PN AAX-779
51209

Toward a Mechanism for the Financing of Rural Land Sales

Prepared for the U.S. Agency for International Development Mission in Honduras under Contract Number PDC-1406-I-15-1089-00.

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October 1983

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FACILITATING ACCESS TO FARM LAND THROUGH AN IMPROVED LAND MARKET IN HONDURAS: A PROPOSAL

EXECUTIVE SUMMARY

Campesinos and small farmer entrepreneurs in Honduras find it difficult to acquire land because there is no established mechanism for long-term mortgage finance. Farm land rental and sharecropping are prohibited by law. In the areas of population pressure, no more land is eligible for expropriation. Many landowners, fearing an illegal occupation of their lands, are willing to sell for prices well below market prices. Many campesinos are willing to buy, as an alternative to waiting for the land reform agency (INA) to find them some land.

This proposal builds on a small fund already set up at the Central Bank, with ESF money, to enable many campesinos and small commercial farmers to acquire needed land through market mechanisms. It assumes that ESF monies will again be available in the future. If and when political stability and confidence return to Honduras and its neighbors, it should be possible to attract long-term savings deposits, and land sellers should also be more willing to finance their sales.

On the advice of bankers and campesino leaders, eligibility would be limited to persons who earn or will earn most of their livelihood from farming. To avoid financing reconcentration, the present money limit on a loan would be replaced by a size limit: borrowers must not have more than a "family farm," including the proposed acquisition, or about 10 manzanas.

To discourage speculators and land purchase for extensive use, the loan application would require an explanation of how the proposed transaction would lead to increased production and more fulfillment of the social function of land ownership. (Idle land would be brought into production, new jobs would be created, and no one laid off.)

To ensure that the creation of this financing "window" does not merely lead to higher prices, the lending bank, INA, and a campesino organization chosen by the buyer would review proposed transactions. If the price was thought by any to be too high for the buyer(s) to pay the amount easily out of potential production, the loan would be postponed until a better price was negotiated. (The owner would of course be free to sell the land to someone else, but this particular financing mechanism would not be available to finance the sale at the higher price.)

For buyers unable to provide collateral other than the land being purchased, a guarantee mechanism would be established. Drawing in part on the experience of private mortgage insurers in the United States, land purchases would be financed basically by a premium of 2 percent per year on the unpaid balance, charged to the borrower in addition to interest. This premium would be deposited in a savings account at the lending bank, in the name of the guarantor. In the event of default, the bank could take the missing payments from this account, and the guarantor would seek to recover the money from the mortgage borrower.

It is expected that the major campesino federations and INA would be the principal guarantors, but other responsible organizations would be welcome. To reward their efforts to see that groups buying land do not default, the guarantors would be allowed to withdraw and spend all funds accumulated beyond amounts necessary to guarantee payment of loans they had guaranteed; 20 percent of outstanding balances would probably suffice.

To help get the guarantee funds started, the Central Bank would match the 2 percent premiums during the first five years of the new program, out of the 8 percent interest it charges for all land purchase loans. In addition, we suggest that USAID make an outright grant of L/. 25,000 to open each guarantee account the first time a loan is approved for a guarantor organization in each private bank. (This money would be a permanent base for the guarantee account, and could not be withdrawn by the organization until all loans guaranteed by them at that bank had been paid in full.)

We also recommend that the interest rate on land purchase loans be set in the range of 11 to 14 percent, rather than the present 16 percent. It appears unlikely that higher rates to depositors will attract increased savings by individuals until political peace is restored in Central America. The lower cost of external funds and the yield on agricultural investment suggest that interest rates of 11 to 14 percent are more appropriate.

Conversely, if devaluation is expected, 16 percent is far too low for long-term interest rates. However, recent experience in Mexico, coupled with the active labor movement and electoral democracy in Honduras, indicate that devaluation in Honduras would be a great error, and that export stimulation and a better balance of trade should be sought by other more direct means.

Finally, we suggest that another portion of the interest charged by the Central Bank for rediscounting land purchase loans could be used to finance technical assistance to land buyers. We suggest exploration of voucher methods, under which campesinos would be given vouchers to hire the advisor of their free choice.

This should lead to the creation of a new and lively free market in agricultural services; input suppliers, unemployed agricultural professionals, and some extension agents now in the public sector would compete for business. The campesino organizations might also find this an opportunity to serve members (and finance their overhead) even after they have acquired land.

WHERE TO GO FROM HERE

If USAID decides to implement this improved land market mechanism, probably in close relationship with the titling program already under way, the principal steps would be to:

- Encourage the Central Bank, INA and the campesino organizations to discuss the proposed mechanism, including the guarantee program, and suggest any modifications they deem wise.

- Encourage the Central Bank staff and INA to write out the rules on eligibility and on procedures for rediscounting land purchase loans. This could include the earmarking of some part of the present L/ .4 million for loans to groups, which take more time to structure and disburse than do loans to individuals. The procedures should also allow lending banks to submit a short form application and obtain a commitment that the loan will be discounted, provided a reasonable price is negotiated and legal formalities are met within, say, 60 days. Thus no buyer will incur big expenses for the legal costs of a mortgage, nor will a bank commit itself to make a loan, only to find out that the borrower or the loan does not qualify for rediscount.

- Encourage the campesino organizations to meet with bank officials and decide how to resolve speedily (between themselves) whether the price of a proposed land transfer is indeed low enough that the buyer(s) will not have trouble paying for the land. In general, this will involve the same farm plan study that the bank will make in promising to provide production credit to the land purchaser.

- Encourage the Central Bank and campesino organizations to draft regulations for the guarantee funds, and obtain any needed approvals (e.g., from the Superintendency of Banks), so this mechanism will be ready when the first groups apply.

- Experience in Honduras and elsewhere makes it clear that implementation of this improved land market mechanism will happen only if there is follow-up over the next several months by someone attached to USAID, who is not distracted with numerous other tasks. This could be done by a regular staff member, or by consultants making one or more trips as the Mission prefers.

INTRODUCTION

The debate over what Honduras should do with its agricultural sector promises to continue for years, but there are some points on which there is broad agreement. These include the need to clarify land ownership and issue freehold titles to those campesinos now holding use rights only, and the need to create a more effective private land market. The present democratically elected government has taken some major steps on the titling program, with technical and financial assistance from USAID, and its officials have shown great interest in improving campesino access to land through market mechanisms as well.

One recurring issue in policy debates is the nature and role of the land market in rural Honduras. Some development planners even ask whether such a market exists. It does exist, but the market is so imperfect that its size and characteristics are not very visible, and campesinos have difficulty seeing how they can use it to satisfy their demand for land to farm.

Closely related questions have been raised about what interest rates are appropriate for production and land purchase loans, and whether farming is even profitable in Honduras. (Currently, production credit in farming costs 19 percent a year, while a modest new program in farm mortgage credit offers loans at 16 percent.) These issues, less complex than they sometimes seem, are key elements of this study of the Honduran land market.

This report, prepared by Development Alternatives, Inc. (DAI) for the USAID Mission in Honduras and for the Government of Honduras, does not pretend to answer all of these questions in a definitive way. We do, however, attempt to focus them in a practical and pragmatic way that will enable the reader to cut through their complexity.

On many issues, the report offers alternative mechanisms for addressing specific problems, with the choice left to the policy maker. In particular, a choice must often be made between simple methods and others, more complicated, that create clear market incentives for desired action.

The team included an agricultural economist, a rural sociologist, and a specialist in development finance. They met with a wide variety of persons, consulting bankers, campesinos, landowners who wanted to sell (including some whose lands had been invaded by campesino groups), agricultural professionals, and government officials. Field work and report writing were done mainly in Honduras, during three weeks in October, 1983.

During this period the team interviewed various persons within the AID mission, the National Agrarian Institute (INA), the National Agricultural Development Bank (BANADESA), the Ministry of Natural Resources (MNR), the private sector, including numerous bankers, campesino organizations. the Interamerican Institute for Cooperation in Agriculture (IICA) and the United Nations High Commission on Refugees.

Additionally, the team consulted a considerable number of written documents, reports and studies, a list of which appears at the end of the report. There are two editions of the report; one in English, and an earlier version in Spanish.

The three members of the team wish to thank the many persons who gave us the benefit of their experience and views. Without their help and insights, this difficult task could not have been accomplished.

1.0 THE PRESENT SITUATION

1.1 BACKGROUND

The history of the agrarian reform movement in Honduras is a long and complicated one, complete with many programs and activities whose goals and objectives have not been achieved. Since 1962, when the first reform law was passed, the need for a radical change in land tenancy has been officially recognized. The problems leading to this recognition included the fact that a vast percentage of rural lands were (and still are), legally the property of the state, that a small minority controlled much of these lands through usufruct practices, and that the vast majority of small campesino farmers were relegated to micro-sized uneconomic plots for the subsistence cultivation of basic grains, and in certain regions coffee. In essence, the traditional latifundio-minifundio dichotomy existed as well in Honduras, with the lone exception that much of the land was the property of the state, while only being used by the latifundistas.

