capital control 90% of the sugar market in the Czech Republic. A production quota is given to the sugar refinery and the farmer is thus dependent on the sugar refinery and its behaviour.

Example 2. Milk - a minimum price is set by the state. The price that producers receive from the dairies is the minimum price adjusted according to the quality of milk delivered. Dairies decide on the adjustment, which often results in a lower farmer price. Dairies extend the terms of payment beyond 120 days. The farmer thus effectively provides credit to the dairies and loses his profits through bank interest rates.

Example 3. Cereals – Grain elevators have a monopoly. Their position is reinforced by the state’s policy, until recently, of setting a high intervention price. The terms of payment for grain elevators are up to one year. The farmer needs financial credit to cover the period when he receives no income or to invest in his own storage facilities.

At this stage, the processor comes along with a so-called **green credit**, which means that he provides the farmer with all the necessary inputs. He simultaneously subtracts the credits from the farmer's profits. He also negotiates a discount from the farmer/supplier because he purchases a large volume.

Example 1. Sugar refineries, as suppliers of seed, chemicals, fertilisers and harvest techniques, directly request the farmer to purchase all his inputs from them.

Example 2. Grain processors not only supply seed, fertilisers, chemicals and oil, they can also charge fees for harvesting, cleaning and storing, as well as interest on the inputs provided.

In essence, this method of financing forces the farmer to work for a wage.

**The producer (farmer) is responding to this situation in various ways:**

1. He is looking for serious partners.
2. He is founding, successful, agricultural co-operatives (Agropork, Vysočina, Brassica).
3. He is investing in his own storage capacities.
4. He is establishing his own sales-processing channels to the final consumer.

**New approaches are being taken by supermarket chains, for example:**

1. The Belgian owners of the *Delvita* chain have their own meat processing system and buy supplies directly from producers at a low price.
2. Another supermarket system is getting ready to invest directly in primary production, especially in pig breeding, and to provide financial credits to farmers.

The financial resources that the supermarket invests are in reality the farmer's resources because supermarkets pay with up to 90 days' delay. This can result in a situation where the farmer, as an entrepreneur, is paid a wage.

**Conclusions:** The process of change is providing new opportunities that are mainly benefiting cheap investments by supermarket chains. In other words, the farmers are bearing the costs.



## **COUNTRY NOTES**



## Country Note: Croatia

By Ms. Jasna Mikulecky and Ms. Vesna Matijašević

### Abstract

*The purpose of this paper is to describe the current rural credit situation in Croatia, identify the problems and issues, and current Government policies to address them, as well as the measures required to establish a functioning agricultural credit market.*

### Background

After the war in Croatia one of the significant obstacles to economic development, especially in the agricultural sector, was the lack of credit available on terms existing in most developed countries.

The previous socialist system of agricultural credit, which was channelled from commercial banks to the social sector farms and through them to family farms, was no longer functioning. The agriculture sector lost its traditional sources of credit during the post-war economic collapse. Primary transfers from national banks were terminated as part of the economic stabilisation programme. The collapse of commercial banks resulted in a ten-fold contraction in the supply of credit to agro-kombinats (AKs) and agro-processors. The collapse of the AKs, in turn, meant the disappearance of the major source of seasonal credit for small-scale farmers. The rural finance system was highly inflationary, characterised by a weak and distorted commercial banking sector, and obliged small-scale farmers to market a high proportion of their produce through socially owned enterprises. Hence no attempt has been made to reinstate it.

A severe shortage of credit, combined with high interest rates, constrained all activities within the agricultural sector. The difficulties in the banking system restricted the supply of credit for even normal working capital requirements, with the result that the additional demands associated with privatisation were completely unsatisfied. New investment in the processing sector, the purchase of newly privatised agricultural land and other farm assets and the acquisition of shares in former social sector companies have all been seriously impeded.

In 1997 the Croatian banking system entered a new phase of development. Croatia received its first credit rating from the three important credit rating agencies, which marked the end of the extreme political risk and the beginning of peace and reconstruction in the country. Also, rehabilitation processes had begun in the four most significant banks (difficulties experienced by these banks previously created serious distortions in the banking sector). Another important feature was the rapid entry of foreign banks, which has contributed to creating a more competitive environment in the banking sector.

Although there are many commercial banks in Croatia, there has been little progress in the banking sector in understanding the credit needs of agricultural producers. Commercial banks in Croatia are still showing little interest in servicing the credit needs of the great majority of farmers. There are many contributory factors:

- lack of history and expertise in dealing with small farmers;

- low profitability of farming, and potentially high risk (partly due to changeable government support policies);
- relatively high transaction costs associated with crediting small scale farming which requires small loans;
- lack of provable land titles and the inadequate land market limiting the collateral farmers can provide;
- weak enforcement of contracts and bankruptcy procedures, and a tradition of non-repayment of loans (especially state loans to agro-kombinats).

These constraints have to be overcome, but it will take time and consistent policies. As a transitional measure, most rural credit currently comes from public sector institutions and international credit lines such as:

1. Funds of the Ministry of Agriculture and Forestry (MAF);
2. Croatian Bank for Reconstruction and Development (CBRD);
3. Ministry of Small and Medium Crafts (MSMC); and
4. International credit lines to Croatia (World Bank, EBRD) some of which are used for agricultural development purposes.

Most of the credit from the MAF and CBRD programmes is disbursed and administered by commercial banks. The decision on the allocation of the available credit is made by the administration committee and is not based on purely commercial criteria.

### **Funds of the Ministry of Agriculture and Forestry**

Funds assigned to agriculture in the overall state budget are relatively small but show a growing trend. In 2000, the total value of the funds assigned to MAF activities amounted to HRK 1.5 billion<sup>1</sup> (USD 176 million), which is approximately 3.11% of the total state budget.

---

1. HRK - the Croatian kuna.

Table 1. The MAF budget and its share in the state budget of the Republic of Croatia

HRK

| Year  | Total state budget | MAF budget      | MAF budget as % of total state budget |
|-------|--------------------|-----------------|---------------------------------------|
| 1993  | 9 366 036 000 000  | 350 488 000 000 | 3.74                                  |
| 1994  | 24 632 018 000     | 587 740 000     | 2.39                                  |
| 1995  | 31 095 660 294     | 537 927 979     | 1.73                                  |
| 1996  | 35 611 127 329     | 636 726 799     | 1.79                                  |
| 1997  | 39 745 293 888     | 732 005 667     | 1.92                                  |
| 1998  | 46 846 452 957     | 1 194 078 991   | 2.55                                  |
| 1999  | 49 334 031 813     | 1 573 518 496   | 3.19                                  |
| 2000  | 50 621 634 113     | 1 573 666 244   | 3.11                                  |
| 2001* | 49 747 823 000     | 2 000 029 468   | 4.03                                  |

Note: For 1993 the monetary unit is the Croatian dinar.

\* Planned budget and estimated budget spending by MAF.

Source: Ministry of Agriculture and Forestry, Republic of Croatia, Zagreb.

Direct support from the state budget constitutes a very significant form of financial support to the agricultural sector in Croatia. The MAF is the lead Government institution for the creation and implementation of this important part of Croatian agricultural policy.

The MAF operates *two rural credit programmes*, one funded directly from the Ministry budget and the other one from the accumulations of special land fees. The latter are collected from the users of agricultural land when this land is diverted to non-agricultural use (*e.g.* for construction, mining, waste disposal, etc.).

**Fund for agricultural development.** Creating a Fund for Agricultural Development (FAD) to support the financing of the agricultural sector was one of the most important short-term policy actions in the Croatian strategy for agricultural development (1995). It has been envisaged that the Fund would be revolving, with repayments used to finance new projects.

It was planned that the initial sources of capital for this Fund would include:

- funds from the state budget;
- import levies on agricultural commodities and/or services;
- income generated from sales, leases and concessions of agricultural land;
- funds from commercial banks and other financial institutions.

FAD has not yet developed as planned. As an interim measure before the institutional establishment of FAD a Special Account for the Development of Agriculture (SADA) was funded from the budget in 1996. Control over SADA was given to the Council for Finance, which includes representatives of the ministries and two members of parliament.



Between 1996 and 2001, the functioning of SADA helped agricultural producers to obtain relatively favourable credits on the domestic market to support the development and renewal of agriculture.

**Table 2. The importance of SADA in the MAF budget**

| HRK          |                      |                    |                             |
|--------------|----------------------|--------------------|-----------------------------|
| Year         | MAF budget, HRK      | SADA, HRK          | SADA as % of the MAF budget |
| 1996         | 636 726 799          | 95 000 000         | 14.9                        |
| 1997         | 732 005 667          | 95 000 000         | 13.0                        |
| 1998         | 1 194 078 991        | 85 000 000         | 7.1                         |
| 1999         | 1 573 518 496        | 102 898 000        | 6.5                         |
| 2000         | 1 573 666 244        | 73 000 000         | 4.6                         |
| 2001         | 2 000 029 468        | 168 000 000        | 8.4                         |
| <b>TOTAL</b> | <b>7 710 025 665</b> | <b>618 898 000</b> | <b>8.0</b>                  |

*Source:* Ministry of Agriculture and Forestry, Republic of Croatia, Zagreb.

Credits have been allocated mostly to small family agricultural holdings (nearly 80% of the total). The annual interest rate for these loans is 5% (3% in regions with special state support<sup>2</sup>), with a repayment period of 2 to 8 years (including a grace period of 1 to 3 years).

As shown in Table 2, the share of SADA in the total agricultural budget in 1996-2001 was 8.0% on average.

The procedure for credit approval is the following:

1. The agricultural extension service in the field informs farmers of the procedure for obtaining credit, visits every potential borrower (physical person) who wants to apply for credit and gives an opinion on the justification of the investment. The district office for agriculture is in charge of investment statements for legal entities in their areas.
2. A commercial bank on behalf of the Ministry controls the applications for credit according to criteria prescribed in the Regulation.
3. The SADA Council in the Ministry approves loan applications.

In 2000, the SADA Council approved 750 loans, 98% of which were to physical persons. Additionally, 882 loans to auction purchasers of heifers, goats and boars were approved.

---

2. Regions affected by the war, suffering depopulation, islands, mountainous areas, etc.

Table 3. **Approved SADA Credits in 2000**

|                                    | Total Croatia       |                   | Areas with special state support |                   |
|------------------------------------|---------------------|-------------------|----------------------------------|-------------------|
|                                    | Number of borrowers | HRK               | Number of borrowers              | HRK               |
| Physical persons                   | 736                 | 44 944 624        | 134                              | 16 321 756        |
| Legal entities                     | 14                  | 7 942 000         | 2                                | 1 002 000         |
| Auctions - (heifers, goats, boars) | 882                 | 14 337 005        | -                                | -                 |
| <b>TOTAL</b>                       | <b>1 632</b>        | <b>67 223 629</b> | <b>136</b>                       | <b>17 323 756</b> |

From a total of HRK 67.2 million agricultural loans approved in 2000, 25.7% were for areas eligible for special state support. The average loan size for physical persons (individual farmers) was HRK 61 000, for legal entities HRK 567 000, and for auction purchases HRK 16 000. In the special support areas, the average loan size was HRK 127 000 compared to HRK 33 000 in other areas.

### ***Credit for land improvement***

An Account for Land Improvement is also set up within the MAF budget to support credit for land improvement (irrigation, private land purchase etc). On the basis of the Regulation, a public announcement is made, and the consequent credit applications are collected. The average annual budget of the Account for Land Improvement amounts to HRK 10-12 million.

### **Loans from the Croatian Bank for Reconstruction and Development**

In addition to credit funded from the state budget, the state investment bank, the Croatian Bank for Reconstruction and Development (CBRD), directs substantial loans towards agricultural programmes. The loans are targeted mainly to small and middle entrepreneurs in agriculture and are given for cattle herd renewal and for agricultural mechanisation. Between 1995 and 2001, the total value of these loans amounted to approximately USD 480.8 million and the number of loans approved reached 5 360 (with an average loan size of USD 90 000 or HRK 720 000).

The average annual interest rate for these loans is 3-5% with the repayment period from 4 to 12 years. These terms are much more favourable than those offered elsewhere in Croatia. In 2000, CBRD disbursed 688 agricultural loans totalling HRK 63.3 million.

The operational loan arrangements are carried out by about thirty commercial banks contracted by CBRD.

### **Ministry of Small and Medium Crafts**

In July 2000, the Ministry of Small and Medium Crafts (MSMC) initiated several credit programmes covering different areas (export-import promotion, development of tourism, innovation, business restructuring, new technologies, loans to small businesses, etc.).

Agricultural producers are eligible for loans under the credit programmes for small entrepreneurs (the so-called Snowball programmes). These loans can be used to purchase land, equipment and machinery, and for construction.

The system functions on the basis of a contract between the MSMC, the district administration offices and commercial banks (combining funds). The district administration office publicly invites interested entrepreneurs to submit applications for credit. Each county has established a committee consisting of five participants from the following institutions: District administration office (co-ordinator), the MSMC, commercial bank, Crafts Chamber and Chamber of Economy.

The committee considers the credit applications and selects those consistent with the regional development plans. The selected applications are sent to the commercial bank, which reviews the commercial side of the project and the financial status of the potential credit user. The commercial bank approves the project and informs the MSMC about its decision. This credit line is a mix of commercial and administrative credit. Its main disadvantage is that few users could otherwise comply with all the commercial bank requirements. However, the bank functions as a filter sorting out commercially non-viable loans.

### **Foreign credit lines**

Due to the war in Croatia, credits from international financial institutions to support adjustment in the agricultural sector, were mostly symbolic. The first more significant agreement, an Emergency Loan for war damage, was concluded in 1994 with the World Bank. Under this facility, approximately USD 20 million were allocated to agriculture. Loans were given to purchase breeding cattle (heifers, goats), machinery, and veterinary equipment. Beneficiaries were exclusively small family holdings in the areas devastated by the war. Loans were mostly interest-free, with repayment periods of 5 to 10 years and grace periods of 6 to 24 months.

The next significant agreement with the World Bank was signed in April 1996. Its main goal was to promote the development of support services for private farmers, especially market-oriented farmers. The implementation phase of the programme began at the beginning of 1997. The total value of the programme was USD 30 million, including USD 17 million worth of loan funds, and the equivalent of USD 13 million provided from the state budget over the course of four years.

The project has six major components: (1) applied research in agriculture, (2) extension service, (3) development of veterinary service, (4) promotion of pastureland use, (5) development of the seed sector and (6) improvement of agricultural policy analysis.

Credit funds from the European Bank for Reconstruction and Development (EBRD) amounting to DM 20 million per year have been disbursed through three domestic commercial banks since 1995. These funds were allocated to investments in inputs for agriculture and the food industry.

The Government has initiated a programme for wholesale markets in the Republic of Croatia in co-operation with the EBRD. This programme envisages financing the construction of a central wholesale market in Zagreb and five regional wholesale markets. The total value of the project amounts to USD 22.4 million, including a USD 13.9 million loan from the EBRD, and USD 8.5 million from Croatian. Two regional markets were completed in 2001 (Rijeka and Osijek) and the other three are expected to be finished in 2003.

## **Reform of the credit system in Croatia**

In 2000, the new Croatian Government embarked on agricultural policy reform. The most important changes relate to agricultural subsidies and payments and the credit system.

The government intends to facilitate the development of a credit market in Croatia which, as in the western countries, is based on agreements between commercial financial organisations (banks) and private farmers. In a market economy, the role of the government is limited to setting the rules by which banks and producers operate, ensuring that contracts between them are enforced and that there is adequate competition. There is normally no role for government in the decision-making process on the amount of the loan, its term, the interest rate or the fees involved.

In Croatia the level of the bankers' expertise with regard to evaluation of agricultural programmes and knowledge of the basic characteristics of Croatian and global agricultural commodity markets, is not yet adequate.

Available data indicates that there are profitable farm investments, which could be credited under realistic loan conditions. To stimulate commercial bank lending to family farms, it will be necessary to improve the access of farms to capital and the banks' understanding of family farms which are the basis of Croatian agriculture.

The broad policy objective concerning rural finance is common and clear, namely to create a viable financial system which meets the needs of the rural sector for credit and savings mobilisation. In meeting this objective it is essential to consider the potential role of both private and public institutions.

