

# Credit Problems in Agricultural Sectors of CEECs

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*The lack of agricultural credit markets in the former communist countries of Europe poses a serious challenge to improving the quality of life of the rural poor in these countries. What should the governments there do? Rowena Dwyer examines the problems of land restitution and poorly defined property rights, and the possibilities of credit subsidies, loan guarantees and special institutions. Using the case of Poland, she rejects the latter proposal but sees a short-term role for subsidies and loan guarantees in improving these credit markets.*

## Introduction

*'...in all countries, the incomplete process of defining land ownership rights and the lack of active land markets undoubtedly hampers agricultural development as farmers are thereby deprived of their best source of collateral for securing loans.'* (Buckwell, A., & S. Tangermann, 1997: 315)

Reform of the economies of Central and Eastern European countries, hereafter CEECs, over the past decade has led to the restructuring of both the agricultural and the banking sectors. The resultant fall in productivity in agriculture and the general disruption caused by reforms has led to it being viewed as a very high-risk area for investment. The fledgling banking institutions, with access to a very limited amount of funds are loath to direct any of these to a sector with so little prospect or return. Hence, the investment that is needed to enable the agricultural sector evolve into a competitive structure is not being provided. What factors have caused this virtual elimination of an agricultural credit market? Is it the actions of the banking institutions, or are they merely reacting to failures in other aspects of the transition economies? This essay posits that both explanations are true. It looks at three government policies used in developed economies to aid agricultural credit markets and questions whether any of these are suitable for the transition economies. Policy measures being used in Poland will be looked at, as with over 25% of the population involved in agriculture and facing EU accession, it is imperative that a successful formula be found to ensure future investment in their agricultural sector.

Credit markets operate under conditions of imperfect information. This is particularly true for the agricultural sector, as in agricultural production there is an inevitable time lag between the period of investment and costs and the time of harvest and revenues. The possibilities of failure are consequently higher – farmers can only base their supply on what was demanded in the previous time period. A

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change in demand cannot be adjusted for by a similar, instantaneous, change in production. Two by-products of imperfect information are:

- Adverse selection: *'potential borrowers who are the most likely to produce an undesirable outcome (default on loans) are those who most actively seek loans and are therefore most likely to be selected,'*
- Moral hazard: *'the lender is subject to the hazard that the borrower has an incentive to engage in activities that are undesirable from the lender's point of view'* (Swinnen, J., & H. Gow, 1997: 3)

Both of the above are prevalent in transition economies – but are they an inevitable fall-out from agricultural reforms or have they occurred due to government actions?

### Restructuring of the banking-system

*'...in a market economy, the main monetary policy instrument is the control of the total money supply, leaving the allocation of credit inside the economy largely to independent financial institutions, which base their lending policies on assessments of risk and financial returns. In centrally planned economies, the main monetary policy instrument was credit allocation.'* (ibid.)

Credit was not allocated on a merit basis and was instrumental in propping up unsuccessful agricultural enterprises for an indefinite time period. Funding was often given with no interest attached, therefore there has been a problem in transition countries in accepting the 'costs' of borrowing – the payment of interest on credit. As stated earlier, credit has been limited for the newly independent banking institutions. For all the transition countries, rising inflation and the arrival of unemployment caused economic turbulence. However, in the CEECs, both have now largely been contained and the macroeconomic stabilisation necessary for growth is present. As the economies recover, it is instead the accumulation of bad debts from central planning and the lack of experience on the part of the banking institutions that are causing the most problems. How have the issues of land restitution and property rights, common to all the CEECs, been dealt with by the banking sector?

'Land during collectivisation could be changed quite dramatically in qualitative terms, but, as a defined physical location, it remained legally privately owned throughout the Communist regime in many CEECs' (Swinnen, J., Buckwell, A., & E. Mathijs, 1997: 351). As a result, the new governments of the CEECs had little choice but to reconstitute collective farm land to its original owners. It was

thought that this restitution to owners would result in the break-up of large farm structures. This would only result if there were a strong link between asset ownership and asset use. Tied to this, the benefits from leaving the collective farm system would have to outweigh the costs.

But what are the incentives for leaving a collective farm? Private farming is typified by one individual being able to perform a variety of tasks – including taking on the risks and responsibilities of one's own business. But with credit largely unavailable for small farmers, remaining under the mantle of collective farming is the more attractive option. Those who do leave the collective system are not investing. In Romania in 1996, only 4% of farmers had bought any type of equipment in the previous year, and 'in the few cases where loans were obtained, most loans were from family associations or formal associations, with very small incidence of borrowing from formal financial institutions, such as banks' (Sarris, A., Doucha, T., & E. Mathijs, 1999: 317).