For the most part, the initial attempt at reform during the 1960s stagnated for over ten years until 1974, when the current Agrarian Reform legislation was enacted (Law 170). As a result of its passage, several modifications in the traditional land tenure structure were achieved, the most obvious of which being the emergence of the 'Reformed Sector' with a very definite collective focus. In effect, 'campesino groups' became the principal objective of the agrarian reform and as such the beneficiaries of the majority of services provided by INA. This, in spite of the fact that the law proposes to treat individuals and groups in the same light, has had the effect of making the Reformed Sector the overall spokesman for, and recipient of, the vast majority of reformist policies.

Now, almost nine years after the passage of the present legislation, it is possible to conclude that significant changes in the agrarian structure of Honduras have occurred. Many properties, in order to become 'unaffectable' under the law, have become 'modernized'. Others were affected and were passed to the hands of campesino groups, and today are achieving a 'social function' as is described in the reform legislation. (This 'social function', however, has not always been in accord with an 'economic/production function' which is supposed to have been accomplished as well.) On the other hand, many large properties were allowed to slip through the loopholes of the legislation, and have been left unaffected by the law. It is thought that many of these properties are still not achieving their economic or their social functions.

The sum total to date of the reform legislation is difficult to evaluate. Nevertheless, it can be said with certainty that the agrarian structure of Honduras is far more complex today than it was when the law was enacted. Very probably increased complexity and heterogeneity are due to the combined effect of the activities carried out by the reform through INA, the fear of many large land owners of having their properties expropriated, and the pressures from organized groups of campesinos.

Without attempting to exhaustively characterize the above mentioned agrarian structure, the team would like to emphasize the following issues of concern:

a) The existence of an enormous group of landless campesinos who refer to themselves as rural 'laborers'. Some give up agriculture and migrate to the cities in search of better opportunities, often not finding them. The number of landless agricultural workers is hard to determine with any certainty, however, it is safe to assume that it is quite high.

b) The existence of another very large group of small landowners (minifundistas), who while having access to a small plot of land, are unable to support their families from it due to its size, poor quality, or both. These people have the choice of seeking scarce day work on neighboring parcels, or becoming underemployed.

c) The embryonic existence of a very small group of what might be considered a 'rural middle class'. While they apprear to be without permanent access to land of sufficient size and quality, these farmers (actual and potential), however, do often have access to technical and administrative expertise (often their own), and working capital. Once the issue of access to the land can be resolved for this group, the combination of these other positive factors will go a long way toward assuring production success and economic viability.

These observable divisions in the structure of the Honduran agricultural sector have also had their influence on the overall national political economy, giving rise to serious economic and social problems. For example: the ever present threat of land invasions in areas of high demographic pressure, (often on lands declared 'unaffectable' by INA); the often extremely low productivity among the basic food crops, which in turn requires the increased importation of foodstuffs; and, often very high rates of unemployment and underemployment with the corresponding effects on the economic and social welfare. Factors such as these, therefore, lead one to conclude that a lasting solution to the problems of land would go a long way toward resolving many of Honduras' development problems in general.

It appears that many of the defects which gave rise to the reform legislation of 1974 still exist in great measure, leading one to presume that the law was of little effect. Nevertheless, it was INA, as the implementor of the law, which played a substantial role (which continues today), in the transformation of the agrarian structure, and which must bear the responsibility for the shortcomings and present conflicting situations in the rural areas of the country.

It was generally felt by those people interviewed, and attested to in various documents, that serious abnormalities were perpetrated by INA in the past. Current INA administrators have had to accept, almost as their primary duty, the rectification of past wrongs and the reconstruction of the Institute's reputation and credibility. The purchase of land at grossly overvalued prices, the expropriation of utterly worthless lands, the sale of lands to campesino groups without providing the necessary support services, and the virtual abandonment of many organized groups of campesinos, all have had a very negative effect on the institutional viability of INA. This in its turn has had the following 'second round' negative effects on the institution and its supposed beneficiaries: i) decapitalization, budget cuts, financial disarray and the ensuing inability on the part of INA to provide necessary services to beneficiary groups; ii) miserably poor repayment rates for those campesino groups who received land under the reform; iii) necessity of many groups to resort to 'de facto', often potentially violent, acts in order to resolve problems which INA itself was unable to resolve; and, iv) the loss of credibility on the part of these organizations in terms of their willingness to act in good faith.

Given this negative reputation, one can justifiably understand the position of most private sector bankers in their reluctance to lend to groups under the recently constituted L/. 4.0 million land purchase fund, (Economic Support Fund financed, USAID/Central Reserve Bank administered).

Fortunately, present INA administrators are attempting to change this negative image, and to improve the credibility of the groups it works with as well. In this vein present efforts are being directed towards consolidating their work among those groups which have already received land, by providing them with badly needed services in extension, group administration, marketing, and recently, credit for small projects. These complementary activities are part of a new thrust to provide development services in an integrated and coordinated manner. By doing this INA hopes to relax several constraints to small farmer production at once, rather than with the one-shot solutions of the past (such as merely providing land to farmer groups).

Critical to this new approach is the inclusion of the USAID financed Land Titling Project, as well as future activities or programs designed to promote a land sale financial mechanism. Taken alone, neither the Titling Project nor the land sale activities will resolve the multiple-faceted problems of the small farmer sector. While both activities are seeking to resolve key constraints to the advancement of the sector, these programs cannot and should not be carried out in isolation. To do so would run the risk of raising rural expectations without providing the wherewithal for their realization. Said differently, a campesino farmer, or group of farmers with title to its property, could actually end up in worse socio-economic conditions than before, if additional support servivces are not provided.

1.2. THE MARKET FOR LAND

Having presented the above general considerations concerning the agrarian sector of Honduras, we will now discuss the present land market in Honduras, as we had the opportunity to perceive it during our field visit.

1.2.1. The Supply of Land

Inspite of the agrarian reform measures implemented over the past twenty years, agricultural tenure (which percentage of the rural population controls which percentage of the land), continues to be quite skewed. According to an often cited source, 269 large landowners hold 20 percent of total arable land, while at the other end of the spectrum 126,000 campesino families are 'owners' ('have access to', might better be the term) of small parcels of 4 hectares or less, and a similiar number of rural families are landless and do not posses the necessary resources to provide for their own basic needs. Until recently, the number of legally titled properties (fee simple/ dominio pleno) barely reached 3,000 out of a total 185,000-190,000 agricultural properties. In other words, the vast majority of land in Honduras is untitled land which belongs to the government, with only usufruct rights having been granted over a portion of it.

The key question in this situation is the following: how can a rural land market operate in an agricultural sector with such singular characteristics? As a starting point we must point out that, unlike in many countries, there is no real 'clearing house' for land sales, be it private or public. Likewise, there are no observable real estate agents whose job it is to put buyers of rural land together with sellers. As such, the land market appears to be somewhat inefficient. Nevertheless, as a result of the team's interviews with farmers, INA and Natural Resource

Ministry staff, bankers and others, it appears that an active land market does indeed exist. It is, however, a somewhat imperfect market when compared to the land markets of other countries. For example;

- First, many of the transactions are simply for the value of the improvements on the land. This appears, for the most part, to be caused by the vast majority of agricultural parcels not having title. In the majority of the cases the State has been, and continues to be, the official owner of the land, and therefore a seller of land merely transfers to the buyer rights of ownership in the improvements on the land. This transfer, however, also appears to guarantee (or, at least, substantiate in many cases), the passage of whatever usufruct rights the seller has had over time. The State lacks an organized inventory of its lands which would permit it to know who had bought, or sold, improvements on 'its' lands. This situation will be corrected to some extent by the implementation of the Land Titling Project currently underway. In order that this process be lasting, however, a mechanism must be put in place which will periodically update ownership roles to reflect recent land transactions.

- Second, the land market of rural Honduras, in the absence of financial mechanisms, is often based on cash payments, or on the receipts of the first harvest, or two; in other words, short term purchasing. The only medium term land transactions which we were able to uncover were handled through banks which had received the parcels in foreclosure procedings and were attempting to sell them at auction.

In these cases, the banks normally cannot find buyers with sufficient cash to purchase the land outright. This obligates the banks to sell at terms often approximating a 20 percent down payment, with the balance due in five annual payments. When this type of transaction takes place it is common for the bank to also finance production credit. This is an extra precaution towards assuring that the land will be exploited properly and the land debt will be paid off.

- Third, the land market also embodies certain subjective factors which appear to influence both the price of the land and the willingness of the land owners to sell their land. The first of these factors concerns the fear of armed conflict spilling over from the country's three neighbors, already in conflict. Furthermore, the present democracy in Honduras is an incipient one after many years of military rule. While hopes for a continuation of this trend are high, there are certainly no guarantees that it will continue. These reasons, and others, give rise to uneasiness on the part of property owners who would rather have their wealth in other assets; often, preferably, outside of the country.