Development needs to occur at three levels:

- a) The farmers need training and advice on farm management and assistance in farm business plans (cash flows, capital budgets, gross margins and profit and loss accounts).
- b) The bank officials need training in farm economics so that they can properly interpret and assess loan applications.
- c) Extension services need to provide management and planning advice so that farmers can make proper loan applications.

Of course, other problem areas identified at the beginning of this paper (lack of collateral, inconsistent government policies, weak enforcement of contracts) have to be addressed simultaneously.

Because the market is underdeveloped, there is also a case for a public subsidy to initiate and speed up the process. However, this subsidy should work for the development of the financial market. It should therefore be aimed at utilising commercial organisations from the start and at commercial finance. The government's role is not to provide all the finance (it could not even if it wanted to, and should not because that is not its role), nor to assume the risks. This is the banks' role.

One possible method of stimulating the commercial provision of rural credit would be to provide a subsidy for every agricultural loan issued by the banks. The subsidy per loan would cover a proportion of the fixed costs that banks incur in establishing a loan (assessment of application and collateral offered, and administrative set up costs). By granting a fixed subsidy per loan, the government would be encouraging the provision of small loans as well as large loans (which are usually preferred by banks because the administrative costs do not usually increase with loan size). The scheme would therefore not discriminate against smaller farmers as many policy measures do.

## **Conclusions**

Croatian agriculture has faced a number of problems in obtaining adequate credit. A range of Government programmes have provided attractive loans in terms of interest rate levels and repayment periods, but budgetary limitations have prevented the majority of farmers from benefiting from the support. Moreover, these programmes are not solving the fundamental problems that are impeding the development of a vibrant rural credit market. The Croatian government is determined to overcome these obstacles and to create the conditions within which a credit market can operate efficiently in the long term without government intervention. To this end the Government is considering a number of options including the ways in which financial assistance could be targeted more effectively.

## BIBLIOGRAPHY

Ministry of Agriculture and Forestry of the Republic of Croatia, Food and Agriculture Organisation of the United Nations (1995),  
*A Strategy for Sustainable Agricultural Development*, Zagreb.

Bozic M. and Berak, Z. (1997),  
*Agricultural Credits in the Republic of Croatia*, *Racunovodstvo i financije*, Vol. 43, No. 3: 63-70.

Koester, Christensen, Haynes (2000),  
*Competitiveness in Croatian Agriculture and EU Integration, A Strategy for Croatian Agriculture*, Ministry of Agriculture.

Kraft, Curavic, Faulend, Tepuš (1998),  
*Report on the Credit Policies of Croatian Banks*, National Bank of Croatia.

World Bank (2000),  
*Croatia - A Policy Agenda for Reform and Growth*.

## **Country Note: Romania**

### **By Experts from the Ministry of Agriculture, Food and Forestry**

The Romanian agricultural sector has been undergoing a process of market transformation for more than ten years. Romania disposes of nearly one quarter of the total agricultural land of Central and Eastern Europe. Though agriculture, which currently accounts for about 15.6% of GDP, is and will continue to be an essential part of Romania's national economy, it is currently facing a profound structural, technical, organisational, production, financial and economic crisis.

The successive reforms implemented since the beginning of the transition have not resolved the problems of farming at the micro-level, and have not led to the emergence of competitive market structures and an efficient rural finance system.

The new Romanian government, elected in November 2000, considers the recovery and the development of Romanian agricultural sector as one of its priorities. The 2001-2004 Government Programme for Agriculture begins with a comprehensive analysis of the economic, social, and political situation of Romania, also taking into account the European and global context in which this programme will be carried out. The government strategy and the objectives are determined in accordance with the European and Euro-Atlantic integration requirements.

More specifically the main objectives in the area of agricultural development are:

- acceleration of land reform;
- continuation of the privatisation of agricultural commercial companies;
- consolidation of the farm structure (increasing farm size);
- improvement of agricultural marketing;
- improvement of the animal breeding sector through enhanced farm performance;
- technical and technological advancement in agriculture;
- development of a competitive, functioning and stable market, ensuring the stability of farm income;
- implementation of a comprehensive national rural development programme;
- improvement in the competitiveness of Romanian agro-food products on domestic and international markets through the development of market infrastructure and higher quality standards;
- fulfilment of target investment programmes in agriculture;
- environmental protection and food security.

Three stages are envisaged in the implementation of the government Programme for Agriculture:

- the spring and summer 2001 agricultural campaign;
- the autumn 2001 agricultural campaign;
- 2002-2004 and onwards.

The Programme envisages the following measures:

- support of agricultural producers;
- allotment of arable land (0.5 ha) to young rural families with low incomes;
- special assistance for young farmers for the purchase of tractors, agricultural machinery and equipment;
- promotion of professional associations and unions;
- support of agricultural research;
- rehabilitation of irrigation and drainage systems;
- preparation and adoption of key legislation.

In view of future accession to the European Union, Romanian agricultural sector must undergo major adjustments. This includes harmonising the existing market systems with the EU agricultural market regimes, introduction of specific policy measures, instruments and mechanisms, and implementation of structural policies.

In order to integrate successfully into the EU market, the following main tasks should be achieved:

- reorientation of agricultural production along market principles;
- development and modernisation of distribution chains, marketing system and agricultural management.

Of the former 737 former state farms, 103 have been privatised, 21 are under negotiation procedures, and 147 are undergoing liquidation procedures. In the food industry, of the 440 formerly state-owned units, 345 have been fully privatised; privatisation of the remaining enterprises is advancing at a slower pace as they are less attractive for potential investors.

About 85% of agricultural land has been privatised, meaning that private land ownership has become dominant in Romania. Private family farms are estimated to contribute about 85% to the total value of agricultural production in Romania, but only about 20% of family farms' production is marketed. However, excessive land fragmentation represents a major obstacle to the development of a healthy agricultural sector. In particular, land fragmentation impedes technological progress, as the majority of subsistence farms do not have the financial means to invest in new machinery and other equipment. One of the objectives of the current agricultural policy is to increase the average size of private farms.



In some regions, small-scale landowners lease land to emerging private companies. These companies have provided a constructive example of land consolidation in the situation of excessive fragmentation of land ownership and rather adverse legislation for large scale private farming (in particular up to 1997). They also demonstrate the potential for rapid development of agro-business in Romania, provided that reliable markets are found.

The revitalisation of agriculture and its sustainable development will depend to a large extent on the privatisation and restructuring of upstream and downstream enterprises. The economic *raison d'être* for privatisation is to create an enabling environment for the transfer of productive assets to those who have an active interest in using them in the most effective way and who are able to improve these assets through investment. In turn, the creation of competitive commercial relationships between all agents in the food chain is a precondition for linking farmers with domestic and foreign markets efficiently.

In order to support agricultural producers the Romanian government has adopted the following important acts:

- Government Emergency Ordinance no. 30/2001 on financial assistance to agricultural producers amounting to ROL 1 million (approximately Euro 40) per hectare;
- Government Decision no. 297/2001 introducing 50% compensation of cost of seed for the 2001 sowing;
- Decision no. 97/2001 of the Minister of Agriculture, Food and Forestry introducing 55% compensation of the prices paid by farmers for domestically produced tractors, agricultural machinery and irrigation equipment;
- Government Emergency Ordinance no. 29/2000 on incentives for milk producers in 2000.

The settlement of the land ownership rights represents an important challenge for the successful transposition of the *Acquis Communautaire* into Romanian legislation. In 1991, at the beginning of the market reforms in Romania, Law no. 18/1991 was adopted. This Law re-instated private ownership of agricultural land in Romania and laid the foundations for the development of the private sector in agriculture. Other Laws, enacted subsequently, introduced land lease regulations, which facilitated land transfers and the creation of a land market.

The recent period has been marked by institutional and legislative adjustment in Romania to the EU framework. In order to create an institutional structure capable of implementing the stipulations of the *Acquis Communautaire*, especially those concerning the Common Agricultural Policy, the Ministry of Agriculture, Food and Forestry was reorganised by Government Decision no. 12/2001. Another major step was the preparation of the National Plan for agriculture and Rural Development, to serve as a basis for the implementation of the EU Special Accession Programme for Agriculture and Rural Development (SAPARD).

## **Country Note: Russia**

**By Ms. Renata Yanbykh**

### **Abstract**

*This paper discusses agricultural finance and credit policies during the transition period in Russia. The shortcomings of various government agricultural credit programmes implemented during this period are examined. Positive developments – for example, the replacement of direct state lending by subsidisation of interest rates – are also discussed. The overall concern is that until now the government has been addressing the consequences but not the causes of the problems. Continuing delays in the amendment of existing agricultural finance and credit policies further strengthens this concern.*

### **1. Introduction**

Agricultural credit has become one of the most acute problems during the transition period in Russia, strongly affecting not only the situation in the agro-food sector but also with serious macroeconomic implications. The institutional changes that followed the overall economic liberalisation were not reflected in the agricultural credit sector. Agricultural credit continues to be government-based, with the government the main lender, guarantor and, in a certain sense, manager of agricultural lending. Furthermore, the transition process has aggravated pre-reform problems and created new ones, which has made the task of reforming agricultural credit even more complicated. It emerged from the financial crisis in August 1998 that the success of agricultural and rural policies to a great extent depends on institutional reforms. Several steps are being taken by the Russian government to transform existing policies to more market-based ones, but progress is still slow.

### **2. Before transition**

Prior to economic reform, agricultural credit in Russia was based on administrative and command principles. Loans were allocated to producers according to *credit plans* approved by regional (*oblast*) and federal authorities. The level and use of borrowed funds were determined according to farms' *production* and *investment plans*. These plans were also subject to administrative approval and control. Interest rates for short-term loans were fixed at 2%, and at 0.75% for long-term loans (SEMYONOV 1982). Producers operating at so-called «planned losses», *i.e.* anticipating losses on the basis of the price and commodity mix in their production plans, received special 2-year grants for «replenishment» of working capital. The repayment of loans was very poor, leading to regular restructuring and write-offs.

### **3. Credit policies in 1992-2000**

Lack of credit resources for the agricultural sector was one of the most acute problems to emerge from the onset of economic reform in Russia. As a natural consequence of credit market liberalisation, resources flew to the most profitable economic activities. Agriculture was not one of them. As a result

the Government introduced new credit instruments for agriculture<sup>1</sup>. The first one to be applied was *direct credit* for the agro-industrial sector. The initial main objective was to provide agriculture with seasonal credit and to replace the old system of «planned» credit. The ultimate goal, however, was to create a favourable environment for the development of a market-based agricultural credit system. But in practice, the provision of direct credit both in monetary (1992-94) and commodity (1995-96) terms has increased the deterioration in farms' solvency, periodical debt restructuring and debt write-offs. The Special Credit Fund introduced in 1997 for preferential lending to agriculture was not successful either and was shut down in 2000.

### 3.1. Direct credit in 1992-1994

Price liberalisation at the beginning of the radical economic reforms of 1992 led to a sharp deterioration in terms of trade for the agricultural sector. As a result, agriculture immediately lost its working capital and ran into an acute need for seasonal credit. This led the Government to introduce a programme of subsidised direct credit for working capital for agricultural producers. This programme existed between April 1992 and fall 1993. The loans were allocated through a disbursement of credit to all agricultural producers according to their sowing areas. No account was taken of the creditworthiness or economic viability of the borrowers (SEROVA and IANBYKH 1998). The principal bank implementing this programme was the para-state *Agroprombank*. Before the transition *Agroprombank* was the principal distributor of state loans to agriculture. Even after the bank's privatisation in 1991 and its transformation into a commercial profit-oriented institution, the role of *Agroprombank* was mainly to disburse credit from the state budget. Since the rate of repayment on direct credit was very poor, by 1996 *Agroprombank* had gone bankrupt.<sup>2</sup>

At the end of 1993, subsidised interest rates on direct credit were abolished and set at market levels ranging from 180% to 210% (Table 1). Repayment terms, however, remained preferential, *i.e.* 1 year compared to 1-3 months in the real economy (SEROVA 1998). The total amount of direct credit to all types of legal agricultural producers, the downstream sector and consumer co-operatives during

- 
1. It should be stressed from the very beginning that most government support is channelled to large scale *agricultural enterprises* - successors of former state and collective farms (*kolkhoz* and *sovkhoz*). In the course of agrarian reform, these farming units were re-organised into various legal forms. New *private family farms* that have emerged since 1989, were not able to replace traditional large-scale units as has been anticipated in the early years of reform: the share of private family farms in total agricultural land is currently 5% and the share in production does not exceed 2%. A third production «force» - the so-called *private subsidiary plots* - have traditionally been and remain out of the scope of the Government policies due to their small size and limited capacity. Nevertheless, these subsidiary plots currently produce more than one half of total potato, vegetable and meat output. Hence, credit policies discussed in parts 3 and 4 concern large-scale farms, *i.e.* former *kolkhoz* and *sovkhoz*, and only in a few cases relate also to private family farms.
  2. The critical financial condition prompted the sale of *Agroprombank*. Several large commercial banks bid to buy the bank. Finally in November 1996, *Stolichny Bank Sberezhny (SBS)* became the new owner of *Agroprombank*, and the latter has become part of the financial group *SBS-Agro*. After the sale, the role of the bank changed from a mere distributor of budgetary funds to assessing borrowers' creditworthiness and selecting clients. During the August 1998 financial crisis *SBS-Agro* became one of the «problematic» banks. As a result of government's programme for rehabilitation of the baking sector, in 2000 *SBS-Agro* was again transformed into a state bank - *Rosselkhozbank* – see section 4.2.

1992-1994 was 10 422 million roubles, i.e. 274.6 million roubles in 1992; 1 806 million roubles in 1993; and 8 341 million roubles in 1994 (RUSSIAN MINISTRY OF FOOD AND AGRICULTURE 1998).<sup>3</sup>

**Table 1. Subsidised interest rates on direct agricultural credit in 1992-1993**

|                                                                     | 1992        |      |            |             | 1993                    |                         |     |
|---------------------------------------------------------------------|-------------|------|------------|-------------|-------------------------|-------------------------|-----|
|                                                                     | April - May | June | July - Dec | Jan - March | Apr - Sep               | Oct                     | Nov |
| Central Bank of Russia refinancing rate, %                          | 50          | 80   | 80         | 80          | 100 to 180 <sup>1</sup> | 180 to 210 <sup>1</sup> | 210 |
| Interest rate for large-scale farms (former kolkhoz and sovkhoz), % | 12          | 12   | 25         | 25          | 25                      | ad hoc <sup>2</sup>     | 210 |
| Interest rate for small private farms, %                            | 8           | 8    | 8          | 25          | 25                      |                         | 210 |

1. The Central Bank of Russia refinancing rate changed during this period within the indicated range.

2. The fixed subsidised rate of interest was removed, with the amount of subsidy defined by «the funds available for this purpose in the Federal budget».

The terms for direct credit were extended several times because it was obvious that the borrowers were unable to repay the debt (Table 2). Debt restructuring implied the deferral of repayment under certain conditions. Nevertheless, «hopeless» debts were written off meaning complete exoneration of debt which was subsequently transformed into internal state debt.

**Table 2. Official documents enacting the restructuring of debt on direct credit allocated in 1992-1994**

| Document                                                                                                    | Date of issue | The period of prolongation |
|-------------------------------------------------------------------------------------------------------------|---------------|----------------------------|
| Presidential Decree N 2218<br>«Debt Restructuring on Directed Credit for Agricultural Producers of 1993-94» | 29.12.94      | until 2005                 |
| Federal Law N 46<br>«Debt Restructuring on Directed Credit and Penalties of Agricultural Producers»         | 24.04.95      | until 2008                 |
| Presidential Decree N 565<br>«On Economic Stabilisation and Reform Progress in the Agro-Industrial Complex» | 16.04.96      | until 2005                 |

Source: Decree of President (1994), Decree of President (1996), Federal Law (1995).

In 2000 the total debt on direct credit over the period 1992-1994 including penalties, amounted to 21 billion denominated roubles (USD 3.5 billion), two times the level of the agricultural budget.