How productive is the collective farming system? The accumulated debts run up by these during central planning were written off by the state, thus reducing incentives for better management. Unlike the industrial sectors, where outside owners provide access to capital, farms with a large share of outside owners are less efficient than those owned by insiders. Moral hazard is apparent in this situation with respect to the governance of the farm. If the owners are not in control of the running of the farm there is difficulty in linking effort to output. Consequently, farms are not as efficient as they could be. By not providing investment opportunities to private farmers, financial institutions can be held partly responsible for the continued existence of collective, and less efficient, farms. Their continued existence leads to adverse selection – the more inefficient the farm structure, the greater the likelihood of their requiring financial assistance.

### Property rights

'Land restitution has not necessarily led to the full transfer of property rights to the new private owners' (Sarris, A., Doucha, T., & E. Mathijs, 1999: 308). Land restitution programmes generally have five steps (Swinnen, J., Buckwell, A., & E. Mathijs 1997: 342):

- Claims are submitted
- Ownership certificates are issued, indicating the rightful claim of the person or family to an asset
- The precise value of the asset is calculated and/or land parcels are redrawn

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and the precise land parcel identified and registered

- Surveys are completed
- Land titles are issued.

Until all of these steps are carried out, land is not tradable. Because of this, land has generally been leased or rented in the CEECs, but for short periods only. Those renting the land have, therefore, very little incentive to invest in land improvement. This has led to lands being over-used, hence, productivity and land value have fallen. For those owning the land, this uncertainty has also led to a lack of investment, as 'legislation typically prevents the pledging of assets when they are under the process of privatisation and restitution' (Swinnen, J., & H. Gow, 1997: 7). Rural land is still not accepted as collateral. 'Land as security for long-term loans has been accepted only in Poland' (Trzeciak-Duval, A., 1999: 297). This occurs even in areas where property rights have been fully restored, as there is very little likelihood of banks being able to sell the property, if the borrower defaults. Farmers are required to provide more capital and pay higher interest rates for loans than borrowers in other industries. In this situation, it is the governments, rather than the banking institutions, who are hampering investments in agriculture, by not ensuring the legal establishment of property rights.

### Government intervention in agricultural credit markets

How do governments intervene in the agricultural credit market? Does this investment help to improve the productivity of the sector, or merely finance inefficient practices? One of the most prominent institutions in the European Union is the Common Agricultural Policy. Its stated aims are of guaranteeing food security and quality for consumers at a reasonable price, whilst maintaining a proper standard of living for those working in agriculture. It has succeeded in creating an artificial system, whereby the prices received by producers are far removed from those they would receive on the world market. This artificial market has proven to be a financial burden for the EU and in recent years, reform of the CAP has been implemented, in order to reduce its crippling budget and to comply with WTO regulations.

In the CEECs, support for the agricultural sector was provided under central planning. Reform has led to farmers being exposed to world market prices, and subsequently, farm incomes fell dramatically. Government intervention in the agricultural credit market has increased in the last decade, and will be looked at under three headings – Credit subsidies, Government loan guarantees, and the

creation of Specialised Agricultural Credit institutions. The main advantages and disadvantages of the above are now outlined.

### **Credit subsidies**

These involve "providing credit at 'preferential' interest rates to agricultural producers" (Swinnen, J., & H. Gow, 1997: 10). If land is accepted as collateral, then offering credit at reduced interest rates can help rejuvenate an agricultural sector 'crowded-out' by more attractive industries for investment. However, the subsidies have to be paid for by the government. Therefore, money is being channelled to a high-risk sector. If loans are defaulted on, then governments will have wasted funds that could have been more successfully employed elsewhere, perhaps for investment in public goods or infrastructure, which would indirectly have stimulated the agricultural sector.

As already mentioned, the use of rural land as collateral is still generally not accepted, therefore credit subsidies will have very little effect on the problem of farmers obtaining financing. For credit subsidies to be successful, they must only be for a limited time period – experience has shown in the EU that any form of subsidisation introduced into the CAP has subsequently been very difficult to dismantle. The governments of the CEECs cannot afford to provide unlimited support to the agricultural sector without running the risk of harming other sectors in their economies.