- Fourth, many land owners or potential sellers of land also fear the possibility of land invasions by groups of organized campesinos. Once this happens the normal practice of the government has been to expropriate the land, if it officially belongs to the state, or to purchase it if it is in private hands and has been cultivated efficiently, (thereby being 'unaffectable' according to the Reform Law). In other words, with or without legal title, a property owner who may merely have usufruct rights, but is still considered the owner of the improvements on the land runs the risk of having his land invaded at any time with his only recourse being reimbursed for it at some future date. (Given INA's current illiquid situation, indemnization is even less probable.) This real, or perceived, fear of invasion is far more prevalent in areas of high demographic pressure, such as Copan and Santa Barbara, where affectable lands under the reform legislation are apparently nonexistent.

Classified ads in local newspapers are often indicators of the size and scope of the land market in many countries. While this custom exists in Honduras, it exists at a scale far below what the team expected. Over the period of one week the four daily papers of the capital only offered a dozen rural properties for sale; and most of these were from banks attempting to liquidate parcels which they had foreclosed upon. In other countries of similar size the newspapers would have had over a hundred such offers in the same time period.

Real estate agents do exist in Honduras, but they deal primarily with urban parcels and only rarely with rural ones. As a result, a potential buyer of rural lands is, for the most part, left without the two traditionally most important sources of real estate information: the newspapers and professional intermediaries. At the same time, the small number of newspaper advertisements is probably an indicator of the relative inefficiency of this means of putting a buyer together with a willing seller. Supporting this view were several potential buyers, who when interviewed, stated that it had not even occurred to them to consult the newspapers as a source of information.

These factors, however, do not necessarily indicate the unwillingness of land owners to sell their properties. During field trips made by team members we were able to identify and talk with several property owners seeking to sell their lands. The mechanisms used by them to 'advertise' their parcels were, without a doubt, more informal. We were not able to ascertain, however, if these 'voice of mouth' mechanisms were generally any better at obtaining the price, or the terms which the seller desired.

In the Department of Santa Barbara, where the Titling Project is currently being implemented, the survey teams are obtaining information concerning the supply and demand of land for sale (or perhaps more correctly, the improvements on the land, since that has been the experience up until now). As far as the team was able to ascertain, various factors have influenced the supply of land for sale. Perhaps the most dominant of which has been the international price of coffee which was at its peak between 1976 and 1981. During that period, as a result of relatively high levels of profitability made possible through coffee cultivation, land sales (read sales of 'improvements') reached their highest levels. Some of the highest land values were negotiated during this period (figures of up to L/. 5,000 per hectare were not unusual). These were commonly paid off after two, or sometimes even one, harvests. With the fall of these high prices, and with the outbreak of coffee rust, the land market changed substantially and currently appears to have stagnated.

Other reasons for the sale of land appear to include: inherited parcels which are subdivided by heirs, migration to other areas, especially urban ones, and crop losses resulting in foreclosure by a bank.

In a 'normal' land market situation, many of these imperfections whould be dealt with, at least in the short run, through the practice of land rental. In these cases a person without the means to purchase land outright would rent all or part of a parcel. Without a doubt, this also occurs in Honduras, but since the practice is officially illegal under the Agrarian Reform Legislation, various subterfuges have been invented to avoid the impact of the law. (To rent illegally constitutes 'conducciòn indirecta' and can be punishable by immediate expropriation, with payment being made in 20 year bonds at 4 percent interest.) Some of these mechanisms have included the 'lending' of land in exchange for the future return of the favor, and the 'selling' of grass, (in the case of a pasture) for a specified time period. Needless to say, these mechanisms further serve to make the market more imperfect.

In summary, there is an active land market in Honduras but it is far more imperfect than in most countries. Some of the apparent reasons for this transparency are: a general lack of titles to rural properties, the fear of war or civil strife, the fear of land invasions, the illegality of rental arrangements, and, as a consequence of these, the very real lack of financial mechanisms for the purchase of rural land.

1.2.2. The Demand for Land

Different socio-economic groups are currently expressing their desire to purchase rural farm land. The most obvious of these are the landless campesinos. This group is estimated to be large but exact figures are not available. (The last agricultural census was performed almost ten years ago and it is felt that the numbers have changed significantly since then.)

Current estimates as to the size of this group vary between 100,000 and 300,000. Julin Mendez, president of ANACH, in an interview in the magazine of the same organization, (No. 2, May 1, 1983) stated that 150,000 families living in all parts of the country, "do not even have a 'cuarta' of land", and "wait anxiously for the State to provide them a parcel of land on which they can cultivate the foodstuffs to assure their existence."

Whatever the real figures, it is safe to assume that there are many thousands of campesinos who have never owned, nor had access to even the smallest parcel of land. These families appear to be extremely desirous of obtaining land and appear willing to do so in a peaceful and legal way. Nevertheless, once the legal and peaceful efforts are exhausted, and frustrations rise, the incidence of land invasions will rise as well.

Another potential source of the demand for rural lands lies in the recent emergence of a group of agricultural professionals who desire lands for cultivation. For example, the team talked to several agronomists, veterinarians, farm administrators and other agricultural sector professionals in the public sector who wanted to try their hand at farming. This group is of special interest, since it would be the group which would have the best chance at survival. The reasons for this are various and would include the following: they would be willing to attempt specialty crops for internal or export markets; they either have, or can gain access to, technical and marketing information; they would be seen as a preferred credit risk at a bank and have easier access to production credit; and they would most likely be able to make a down payment in the case of land purchases, and would therefore be more attractive to bankers.

Returning to the campesino group, we also found the normal cases of families with their economically insufficient 'pedacito de tierra', who would like to obtain more. As noted above, there appear to be a significant number of small scale land transactions, especially in the coffee regions, and wherever the demographic pressure is high. These transactions appear to be between people who know each other, and who are also from the same area. The terms are most likely to be either all cash or a high down payment and a short-term note. This fairly large group of families wishing to expand into a economically viable unit also represents another potential source of demand for an improved land market. Already having some land, and therefore some collateral, these potential borrowers could offer a better credit risk to bankers.

We also learned of demand on the part of 'displaced persons', or the organizations which are seeking to aid them. These people, most often refugees from the fighting elsewhere in Central America, are often temporarily located on lands recently purchased by organizations such as the United Nations High Commission on Refugees. This is done with the idea that these people will be able to produce their own sustenance until it is eventually feasible for them to return to their countries.

Finally, there are numerous campesino groups, affiliated to one of the various organizations existing in the country. Many of these are currently in an extended negotiation process with a landowner over the price and terms. Since INA, being the principal financing agency for this type of transaction in the past, currently has no budget for land purchases, a potentialy explosive demand for land is going unanswered. At present INA staff can merely aid in the negotiations, and keep the level of tensions low.

The presidents of two of these campesino organizations maintained that they had, "long waiting lists," of groups ready and willing to enter into purchase agreements with landowners willing to sell. Both leaders did insist, however, that each parcel offered for sale be of good quality, in accord with its price and debt burden.

It also appears that these organizations would be willing to not only guarantee loans to these groups, but would also be prepared to provide technical assistance and even share in making the down payment.

In summary, inspite of the fairly short time we were able to give to the subject, we can conclude that there is a very high demand for agricultural lands from various sectors. At present wherever this demand is being met, it is normally with a high percentage of cash payments, and at somewhat depressed prices due to the regional fears and the desire to aquire liquid assets.

1.2.3. The Price of Land

As was stated several times above, whatever rural land market exists in Honduras, it has a tendency towards outright cash sales, or terms of very short duration. These factors themselves seem to have a deflationary effect on prices, since a seller's primary interest in selling a property is most commonly to liquify assets, rather than to maximize returns from the sale. This situation has been caused by a series of factors including: the overall unstable situation in Central America; the real threat of land invasions and/or expropriation, and; the present overall lack of profitability of the agricultural sector. These factors have led to the coining of the term 'political price' when speaking of the value of land. This is in contrast to the 'commercial price' of the land which would appear to be 20 to 50 percent higher under 'normal' conditions.

We have previously made mention of the prices paid for coffee lands. These appear to be influenced by the world price of coffee, as well as by the recent outbreaks of coffee rust in those regions. During the latter part of the 1970s, when coffee prices were at all time records, it was not unheard of for good coffee lands to sell for up to L/. 5,000 per hectare, (now L/. 2,000 would be more common). Likewise, the specter of coffee rust, which is highly destructive, as well as costly to control, has also driven the price of these lands down.

Other factors influencing the price of land appear to be the normal ones which one might expect: its quality, its location, and whatever infrastructure it might contain. With all these factors taken together land prices appear to vary between L/. 50 and L/. 5,000 per hectare with the mode being between L/. 500 and L/. 1,000.

In summary, it is quite difficult to be precise in a discussion of land values in rural Honduras. Normal variations would be sufficiently difficult to assess, let alone at present with several additional exogenous factors further influencing the market.

1.2.4. The Role of Financial Institutions

In the recent past the only role which financial institutions have played in the land market was to finance (usually through an auction process to the highest bidder), the sales of properties which the bank had received as a result of foreclosure proceedings. Other than in this 'forced situation' private banking capital simply has not been available for the financing of rural lands.