### **3.2. State commodity credit, 1995-1996**

In 1995 direct monetary credit was replaced by commodity credit, and again in 1996. Under the commodity credit system, fuel producers/suppliers selected by regional governments delivered fuel to

3. In 1998 the Russian rouble was denominated by a factor of 1 000. All values in this report are given in denominated «new» roubles.

farms and in exchange their tax dues to the federal budget were written off. Agricultural producers became debtors to the regional governments based on the commodity loans received, and regional governments became the ultimate debtors of the federal government (MELYUKHINA and IANBYKH 1997). Since commodity credit, did not require money emission, the inflationary effects associated with direct monetary credit were avoided. However, the basic principles of credit allocation did not change. Commodity loans were still based on administrative rationing and lacked loan security considerations. Moreover, the system was technically more complicated and the repayment terms were defined at the discretion of the regional governments. And the system introduced additional players into the bad-debt chain - the fuel producers and the regional governments. The latter selected fuel producers without any process of competition. The fuel companies used their monopoly position to set fuel prices 20-30% above market levels. Therefore, agricultural producers participating in this scheme had to cover the cost of advanced fuel at higher prices. The repayment rate on state commodity credit was very low (Table 3).

**Table 3. State commodity credit and overdue debt in 1995-1996**

| Year | State commodity credit |             | Overdue debt,<br>million roubles | Prolongation of the term                                                                                                                           |
|------|------------------------|-------------|----------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------|
|      | Million roubles        | Billion USD |                                  |                                                                                                                                                    |
| 1995 | 7 200                  | 1.5         | 5 100                            | Until 2005 under the 1998 Law on Budget                                                                                                            |
| 1996 | 1 1100                 | 1.85        | 9 800                            | Regional bonds issued for the total amount of debt, funds secured from the sale of bonds to be accumulated in the Special Credit Fund (see below). |

Source: Federal Law (1998), Government Resolution (1997 a, b).

The 5 billion roubles debt on 1995 *commodity loans* has been restructured until 2005. A more complicated arrangement has been implemented for the 1996 debt. As regional governments were the ultimate debtors to the federal government on 1996 loans, the federal government obliged them to issue *regional rural bonds* to cover the debt. The rural bonds were subsequently accumulated and sold on the stock market by the Treasury. This new practice marked an important change in the federal government's strategy: agricultural bad debt was first transferred to regional governments, and then through the selling of rural bonds, to private investors. The total estimated emission of rural bonds by 70 regions-debtors was 9.8 billion roubles (USD 1.6 billion). However the market cost covered only two-thirds of the total debt as the rural bonds were quoted at a 75% discount rate. In 1998, the sale of rural bonds was very flaccid and finally stopped completely following the collapse of the stock market in August 1998.

### **3.3. Special Credit Fund**

Following the unsuccessful experience with state commodity credit, the Federal Special Fund for Subsidised Credit to the Agro-Industrial Complex (Special Credit Fund - SCF) was set up in 1997. Its objective was to provide agriculture with seasonal credit. The interest rate was set at 25% of the prevailing Central Bank rate. This programme also provided preferential terms of repayment: agricultural producers received loans at the beginning of the year and had to repay them at the end of the year after harvesting. Thus, the repayment term was almost one year while the usual maturity terms on short-term loans under inflationary conditions were from 1 to 3 months.

The SCF was managed by the SCF Board, which included the Minister of Agriculture and Food, representatives from the Ministry of Economics and the Ministry of Finance, commercial banks and regional authorities. The SCF Board determined regional credit quotas, while commercial banks determined the creditworthiness of borrowers after consulting with the regional authorities who provided the banks with guarantees.

Budgetary funds were to be disbursed by commercial banks, which signed contracts with the government. Under the new scheme banks had the freedom to select the borrowers and control the repayment process, but they also assumed the risk of loan repayments and were responsible for the return of budgetary credit funds.

The new system had defects however. First, the majority of agricultural producers were highly indebted and their bank accounts were «blocked». To circumvent this, the banks disbursed the credit funds through their affiliate trading companies and, worse, through the regional administrations, which reverted to their traditional practices of preparing lists of recipients. The credit disbursement reverted to pre-reform principles and the funds flew to inefficient borrowers under regional plans. About 50% of all funds from the SCF were disbursed in 1997 according to lists prepared by regional administrations that included indebted farms.<sup>4</sup> Secondly, while an attempt was made to choose the agent banks on a competitive basis, the selection process was nevertheless, imperfect. For example, in 1998 several of the banks selected had no outreach branches so they had to make contracts with third-party banks, which inflated the cost of credit to final borrowers.<sup>5</sup>

There were two sources for the SCF in 1997: the federal budget (2.5 billion roubles or USD 400 million) and repayments on the 1996 state commodity credit (3.7 billion roubles or USD 600 million). For 1998, it was expected that the sale of rural bonds plus repayments to the SCF on 1997 loans would provide the Fund with core money; and the third source would be budgetary funds (2 billion roubles). However, the sale of regional bonds was not successful, and the repayment of the SCF loans was not as high as expected.

In 1997 two banks - SBS-Agro and Alfa-bank - won the tender for disbursement and management of SCF loans. The main eligibility criteria for banks was the availability of regional networks and a healthy financial condition. SBS-Agro had the advantage as a traditional agricultural bank with nearly 1 300 branches across Russia. Alpha-Bank was one of the largest and most successful private commercial banks in Russia, becoming progressively involved in operations with the agro-food sector. Twelve banks won the tender in 1998, including Alfa-bank, SBS-Agro, Vozrozhdenie, Incombank, ONEXIM, Roscredit, and Unicombank. However, only 6 banks had actually begun to work with the SCF funds. After the August financial crisis when 8 of the 12 assigned banks collapsed, a new tender was organised in November that resulted in the selection of 4 banks - Alfa-bank, SBS-Agro, Vozrozhdenie and Sobinbank. . In 1997, SBS-Agro disbursed over 80% of SCF loans, with Alfa-bank accounting for the remainder. In 1998, SBS-Agro managed 45% of the SCF loans, Alfa-bank 17%, Vozrozhdenie 8%, and Sobinbank 4%.

---

4. Two of the most frequently mentioned reasons why regional administrations support indebted farms, are: (1) to give farms the chance to readjust their financial situation; and (2) in many regions (*i.e.*, Pskov, Bryansk, and Lipetsk) almost all agricultural enterprises are insolvent. Regional administrations prefer to credit indebted farms rather than to make no use at all of regional quotas for credit resources available from the SCF.

5. Though the subsidised interest rate was set at one quarter of the refinancing rate of the Central Bank, commercial banks working with the SCF could charge a 3% margin on top of the preferential rate. If the agent bank had no own branches in some localities it could sub-contract to other banks with regional networks. The latter could charge an additional 3% for its services.

In 1999, following the 1998 crisis and the collapse of many banks, only five banks were selected. In 2000, SBS-Agro did not participate in the programme due to restructuring, and only four banks continued the SCF activity. Loans worth 4.6 billion roubles were disbursed in 1999 (USD 170 million) and 2.3 billion roubles in 2000 (USD 82 million).

### **3.4. 2000 subsidised interest rate scheme**

In late 2000, the system was again substantially changed. The government announced an interest rate subsidy scheme, whereby a borrower would be compensated from the federal budget for up to 20 points of the Central Bank's interest rate. This scheme was operational from 15 September to 15 December, 2000 to help finance harvesting. According to Mr. Gordeev, Deputy Prime Minister in charge of agriculture, this mechanism attracted an additional 1.17 billion roubles (USD 40.6 million) in soft loans to agriculture, at a cost of only 55 million roubles (USD 1.9 million) to the Federal budget. More than 1 000 agricultural borrowers participated in the programme, with 60 banks from 48 regions providing credits. Mr. Gordeev believes that this experiment was successful and that in future the scheme should be extended to food processing enterprises.

Given the fact that during the first nine months of 2000 about 1.6 billion roubles of soft loans were provided to agriculture and the repayment rate was low, the new mechanism of agricultural credit may be regarded as a considerable improvement. The banks, rather than the federal budget, assume the repayment risk, so they must evaluate the risk of the loans. This has the potential to encourage banks to develop their expertise in agricultural projects and risk assessment, which may stimulate independent lending, without recourse to state subsidised schemes. The amount of credit allocated under the new procedure (1.17 billion roubles during the fourth quarter of 2000) was relatively higher than under the old system. However, the participation of commercial banks remains limited. About 62% of total loans were issued by the State Sberbank and 3.4% by Vneshtorgbank, another state bank. The remaining 58 commercial banks delivered only 408 loans amounting to 408 million roubles. In the 2001 Federal budget, 1 400 million roubles (about USD 50 million) have been allocated for interest rate subsidies, from which it is planned to leverage 10 000 million roubles in commercial bank lending. The Ministry of Agriculture estimates each budgetary rouble invested in interest rate subsidies to generate seven roubles of commercial banks' funds.

### **3.5. Russian Agricultural Bank (Rosselkhozbank)<sup>6</sup>**

The Russian Agricultural Bank (RAB) was created in April 2000 by order of the President. The bank's objective was to "form the core of the national agricultural credit system". The presidential order also assigned the government to submit to Parliament the draft law on Russian Agricultural Bank.

According to the 2001 Law on budget, in 2001 RAB will become an agricultural bank fully owned by the Russian Federation, with capital of about USD 100 million, two-thirds more than at present. The bank's capital is currently invested in agricultural credits. The bank is planning to allocate about one third of its capital to long term lending for investments and leasing of agricultural equipment.

It is evident, that RAB will not become the largest bank in Russia nor the largest investor in the agricultural sector. Rather, RAB's main function will be to act as banking agent for the implementation of state programmes. RAB was created in an effort to reinstate an agricultural bank with diversified regional network like SBS-Agro before its collapse.

---

6. This section is prepared by Pavel Joukov, head of state programmes department at Rosselkhozbank.

Restoration of regional network is one of RAB's main tasks at the moment. It currently has 44 operating regional branches. It is planned to open offices in every important agricultural region in 2001. The next step will be the creation of a large network of external offices.

Building regional networks will be likely associated with losses at the initial stage. In 2000 the bank showed a profit and the government demands that the bank remains profitable in 2001. This will be a challenging task, as competition is high. The RAB's strongest competitor is Sberbank of Russia, the biggest Russian bank. In the spring of 2001, Sberbank issued over USD 20 million in credits for agricultural producers in the Krasnodar region, a considerable sum for Russia. Comparable amounts were invested by the Krasnodar regional offices of the South-bank and the Alfa-Bank. All these banks are diversified with agricultural business one of their activities. As RAB currently has only one third of its capital, it cannot afford to invest more than USD 2-4 million in one region. Therefore, RAB is not yet a big investor nor it is the biggest banking agent for disbursement of state preferential loans.

What is RAB's role as a state bank?

**First**, RAB is a government agent for taking back bad agricultural loans based on budgetary funds. This is a very difficult task, because budget debts cannot be discounted.

**Second**, as noted above, RAB is supposed to become the main government agent for state programmes in the agricultural sector. In general, budget execution in Russia both at the federal and sub-federal levels is implemented by the State Treasury, meaning that the latter controls all budget revenues and expenditures. But the State Treasury is responsible only for budget execution, and does not deal with agricultural enterprises. As agricultural enterprises are the recipients of budgetary funds under some state programmes, RAB will be responsible for this activity.

**Third**, as RAB is state agent for the recovery of budget loans, it would be reasonable to make it also a state agent for budget credits. This issue is not resolved yet, because commercial banks also seek this role. Even some Ministries would prefer to disburse state-supported loans themselves. But the Ministries are bad creditors – it is not their area of professional competence. Unfortunately, private banks have also proved to be bad managers of budgetary funds as illustrated by the experience with SCF lending. After 1998 most commercial banks involved in the disbursement of SCF loans became bankrupt. The rare exception is Alfa-bank- one of the biggest Russian private banks which is successfully recovering budgetary funds, which it disburses as an agent-bank. Therefore, the need for a state banking agent for budget credits is evident.

**Fourth**, the Russian Agricultural Bank is supposed to become the main state operator of agricultural land. The legislative base for this type of bank operations is not developed, but is expected to be completed in 2002.

These four areas are not all the potential functions of RAB as a state bank. There are others important areas, such as agricultural insurance with state participation, financial restructuring of agricultural enterprises, development of credit co-operation in Russia, as a way of providing access for small enterprises to credit, and many others state programmes, where participation of the Russian Agricultural Bank could be logical. Involvement of RAB in these programmes is now under discussion and perhaps it will play a role in many of these areas..

The Russian Agricultural Bank will never be the sole bank in any area, but it will be, perhaps, the sole state agent for the development of credit infrastructure in Russia.



#### 4. Agricultural machinery leasing (long-term credit)

In 1994 the government introduced a programme supporting the purchase of agricultural machinery and livestock for agricultural producers (GOVERNMENTAL RESOLUTION 1994). Under this programme, the government finances purchases of agricultural machinery and leasing this machinery to producers under long-term leasing contracts (Table 4.1). For this purpose a special leasing fund financed from the federal budget was created. Preferential credit for agricultural machinery was introduced: farms selected by the local authorities on the basis of solvency and their importance to the local economy received zero-interest loans on a 3-4-year terms for loans below 50 000 roubles and on a 5-year terms for loans above 50 000 roubles.

Table 4.1. Machinery deliveries to agricultural producers in 1994-1999, units

| Period    |                     | Tractors | Cars   | Grain harvesters | Feed harvesters |
|-----------|---------------------|----------|--------|------------------|-----------------|
| 1994-1999 | Total               | 73 327   | 20 744 | 21 809           | 11 515          |
|           | <i>of which:</i>    |          |        |                  |                 |
|           | under state leasing | 15 834   | 5 724  | 17 997           | 3 536           |
|           | % of leasing        | 21.6     | 27.6   | 82.5             | 30.7            |

Source: Russian Ministry of Agriculture and Food (2000).

Initially, the only leasing operator was Rosagrosnab - the former state-owned monopoly supplier of machinery to agriculture which has a large regional network. In 1996, there were 1 792 enterprises within the Rosagrosnab system. Using its monopoly position, Rosagrosnab sold agricultural machinery to participants in the leasing programme at prices 25% above the market level. In addition, Rosagrosnab charged a marketing commission to agricultural machinery plants. For example, in 1997 the market price of a DT-75 tractor was 83 000 roubles while the same tractor under the leasing scheme was priced at 128 000 roubles, or 1.5 times higher. But the majority of farms had no choice since the State Leasing Fund was their only source of long-term credit.

This was one of the reasons why from the beginning of the state leasing programme, leasing payments were not meticulous. In 1994-1995 only 85% of agricultural producers participating in the leasing scheme paid their dues. In 1996 this share fell to 70%. Local branches of Rosagrosnab had to accept repayments in-kind with agricultural products. In 1995-1996, 2 700 agricultural machinery units leased were repaid on a barter basis.

At the end of 1997 the government began to allocate leasing funds to leasing operators on a competitive basis. The main criteria for selection was the level of resources the leasing company could add to one rouble of budgetary resources. During the same period attempts to create a market structure linking manufacturers and leasing companies were made. In 1997 the joint-stock company Rosagromash (Russian Corporation of Machinery for Agro-Industrial Complex) was formed. Among the 29 founders were agricultural machinery plants (Volgograd and Vladimir tractor plants, Tula combine plant, Rostov-on-Don agricultural machinery plant and other); Rosagrosnab; and the financial group SBS-Agro. Though officially registered, Rosagromash did not begin its work in 1998 and the August 1998 financial crisis eventually stopped the endeavour.

So far the federal government is the largest source of funding for leasing transactions, through the mechanism described above. However, regional budgets and private investment are also becoming significant (see figures below for 1999), although some of the regional funding comes indirectly from the federal budget.

Table 4.2. Investment funds for leasing (1999)

| Sources                            | Amount                       | % of         |
|------------------------------------|------------------------------|--------------|
| Private Investments, including:    |                              |              |
| foreign direct investment          | 1 831 million roubles        | (32%)        |
| <b>Funds from regional budgets</b> | <b>1 603 million roubles</b> | <b>(28%)</b> |
| Funds from the federal budget      | 2 280 million roubles        | (40%)        |
| Total                              | 5 714 million roubles        | (100%)       |

Source: Ministry of Agriculture of the Russian Federation.