### **Government loan guarantees**

The idea behind these is to make lending to farmers more attractive by the government agreeing to pay some percentage of the loan in the event of the borrower defaulting. The success of this scheme depends on the terms of the loan. If both the borrower and the bank involved are responsible for repaying as much as possible in the case of default, it will be in the bank's best interest to screen applicants and monitor repayments carefully. However, the danger can arise that by softening the bank's budget constraint, the guarantees will lead to an inefficient screening process. Also, moral hazard could arise. As the borrower believes that the government will automatically bail them out if they fail to repay the loan, their incentive to pay back the loan is thus diminished. For countries in transition, such a scheme may be unwise, with not only a fledgling banking institution, but also many

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uncertainties surrounding government credibility.<sup>1</sup>

### Specialised agricultural credit institutions

The creation of these should lead to a reduction in the asymmetry of information between borrower and lender. However, specialisation in the agricultural sector will lead to these financial institutions being open to greater risks and hence a higher chance of default. The lower success rate that these institutions have as compared with commercial banks will lead to the agricultural credit market being viewed in an unfavourable light. Credit will be available to farmers from these institutions alone – the credit market will become highly segregated. In the event of these institutions being disbanded on grounds of unprofitability, farmers will have no method of securing credit. Credit for the agricultural sector should be made available through the commercial banks. Segregation of the economies in the CEECs should be, if possible, avoided.

### Poland

In Poland, credit subsidies were available before transition, through the co-operative state owned 'Bank for Food Economy' (BFE). After transition, farmers became high-risk investors and the collateral necessary for obtaining credit was so high that there was a decrease in the amount of preferential credit being requested. To address this problem, the government established, within the competence of the Minister for Agriculture and Rural Development, the 'Agency for Modernisation and Restructuring of Agriculture'<sup>2</sup> which 'operates its credit programmes through the commercial banking system, with the banks providing the system for the evaluation of suitable investment projects and the disbursement of the preferential credit at fixed interest rates' (Swinnen, J., & H. Gow, 1997: 19). The BFE is currently undergoing privatisation but still faces the problem of difficulties in loan recovery.

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<sup>1</sup> In Romania in 1996, a law was passed whereby defaulting borrowers are provided with unrestricted access to fresh loans (Swinnen, J., & H. Gow, 1997: 23).

<sup>2</sup> Agricultural Restructuring and Debt Rescheduling Fund was set up in 1992. Its activities were suspended in June 1993, due to irregularities in its administration (Swinnen, J., & H. Gow, 1997: 19).

With accession to the EU fast approaching, the Polish government has set out the following requirements for a coherent policy for rural development and agriculture (Polish Ministry of Agriculture and Food Economy, 1999: 61):

- 'the provision of sufficient national matching funding for the EU funds
- harmonisation of financial systems , in terms of subsidised credit, grants, guarantees and warranties
- arrangements for co-ordination between institutions responsible for programming, cofinancing and management.'

Ad-hoc measures will only lead to resource being wasted, therefore there will be strict monitoring of all programmes designed to financially aid agricultural and rural development, with progress reports being submitted to the statutory supervising bodies in an attempt to reduce the asymmetry of information existing in the agricultural credit market. 'In recognition of the importance of evaluation for effective management of public programmes, the Government of Poland intends to have the evaluation [of schemes] carried out in a more systematic manner so as to ensure that the limited aid resources are channelled into priority areas' (*ibid.*).

### Conclusion

Government intervention is necessary in the agricultural credit markets of the CEECs. The new banking institutions, with access to a limited amount of funds will not, without some extra incentive, choose to lend money to a sector with such a high risk of defaulting. However, caution must be exercised as to the type and duration of aid that should be given by governments. Land restitution has not resulted in the emergence of private farms, and the remaining collective farms still exhibit a great degree of inefficiency. The uncertainty of property rights and the absence of a viable land market cause this slow emergence of a private farming sector. Therefore, governments can help the agricultural credit market, not just with financial aid, but also by firmly establishing the property rights of new owners.

Of the three policy choices discussed, the creation of specialised credit institutions is the least attractive option. Although they would result in a reduction of the asymmetry of information between borrower and lender – their likelihood of causing a complete segregation of the credit market, and of becoming a financial drain on the countries' economies is too great as to make their continuation/existence particularly viable.

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Both credit subsidies and loan guarantees are necessary to stimulate investment in the agricultural sector. However, it is necessary to set out a definite time limit to their operating and, again, to establish property rights and a land market. The Polish example outlines how important effective monitoring of all credit schemes is. If there is no improvement on the default level of agricultural loans and if the government is seen as still operating a soft-budget constraint – agricultural productivity will not have improved and there will be a further increase in the opportunity cost of providing credit for the agricultural market.

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