In the case of the National Development Bank, (BANADESA) the situation has been the same. In fact, it is currently against the bank's regulations to use its own money in the granting of loans for land purchase. An exception to this, however, is in a situation where land purchase is part of an overall integrated project being financed by the bank. Additionally, the regulations permit loans for land purchase if the funds are supplied by other institutions or international donors. In this case the bank merely acts as an administrator for these funds and collects a 'trust fund' commission.

Given these circumstances it can be stated that both public and private sector financial institutions have had very little to do with land financing. As such, it would be expected that they would enter into any land sale program with extreme caution due to their perception of the various risks and unfamiliarity as to how to cover them; their traditional perceptions of the credit worthiness of potential borrowers, (the lending to groups would be the principal issue here); and the often extreme length of the lending process which lacks the necessary mechanisms for rapid and efficient loan processing.

Nevertheless, the attitude of the various financial institutions towards the creation of a mechanism for land purchases is variable. While the representatives of the Banco de Occidente expressed interest in the current L/. 4.0 million fund, and in fact had begun to process, at least, one loan, two other banks had not given serious concern to the offer by the Central Reserve Bank.

Another financial institution-the Banco de los Trabajadores-has had success in its past operations with groups and is inclined to continue to loan to groups in the future, (they have included 10 group loans in their future work plan for this year), while another bank stated that they did not wish to have anything to do with groups. At least one bank thought to use the present fund for its own purposes by arranging the mutual sale of properties of two of its debtors in arrears and then discounting the entire operation through the fund in the Central Reserve Bank.

In summary, access to a fund of this type by financial institutions is totally new and should be carefully monitored to assure that the proper stimuli are being implemented to provide for the fund's use, while at the same time assuring that the original goals of the fund are being met.

1.2.5. The Role of 'Campesino' Organizations

The number of roles which campesino organizations can play in supporting a land market are various, and include; i) the promotion and organization of new groups desirous of obtaining land; ii) assisting in the negotiation process of groups obtaining land, (determination of a just price, and adequate terms and quality); providing administrative and technical assistance to groups once they have obtained land; and iv) providing continuing supervision and control of groups entering into financial agreements to assure prompt payment of loans.

Without a doubt, the three national level campesino organizations (ANACH, FECORAH and UNC), are sufficiently organized and equiped to provide some or all of these services to their member groups. This would not only substantially benefit the transition of these groups to landed status, but would go far to improve the credibility of the organizations to their membership and to the general public, as well.

1.3 THE PROFITABILITY OF AGRICULTURAL ACTIVITIES

Of all of the issues researched under this contract, this one provided the greatest disparity of replies among those people interviewed. Some maintained that it was extremely difficult to break even at present, while others stated that profitability could be quite high depending on the crop.

Without attempting to give a decisive answer to this debate, nor support one side, or another, the team believes that both arguments are correct depending on the conditions. If a crop can be grown under favorable climatic and soil conditions (especially a 'commercial' one, as opposed to basic grains), with adequate production credit and technological advice, the chances are quite good that the farmer(s) will make a profit. Nevertheless, if these conditions are not met, as is the rule -- especially in the cases of credit and technology -- the outcome can be quite the contrary.

Farmers and development planners can control for some of these factors, but for others (drought, or torrential rains) the control which can be applied is minimal, or very costly. It is therefore incumbent upon both the planners, as well as the receipients of development programs, to attempt to control for as many factors as possible. The controllable factors most likely will be in the areas of production credit, technical assistance, marketing and administrative capability. To iniatiate land market activities without providing for these agricultural services would be to invite failure in the agricultural process.

In conclusion, the profitability of agriculture is a relative issue. What might be profitable for one farmer could represent a loss for another under different circumstances. The real task for the designers of a land market mechanism will be to gain assurances that the other necessary agricultural services will be available to new land recipients in a timely fashion. To do so would go a long way towards assuring agricultural success, and incidentally increase the probability of loan repayment.

2.0 THE LAND MARKET PROGRAM; PROPOSED ALTERNATIVES

2.1 OBJECTIVES OF THE PROGRAM

The basic purpose of the land market program is to make it possible for Honduran campesinos, individually or in groups, to obtain land by their own initiative, through market mechanisms.

Secondly, the program seeks to make it easier for other persons to buy land for farming purposes. For example, there are graduates of agricultural schools, now employed in the public sector, who want to go into farming but are unable to rent or buy land in the present inefficient land market.

By achieving these direct objectives, the land market program also furthers other objectives:

- Intensified crop and livestock production, leading to an increased supply of food, increased exports, and replacement of products now imported that could be produced domestically.
- Increased employment and reduced rural unemployment.
- Help in restoring peace and tranquility in rural Honduras, by resolving conflicts over land.
- To help INA honor its commitments to several campesino groups and to the owners of land that has been invaded, or is under the threat of invasion, in spite of the fact that the land is not 'affectable' under the agrarian reform. (INA has promised the parties to find a way that the campesinos can buy the land instead of seizing it. The owners have agreed to prices well below "normal" market values, but for payment in full in cash.)

- To respond to the desire expressed by some landowners to get out of the agricultural and livestock sector. These owners have not found any buyers able to pay them cash in full, they do not want to sell the land to INA in exchange for long term, low interest bonds, and yet they fear an imminent seizure of their lands by landless campesinos.

- To create mechanisms for financing transactions in farm land through private commercial banks, at market interest rates.

It is believed that the social and economic development of Honduras would be enhanced by the creation of such a financial mechanism, almost inexistent in the country today. It is also expected that the private commercial banks, seeing that land sale finance could be good business for them, would decide to finance farm land transactions on long term and with their own resources.

In the sections that follow, we analyze the various aspects that must be covered if the program is to be implemented efficiently. The analysis, as well as our recommendations, all benefited greatly from our discussions with the managers and staff of the banks and other institutions that we visited during three weeks in October, 1983.

2.2. THE INTEREST RATE

2.2.1 Background and Macroeconomic Aspects

In the conventional wisdom of macroeconomic theory, it is usually argued that rational individuals will respond to higher interest rates by reducing consumption spending and increasing total savings. Part of the added savings are expected to be deposited in bank accounts, and as a result the banks will have more loanable funds. Thus the banks, by paying "market" interest rates to their depositors, need not seek external "soft" loans with which to serve their borrowers. Likewise, adoption of "market" interest rates for loans will discourage borrowing for projects that are not profitable enough to cover high interest rates, and it is sometimes stated that the resulting allocation of resources to only very highly profitable activities is "good."

This macroeconomic model leads to policy recommendations in favor of "liberating" banks from controls over interest paid to savers and charged to borrowers. It also leads to recommendations that external aid not be used to fund credit for local borrowers below commercial "market" rates, lest it be used inefficiently or for purposes other than those stated by borrowers.

In Honduras, in 1983, statements by private commercial bankers cast serious doubt over the applicability of this model and its policy implications. When we asked what interest rate it would take to get Hondurans to reduce their consumer spending and increase their savings deposits, the usual reply was a laugh. The bankers then explained that their higher income customers usually prefer to use their excess lempiras to buy dollars in the black market; they then "save" these dollars in Miami banks.

The private commercial banks in Honduras now pay between 10 and 11 percent for time deposits (in Lempiras), and the amount in such deposits has risen slightly over time. However, the bankers see the increase as mainly a shift of funds previously in other types of accounts (especially checking account balances). It is not at all clear that they represent a net increase of resources available to the banking system, resulting from a sharp increase in the interest rate paid to savings depositors.

Some bankers mentioned the belief by some of their clients that there would be a devaluation of the Lempira. Thus any interest rate below 50 percent, say, would probably not persuade these clients to make savings deposits in Lempiras. And few if any borrowers have socially desirable projects so profitable that they could afford to pay interest rates on loans in excess of 60 percent a year. Thus "liberating" interest rates could well lead to a rise in rates for both borrowing and deposits, but the higher rates would not be likely to make the capital market much more active.

If and when the political and military risks, both inside Honduras and in neighboring countries, disappear and once the currency is again regarded as stable and not likely to be devalued, then movement toward a free capital market would be both feasible and a good policy. However, in the next few years it seems likely that for Honduras, a "Theory of the Second Best" will be more appropriate. In this, much local borrowing will still be based on resources from external lenders on concessionary terms, and some system of rationing this cheap credit among borrowers, according to intended use, will still be needed.

In short, after talking with Honduran private commercial bankers, we cannot recommend an interest rate for long-term savings deposits that would be sufficient to attract deposits for periods of 10 years or more. Yet mortgage lending on long terms with resources that can be withdrawn on short notice is inherently risky, as U. S. savings & loan associations learned painfully a few years ago.

2.2.2 Interest Rates Based on the Cost of External Funds

Another approach in the search for the "appropriate" interest rate is to start with the cost of funds to the external lending agency, adding "spreads" to cover the cost of administration both for the external agency and for Honduran banks. For example, it was recently decided that farm production credit should carry a 19 percent interest rate, because the World Bank had to pay about 14 percent for its funds in world capital markets, at the time at which it made the loan to Honduras.