\*\*\*\*Budgetary allocations to assist agricultural producers to purchase agricultural machinery and breeding cattle increased considerably in 2001 (compare with 1994-2000 figures in Table 4.3). The basic Federal budget foresees 3 billion roubles to finance these purchases. In addition, 2.5 billion roubles are allocated from additional revenues of the 2000 budget. Thus, the total expenditure of the Federal budget on agricultural leasing will reach 7 billion roubles in 2001. However, the decision on these allocations was not backed by economic assessment and was made before the leasing concept had been approved by the Inter-Ministerial Commission.

Table 4.3. Federal budget allocation to the Federal Leasing Fund in 1994 – 2000 (as of October 1, 2000), million roubles

|                                                              | Years   |         |         |         |         |         |         | Total    |
|--------------------------------------------------------------|---------|---------|---------|---------|---------|---------|---------|----------|
|                                                              | 1994    | 1995    | 1996    | 1997    | 1998    | 1999    | 2000    |          |
| Approved in the budget                                       | 1 000.0 | 1 351.0 | 2 700.0 | 2 400.0 | 2 000.0 | 2 280.0 | 1 000.0 | 12 731.0 |
| Actually allocated                                           | 1 053.6 | 1 080.6 | 1 928.9 | 736.6   | 1 007.0 | 2 280.0 | 1 050.0 | 9 136.7  |
| <i>Including:</i>                                            |         |         |         |         |         |         |         |          |
| Rosagrosnab for agricultural machinery leasing               | 1 053.6 | 1 065.6 | 1 828.9 | 712.6   | 971.0   | 2 200.0 | 975.0   | 8 806.7  |
| Actually allocated funds as a percentage of the budget funds | 105     | 80      | 71      | 31      | 50      | 100     | 105     | 72       |

Source: Russian Ministry of Agriculture and Food (2000).

Although the budget remains the main provider of funds for agricultural leasing, private companies are becoming more active in this field. New equipment leasing companies are composed of: (a) companies affiliated with banks (SBS-Leasing, Agroinkom); (b) leasing companies established to support foreign technical assistance projects (for example, in Kolomna region); (c) recent commercial vertical integration initiatives (Cebeco, Campina, Nutricia). Recently, Russian John Deere Finance (an affiliate of the US corporation Deere & Co) received a license to conduct leasing operations in Russia.<sup>7</sup>

7. See John Nash and Vera Matusevich in Developing Rural Financial Markets, - World Bank proceedings (2001), forthcoming.

## **5. Credit for private family farmers and small entrepreneurs**

As was noted above, most government-supported credit is channelled to large scale farms. Emerging small and medium businesses including private farmers have very poor access to credit funds (IANBYKH 1996). Subsidiary plots of rural dwellers which play a very important role in supporting rural families, are now becoming suppliers of marketable agricultural production. These producers remain outside government support, although some of them can be compared with viable private farms. The incomes from private subsidiary plots often accounts for more than half of total rural family income (PETRIKOV 1998).

### **5.1. Credit sources for private farms**

Currently, private farmers have three principal sources of credit: different funds for private farmer support, the SCF, and commercial banks. There is no co-ordination of funds private farms, some of them are regional and receive money from the local administration, other are financed by international money through technical assistance programmes. Most of the funds are from the «Food for Progress» programme of the US Department of Agriculture. Under this programme the Department buys agricultural production from American farmer co-operatives, then sells it in Russian markets. The money flows to different funds. One of them is the Fund for «Russian Farms» established by an American citizen of Russian origin in 1995. The fund disbursed 10 000 roubles to 2 million roubles (USD 1 700 - 350 000) credits for seeds, machinery and livestock at 30% interest per year in 1997. Part of the sponsorship money provides extension services to farmers who participate in the programme. The fund «Russian Farmer» was established in 1990 under the umbrella of the Association of Private Farmers and Co-operatives (AKKOR) to support private farmers with funds that were expected to come mostly from budget sources. However these expectations were not realised as budget resources were drastically cut after 1992. The «Russian Farmer» obtained some funding from the «Food for Progress» programme. In 1999-2000, 50 farmers received 4-year loans to buy agricultural machinery and equipment from the Fund. Such funding is occasional and reaches a very limited number of farmers.

The SCF was expected to become the principal source of seasonal credit for private farmers. However, in 1997 only 200 of a total 274 000 small private farmers received subsidised loans from the SCF (private farmers received only 14 billion roubles from the 180 000 billion earmarked for 1997). The cause was very simple: both SBS-Agro and Alfa-Bank who officially worked with SCF funds in 1997 had no experience in dealing with small private farms with no credit history. Collateral was also a problem. Banks asked for highly liquid collateral amounting to 120-150% of the loan. In most cases machinery, equipment and cattle were accepted as collateral. Both borrowers and bankers were unwilling to use land as collateral. For the same reason commercial bank credit for private farmers was quite rare. Thus, though private farmers needed credit they had limited access to it compared even with indebted large-scale farms.

### **5.2. Rural credit co-operation**

Rural credit co-operatives with their joint liabilities and mutual trust between members could be a solution for the development of small and micro credit for rural areas.

However the legal base for credit co-operation is not well developed in Russia. The basic provisions on credit co-operation are contained in the Civil Code of the Russian Federation and federal laws «On Agricultural Co-operation», and «On Introducing Changes and Additions to the Law on Banks and Banking Activity», but none of these documents reflects the specificity of credit co-operatives, their

distinction from production and service co-operatives, on the one hand, and from bank institutions, on the other. An attempt to fill the gaps in legislation was made in the draft law «On Credit Consumer Co-operatives of Citizens (Credit Consumer Societies)» which regulates the activity of credit co-operatives, though, only in the sphere of consumer credit.

Some regions took the initiative into their hands and promulgated acts allowing the activity of credit co-operative institutions. Thus, in 1995 the Volgograd Regional Duma adopted the law «On Credit Consumer Co-operatives in Volgograd Region», and later in 1997 the law «On Credit Consumer Agricultural Co-operatives in Volgograd Region». But because of the complete absence of any Central Bank regulations in this area, as well as the lack of experience in organisation of such credit and finance institutions, credit co-operation has not taken root in the countryside despite the vigorous attempts of the regional Department of Agriculture to support this innovation. In the «pioneer» Volgograd region 42 credit consumer co-operatives are currently registered including 20 rural ones. Since 1996, 1 050 loans amounting to 26 million roubles (about USD 1 million) have been given to small entrepreneurs. The loans were mostly short-term and in monetary form, but in some cases loans were given in-kind (seeds, building materials, and fuel) and also paid back in kind with agricultural products.

To date, there are 60 rural credit co-operatives in 20 Russian regions (Volgograd, Tyumen, Saratov, Leningrad, Rostov, Penza, Perm and others) bringing together more than 3 500 private farmers and rural entrepreneurs. The size of co-operative shares range from 12 roubles to 15 000 roubles, loan maturity is usually set at 3 months, 6 months, and 1 year (IANBYKH 1998). In 1997, these co-operatives joined an inter-regional Union of Rural Credit Co-operatives. Credit co-operatives are most intensively developed in Volgograd region which has 48% of total credit co-operatives, 51% of registered co-operative members, and 64% of the volume of loans.

According to a survey of 15 rural credit co-operatives conducted in 1999, in seven Russian regions, most co-operatives are quite recent, with 79% beginning operations only in 1998-1999. Membership ranges from 7 to 222, with an average of 63 members. On average 32% of the members are legal entities with variations in some co-operatives from 10% to 100%. It is more common for rural credit co-operatives that legal entities (usually, private farms) prevail among their founders. But gradually, if the co-operative is successful, it becomes attractive for a broader rural population (mainly, owners of individual holdings and garden plots), and its membership shifts to natural persons.

The survey also showed that as a co-operative expands its membership, it often involves other local businesses (processing, trade, and marketing services and other enterprises and institutions). In the largest (and oldest) co-operatives, agricultural producers account for 45% of membership. Five of the surveyed co-operatives were involved both in lending and saving activities, and three only in lending. The average size of co-operatives' share capital is 41 000 roubles, ranging from 7 000 to 75 000 roubles. The average asset size per co-operative (the most representative credit potential indicator) is 187 000 roubles, with variations from 10 000 to 569 000 roubles. Overall, in 1998 there were on average 40 loans per co-operative with the average total amount of credited funds 462 000 roubles (from 10 000 to 1 741 000 roubles). The average loan size slightly exceeded 11 500 roubles, ranging from 1 000 to 536 000 roubles. Loans were made at an annual interest rate of 30% to 72%. In all co-operatives, the loan repayment rate was close to 100%.

### **5.3. Informal finance**

Surveys in several Russian regions show that rural dwellers give credit to each other: in the Rostov-on-Don region at average market interest, in Pskov and other Northern regions of Russia, with no charge. The amounts lent are usually too small to invest in production. According to expert

estimates (PETRIKOV 1998) about 35% of farmers and owners of private plots participate in mutual credit on a permanent basis. This leads to the following conclusions: first, in contrast to prevailing opinion the rural population in Russia has savings; second, the rural population is confident to lend to their friends and neighbours; third, there are some important preconditions for further development of credit co-operatives in rural areas in Russia.

## **6. Conclusions**

The August 1998 financial crisis, and its negative impacts, gave an appreciable impulse to the economy in general and to agriculture in particular. Agricultural producers benefited from the competitive edge that emerged after the sharp depreciation of the rouble strongly increased the cost of imports. This to some extent shifted the demand for domestic food processing and retailing sectors to domestic supplies. This shift contributed to the fact that the share of profitable large-scale farms rose from 18% in 1998 to 45% in 1999 and 52% in 2000.

However, the main problems of agricultural and rural credit in Russia remain:

- agricultural production generally continues to be non- or low-profitable and financially risky;
- although the financial condition of large farms has been improving during 1999-2000, the accounts of 48% of the large-scale farms are «blocked» due to their high debts;
- preferential state credit still dominates, crowding out commercial credit;
- small agricultural and rural businesses have very poor access to credit.

Therefore, serious problems for agricultural credit persist in Russia: debt restructuring and write-offs continue; banks that served the agricultural sector in the past collapsed following the August 1998 financial crisis; state credit disbursement leads to distortions in the entire credit system; due to the lack of credit the rural population has little incentive to seek other more profitable activities than simple subsistence agriculture. Agricultural credit continues to be strongly dependent on the government. However, the government has recently made sustained attempts to move away from traditional state credit distribution to credit programmes based more on market principles.

## BIBLIOGRAPHY

Centre of Economic Marketing (1998): October, 1998.

Decree of President (1994): N 2218, December, 1994.

Decree of President (1996): N 565, April, 1996.

Federal Law (1995): N 46, April, 1995.

Goskomstat (1997): *Sel'skoye Khozyaistvo Rossii, Oficial'noye Izdanie*, State Statistical Committee of Russia, 1997, Moscow.

Government Resolution (1994): *On providing the Agro-Industrial Complex with agricultural machinery and livestock on the base of long-term leasing*, N 686, March, 1994.

Government Resolution (1997a): N 224, February, 1997.

Government Resolution (1997b): N 635, May, 1997.

*Interfax* (1998): Food and Agriculture, N 42, November 22.

Ianbykh, R., and Melyukhina, O. (1997): "Russian Farm Credit, Rural Finance, and Agriculture Considerations Revisited", Paper prepared for XXIII International Conference of Agricultural Economists, Sacramento, August 10-16, 1997.

Ianbykh, R. (1997): "Rural Financial Markets: are there any preconditions for their Development?" (in Russian), *Entrepreneurship in Russia*, 1997, Vol. 9, pp. 32 - 36.

Ianbykh, R. (1998): "Co-operative forms of financial self-help in rural economy of Russia and regional peculiarities of it's support" (in Russian), *Entrepreneurship in Russia*, 1998, Vol. 12, pp. 26 - 32.

Krestyanskies Vedomosti (1998): Four banks instead of 12 will credit agriculture next year, November 16-22, 1998.

Petrikov, A. (1998): "Co-operation between rural individual producers and their integrational relations with collective agricultural enterprises", *Working papers of the Agrarian Institute*, pp. 14-17.

Poganietz, W.-R. (1998): "Inflation and Exchange Rate Policy", paper presented at a joint seminar Russia's Food Economy: Towards Truly Functioning Markets (July 13<sup>th</sup> and 14<sup>th</sup>, University of Bonn); Organised jointly by: Centre for Development Research (ZEF), University of Bonn; Institute of Agricultural development in Central and Eastern Europe (IAMO), Halle; Institute for Economy in Transition (IET), Moscow.

Russian Ministry of Food and Agriculture (1998): Mimeo.

Semyonov, V. (1983): *Financial and Credit Mechanism in the development of agriculture*, Moscow.

Serova, E. and Ianbykh, R. (1998): "State programmes of support of agricultural credit in transitional economies (Russia in comparison with other countries)", Paper prepared for EAAE European Seminar: Financing the Agribusiness Sector, Subotica, Yugoslavia, February 2-6<sup>th</sup> (forthcoming).

Serova, E. and Ianbykh, R. (1996): "Agricultural credit in Russia: status quo and perspectives" (in Russian) - *Voprosy ekonomiki \ Issues of Economics*, N 8. pp. 59-73.

Uzun, V. and Shagaida, N. (1998): "Recommendations on financial recovery and reorganisation of insolvent farms" (in Russian), *Working Papers of Agrarian Institute*, 1998, pp. 5-10.

## **Country Note: Slovenia**

**By Mr Dušan Vujadinovič**

### **Abstract**

*The purpose of this paper is to present the principal forms of financing Slovenian agriculture, as well as the main recent changes in this system. Three major agents are engaged in agricultural and rural credit in Slovenia: commercial banks through savings and loan services; the Ministry of Agriculture, Forestry and Food; and the Fund for Regional Development and Preservation of Rural Settlement in Slovenia. This paper focuses on government measures to support agricultural and rural credit, such as subsidised interest rates, investment grants, and credit guarantees.*

### **State-supported investment programmes in Slovenian agriculture**

Co-financing of investments in agricultural holdings and the food processing industry is the most important structural policy in Slovenia. The measures are implemented either in the form of preferential loans (with subsidised interest rates), or in the form of investment grants. The following state-supported investment programmes for agriculture are being implemented in Slovenia:

- Land operations (consolidation of land, land improvement, accumulation, irrigation, etc.); co-financing of land operations was essential particularly in the 1970s and 1980s, and has contributed to improvement of the structure of agricultural holdings and production efficiency. The programmes have continued after Slovenia's independence and a larger share of financial participation in these activities by agricultural holdings is now required.
- Investment programmes in agricultural holdings including compensation of interest rates and grants. In 1999, about 3 300 agricultural holdings benefited from such support which amounted to between 5% and 25% of the investment value.
- A special investment programme for young farmers first introduced in 1998. Support under this programme equals Euro 7 000 per farm.
- A programme for the restoration of permanent plantations (vineyards and orchards) and the preservation of their production potential. Substantial resources were allocated under this programme between 1997 and 1998, while between 1999 and 2000, the number of applications was far below the expected level.

Budgetary support for investments in agriculture and food processing industry has been increasing in the past few years both in terms of funds for subsidising interest rates on long-term loans and investment grants (Table 1). Any entity engaged in agriculture is eligible for such support. Investment grants in agriculture are becoming more and more conditional on the availability of appropriate business plans. One drawback is the frequent changes in criteria and conditions for support which to some extent complicates access for potential beneficiaries.



Table 1. Investment support to agriculture and the food sector

|                                                                        | 1992    | 1993    | 1994    | 1995    | 1996    | 1997    | 1998    | 1999    |
|------------------------------------------------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|
| Interest rate subsidies on long-term loans, million SIT                | 45.0    | 31.8    | 47.9    | 55.3    | 175.7   | 215.1   | 1 016.3 | 1 053.7 |
| Capital grants to agricultural producers, million SIT                  | 1 038.5 | 1 114.9 | 1 033.2 | 882.2   | 1 442.3 | 1 740.7 | 1 775.2 | 2 050.8 |
| <i>of which in per cent</i>                                            |         |         |         |         |         |         |         |         |
| On-farm investments                                                    | 41.3    | 39.2    | 22.3    | 6.4     | 5.2     | 2.8     | 2.3     | 2.7     |
| Renewal of permanent plantations                                       | 18.0    | 20.3    | 23.5    | 29.1    | 50.8    | 55.5    | 41.1    | 29.8    |
| Land improvement                                                       | 40.7    | 40.5    | 54.2    | 64.4    | 43.3    | 41.7    | 47.4    | 41.6    |
| Programme for young farmers                                            | -       | -       | -       | -       | -       | -       | 3.1     | 14.4    |
| Other capital grants                                                   | 0.0     | 0.0     | 0.0     | 0.0     | 0.7     | 0.0     | 6.1     | 11.6    |
| Investment support to food industry, million SIT                       | 171.6   | 0.0     | 32.7    | 95.5    | 169.2   | 630.2   | 714.9   | 233.6   |
| Total investment support to agriculture and food industry, million SIT | 1 255.1 | 1 146.7 | 1 113.8 | 1 033.0 | 1 787.2 | 2 586.0 | 3 506.4 | 3 338.1 |
| as per cent of total budgetary transfers to agro-food sector           | 18.3    | 17.3    | 14.1    | 11.2    | 16.7    | 17.6    | 20.7    | 14.3    |

- : not applicable.

Source : OECD Secretariat.

Beside programmes designed for agriculture, investment support is also available for the food processing industry to improve marketing, competitive capacity, warehousing and processing of food products. The support is in the form of investment grants, long-term loans and state guarantees for capital investments. This type of support was significant in 1997–1998 when large investments were carried out especially for the construction of warehousing capacity for fruit.

## Savings and Loan Services

Farmers mostly take loans from Savings and Loan Services (SLS), and partly also from commercial banks. In 1999, 72 SLS operated in Slovenia as independent legal entities. The majority of SLS – 59 units – were established with agricultural and forestry co-operatives and united under the umbrella of the Association of Savings and Loan Services (ASLS). SLS play an important role in savings and crediting of farmers and rural areas in general. The basic functions of SLS are to collect savings from the farming population and lend these funds to farmers–members of co-operatives, farm-related businesses and other enterprises.

The terms of crediting are competitive with those offered by banks, with interest rates equalling:

- from T+6% to T+8% for long-term loans;
- from T+5% to T+7% for short-term loans.

The Savings and Loan Services Act (Ur. l. RS 14/99) allows SLS to give loans exclusively to their founders. In 1999, loans to founders - mainly farm co-operatives - equalled SIT 5 176 million. In 1999, 4 294 farmers received **loans for current production**, amounting to SIT 1 940 million. The total value of loans for current production issued to non-farmer borrowers, totalled SIT 1 278 million in 1999.

**Long-term loans for agricultural production.** In 1999, SLS credited 2 130 farms, almost 40% more than in 1998 (1 533 farms). The total credit given in 1999 equalled SIT 4 229 million, compared to SIT 3 980 million in 1998. In 2000, the SLS issued loans to 1 386 farms (a 35% decrease), with a total value of SIT 3 249 million (a 23% decrease compared to 1999).

In 1999, before VAT was introduced, a very active withdrawal of savings deposits and borrowings was observed. The SLS issued loans primarily for the purchase of agricultural machinery. Compared to 1998, the value of these loans increased more than two-fold and they comprised 36% of investments in 1999. In 2000, investments in agricultural machinery declined (by one-third compared to 1999), but they still accounted for 31% of total investments.

**Long-term loans for agro-tourism and supplementary farm activities.** Loans for agro-tourism are granted by 14 SLS. These loans totalled SIT 162 million in 1999 (SIT 480 million in 1998). In 2000, agro-tourism credits continued to decrease, with their value falling to SIT 114 million. Loans for supplementary farm activities were granted by 8 SLS in 1999 with an estimated value of SIT 171 million (282 million SIT in 1998). In 2000, such loans totalled SIT 283 million, which was slightly above the 1998 level.

**Table 2. SLS investment loans by type**

|                          | 1996         |              | 1997         |              | 1998         |              | 1999         |              | 2000         |              |
|--------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
|                          | Mln SIT      | % Mln SIT    | Mln SIT      | % Mln SIT    | Mln SIT      | % Mln SIT    | Mln SIT      | %            | Mln SIT      | %            |
| Agricultural machinery   | 1 023        | 30.1         | 652          | 17.2         | 643          | 16.4         | 1 522        | 36.0         | 998          | 30.7         |
| Purchase of land         | 188          | 5.5          | 296          | 7.8          | 283          | 7.2          | 207          | 4.9          | 187          | 5.8          |
| Crop husbandry           | 172          | 5.1          | 78           | 2.1          | 49           | 1.2          | 152          | 3.6          | 187          | 5.8          |
| Gardening                | 4            | 0.1          | 12           | 0.3          | 37           | 0.9          | 4            | 0.1          | 2            | 0.1          |
| Fruit growing            | 77           | 2.3          | 42           | 1.1          | 84           | 2.1          | 71           | 1.7          | 56           | 1.7          |
| Viticulture              | 325          | 9.6          | 488          | 12.9         | 218          | 5.6          | 242          | 5.7          | 101          | 3.1          |
| Hop growing              | 35           | 1.0          | 15           | 0.4          | 1            | 0.0          | 29           | 0.7          | 55           | 1.7          |
| Cattle breeding          | 863          | 25.4         | 804          | 21.2         | 1 229        | 31.3         | 984          | 23.3         | 667          | 20.5         |
| Pig breeding             | 253          | 7.4          | 190          | 5.0          | 182          | 4.6          | 125          | 3.0          | 44           | 1.4          |
| Sheep and goat breeding  | 27           | 0.8          | 27           | 0.7          | 30           | 0.8          | 27           | 0.6          | 1            | 0.0          |
| Other animal husbandry   | 33           | 1.0          | 24           | 0.6          | 110          | 2.8          | 29           | 0.7          | 21           | 0.6          |
| Agro-tourism             | 160          | 4.7          | 260          | 6.9          | 474          | 12.1         | 162          | 3.8          | 114          | 3.5          |
| Complementary activities | 118          | 3.5          | 113          | 3.0          | 282          | 7.2          | 171          | 4.0          | 283          | 8.7          |
| Other                    | 121          | 3.6          | 802          | 21.2         | 303          | 7.7          | 504          | 11.9         | 533          | 16.4         |
| <b>TOTAL</b>             | <b>3 398</b> | <b>100.0</b> | <b>3 790</b> | <b>100.0</b> | <b>3 925</b> | <b>100.0</b> | <b>4 229</b> | <b>100.0</b> | <b>3 249</b> | <b>100.0</b> |

Source: ASLS.

**Table 3. Number of farms receiving investment loans from SLS**

|                 | 1996  | 1997  | 1998  | 1999  | 2000  |
|-----------------|-------|-------|-------|-------|-------|
| Number of farms | 2 010 | 1 744 | 1 533 | 2 130 | 1 386 |

Source: ASLS.

Of the total estimated value of investments in 2000 where SLS loans were involved, 47% represented borrowings from SLS, 36% farmers' equity capital, and 17% other sources (state and municipality funds, etc.). Between 1996 and 2000 the share of SLS borrowings in farm investments reached its peak - 61% - in 1999 (Table 4).

**Table 4. Structure of farm investments by source**

(includes only projects involving the SLS loans)

|                | 1996         |            | 1997         |            | 1998         |            | 1999         |            | 2000         |              |
|----------------|--------------|------------|--------------|------------|--------------|------------|--------------|------------|--------------|--------------|
|                | Mio<br>SIT   | %          | Mio<br>SIT   | %          | Mio<br>SIT   | %          | Mio<br>SIT   | %          | Mio<br>SIT   | %            |
| Equity capital | 1 429        | 42         | 2 046        | 54         | 2 213        | 56         | 1 294        | 31         | 1 170        | 36           |
| SLS loans      | 1 563        | 46         | 1 327        | 35         | 1 518        | 38         | 2 583        | 61         | 1 527        | 47           |
| Other sources  | 404          | 12         | 417          | 11         | 249          | 6          | 352          | 8          | 552          | 17           |
| <b>TOTAL</b>   | <b>3 398</b> | <b>100</b> | <b>3 790</b> | <b>100</b> | <b>3 980</b> | <b>100</b> | <b>4 229</b> | <b>100</b> | <b>3 249</b> | <b>100.0</b> |

Source: ASLS.

According to the ASLS, the decline in the number of farms borrowing from SLS stopped in 1999, when 2 130 farms took loans. In 2000, however, the number of farm-borrowers strongly declined again to 1 386.

### **Ministry of Agriculture, Forestry and Food**

The Ministry of Agriculture, Forestry and Food (MAFF) is not a financial institution. Recently, it has largely withdrawn from activities such as subsidising interest rates on agricultural loans. Also, the provision of state guarantees has been reduced, in line with the process of harmonisation with EU rules. The only form of support that MAFF has maintained is financing investment grants.

Long-term loans with subsidised interest rates for cattle breeding, pig farming and some crops existed until end-September 1998. Since then, the MAFF had stopped subsidising interest rates on long-term loans. The only exception is credits under joint projects supported through the Fund for Regional Development and Preservation of Rural Settlements.

In 1999, SIT 4.45 billion were allocated by the MAFF for investment grants. In 2000, SIT 4.9 billion were budgeted for the same purpose, but due to budgetary constraints the actual funding was only about SIT 3.7 billion. Table 5 shows the main directions of investment grants. The latter are given not only for investments in agricultural holdings and food processing but also for the development of rural infrastructure (roads, pipelines, etc.), education and research services, as well as transfers to public funds, agencies, and non-profit organisations, and abroad.

**Table 5. Capital grants allocated to agriculture and rural development from the MAFF budget**

SIT

|                                                        | 1999          | 2000          |
|--------------------------------------------------------|---------------|---------------|
| Total capital grants                                   | 4 456 160 000 | 3 706 350 873 |
| Other state levels                                     | 513 465 000   | 245 880 189   |
| Capital transfers to public funds and agencies         | 35 390 000    | 17 667 489    |
| Non-profit organisations                               | 115 344 000   | 79 725 254    |
| Public enterprises                                     | -             | -             |
| Private businesses and individuals                     | 2 976 627 000 | 2 868 378 822 |
| Public institutions and public commercial institutions | 815 334 000   | 491 625 152   |
| Foreign investment                                     | -             | 2 983 967     |

Source: MAFF.

### ***Fund for Regional Development and Preservation of Rural Settlements in Slovenia***

The Fund for Regional Development and Preservation of Rural Settlements in Slovenia is a financial facility established by the Government of the Republic of Slovenia to fulfil long-term regional policy objectives. The Fund accumulates and allocates resources to implement regional structural policies. The Fund has operational links with the Agency for Regional Development, the Agency for Agricultural Markets and Rural Development, the Slovenian Development Agency, regional agencies and with other organisations.

Based on the initiative of the Minister of Agriculture, Forestry and Food, the Fund and the MAFF organised in 1998 a joint tender entitled “Special projects in agriculture” that comprised the following programmes:

#### ***1. Young farmers***

This programme was carried out in 1998 and 1999. Within the framework of this programme, a pilot project “*Credit generation for young farmers*” was implemented. SIT 404 500 000 were allocated to the programme in 1998; the co-financing share (including credit and investment grants) could not exceed 80%. In 1999 the state funds allocated to the programme were increased by 228%, and co-financing rate set at 75% of the estimated project value.

#### ***2. Farm restoration***

This programme involves various types of assistance, including granting of additional loans, guarantees against the rescheduling of farms’ liabilities, and/or subsidising interest rates, and investment grants. The repayment period for loans is up to 15 years, with the interest rate of TOM + 2%. A 2-year grace period for repayment of the principal loan is granted during which the interest rate is subsidised. The funds allocated to this programme in 1999 were 168% higher than in 1998, but decreased by 33.7% in 2000.

### 3. Restoration of agricultural companies and co-operatives

This programme was first implemented in 2000. As was the case under the *Farm restoration* component, assistance within this programme includes granting of additional loans, guarantees against the rescheduling of farms' liabilities, and/or subsidising interest rates, and investment grants. A joint tender was announced by the MAFF and the Fund on projects for restructuring co-operatives. Investors can be business entities organised according to the Co-operatives Act, or commercial associations of co-operatives such as consortiums, groups, etc. The share of loans and capital grants in the project value cannot exceed 50%, with up to 25% accounting for Fund loans, and up to 25% for capital grants funded by the MAFF.

The Fund had introduced some innovations for additional public tender in 1998 in order to play a pro-active role in resolving critical issues of regional development and the preservation of rural settlements in Slovenia. The main tasks were primarily the following:

- to reduce interest rates;
- to increase amounts available for lending;
- to introduce special agricultural projects and projects of active employment policy.

The tender was for loans and guarantees from the Fund to investors (individuals, business entities and municipalities) from demographically endangered areas. Specific activities supported included:

- A. Agricultural projects and complementary farm activities in demographically endangered and mountainous areas.
- B. Support of economic activities for projects carried out in demographically endangered and mountainous areas.
- C. *Bridging financing of infrastructure projects*: only municipalities in the Republic of Slovenia could apply (under the condition that the municipality involved was covered by the CRPOV<sup>1</sup> and VTC programmes, or any other integrated sectoral or regional programme verified by the Fund); this activity was continued also in 1999.
- D. *Active employment projects*: eligibility is limited to individuals included in the self-employment programmes at the Employment Office living in demographically endangered and mountainous areas, and in municipalities where the unemployment rate exceeds the national average rate. This activity was continued also in 1999.
- E. *Guarantees for projects in areas with particular developmental problems*. Investors meeting the requirements defined in any of the A, B, C, D and 1, 2, 3 items were eligible, who had a bank loan contract, but had not managed to obtain any other guarantee due to unfavourable condition of real estate market in the areas with specific development problems.

The funds available under the tender were: SIT 1.1 billion for loans and SIT 300 million for loan guarantees.

---

1. CRPOV - Programmes of Integrated Rural Development and Village Renewal.

In 1999, this joint activity of the Fund and the MAFF was continued. In addition to programmes continued from 1998, several new components were introduced:

**A. Agricultural projects and complementary farm activities:**

- *improvement of farm structure*, with a maximum co-financing rate of 50% (including loans and capital grants);
- *farm modernisation*.

The support represented a combination of subsidised loans and investment grants with a repayment period up to 15 years and an interest rate of TOM + 2%. The share of funds committed depended on the farm location (priority was given to farms in mountainous and hilly areas).

**B. One-off assistance** - investment grants to farmers of up to SIT 1 million in the case of a family accident or a natural disaster.

**C. Farm financial rehabilitation.** Assistance to farms suffering insolvency in cases when the failure to settle the debt was due to objective reasons.

Table 6 illustrates the activity of the Fund between 1998 and 2000.

**Table 6. Activity of the Fund for Regional Development and Preservation of Rural Settlement in Slovenia in 1998-2000**

|                                                         | Approved in 1998       |                        | Approved in 1999       |                        | Approved in 2000       |                        |
|---------------------------------------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|
|                                                         | Number of applications | Amount of support, SIT | Number of applications | Amount of support, SIT | Number of applications | Amount of support, SIT |
| Agriculture                                             | 225                    | 532 850 000            | 890                    | 2 377 703 922          | 450                    | 1 270 626.07           |
| Guarantees                                              | 9                      | 348 364 707            | 19                     | 925 000 000            | 4                      | 171 457.00             |
| Young farmers                                           | 95                     | 404 500 000            | 147                    | 1 329 185 472          | -                      | -                      |
| Restoration of farms                                    | 43                     | 70 135 000             | 76                     | 188 426 764            | 87                     | 124 770.10             |
| Restoration of agricultural companies and co-operatives | 8                      | 75 000 000             | -                      | -                      | -                      | -                      |
| Restructuring of co-operatives                          | -                      | -                      | -                      | -                      | 24                     | 736 416.58             |

## Conclusions

The forms of state support for financing agriculture in Slovenia have evolved according to changes in the agricultural policies. Due to the well-known structural weaknesses, there is a considerable need for restructuring of agriculture and food processing industry in Slovenia and adaptation to EU conditions.