This basis is of doubtful relevance to the Honduran economy right now. At the time the World Bank loan was made, the prime rate of interest to the very best credit risks in U. S. capital markets was more than 20 percent a year. This lasted only a few months, and the comparable rate is now about half that. The World Bank can now obtain resources for much less than 14 percent, and so if the world financial markets are seen as the appropriate starting place, present rates would suggest an interest rate to borrowers well below the present 19 percent; probably around 13 percent would suffice.

Thus if it is "sound policy" to avoid interest rates below market rates it is also sound policy to avoid rates much above the same market rates. When coffee growers decide whether to invest, they base their decisions on present and foreseeable coffee prices, and not on the highest prices obtained in the past. Likewise, interest rates should reflect the rate at which the World Bank is currently obtaining funds, rather than the higher rates at which it acquired funds a year or two ago.

2.2.3 Interest Rates for 1983 and 1984

It is a good idea to establish mechanisms to attract savings deposits, and higher interest rates will help. Honduras has begun to do this. But results will be modest at best until the political and military risks disappear from the region and the currency is considered stable and unlikely to be devalued. Once these conditions do exist, then Honduras will have little need for any external sources of credit on concessionary terms.

Interest rates for loans based on external resources obtained on concessionary terms should be set at levels that do not bring in additional distortions. However, the reference point is not the present "market," distorted by multiple perceived risks. Rather, borrowers and depositors should become accustomed to rates that would be suitable for a "normal" market setting. We believe these rates for borrowers would be approximately 13 percent on long-term credits for land purchase and 15 percent for production credit. (Short-term production credit involves more supervision, field verification, and bank staff time than do land purchase loans, which are likely to require only one review of documents and at most one visit to the farm, for the entire period of the land purchase loan.)

2.2.4 Higher Rates for Commercial Farm Operators

For small commercial farmers, the interest rate on production credit might well be the same as for campesinos. In the short run, however, our discussions suggest that lower interest rates to this group would greatly increase the demand for such loans, beyond available loanable funds.

The external lenders who provide funds on concessionary terms usually seek to assist campesinos, specifically. It is felt that campesinos, at least at present, do not have as great an ability to pay high interest rates as do commercial farm operators. In addition, part of the greater profitability of the commercial operators is a result of the training they received, often with large public subsidies, in secondary schools and the university. It is thus equitable and logical that commercial farm operators pay rates of interest somewhat higher than those charged to campesino borrowers, who never had similar oportunities.

2.2.5 Future Interest Rate Adjustments

Interest rates for production credit could appropriately be adjusted each year, for the next season, according to the cost of funds that year for the financial institution. If funds are made available at different costs, the lending rates might also differ in order to reflect that difference in the cost of loanable funds to the lender.

For longer-term loans for land transactions, the interest rates for new loans should also be revised from time to time to reflect the cost of loanable funds. In some countries, including the USA, some mortgage loans are made with variable rates that move up or down each year according to changes in the prime rate, the cost of loanable funds to the lending bank, or a price index. However, in Honduras at the present time, what little credit exists for land purchase is generally available only from banks using their own resources, and from a rediscount line administered by the Central Bank with ESF monies. Since these loans are made with funds not subject to withdrawal on short notice, it does not appear necessary that the interest rate for existing land loans needs to vary from one year to the next. Certainly, in opening a new land market program there is merit in simplicity, and a rate fixed for the life of the loan is much easier to explain than a variable rate.

In the future, if banks or savings and loan institutions in Honduras begin to offer deposit accounts for which the interest rate fluctuates, or includes an inflation indexing, it will be appropriate to make long-term mortgage loans with those deposits, with an interest rate that moves up and down with the rate paid to depositors. Although we did not poll every bank nor banker in Honduras, we did not find any that plan to initiate such a system any time soon. Given the subjective factors (fear of political upheaval, problems with neighboring countries, etc.) operating in Honduras today, even freely fluctuating rates would probably not attract substantial new deposits.

One possible adjustment, even in long-term loans, would be a form of penalty for those failing to meet their annual payments on time. Specifically, in some countries banks provide for higher interest rates on loans which refinance earlier loans that became delinquent. At a minimum, it might be suggested that the refinancing of land loans for be made at interest rates higher than those on loans which were overdue.

2.3 THE TERM OF LAND PURCHASE LOANS

Apart from the interest rate, the critical factor in land purchase finance is the term of the loan. Some crops yield good profits almost immediately, while others require many years of investment and care before they materialize. The latter may well need longer term loans than the former, though the problem is dealt with principally through the use of years of grace with no payment due on principal until the harvests begin.

It is important to stress, however, that if farming is not profitable, then no loan term is long enough to make land purchase a feasible, desirable transaction. (We assume that any land purchases for speculation on future urban growth would not be considered appropriate for financing, by the staff of USAID or the Central Bank.)

2.3.1 The Rate of Annual Amortization of Land Purchase Loans

Net profits accruing to landowners (above reasonable wages for their management and labor) can and should be reinvested in further productive improvements and/or in paying off the land debt. If the banking system also offers loans for capital improvements, then the borrower and the bank will probably prefer that profits go mainly toward land debt amortization at first, and that new investment be financed separately. This provides an additional scrutiny of the proposed investment, assuring the investor and land financing institution alike, that the investment is likely to be profitable. If on the other hand, land owners reinvest profits in other activities, and postpone reducing the land debt, they may fail to build equity and so may not regard the land as really theirs.

Nonetheless, agriculture in Honduras as elsewhere has many surprises, such as drought, disease or falling world market prices. Thus the feasibility study done for each proposed land purchase financing, should not assume that all of the profit in each of the good years will be available every year for reducing debt. Some safety margin should be left for surprises.

2.3.2 The Maximum Desirable Period for Land Purchase Finance

Many campesinos and others trying to buy land assume that the longer the period of repayment of a mortgage loan, the better for them. This is often not the case. The longer the term, the more of each payment goes for interest, and the less goes to pay off the loan. When the terms exceed 15 or 20 years, so little of the early payments goes to reduce the loan that borrowers may become very discouraged.

2.3.3 Impact of Mortgage Loan Terms on Land Prices

In imperfect land markets such as that of Honduras, any extension of the term for repayment of a land purchase loan tends to favor the seller much more than the buyer. Any land purchase is based in part on an estimate of how much net income the land can yield, above costs, in order to meet the payments for interest and principal. The longer the period in which the payments are to be made, the more money the buyer can pay, and so sellers will be able to demand and get higher land prices. Table 2.1 shows how the price a seller may demand is related to the term of the loan in years, and to the interest rate. (Note, too that the lower the interest rate, the more the buyer can afford to pay the seller.)

Table 2.1 Impact of the Term in Years and of Interest Rates on the Market Value of a Farm that Yields Net Profits of L/.1,000/year

Term (years)	5	10	15	20
Total Land Payments	5,000	10,000	15,000	20,000
Interest rates:	Present Value of these Payments:			
10%	3,791	6,146	7,686	8,514
12%	3,685	5,658	6,811	7,469
14%	3,433	5,216	6,142	6,623
16%	3,274	4,833	5,575	5,929
18%	3,127	4,494	5,892	5,353

In Table 2.1, we indicate the maximum price that could safely be paid by a buyer who believed that the parcel would yield L/. 1,000/year in net profits. If the seller and any other potential buyers agree as to what the parcel will produce, then these are the maximum prices the seller will be able to get in the market. (This is a simplified description of a "perfect" market, in which all parties have full information and no party is under unusual pressure to sell or to buy quickly.)

Thus if no land purchase finance is available for terms longer than 5 years and the interest rate is 12 percent, the market price will be L/. 3,685 but if loans are available for 10 years, the market price will tend to rise to L/. 5,658. Beyond ten years, creating longer-term finance still raises the price of land, but not by as much. For example, at 12 percent interest, if loans become available on 15-year terms, the market price will rise to L/. 6,811, and if the terms are lengthened to 20 years, the price will rise to L/. 7,469.

From the seller's point of view, the longer the term for which financing is available, the better. From the buyer's point of view, however, the longer the term, the more he will have to pay, both in the land price and in interest.

Table 2.1 also shows clearly the relationship between interest rates and land market prices. If "normal" loan terms are for 10 years, and interest rates are set at 18 percent, the best the sellers can expect is a market price just under L/. 4,500. But if the interest rate were only 12 percent, the market price would tend to rise to L/. 5,650.

To the campesino buyer, the interest rate is not all that important in an active land market. He pays the same amount, in this example L/. 1,000 per year, regardless of the interest rate. But the higher the interest rate, the more of this goes to banks or other lenders, and the less to the seller of land. Sellers and buyers thus have a common stake in avoiding interest rates that are unreasonably high.

On the other hand, note that if the interest rate is high enough to be attractive to the seller, he has the option of financing the transaction himself, through a land contract or mortgage loan. In other cases, the seller might agree to deposit the proceeds of a cash sale in a time deposit in a land bank; he would thus still finance the transaction, but indirectly. In this case, he earns the interest in addition to the land price agreed upon. In the longer run, when political conditions are such that landowners will be willing to accept the payment in local currency, over a period of years, this would be a healthy situation. Thus one should also avoid creating a land financing mechanism with interest rates so low that sellers would never, even in a politically stable situation, be willing to take on the bulk of land sale finance themselves. In our judgement, this would rule out loans at 6 percent or less, such as long prevailed in the USA under subsidized farm purchase financing.

The preceding discussion is of course oversimplified. In the real world, other subjective and objective factors enter in the process of setting land prices through the market. For example, some buyers will be willing to pay more than the price justified by the productivity of the land in agriculture, if the land is near a city and they foresee a future higher value in housing or industry. That is a speculative demand, rather than a demand for the land for farming purposes.

In some cases, investment in land has produced higher social status for the buyer. In still other cases, buying land is seen as a prudent defense of one's wealth against inflation. This was apparently quite significant in the rise of U. S. land prices until farm prices stabilized and then actually fell, about two years ago -- largely as a result of the ending of cheap, long-term financing for land purchases. As interest rates rose and the availability of very long-term credit for land purchase dwindled, land prices fell. Even in the USA, it was clear that the ready availability of long-term land purchase financing did more for the sellers than for the buyers who sought it so eagerly.

2.3.4 The Impact of Land Purchase Financing on Campesinos

In Honduras today, political uncertainty, especially in the neighboring countries, and the scarcity of long-term financial mechanisms for land purchase, work together to influence prices from landlords that are well below what people state is the "commercial" market price for a given piece of land. For example, a landowner in Santa Barbara, some of whose irrigated land was recently occupied by a campesino group, stated to us that he would be happy to settle for L/. 400 per manzana, provided it were paid to him in cash. He is hoping that INA and the campesino organizations can come up with some way to finance the transaction. According to various sources, a "normal" price for flat, irrigated, fertile soil of this sort, in this area, would be closer to L/. 2,000 per manzana.

Clearly, the campesinos who wish to buy this land will gain a good deal if financing can be arranged. So will the present owner, who just wants out. On the other hand, it also appears clear that if a long-term lending mechanism were already in place, with ample loanable funds, and especially if the campesinos had not already moved onto the land, then the owner would demand a much higher price.

There is little doubt that the campesinos will be able to make the payments that would be associated with a land price of L/. 400 per hectare for flat, fertile soil in that area. But with a much higher land price, it would be necessary to make a very careful study before asserting with confidence that the campesinos wanting to buy the land would be able to make the payments out of their earnings.

In this way, our analysis suggests that although a long-term financing mechanism is highly desirable, it should be implemented with care, and without attempting to guarantee that all applicants would be financed, no matter how high the land price agreed to by the parties. Otherwise, the net result of the creation of a land purchase financing mechanism will be mainly a transfer of wealth back from the campesinos to the former owners, through land prices much higher than they are willing to accept now, in the absence of such a financial mechanism.

At present, in Honduras, most land transactions are for 100% cash, or at most for a high down payment and the balance in one or at most two years. When a new land purchase credit mechanism is created, it would be unwise to extend credit for more than 8 to 10 years. Even this will be very favorable to land sellers, who will not only get cash payments, but land prices they cannot possibly obtain at present.

Any terms longer than 10 years would not favor sellers much, and not favor buyers at all; they would essentially just raise the amount of interest the buyers would have to pay to the lenders, and delay the day when the buyer is truly better off as a result of having bought the land.

In addition, if the planned cropping pattern is not able to produce enough profits to pay off the agreed land price in 10 years, it is unlikely that the proposed land purchase would be a good idea even if longer-term financing is available.

The design and implementation of a land purchase financing mechanism thus requires sensitivity to political conditions, and provisions that prevent landowners from taking the mechanism for granted and thus raising their selling prices significantly.

The "textbook" ideal market, of informed, willing buyers and informed sellers under no pressure, has not existed in Honduras of late and probably should not be sought as a short-run goal. However, once a significant transfer of land from present owners to campesinos has taken place, so that subsequent land sales are among parties of equal bargaining power, then it would be appropriate to move closer to the ideal market, in which land purchase financing is widely available on terms which are the same for all. For that matter, under those conditions the sector could be expected to generate savings that will finance land transactions, and there will be little or no need for external capital. It must be emphasized, however, that the appropriate conditions for this will not exist while access to land is quite unequal between campesinos and traditional owners, nor while there are major political stresses in Honduras and in all of the neighboring nations. Meanwhile, there does appear to be much to be gained by creating a mechanism by which campesinos and others who want land for farming purposes, can purchase it on terms much closer to a "normal" land market than those now existing. We see such terms as being on the order of 8 to 10 year financing, at an interest rate in the neighborhood of 10 to 14%, with a mechanism to review the price of proposed transactions to ensure that all of the benefits of creating this mechanism have not passed to the seller.

2.4 DOWN PAYMENTS AND OTHER COLLATERAL

When a financial institution reviews an application for land purchase credit, it normally asks how much the purchaser is going to pay in cash, as a down payment ("Prima," in Honduras). Such payments reassure the bank that the buyer is risking some of his own money in the purchase, and hence will take the whole matter more seriously than he might if it were 100 percent financed by others.

2.4.1 Alternative Approaches

In the design of any land market financing scheme, one must always make a judgment as to the merit of simplicity versus the merit of market incentives to reward desired behavior. If it is seen as good public policy to encourage and reward buyers who are able to make a down payment, the interest rate could vary as a direct incentive to encourage buyers to put in some of their own money. At the same time, since lenders are more secure when buyers make a large down payment, they should be willing to accept a smaller "spread" in those cases. Table 2.2 illustrates such a system.

We recognize that the buyers least able to make a large down payment will tend to be the poorest, and hence a mechanism that charges them more appears unjust, even though in the eyes of the bank they are a greater risk. We also suggest an incentive for them: by making their payments punctually, they would receive a rebate of part of the higher rate that was applied to them because they could not make a down payment.

Table 2.2 Interest Rates as a Function of Down Payments (an illustrative example, and not our final recommendation as to rates)

Down payment	20%	10%	0%
Interest rate on loan	12%	14%	16%
Rediscount rate at BCH	6%	6%	6%
Spread for lending bank	6%	8%	8%
Incentive reserve			2% *

* Amount placed in a time deposit in the name of the land buyer, returned to the buyer upon faithful completion of the first two payments. Thereafter, the interest rate on the transaction reverts to the same 14% charged those who made a 10% down payment. There is no change in the discount rate at the BCH.

Solely for purposes of illustration, Table 2.2 provides an example of how such interest rate incentives might be provided in Honduras at the present time. Under present conditions, the only source of funds for long-term land purchase finance is likely to continue being the Central Bank, with ESF money. The Central Bank would rediscount these loans at the same 6 percent rate applied for loans with a 10 percent down payment. The lending bank would set aside two percent in a time deposit in the name of the buyer(s), and this amount would be paid to the buyer as a reward if the first two years' payments were made punctually. (If not, any expenses incurred by the bank to deal with the problem would be deducted, and the remaining balance could still be credited toward the balance due.)

2.4.2 Opinions of Honduran Bankers about Down Payments

The bankers interviewed generally would welcome a down payment in land purchase operations, but most of them felt that the risks of agriculture in Honduras are such that diversification in collateral would be even more reassuring. For example, if the buyer were able to mortgage an urban property, they would have more confidence in their ability to collect the loan made to finance the purchase of farm land. Even another parcel in another area would offer some guarantee that the buyer would not be wiped out by crop disease, hurricane, drought or low world market prices that only affected the land just acquired.

This is a reasonable proposition, and hence we would favor charging the lower interest rate ("with 20 percent down payment") for a buyer who put up other collateral. The banks likewise would receive a lower spread, in the example of Table 2.2, because they have less risk.

As usual, the mechanism thus responds to economic risks as perceived by the bankers, who are expected to assume the risk that the buyer will not repay the land purchase loan. The market financing mechanism could be criticized for hurting those least able to put up other collateral because they do not have land, let alone inventories, stock and bonds, Miami bank accounts, or other collateral to offer. If this is a primary consideration for policy makers, then other sorts of guarantees could be created, and we turn to these below.

2.4.3 Buyers Who Cannot Offer Collateral

If a land market mechanism is to assist campesinos, both individually and in groups, it will often be necessary to develop a method that allows banks to grant a loan, even though a buyer may have no other real estate to pledge as collateral.

For individual campesinos, a down payment is sometimes quite possible. Some of them have at least some savings, fearful of medical or other emergency requirements. Since they will have property against which they could get a loan in an emergency, they are likely to be willing to put that modest amount of money in as a down payment. (This assumes that there is a functioning system of production credit; otherwise, the money will be needed to help finance seeds, fertilizer, etc.)

Other campesinos already have one or two small parcels, and seek to add to them. They may thus be able to offer this land as well as the land now to be purchased, and reach the 160 percent ratio of collateral value, in proportion to the amount of the loan, which Honduran banks are generally required to obtain.