The subsidising of long-term loans had been increasing between 1992 and 1999, with the exception of 1993. Between 1998 and 1999, when the government began agricultural policy reform, this support rose almost five-fold and exceeded SIT 1 billion.

Investment grants to agriculture have also been constantly increasing between 1992 and 1999, with the exception of 1995, reaching about SIT 2 billion in 1999. However, the decrease in investment grants to the food processing sector in 1999 by about 67 percentage points, is a cause for concern. The reason is the relatively limited financial resources available for this type of assistance.

The commercial banking sector in Slovenia is capable of servicing financial needs of all industries, including agriculture, but on the prevailing commercial terms. The provision of financial resources is not an issue, the problem is rather finding profitable projects.

On the other hand, there is a great need for financial resources to restructure agriculture and the food processing industry. Most projects do not yet comply with free market conditions. The role played by the state in the transition period is to provide sufficient funds under more favourable terms than commercial ones for projects that contribute most to the harmonisation of Slovenian agriculture with EU conditions. These funds are relatively limited; it is therefore necessary to finance well-grounded structural measures that can guarantee optimal development results.

## BIBLIOGRAPHY

- Fund for Regional Development and Preservation of Rural Settlement (1999),  
*Yearly report for the year 1998* (in Slovene), Ribnica; 1-48.
- Fund for Regional Development and Preservation of Rural Settlement (2000),  
*Yearly report for the year 1999* (in Slovene), Ribnica; 1-38.
- Fund for Regional Development and Preservation of Rural Settlement (2001),  
*Yearly report for the year 2000* (in Slovene), Ribnica; 1-25.
- Ministry of Agriculture, Forestry and Food (1998),  
*Report on Agriculture, Forestry and Food processing in the year 1997* (in Slovene), Ljubljana; 1-98.
- Ministry of Agriculture, Forestry and Food (1999),  
*Report on Agriculture, Forestry and Food processing in the year 1998* (in Slovene), Ljubljana; 1-102.
- Ministry of Agriculture, Forestry and Food (2000),  
*Report on Agriculture, Forestry and Food processing in the year 1999* (in Slovene), Ljubljana; 1-107.
- OECD (2001),  
*Review of Agricultural Policies: Slovenia*, Paris: 1-184.
- Sila Tomaž - Savings and loan services (SLS) (2001),  
“Agricultural co-operative savings in Slovenia”, Paper for discussion in National Council of Republic of Slovenia, 1-10.



## Country Note: Ukraine

### AGRICULTURAL FINANCE AND INSTITUTIONAL REFORMS IN UKRAINE

By Ms. Olga Kovalenko and Ms. Inna Chapko

#### Abstract

*In 2000 the government policy of financing agriculture changed from an input supply to a monetary mechanism. As a result of this positive policy change, cash credit resources have finally begun to flow into the agro-industrial complex in Ukraine.*

Until recently, the credit needs of agricultural producers were met by the state and by commercial suppliers. Both used schemes based on advance supplies of inputs to agricultural producers based on the projected agricultural harvest. Bank (cash) credits for agricultural producers were blocked due to difficulties pertaining both to creditors and borrowers.

On the producer side, the main reasons for the low demand for bank credits are the high interest rates (Table 1) and the short term duration of the loans extended. This is further complicated by the macroeconomic situation of high inflation and fluctuating exchange rate, as well as by producers' lack of knowledge and experience in dealing with commercial credit.

**Table 1. Commercial bank interest rates for loans extended in local currency  
1998-2000**

Annual average, %

|                                                                 | 1998 | 1999 | 2000 |
|-----------------------------------------------------------------|------|------|------|
| National Bank of Ukraine (NBU)<br>refinancing rate <sup>1</sup> | 62   | 50   | 31   |
| Commercial bank interest rate <sup>2</sup>                      | 55   | 53   | 40   |
| Inflation rate                                                  | 20   | 19   | 19   |

1. End-period rate of the NBU: base rate for commercial banks credited by the NBU.

2. Average weighted rate offered by commercial banks on credit in domestic currency.

Source: National Bank of Ukraine; State Statistics Committee of Ukraine.

On the lender side, the factors constraining credit to the agricultural sector are:

- low profitability in agriculture;
- lack of liquid collateral;
- relatively long period of capital turnover in the sector due to the seasonality of production and sales;
- agricultural enterprises' debts to the state and other partners;
- state interference in borrowers' financial and economic activities, etc.

Lenders perceive the commercial risk in agriculture to be much higher than in other sectors. As a result, the actual interest rates set for agricultural commodity producers exceed those for other borrowers (Table 2). However, the cost of credit is high even for business activities that are more profitable and are characterised by a shorter period of capital turnover than agriculture.

**Table 2. Commercial bank nominal interest rates for loans extended in August 2000**

| Branches                  | Average nominal interest rate, % |
|---------------------------|----------------------------------|
| Agriculture               | 44                               |
| Input Supplies            | 40                               |
| Industry                  | 39                               |
| Trade and Public Catering | 36                               |
| Construction              | 35                               |
| Other Sectors             | 29                               |

In order to establish a basis for the development of a functioning rural finance and credit market in Ukraine, the following global measures were implemented:

- debts owed by agricultural producers to the state were written off (44% of the total amount of debt);
- agricultural enterprises were restructured, which resulted in an improvement in the sector's profitability<sup>1</sup>;
- the state withdrew from the input and product markets, resulting in more competition in these markets and the establishment of more favourable producer prices;
- a “softer” tax treatment was introduced.

In order to improve access to the finance and credit market, the state introduced a mechanism of partial compensation of commercial bank interest rates on loans extended to agricultural producers, funded from the state budget. Reaction to this measure was initially sceptical in light of the low profitability of agricultural enterprises and the risks associated with using state budget funds. However, the measure has had positive effects. Compensation was set at 50% of the National Bank of Ukraine (NBU) refinance rate with a minimum of 17.5% on loan agreements with commercial banks. Under the 2000 national budget, UAH 175 million were allocated for interest rate compensation. Sectors in the agro-industrial complex have different periods of capital turnover, with the period for agriculture the longest. It is natural therefore that credit needs and loan terms are higher for these sectors. Given the fact, that, on average, agricultural producers borrow money for 6-8 months, funds allocated for interest rate compensation could contribute to attracting total credit of UAH 1.5-2 billion.

In 2000, UAH 818 million were lent to agro-industrial complex enterprises with partial interest rate compensation. The compensation actually paid amounted to UAH 50 million, less than originally budgeted, due to delays in implementation of the scheme<sup>2</sup>.

- 
1. In 2000 profitability of agricultural enterprises increased to 4.9%, compared to minus 22.1% in 1999.
  2. Only the adoption of the Law of Ukraine No. 1712 of May 11, 2000 “On amending the Law of Ukraine “On the state budget of Ukraine for 2000”, made it possible to disburse the budget funds for the interest compensation.

In 2000, 4 150 agro-industrial complex enterprises received loans with partial interest rate compensation, 3 800 (92%) of them were agricultural enterprises, and the rest were service and downstream enterprises. This is certainly a positive result considering that the compensation mechanism was introduced with the aim of stimulating the agricultural finance recovery. Agricultural enterprises also accounted for the major amount of credit – UAH 455 million, or 56% of the total<sup>3</sup>. It should be noted that all types of agricultural producers - large, medium and small ones - received subsidised loans. In particular, individual private farms obtained 4% of the total amount of loans disbursed to agricultural producers.

In 2000, 51 commercial banks participated in this preferential credit scheme. The major lenders were the Bank Ukraina (25%), Aval (21%), Prominvestbank (16%), Ukrsotsbank (5%), Privatbank (5%), Nadra (3%) and Ukreximbank (3%). The lowest annual interest rate was 28%, and the highest 60%. The average repayment rate in 2000 was 86%. The highest repayment rate of 92% was by agricultural services. These repayment levels significantly increased banks' confidence in agricultural producers as borrowers.

The positive experience with preferential credit stimulated commercial bank activity in the agro-industrial complex in 2000. The sum of credits disbursed by commercial banks to the complex amounted to UAH 1.8 billion (of which agricultural enterprises received UAH 1 billion).

The preferential credit scheme was continued in 2001. In accordance with the Law of Ukraine No. 2120-III of December 7, 2000 "On the state budget of Ukraine for 2001", UAH 150 million were allocated in the national budget for interest rate compensation. A differentiated compensation rate was introduced, with a higher rate for agricultural producers and grain purchasing and processing enterprises<sup>4</sup>. The latter are eligible for compensation amounting to 70% of the NBU discount rate, while other beneficiaries are eligible for 50%.

In spite of the fact that the sum allocated in the national budget for interest compensation in 2001 is lower than in 2000, and a differentiated compensation rate has been introduced, the amount of credit for agro-industrial complex enterprises will grow in 2001. First of all, the NBU discount rate (and commercial bank interest rates) decreased from 56% at the beginning of 2000 to 25% in 2001. Secondly, UAH 50 million of the budget funds will be allocated to "other" agro-industrial complex enterprises to purchase agricultural products and provide services to agricultural commodity producers. The average term of such credit equals 3 months, and this requires smaller amounts of compensation. Thus, in the first quarter of 2001 commercial banks lent more than UAH 800 million in credits to agro-industrial complex enterprises with partial interest rate compensation, which is equal to the total amount of credits disbursed in 2000.

The compensation mechanism offers advantages both to lenders and borrowers. It revives the monetary credit and settlement system, guarantees that lenders will receive at least half of interest rate, and reduces the cost of credit to borrowers. A big advantage of the mechanism is the use of separate accounts for farms' settlements with banks. In these accounts, 50% of farms' receipts are accumulated and used for the repayment of the principal loan and interest rates, as well as to finance agricultural works, thus circumventing the problem of "blocked accounts".

---

3. Agricultural producers were the major borrowers in terms of the average loan size per enterprise

4. The Resolution of the Cabinet of Ministers of Ukraine No. 59 of January 27, 2001 "On the partial compensation of interest rates of commercial banks lending to agricultural commodity producers and other agro-industrial complex enterprises"

The introduction of the compensation mechanism cannot solve all the problems connected with agriculture financing. The experience in 2000 has shown that commercial banks still prefer lending to processing and service enterprises. The reluctance of commercial banks to provide finance to agricultural producers shows that the problem of financing cannot be resolved through subsidised credit alone.

A major difficulty is the lack of credit history of the reformed entities. Although a lack of credit history is also a problem in other countries, it is particularly acute for agricultural enterprises that are just starting their business. But the reformed agricultural enterprises in Ukraine are not just starting out. They already have property and products, and these assets may secure a loan.

However, agricultural commodity producers do not meet the banks' requirements for collateral. The lack of a land market makes it impossible to use land as collateral. Other fixed assets are often obsolete or worn-out. Under the current situation in Ukraine land leases may be an alternative to private ownership, but leased land cannot be used as collateral either. Only future crops are accepted as reliable collateral in Ukraine.

In designing the strategy for further development of rural finance market in Ukraine it should be taken into account that 32% of the Ukrainian population lives in rural areas. Agricultural production is the major source of income of rural households, and this type of production also requires credit. Access to credit markets is limited for the majority of rural households. So, the government policy should be aimed not only at financing the agro-industrial complex, but also at financing rural areas as a whole. In order to satisfy the credit needs in rural areas and to expand the finance and credit market it is necessary not only to involve commercial banks, but also to promote credit co-operation and the creation of national and regional co-operative banks.

The mechanism of subsidised commercial interest rates played an important role in establishing partnership relations between the banking sector and agricultural producers. The introduction of interest rate compensation was first of all an attempt to address the problem of the high cost of bank credit. The interest rate compensation is a provisional measure as in 2000/beginning of 2001, commercial bank interest rates continued to decrease. Instead it is necessary to allocate part of the budget funds provided for interest rate compensation for the creation of co-operative banks and the promotion of long-term credit. In order to foster long-term financing it is also necessary to develop the real estate and land markets.

Furthermore, the state should develop a mechanism for ensuring repayment of credits through the creation of an effective institute for collateral and risk insurance, and stimulate the development of the finance and credit infrastructure in rural areas, ensure protection of lenders' and borrowers' rights through the creation of the relevant legal bases. The priority areas for providing state assistance, *i.e.* benefits and incentives, should be activities for promoting the preservation and recovery of the resource potential of the agrarian sector (including human resources), national food security, etc. Implementation of the above-mentioned measures to develop finance and credit markets will ensure the market transparency as well as social protection.

The results of reforms undertaken in the agrarian sector in 2000/early 2001 prove the effectiveness of the policies implemented, in particular:

- Withdrawal of the state from the circular process of input supplies and writing off agricultural debt which put an end to non-transparent financing mechanisms.
- Targeted tax policy, providing impetus for the development of efficient agro-business in Ukraine.

- Establishment of a favourable business environment for new, profit-oriented enterprises.
- Creation of incentives for the banking sector to supply short-term credits to agriculture.
- Freeing agro-business from responsibility for maintaining social infrastructure.
- Addressing social problems in rural areas. Providing rural citizens with land and property as a guarantee of their social security.

The policy of reforms is correct, as it is aimed at creating the potential for a self-regulating agrarian production system. However, there are still a lot of problems to be solved and in pursuing the adopted reform strategy the state has to commit itself to:

- discontinuing interference in the production process;
- assuring adequate social security coverage in both urban and rural areas;
- facilitating the further development of entrepreneurship;
- eliminating monopolies, and encouraging competition in the agrarian sector;
- assuring that environmental goals are not compromised in the process of reforms and competition.

Provided that all these concerns are taken into consideration, land reform will be completed, efficient enterprises will be established, and loss-making ones will withdraw from the market without damage to people and land. New technologies developed in the process of business competition will facilitate the revival of resources. Better integration of environmental concerns into the production process will help Ukraine to enter the world market as a supplier of environmentally clean products.

## ANNEX



# EXPERT MEETING ON AGRICULTURAL FINANCE AND CREDIT INFRASTRUCTURE IN TRANSITION ECONOMIES

29-30 May 2001, Portorož

## PROGRAMME

**Target countries:** South Eastern Europe (SEE) region – Bosnia and Herzegovina, Bulgaria, Croatia, the Federal Republic of Yugoslavia, the Former Yugoslav Republic of Macedonia, Romania, Slovenia, – and also Russia and Ukraine.

**Objective:** to continue dialogue on major problems of rural finance and credit in transition economies; discuss new issues having particular relevance for the countries of the target region, especially how to develop viable credit systems for small-scale farming and rural households in general.

### Tuesday, 29 May 2001

08:30 Registration

10:00 Opening of the seminar: Mr. Shigeki Moriyama, Counsellor, Japanese Embassy to Austria; Mr. Franc But, Minister of Agriculture, Slovenia; Mr. Mitja Drobnič, Ministry of Foreign Affairs, Slovenia; Mr. Ken Ash, OECD

### **SESSION I: *Overview of agricultural finance and credit in transition economies***

**Issues for discussion:** what are the latest developments and main problems of rural finance and credit in SEE countries; what has been achieved in rural finance and institutional reform during more than a decade of transition and what challenges remain; what should be the role of the governments to facilitate the development of sustainable finance and credit systems. The session is conceived to provide a general background for further discussions.