Still other campesinos will probably obtain a co-signer that the bank considers solvent, as a guarantor. If the co-signer is a relative or close friend, this may not require a payment by the campesino. In many cases, however, the campesino will have to pay the co-signer for this service. We did not find clear data as to the going rate for such guarantees in Honduras; in some other countries in Latin America, it runs about 10 percent of the amount of the loan, as a one-time price, payable in advance or out of the proceeds of the loan. For an eight to ten-year loan, this in effect adds another 1% to the interest rate.

Again, in Honduran conditions at present, the bank that has guarantees of this sort is as well protected as if it had a good down payment. In the example of Table 2.2 above, therefore, the buyer would receive financing at the rate appropriate to a down payment of 20 percent or more. From the lower interest rate on the land purchase loan, he would well be able to afford the payment to the private individual who provided the necessary co-signature required by the banks.

All of the bankers interviewed said that the 8 percent spread of the present ESF land financing mechanism is attractive, compared to the 5 or 6 percent spread they enjoy on other operations. Since Honduran laws and regulations require them to demand substantial guarantees for all of their loans based on real estate, it is clear that they in effect have no more risk than if the buyer had put up a relatively large down payment.

2.4.4 Guarantees for Campesino Groups

As indicated above, individual campesinos, even though poor, may well be able to obtain the collateral from a village lender or other individual co-signer, if they do not have liquid savings to use for a down payment. It is much harder for a group to persuade its members to put in their scarce cash resources in order to assemble a down payment; especially if the group is new or large, the members may be unsure whether they could get their money back quickly in a medical or other emergency. While they may favor buying and farming land as a group, they may also well not be willing to bet all of their savings on a successful result of the experiment.

Likewise, the bankers and village moneylenders alike fear that for political reasons, 30 to 60 families would not in fact be evicted by the police if their group failed to make land payments on time. All of our interviewees agreed that small farmers and other individuals who fail to make payments are easy to evict and the courts and the police do this regularly.

This uneasiness on the part of the banks and others who might serve as guarantors or co-signers is reinforced when a group has invaded the lands it wants to buy. Even when the group genuinely wants to buy, and merely acted in frustration at the delays and lack of resources at INA, it is unclear how the group can offer guarantees that are truly reassuring to the banks.

Only two of the bankers interviewed were willing to lend to groups for land purchase without other collateral. Worse, one of them was willing to do so only in one case, where the cooperative was fairly old, quite solvent, and where a loan for land purchase would lead to other business for the bank (e.g., export finance) that would be quite profitable to the bank.

Almost all of the bankers interviewed asked that a guarantee fund be established, from USAID funds or other sources not now available to them, that would underwrite the payments due on any land purchase transactions financed for campesino groups. Such a fund was also endorsed by Honduran government officials and even by some of the leaders of campesino organizations, who recognized the need to offer some kind of guarantee to lenders.

One banker, however, insisted that guarantees against what amount to political risks are only appropriate for investments by foreigners. He said that guarantees should not be given to Honduran banks; "We Hondurans have to learn to resolve our own political problems." What follows is distilled from interviews with him and with other Hondurans, as to how such a fund could be set up and operated to both give needed guarantees, and at the same time "change the rules of the game" so that there would be much less likelihood that a campesino group would default on a loan and nonetheless be able to keep the land. We return to the details of a possible guarantee mechanism in 2.8.2, below.

2.4.5 Financing by Sellers Themselves

In other countries, when land purchase financing is scarce or difficult to obtain, land sellers frequently wind up financing the operation themselves. That is, they transfer the land to a buyer, but keep a mortgage on it until the full price has been paid. If there is a first mortgage loan that does not cover the entire purchase price and the buyer hasn't got the money for the difference, the seller may well accept a second mortgage as his guarantee, and agree with the buyer on payments over several years for the amount by which the land price exceeds the amount of the first mortgage loan.

In Honduras, the following example might well illustrate the principles involved. Suppose that a landowner and a campesino group have agreed on a cash price of L/. 118,000 for fields adding up to 300 manzanas (210 hectares), which the campesinos have seized in a peaceful invasion. Let us suppose that the land is flat, fertile, and apt for almost any crop, and that its value in a "normal" market situation would be L/. 300,000, if it had not been occupied by the squatters. From the viewpoint of the group and of the bank, the price of L/. 118,000 is attractive, and can easily be repaid out of earnings to be generated from farming the land. No other collateral would be needed, if the bank could be assured that it did not run a "political" risk of non-payment.

Now suppose that the landowner instead demanded a price of L/. 240,000 for the land (which various "experts" value at L/. 300,000 in a "normal" market). Since this would be much more than 60 percent of the "commercial" market value of the land, a bank might agree to finance some L/. 180,000 (60%), but if the seller insisted on getting L/. 240,000, then he would have to take the balance of L/. 60,000 in a promissory note secured by a second mortgage on the land.

From the seller's viewpoint, self-financing would seem to be a sound way to obtain a much better price for one's land than is available when the seller insists on 100 percent cash. Nonetheless, many Honduran landowners who want to sell are clearly heeding the subjective risk factors. If and as peace and tranquility returns to the Honduran countryside (and to its neighbors), sellers are likely to become more interested in financing the part of the price that the banking system refuses to finance -- but sellers will also be raising their asking prices for the land.

The banks can also assist the sellers, by receiving the note in collection (typically, for a fee of 0.5 to 1 percent). The campesino buyer would deal only with the bank, paying each year on both of the debts. In the event of default on both, the seller would have to decide whether to abandon both the land and hope of ever collecting the second mortgage, or to himself negotiate with the bank to recover the land and assume (or pay off) the first mortgage.

Before turning to a possible guarantee mechanism, let us deal with several other technical aspects of land market finance.

2.5 GRACE PERIODS AND POSSIBLE ESTABLISHMENT GRANTS

In many countries, schemes to assist campesinos in buying land from either private sellers or the government itself build in an initial grace period during which payments are not required. The assumption is that the buyers are so poor that no payments can be made until they have gotten their feet on the new ground.

Unfortunately, in many cases, when campesinos do not begin making land payments promptly, especially for government-owned land, demagogic politicians frequently appear and persuade them that the land ought properly to have been a gift to them, and in short order the campesinos refuse ever to begin making payments. In some cases, little harm may be done, but in others the lack of scheduled payments means that other campesinos will not be able to buy land themselves. If it is generally expected that planned land payments will not in fact be collected, it is also likely that much of the land will be taken up by speculators rather than by persons genuinely planning to clear and farm it for themselves. Once the political dust has cleared and secure title is given to the occupants, these speculators resell or rent it (for cash) to other less aggressive campesinos, who do in fact want to farm it.

Because of this experience, many economists now advise that land payments should begin as soon as there are harvests from the land. They may be graduated; they may even include payment only of interest for the first years, but they should begin.

This does not ignore the real poverty with which some of the new farmers may begin. But the best way to address that poverty is not through forgiving or delaying land payments, but rather in more direct means. For example, food subsidies for a given time, and establishment grants of tools, seeds, building materials for a house, etc., are probably more efficient and more appropriate. Public works construction projects in the area, giving cash wage employment to the beneficiaries at times when they do not need to work on their land all day, are another effective alternative.

We recommend that the design of a land market mechanism also include, for campesino groups and probably for individuals, some sort of "establishment grants" that will help them get started. But we do not recommend grace periods that delay the first payments beyond the first harvest. The actual choice between level (equal) payments for each year or graduated payments, and a choice between yearly or more frequent payments, should be made in consultation with Honduran lenders and campesino organizations, and would probably vary among locations. It could also differ for campesinos with diversified crops and frequent harvests (e.g., vegetables) and those with only one or two crops a year (e.g., coffee and corn).

2.6 THE REFINANCING OF LAND DEBTS

Inevitably, even with complete good faith, some agricultural borrowers will be unable to repay production loans, let alone land purchase loans, because climate, market prices, or some other disaster strikes. In most such cases, experience elsewhere teaches that it is not a good idea to forgive all outstanding loans in an area (though politicians love to do it). At least some campesinos will have saved something; some crops will not be as affected as others, and a few crops may even have been harvested before the hurricane or drought wiped out all the rest.

Thus almost all production credit schemes now provide that the lending bank visit the area and the actual borrowers during the growing season, and record any anomaly while the crops are still growing. When an unavoidable natural disaster (or a market price disaster) actually hits, the lender can refinance with some confidence. If this is not done, there are always some borrowers who will sell their harvests to a private intermediary and then claim that the crop was a failure, and seek refinancing or even foregiveness of the loan.

In some countries (e.g., El Salvador), lenders charge a higher interest rate when they refinance an unpaid loan. While this is an incentive to pay if you are able, it also strikes most severely at those least able to pay. It appears to us that so far as land financing is concerned, with ESF funding, the spread now contemplated for the lending bank is ample to cover the risk and costs of field checking and refinancing where justified, so we do not recommend a higher penalty rate when the lender decides to refinance an overdue payment.