10:30 Introduction by Chairperson: Mr. Iztok Jarc, State Secretary, Ministry of Agriculture, Slovenia

10:45 Results of the Second Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Countries Mr. Fujiki Hayashi, OECD

11:00 An overview of agricultural credit instruments, institutions and challenges in Bulgaria, Romania and Slovenia Mr. Michael Ryan, OECD

11:15 Public policy and preconditions for sustainable rural finance systems Mr. J.D. Von Pischke, Frontier Finance International, USA

11:30 Agricultural finance and institutional reforms in transition economies: the 1990s and challenges ahead (focus on SEE region) Mr. Ulrich Koester, Kiel University, Germany



- |                                                                                        |                                                                                               |
|----------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------|
| 11:45 Agricultural finance and institutional reforms in Bulgaria                       | Ms. Lena Roussenova,<br>European Institute and<br>University of National and<br>World Economy |
| 12:00 Farm debt in the CIS: multi-country study of major causes and proposed solutions | Mr. Csaba Csaki,<br>World Bank                                                                |
| 12:15 <b>Coffee break</b> (hosted by Slovenia)                                         |                                                                                               |
| 12:40 Large farm debt in Ukraine                                                       | Mr. David Sedik, FAO                                                                          |
| 13:00 <b>Welcome lunch for all participants</b> (hosted by OECD)                       |                                                                                               |

### **Discussion**

- 14:30 Discussants: Mr. Jo Swinnen (Belgium),  
Mr. Tamotsu Kawamura (Japan)

14:40 Discussion

## **SESSION II: *Private and co-operative banking for the agricultural sector and rural areas***

**Issues for discussion:** how to develop sound rural banking in the difficult conditions of transition; how the banking sector should change and innovate to respond to significant changes in farm ownership and production structures; what should be done to facilitate banking for small-scale borrowers; what is the current role of credit co-operatives and what could be their future strategies.

- |                                                                                                       |                                                                       |
|-------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------|
| 15:30 Introduction by Chairperson: Mr. Ulrich Koester (Kiel University, Germany)                      |                                                                       |
| 15:40 Agricultural and rural co-operative banking: EU experience and lessons for emerging markets     | Mr. Gerard van Empel,<br>Rabobank,<br>The Netherlands                 |
| 15:55 Multi-service co-operative financing and other facilities of agri-financing: Japan's experience | Mr. Tamotsu Kawamura,<br>Iwate University, Japan                      |
| 16:10 Romanian Banca Agricola: Agony and Ecstasy                                                      | Mr. Eugen Radulescu,<br>Banca Agricola, Romania                       |
| 16:30 <b>Coffee break</b> (hosted by Slovenia)                                                        |                                                                       |
| 16:50 The role of co-operative financial institutions in rural and agricultural development           | Mr. Paul Armbruster,<br>German Co-operative<br>Confederation, Germany |

17:10 Agricultural credit co-operation in Slovenia: lessons from the past and strategy for the future

Mr. Tomaž Sila,  
Association of Savings  
and Loans Services of  
Slovenia, Slovenia

### **Discussion**

17:30 Discussants: Mr. David Sedik (FAO),  
Ms. Lena Roussanova (Bulgaria)

17:50 Discussion

19:00 End of day 1

19:30 **Cocktail for all participants** (hosted by Japanese Embassy)

## **Wednesday, 30 May 2001**

### **SESSION III: *Informal credit for the agricultural sector and rural areas***

**Issues for discussion:** what are the benefits and limitations of non-bank lending; what role is it currently playing and can potentially play in improving the financing situation in the agricultural sectors of transition economies; how important are own capital resources of rural areas; what are the ways to mobilise these resources; can micro-credit be successful in transition economies; in what ways and to what extent can it help overcome constraints of traditional lending.

09:00 Introduction by Chairperson: Mr. Csaba Csaki (World Bank)

09:10 The role of trade credit and foreign direct investment in improving the agricultural finance situation in transition countries

Mr. Jo Swinnen,  
Leuven University,  
Belgium

09:25 Equity financing for women

Ms. Astra Michels,  
ISIS Management Group,  
USA

09:40 Financing agriculture through vertical integration: the case of Hungary

Mr. Tamás Székelyhidi,  
House of Hungarian  
Tastes Ltd., Hungary

09:55 The role and development of informal and co-operative financial channels in Albanian agriculture

Mr. Hamish Gow,  
University of Illinois at  
Urbana, USA

10:10 The experience of rural micro-credit in north-west Russia

Ms. Renata Yanbykh,  
Government of the  
Russian Federation,  
Russia

## **Discussion**

10:30 Discussants: Mr. J.D. von Pischke (USA),  
Mr. Tomaž Sila (Slovenia)

11:00 **Coffee break** (hosted by Slovenia)

11:20 **Discussion** (continued)

13:00 **Lunch break** (hosted by OECD)

## **CONCLUSIONS OF THE SEMINAR:**

### ***Developing sustainable finance and credit systems: challenges for policy making***

**Issues for discussion:** this session will present the results of the three sessions in the form of policy conclusions

14:00 Introduction by Chairperson, Mrs. Alexandra Trzeciak-Duval (OECD)

14:10 Summaries and policy conclusions for the 3 sessions presented by the discussants

14:40 Discussion

15:50 Closing of the seminar

16:00 Close of day 2

**Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies  
29-30 May 2001, Portorož, Slovenia**

**LIST OF PARTICIPANTS**

**COUNTRIES OTHER THAN SLOVENIA**

**BELGIUM**

|                                                           |                                      |
|-----------------------------------------------------------|--------------------------------------|
| Dr. Johan F.M. Swinnen                                    | Tel: (32-16) 321615                  |
| Professor                                                 | Fax: (32-16) 321996                  |
| Department of Agricultural and Environmental<br>Economics | Email: jo.swinnen@agr.kuleuven.ac.be |
| Katholieke Universiteit Leuven                            |                                      |
| 42 De Croylaan                                            |                                      |
| 3001 Leuven                                               |                                      |

|                                                       |                                            |
|-------------------------------------------------------|--------------------------------------------|
| Mr. Laurent Van Den Haute                             | Tel: (32-2) 208 48 14                      |
| Ingénieur                                             | Fax: (32-2) 208 50 06                      |
| International Affairs                                 | Email: Laurent.Van.Den.Haute@cmlag.fgov.be |
| Administration of Agricultural Policy                 |                                            |
| Ministère des Classes Moyennes et<br>de l'Agriculture |                                            |
| WTC III - 23 <sup>rd</sup> Floor                      |                                            |
| Bd. S. Bolivar, 30                                    |                                            |
| B-1000 Brussels                                       |                                            |

**BOSNIA AND HERZEGOVINA**

|                                          |                           |
|------------------------------------------|---------------------------|
| Mr. Amir Lubovac                         | Tel: (387) 33 442 632     |
| Senior Official to WTO Affairs           | Fax: (387) 33 655 060     |
| Ministry of Trade and Economic Relations | Email: luby98@hotmail.com |
| Musala 9, 71000 Sarajevo                 |                           |

**BULGARIA**

|                                      |                           |
|--------------------------------------|---------------------------|
| Mr. Vladimir Karamishev              | Tel: (359-2) 981 62 44    |
| Deputy Executive Director            | Fax: (359-2) 980 13 18    |
| State Fund Agriculture               | Email: vkaramishev@dfz.bg |
| Ministry of Agriculture and Forestry |                           |
| 55 Blvd. Hristo Botev                |                           |
| 1040 Sofia                           |                           |

Mr. Rumen Porodzanov  
Head of Department  
Financing of Agriculture, Forestry and Trade  
Ministry of Finance  
102 Rakovski Str.  
1040 Sofia

Tel: (359-2) 9859 2550  
Fax: (359-2) 980 68 63 / 987 01 28  
Email: R.Porodzanov@minfin.government.bg

Ms. Lena Roussenova  
Chief Economist and Associate Professor  
European Institute and University of  
National and World Economy  
European Institute  
96 Rakovski Street  
1000 Sofia

Tel: (359-2) 988 64 10  
Fax: (359-2) 988 64 11  
Email: lroussenova@europeaninstitute.net

Ms. Andriana Sukova-Tosheva  
Deputy Minister  
Ministry of Agriculture and Forestry  
55 Blvd. Hristo Botev  
1040 Sofia

Tel: (359-2) 981 55 37  
Fax: (359-2) 980 71 67  
Email: a.tosheva@mzgar.government.bg

Ms. Venceslava Yanchovska  
Manager  
Credit Commission, Embassy of Switzerland,  
Sofia, Bulgaria  
Shipka str. 41 A  
1504 Sofia

Tel: (359-2) 946 1253 / 438 403  
Fax: (359-2) 946 1253  
Email: credits@bulnet.bg

## **CROATIA**

Mr. Vlado Bićanić  
Commercial Director  
Slovonija Slad d.o.o.  
35400 Nova Gradiška, Urije b.b.

Tel: (385-35) 362 732 / 331 120  
Fax: (385-35) 362 030  
Email: slavonsija-slad@sb.hinet.hr

Mr. Nenad Matić  
Advisor, Agriculture Policy Unit  
Ministry of Agriculture and Forestry  
Ulica grada Vukovara 78  
10000 Zagreb

Tel: (385-1) 610 6749  
Fax: (385-1) 610 9203  
Email: nenad.matic@mps.hr

Mrs. Vesna Matijašević  
Senior Advisor, Agriculture Policy Unit  
Ministry of Agriculture and Forestry  
Ulica grada Vukovara 78  
10000 Zagreb

Tel: (385-1) 610 6651  
Fax: (385-1) 610 9203  
Email: vmatijasevic@mps.hr

Mrs. Jasna Mikulecky  
Head of Agriculture Policy Unit  
Ministry of Agriculture and Forestry  
Ulica grada Vukovara 78  
10000 Zagreb

Tel: (385-1) 610 6652  
Fax: (385-1) 610 9203  
Email: mikulecky@mps.hr

## **FEDERAL REPUBLIC OF YUGOSLAVIA**

Mr. Milko Stimac  
CEO  
G 17 Institute  
Trg Republike 5/VIII  
11000 Belgrade

Tel: (381) 63 66 35 02  
Email: institut@g17plus.org.yu

Mr. Sasa Vitosevic  
Federal Minister of Agriculture  
Ministry of Agriculture  
Bulevar Mihajla Pupina 2  
11070 Novi Beograd

Tel: (381) 311 33 19  
Email: smp@yubc.net

## **FORMER YUGOSLAV REPUBLIC OF MACEDONIA**

Ms. Lidija Cadikovska  
Director  
World Bank Private Farmer Support Project  
Ministry of Agriculture, Forestry and  
Water Economy

Tel: (389-2) 127 760  
Fax: (389-2) 109 514  
Email: l.cadikovska@pfsp.gov.mk

Mr. Mile Jakimovski  
State Advisor in the Ministry  
Ministry of Agriculture, Forestry and  
Water Economy

Tel: (389-2) 124 298  
Fax: (389-2) 127 107

## **FRANCE**

Mr. Gilles Della Guardia  
Conseiller économique et commercial  
Ambassade de France en Slovénie  
Barajanska cesta 1  
1000 Ljubljana SLOVENIA

Tel: (386-1) 425 06 73  
Fax: (386-1) 425 15 14  
Email: gilles.dellaguardia@dree.org

Mr. Stéphane Frappat  
General Manager for the CIS  
Aventis Animal Nutrition  
42 ave. A. Briand  
92164 Antony Cedex

Tel: (33-1) 46 74 70 72  
Fax: (33-1) 46 74 71 63  
Email: Stephane.Frappat@aventis.com

## **GERMANY**

Dr. Paul G. Armbruster  
Head of the International Relations Department  
German Co-operative Confederation  
(Deutscher Genossenschafts- und  
Raiffeisenverband e.V.) - DGRV  
Adenauerallee 127  
53113 Bonn

Tel: (49-228) 106 353  
Fax: (49-228) 106 356 / 106 382  
Email: Armbruster@dgrv.de

Dr. Ulrich Koester  
Professor  
Institut für Agrarökonomie  
Christian-Albrechts-Universität zu Kiel  
Olshausenstrasse 40  
24118 Kiel

Tel: (49-431) 880 4436  
Fax: (49-431) 880 4592  
Email: ukoester@agric-econ.uni-kiel.de  
Ukoester@gmx.de

Mr. Guenther Scholz  
Director  
Deutsche Bundesbank  
Wilhelm-Epstein-Straße 14  
D-60431 Frankfurt

Tel: (069-9) 566 2834  
Fax: (069-9) 5664344  
Email: guenther.scholz@bundesbank.de

## **GREECE**

Dr. Kostas Christou  
Director  
Risk Management Division  
Agricultural Bank of Greece  
2, Kriezotou Str.  
10671 Athens

Tel: (30-1) 369 7500  
Fax: (30-1) 369 7885  
Email: kchristou@ate.gr

## **HUNGARY**

Mr. Tamás Székelyhidi  
General Director  
House of Hungarian Tastes Ltd.  
Gödöllő Isaszegi ut. Pf. 417  
H-2101 Budapest

Tel: (36-30) 9549 126  
(36-28) 420 366 / 152  
Fax: (36-28) 420 366 / 152  
Email: mih@katki.hu

## **ITALY**

Prof. Andrea Segré  
Dipartimento di Economia Agraria  
Universita degli Studi di Bologna  
Via Filippo Re, 10  
40126 Bologna

Tel: (39-051) 2091576  
Fax: (39-051) 2091576  
Email: asegre@agrsci.unibo.it

## **JAPAN**

Mr. Tamotsu Kawamura  
Associate Professor  
Faculty of Agriculture  
Iwate University  
3-18-8, Ueda, Morioka  
Iwate 020-8550

Tel: (81-19) 621 6130  
Fax: (81-19) 621 6130  
Email: kawamura@iwate-u.ac.jp

Mr. Shigeki Moriyama  
Counsellor  
Embassy of Japan in Vienna  
Hessgasse 6  
1010 Vienna AUSTRIA

Tel: (43-1) 531 920  
Fax: (43-1) 532 0590  
Email: shigeki.moriyama@mofa.go.jp

Mr. Eiryu Sanatani  
Counsellor  
Permanent Delegation of Japan to the OECD  
11, Avenue Hoche  
75008 Paris FRANCE

Tel: (33-1) 53 76 61 95  
Fax: (33-1) 45 63 05 44  
Email: sanatani@deljp-ocde.fr

## **KOREA**

Mr. Geum-Nam Kim  
Deputy Director  
Policy Coordination on Agriculture and  
Fisheries  
Industry Division, Economic Policy Bureau  
Ministry of Finance and Economy  
88, Kwanmoon-Ro, Kwacheon-City  
Kyunggi-Do, 427-760

Tel: (82-2) 503 9047 / 8  
Fax: (82-2) 503 9068  
Email: kgn3579@mofe.go.kr

## **THE NETHERLANDS**

Dr. Hein van Asperen  
Agricultural Counselor  
Royal Netherlands Embassy  
Opernring 3-5  
A-1010 Vienna AUSTRIA

Tel: (43-158) 939 221  
Email: hein-van.asperen@minbuza.nl

Mr. Gerard van Empel  
Managing Director  
Rabo International Advisory Services BV  
P.O. Box 17100  
UC B920  
3500 HG Utrecht

Tel: (31-30) 216 3670  
Fax: (31-30) 216 3677  
Email: RIAS@rn.rabobank.nl



## **NEW ZEALAND**

Mr. Hamish Gow  
Assistant Professor - International Agribusiness  
Management  
Department of Agricultural and Consumer  
Economics  
University of Illinois at Urbana-Champaign  
1301 West Gregory Drive  
Urbana, IL 61801 USA

Tel: (1-217) 265 0320  
Fax: (1-217) 333 5538  
Email: hgow@uiuc.edu

## **ROMANIA**

Miss Elena Verginica Abagiu  
Expert, Department Programs and  
International Relations  
Ministry of Agriculture, Food and Forestry  
24 Carol I Blvd.  
Bucharest 3

Tel: (40-1) 313 4449  
Fax: (40-1) 312 12 49  
Email: elena.abagiu@maa.ro

Ms. Simona Bara  
Officer  
Ministry of Agriculture, Food and Forestry  
Carol I Blvd.  
Bucharest

Tel: (40-1) 936 83268  
Fax: (40-1) 335 0874  
Email: simonabara@iname.com

Mr. Anton Boerescu  
General Director  
General Division for Agriculture and Food -  
Bucharest  
47 Regina Elisabeta Blvd.  
Bucharest 5

Tel: (40-1) 6419 1403

Mr. Constantin Deaconescu  
Technical Coordinator  
USDA Romania Agribusiness Development and  
Policy Support Project  
4, Natiunile Unite Bloc 106 A  
4<sup>th</sup> fl., ap. 16, sector 5  
Bucharest

Tel: (40-1) 335 2206  
Fax: (40-1) 335 0874  
Email: cdeaconescu@itcnet.ro

Mr. Ilarie Ivan  
General Director  
General Division for Agriculture and Food -  
Cluj  
15 Avram Iancu Street  
Cluj-Napoca

Tel: (40-1) 6419 1403

Ms. Carmen Podani  
Ag. Advisor Assistant  
USAID Romania  
Blvd. Natiunilor Unite No. 1  
Block 108A, "Gemenii Sitraco"  
Floors 5-9, Sector 5  
Bucharest

Tel: (40-1) 335 5805  
Fax: (40-1) 335 0874  
Email: cpodani@usaid.gov

Mr. Eugen Radulescu  
President  
Banca Agricola  
Bd. Mircea Voda no. 44  
742141 Bucharest

Tel: (40-1) 326 2264  
Fax: (40-1) 326 2209  
Email: eugenradulescu@banca-agricola.ro

## **RUSSIA**

Ms. Renata Yanbykh  
Advisor to Mr. Gordeev, Deputy-Head of the  
Government of the Russian Federation  
Office of the Government of the  
Russian Federation  
Krasnopresnenskaya nab., 2  
103274 Moscow

Tel. (7-095) 205 56 68  
Fax. (7-095) 205 56 70  
Email: rgyanb@gov.ru

## **SWEDEN**

Ms. Gunilla Gustafsson  
Deputy Director  
Division for EU Co-ordination  
Ministry of Agriculture, Food and Fisheries  
SE-103 33 Stockholm

Tel: (46-8) 405 1258  
Email: gunilla.gustafsson@agriculture.ministry.se

## **UKRAINE**

Mr. Volodymyr Artyushyn  
Coordinator of Agricultural Policy Analysis Unit  
Secretariat of the Commission for Agrarian  
Policy of the President of Ukraine  
UN Agricultural Policy for Human  
Development Project  
24 Kreshchatik str., Room 624  
Kiev 01001

Tel: (380-44) 228 8639 / 228 4820 / 228 4682  
Fax: (380-44) 228 4820  
Email: viart@agpol.kiev.ua

Miss Inna Chapko  
Ph.d, Analyst, Issues of Rural Finance in  
Ukraine  
Secretariat of the Commission for Agrarian  
Policy of the President of Ukraine  
UN Agricultural Policy for Human  
Development Project  
24 Kreshchatik str., Room 624  
Kiev 01001

Tel: (380-44) 228 8639 / 228 4820 / 228 4682  
Fax: (380-44) 228 4820  
Email: inna@agpol.kiev.ua

Ms. Olga Kovalenko  
Ph.d., Strategic Area Manager  
Secretariat of the Commission for Agrarian  
Policy of the President of Ukraine  
UN Agricultural Policy for Human  
Development Project  
24 Kreshchatik str., Room 808  
Kiev 01001

Tel: (380-44) 228 8639 / 228 4820 / 228 4682  
Fax: (380-44) 228 4820  
Email: olga\_kovalenko@agpol.kiev.ua

## **UNITED STATES**

Ms. Astra Michels  
Managing Partner  
ISIS Management Group LLC.  
1050 17<sup>th</sup> Street N.W.  
Washington, DC 20036

Tel: (1-202) 776 0640  
Fax: (1-202) 463 6246  
Email: ajmichels@isisgroup.org

Dr. J.D. Von Pischke  
President  
Frontier Finance International  
2529 Trophy Lane  
Reston, VA 20191-2126

Tel: (1-703) 860 5654  
Fax: (1-703) 758 1388  
Email: jdvp@erols.com

## OTHER ORGANISATIONS

### European Commission

Mr. Hans-Christian Beaumont  
European Commission  
General Directorate for Agriculture  
International Affairs  
Loi 130 6/63  
200 rue de la Loi  
B-1049 Brussels BELGIUM

Tel: (32-2) 29 55 049  
Fax: (32-2) 29 58 628  
Email: Hans-Christian.Beaumont@cec.eu.int

### FAO

Mr. David Sedik  
Economist  
Regional Office for Europe  
Food and Agriculture Organisation of the  
United Nations  
Room C678  
Viale delle Terme di Caracalla  
00100 Rome ITALY

Tel: (39-06) 5705 6764  
Fax: (39-06) 5705 5634  
Email: David.Sedik@fao.org

### World Bank

Dr. Csaba Csaki  
Senior Advisor (Strategy and Policy)  
Rural Development Department  
MC5-109  
World Bank  
1818 H Street N.W.  
Washington, DC 20433 USA

Tel: (1-202) 473 8099  
Fax: (1-202) 522 3307  
Email: Ccsaki@worldbank.org

## SLOVENIA

### 1. Contributor:

|                                                       |                                  |
|-------------------------------------------------------|----------------------------------|
| Mr. Tomaž Sila                                        | Tel: (386-1) 251 94 04           |
| Director                                              | Fax: (386-1) 252 42 03           |
| Association of Savings and Loans Services of Slovenia | Email: tomaz.sila.zveza@z-hks.si |
| Miklošičeva 4/I                                       |                                  |
| 1000 Ljubljana                                        |                                  |

### 2. Other Participants:

|                                |                                   |
|--------------------------------|-----------------------------------|
| Mr. Štefan Cigut               | Tel: (386-1) 251 93 91            |
| Vice President                 | Fax: (386-1) 426 42 76            |
| Co-operative Union of Slovenia | Email: info.zzs@zadruzna-zveza.si |
| Milkošičeva 4                  |                                   |
| 1000 Ljubljana                 |                                   |

|                                          |                                  |
|------------------------------------------|----------------------------------|
| Mr. Stanislav Čičeroc                    | Tel: (386-1) 47 27 114           |
| Executive Director                       | Fax: (386-1) 47 27 406           |
| Slovenian Agricultural Co-operative Bank | Email: stane.cicerov@szkbanka.si |
| Kolodvorska 9                            |                                  |
| 1000 Ljubljana                           |                                  |

|                                               |                                   |
|-----------------------------------------------|-----------------------------------|
| Ms. Dragana Čuljkovič                         | Tel: (386-1) 478 9471             |
| National Assembly of the Republic of Slovenia | Fax: (386-1) 478 9881             |
| Committee for Agriculture, Forestry and Food  | Email: dragana.culjkovic@dz-rs.si |
| Šubičeva 4                                    |                                   |
| 1000 Ljubljana                                |                                   |

|                                                                  |                           |
|------------------------------------------------------------------|---------------------------|
| Mr. Bojan Dejak                                                  | Tel: (386-1) 836 19 53    |
| President                                                        | Fax: (386-1) 836 19 56    |
| Public Fund of the Republic of Slovenia for Regional Development | Email: rdf.sklad@siol.net |
| Škrabčev trg 9a                                                  |                           |
| 1310 Ribnica                                                     |                           |

|                                                                    |                             |
|--------------------------------------------------------------------|-----------------------------|
| Mr. Mitja Drobnič                                                  | Fax: (386-1) 478 9119       |
| State Undersecretary                                               | Email: mitja.drobnič@gov.si |
| Head of the Sector for European Integration and Economic Relations |                             |
| Ministry of Foreign Affairs                                        |                             |
| Prešernova 25                                                      |                             |
| 1000 Ljubljana                                                     |                             |

Prof.dr. Emil Erjavec  
University of Ljubljana  
Biotechnical Faculty, Dept. of Zootechnics  
Chair of Agricultural Policy  
Rodica  
1230 Domžale

Tel: (386-1) 7217 839  
Fax: (386-1) 7217 005  
Email: [emil.erjavec@bfro.uni-lj.si](mailto:emil.erjavec@bfro.uni-lj.si)

Ms. Liljana Figar  
Advisor to the Government  
Ministry of Foreign Affairs  
Prešernova 25  
1000 Ljubljana

Tel: (386-1) 478 2304  
Fax: (386-1) 478 2119  
Email: [liljana.figar@gov.si](mailto:liljana.figar@gov.si)

Ms. Anica Frelih  
Director  
Savings and Loans Service Unit Škofja Loka  
Fužinska ulica 1  
4220 Škofja Loka

Tel: (386-41) 51 20 604  
Fax: (386-41) 51 20 937

Mr. Iztok Grmek  
Head of the Department for  
Economic Relations  
Ministry of Foreign Affairs  
Prešernova 25  
1000 Ljubljana

Tel: (386-1) 478 2120  
Fax: (386-1) 478 2119  
Email: [iztok.grmek@gov.si](mailto:iztok.grmek@gov.si)

Mr. Michael Hegarty  
Head of the Project  
Phare Project: Assistance for the Farmers  
Associations, Unions and Young Farmers  
Stari trg 26  
1000 Ljubljana

Tel: (386-1) 425 0344  
Email: [phare.orgprojekt@siol.net](mailto:phare.orgprojekt@siol.net)

Mr. Martin Hočevar  
Assistant Director  
Association of Savings and Loans Services of  
Slovenia  
Miklošičeva 4  
1000 Ljubljana

Tel: (386-1) 432 53 21  
Fax: (386-1) 252 42 03

Mr. Kristijan Hrastar  
Farmers' Union of Slovenia  
Miklošičeva 4  
1000 Ljubljana

Tel: (386-31) 339 386  
Fax: (386-1) 252 76 71  
Email: [proteus\\_2@hotmail.com](mailto:proteus_2@hotmail.com)

Mr. Aleš Kuhar  
University of Ljubljana  
Biotechnical Faculty, Dept. of Zootechnics  
Chair of Agricultural Policy  
Rodica  
1230 Domžale

Tel: (386-1) 7217 811  
Fax: (386-1) 7217 005  
Email: ales.kuhar@bfro.uni-lj.si

Ms. Irena Klinkon  
President of Supervisory Board  
Co-operative Union of Slovenia  
Miklošičeva 4  
1000 Ljubljana

Tel: (386-1) 251 93 91  
Fax: (386-1) 426 42 76  
Email: info.zzs@zadruzna-zveza.si

Ms. Mateja Kovač  
Assistant Director  
Institute of Macroeconomic Analysis and  
Development  
Gregorčičeva 27  
1000 Ljubljana

Tel: (386-1) 478 1061  
Fax: (386-1) 478 1067  
Email: mateja.kova@gov.si

Ms. Vesna Kranjc  
Accountant  
Co-operative Union of Slovenia  
Miklošičeva 4  
1000 Ljubljana

Tel: (386-1) 251 93 91  
Fax: (386-1) 426 42 76  
Email: info.zzs@zadruzna-zveza.si

Mr. Ivan Kure  
Director  
Co-operative Unit Metlika  
C. 15 brigade 2  
8330 Metlika

Tel: (386-7) 363 7000  
Fax: (386-7) 363 7011

Ms. Marja Majer Cuk  
Director  
Fund of Agricultural Land and Forestry of the  
Republic of Slovenia  
Dunajska 58  
1000 Ljubljana

Mr. Martin Nose  
Director  
Co-operative Union of Slovenia  
Miklošičeva 4  
1000 Ljubljana

Tel: (386-1) 251 93 91  
Fax: (386-1) 426 42 76  
Email: info.zzs@zadruzna-zveza.si

Ms. Sonja Palčič  
Advisor  
Administrative Unit of Piran  
Tartinijev trg 2  
Piran

Tel: (386-5) 6710 456  
Fax: (386-5) 6710 403  
Email: sonja.palčič@gov.si

Mr. Franc Pribožič  
Vice President  
Co-operative Union of Slovenia  
Miklošičeva 4  
1000 Ljubljana

Tel: (386-1) 251 93 91  
Fax: (386-1) 426 42 76  
Email: info.zzs@zadruzna-zveza.si

Mr. Črtomir Rozman  
Assistant  
University of Maribor, Faculty of Agriculture  
Vrbanska 30  
2000 Maribor

Tel: (386-2) 2505 848  
Fax: (386-2) 229 60 71  
Email: crt.rozman@uni-mb.si

Ms. Veronika Stabej  
Minister Plenipotentiary  
Embassy of Slovenia  
28, rue Bois le Vent  
75016 Paris FRANCE

Tel: (33-1) 44 96 50 60  
Fax: (33-1) 45 24 67 05  
Email: veronika@iway.fr

Ms. Tanja Stniša  
Advisor to the Government  
Government Office for European Affairs  
Šubičeva 11  
1000 Ljubljana

Tel: (386-1) 478 2493  
Fax: (386-1) 478 2310  
Email: tanja.strnisa@gov.si

Prof.dr. Jernej Turk  
Vice Dean for Research Work  
University of Maribor, Faculty of Agriculture  
Vrbanska 30  
2000 Maribor

Tel: (386-2) 2505 831  
Fax: (386-2) 229 60 71  
Email: jernej.turk@uni-mb.si

Dr. Andrej Udovč  
University of Ljubljana, Biotechnical Faculty,  
Department for Agronomy  
Jamnikarjeva 101  
1000 Ljubljana

Tel: (386-1) 423 1161  
Fax: (386-1) 423 1088  
Email: andrej.udovc@bf.uni-lj.si



Mr. Peter Vrisk  
President  
Chamber of Agriculture and Forestry of  
Slovenia  
Co-operative Union of Slovenia  
Miklošičeva 4  
1000 Ljubljana

Tel: (386-1) 241 63 06  
Fax: (386-1) 241 63 50  
Email: peter.vrisk@kgz-slo.si

Mr. Emilijan Žličar  
National Council of the Republic of Slovenia  
Commission for Agriculture, Forestry and Food  
Šubičeva 4  
1000 Ljubljana

Tel: (386-1) 478 9811  
Fax: (386-1) 478 9847  
Email: emilijan.zlicar@ds-rs.si

***Ministry of Agriculture, Forestry and Food:***

Mr. Franc But  
Minister of Agriculture  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9102  
Fax: (386-1) 478 9021  
Email: franc.but@gov.si

Mr. Iztok Jarc  
State Secretary  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9103  
Fax: (386-1) 478 9021

Mr. Darko Simončič  
State Secretary  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9117  
Fax: (386-1) 478 9021  
Email: darko.simoncic@gov.si

Mr. Janez Pevec  
Secretary General  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9134  
Fax: (386-1) 478 9021  
Email: janez.pevec@gov.si

Ms. Sonja Bukovec  
Director  
Agency of the Republic of Slovenia for  
Agricultural Markets and Rural Development  
Dunajska  
1000 Ljubljana

Tel: (386-1) 478 9216  
Email: sonja.bukovec@gov.si

Ms. Sonja Gostiša  
State Undersecretary  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9160  
Fax: (386-1) 478 9084  
Email: sonja.gostisa@gov.si

Mr. Marko Verbič  
State Undersecretary  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9116  
Fax: (386-1) 478 9021  
Email: marko.verbic@gov.si

Mr. Dušan Vujadinovič  
State Undersecretary  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9148  
Fax: (386-1) 478 9021  
Email: dusan.vujadinovic@gov.si

Ms. Snežana Popovič  
Undersecretary  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9131  
Fax: (386-1) 478 9021  
Email: snezana.popovic@gov.si

Ms. Dragica Matijević  
Assistant  
Ministry of Agriculture, Forestry and Food  
Dunajska 56-58  
1000 Ljubljana

Tel: (386-1) 478 9103  
Fax: (386-1) 478 9021  
Email: dragica.matijevic@gov.si

## **OECD SECRETARIAT**

### **Directorate for Financial, Fiscal and Enterprise Affairs**

Mr. Fujiki HAYASHI  
Head of Unit  
Outreach Unit for Financial Sector Reform

Ms. Jaimie ELLIS  
Assistant  
Outreach Unit for Financial Sector Reform

### **Directorate for Food, Agriculture and Fisheries**

Mr. Ken ASH  
Deputy Director

Mrs. Alexandra TRZECIAK-DUVAL  
Head of Division  
Agricultural Policies in Non-Member Economies

Mr. Michael RYAN  
Administrator  
Agricultural Policies in Non-Member Economies

Ms. Olga MELYKHINA  
Consultant  
Agricultural Policies in Non-Member Economies

Mrs. Sally TAYLOR  
Principal Administrative Assistant  
Agricultural Policies in Non-Member Economies

### **Centre for Co-operation with Non-Members**

Mr. Makoto ASANO  
Administrator  
Transition Economies Unit

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16  
PRINTED IN FRANCE  
(14 2001 15 1 P) ISBN 92-64-19547-5 – No. 52141 2001