2.7 INTEGRAL FINANCING; THE WRAPAROUND MORTGAGE

Both bankers and campesino representatives agreed that land purchase credit is not sufficient in Honduran conditions. If the program is to be successful, it must go with production credit and provision for other credit requirements of the campesinos. Since the Central Bank also has rediscount lines for these credit plans, there is no reason that lending banks should not work with land buyers on a "package" which meets most or all of their needs and thus frees them definitively from dealing with "coyotes" or other moneylenders. (One exception would be cases in which one of these persons serves as a co-signer, for which he charges a fee, but in time the campesinos should be able to build up their equity to the point where they no longer need co-signers, or are able to provide this service for each other in solidarity schemes.)

Recent research on rural credit in Honduras (Stringer, 1983) reports that campesinos typically obtain non-bank credit from relatives or from private moneylenders. They use such credit for two main purposes: investment (sometimes long-term and sometimes as short-term as for financing harvest expenses when bank production credit was not available for this), and for personal emergencies, usually medical but sometimes others, such as a marriage or burial. Integral credit plans should thus contemplate both kinds of needs, if the campesinos are to become full participants in the national market economy.

2.7.1 Investment Credits

Once a cooperative or an individual campesino borrower has demonstrated competence in production and faithful repayment of production credit and early land payments, lenders could well ask if the borrower would not be able to increase profitability (and maybe even pay off the land debt faster) through carefully chosen productive investments. While such loans could be handled solely on their own merits, lenders will normally ask that paperwork be done to include the borrower's equity in the land as additional collateral for the investment credit.

2.7.2 Emergency (Personal) Loans

The research already cited (Stringer, 1983) found that much of the use of informal credit by campesinos in 48 INA projects was sought in order to meet unexpected major expenses, usually as the result of illness. In about half of the cases, such loans were obtained from relatives or friends. In most of these cases, interest was not charged, but many borrowers incurred large costs for travel to seek the loans directly, and from earnings lost while travelling.

Within the concept of integral credit, and as an additional incentive for faithful payment of land debt when due, we suggest that the campesino also be able to "tap" his land equity for low-cost personal loans in such emergencies. Once his equity has been built up to, say, 20 percent of the land purchase price, he might become eligible for "automatic" personal loans from the same bank for almost any purpose. The equity in the land would guarantee repayment of these loans, just as it does for investment loans and for the land purchase loan itself.

Instead of the several trips to town, and a wait of days or weeks to find out whether a loan has been approved, and to obtain the first disbursement under it, the campesino would now be able to obtain a personal loan on one trip, in one visit to the bank. Naturally, there should be a simple application form and reasonable limits--for example, such loans might be limited to a maximum period of 90 days, and could bear interest at "commercial" rates of 19 percent a year, and the maximum for each such loan might be set at L/. 100 or some other ceiling appropriate to the most frequent emergency needs.

The key concepts here are two: first, that it is a good policy to encourage campesinos to look to bank lenders for all of their credit needs, and secondly, that if the original paperwork is done appropriately, one mortgage on the land can serve as the principal guarantee for all future loans to the same borrower, with almost no delay or complicated application and review. This kind of approach is called the "wraparound mortgage," and it would make life simpler for both lenders and borrowers.

Of course, not all campesinos will welcome the concept at first. Having struggled hard to obtain a piece of land, they may not want to run the risk of losing it to the lender as the result of additional borrowing which they are unable to repay. In no case would borrowers be required to make use of the concept. For most, the decision would be made after they had made several land payments -- at which point the bank would advise them, during the annual production credit process, that the investment and emergency personal credits were also available if desired. The only difference from existing procedures used by lenders is that the original paperwork for the land purchase credit would include legal language making it possible for the borrower to subsequently use the same mortgage documentation as a guarantee for other loans by the same lender, without further expenses for lawyers, recording, and similar formalities (and delays) that go with even simplified mortgage lending.

2.8 THE 'SPREAD' AND ITS USE

The present L/. 4 million fund for land purchase financing provides that the lending bank shall charge borrowers 16 percent annual interest, and that the Central Bank of Honduras will rediscount the operations at 8 percent interest. That is, the Central Bank takes over the loan, returning to the lending bank the amount of money it originally paid out, less 8 percent per year for the entire period of the loan, on the balances that will be due each year. The lending bank still collects each payment when due, but remits the principal amortization to the Central Bank, which is now the "owner" of the loan.

Since the first loan application had not yet reached the Central Bank when we were in Honduras, the Central Bank had not yet made up its mind as to how all of the details were going to be handled. For example, interest could be deducted in advance (by discount from the proceeds of the loan) or could be collected with each payment. The Central Bank staff expected to apply the same procedures used with other rediscount lines of credit, but no detailed regulations had yet been prepared. While we discussed several alternatives open to the Central Bank, it was clear that the staff proposed to set up the rules once the first actual applications were in hand.

Particularly in any future expansion of this program, there are some opportunities to increase the probability that it will achieve its stated objectives. We review these, with recommendations, in the next chapter of this report. However, it is clear that those concerned (BCH, USAID, INA, interested banks and campesino organizations, among others) will need to decide on the trade-off between a mechanism which is very simple, but may not achieve all of the stated objectives, and one which is more complex but contains incentives for borrowers and for lending banks to operate in specific ways. We are perfectly prepared to draw up a mechanism in either manner, and the ideas that appear in this report are intended to illustrate what could be done. We do not expect that all of them would -- or should -- be incorporated in the final design of the land market mechanism.

For example, we were told that there are likely to be ample ESF funds available, should demand for land purchase loans exceed the original L/. 4 million, as we confidently expect. In that case, we are not persuaded that the 8 percent interest now collected by the Central Bank and added to the capital of that fund, need be so applied. Instead, one might consider certain other priority uses of the money, as follows.

2.8.1 Technical Assistance

While each bank would undoubtedly continue to provide some field visits as part of the production credit process, we found a general consensus that the existing technical assistance organizations were unable to serve all the existing campesino groups, much less individual campesinos desiring such service. At the same time, the Honduran government has shown some interest in encouraging non-governmental organizations of the private sector to provide such service, for a fee to be paid by farmers.

The land market mechanism could provide, for example, that each borrower for the purchase of land could choose freely the group, company or individual that would provide him or her with technical assistance during the coming year. The honoraria and expenses of the technical assistance provider could be paid with a part of the interest now paid to the Central Bank -- for example, with up to 2 percent per year on the amount outstanding for the purchase of land financed under the land market mechanism. For land purchased by groups at the present ceiling of L/. 25,000 per member family, 2 percent on the loan would be L/. 500 per family for the first year. For a campesino group with 10 or more families, this would make it possible to contract with a variety of people who would want to sell technical assistance.

Among others, technical assistance could be offered by the campesino organizations, by the Ministry of Natural Resources, INA, and by private professionals. Even in our short stay in-country, it appeared clear that there would be no shortage of eager would-be providers of technical assistance if honoraria of this amount were available to pay them.

While the amount available each year would decrease as the land debt was paid off, other families would be entering the land purchase program and hence the opportunities for providers of the technical assistance would continue to grow. By the time the land debt was totally paid off, or nearly so, either the campesino would have learned all he or she needed to know, or whould be convinced that the technical assistance was worth its cost and hence should be paid for as a production cost each year.

As one mechanism for handling payments, we would suggest that a lending bank should pay the honoraria to the provider, on receipt of a simple form describing the date of visits and the services provided to the campesino. The bank would no doubt take the opportunity to talk with the provider, thus learning more about the borrower's farming practices and plans, and making it easier to run the bank's own production credit program. In fact, the technical assistance program would thus lower the cost of running the bank's own production credit program, while probably making the production credit more productive.

One of the major duties of the provider of technical assistance would be precisely that of making out all necessary application forms, farm plans, etc. with the campesinos, and getting them back to the bank on time, so that the credit appeared when needed. Another would be to help with marketing, and the technical assistance providers could be charged with the duty of helping the bank make sure it does get repaid out of the sale of each harvest, even when crops are sold to "coyotes" or other alternatives to government market support schemes.

The resulting competition among would-be providers of the technical assistance is likely to be quite healthy. And the fact that the campesinos, borrowers in the land market finance mechanism, are free to choose the supplier of their preference, is likely to mean that the advisers will be much more attentive to the needs and full situation of the campesinos, than when they get the same salary from the same government agency when they do good work or when they do not. It is likely that the national campesino organizations will themselves provide technical assistance, as some of them already do on a small scale. This will give them another way to cover their overhead, and at the same time help them find a productive way to keep busy even after the basic struggle for access to land has been won.

2.8.2 Creating Guarantee Funds for Loans to Campesino Groups

As mentioned above, several Honduran banks indicated that they would be willing to lend to groups for land purchase if, and only if, a guarantee of repayment were provided by someone else. Most of them expressed the hope that USAID would fund such a land market guarantee program. Only a few were aware that in the USA, there are mortgage guarantee companies in the private sector as well as in the Federal government, providing guarantees on the basis of a small insurance premium charged to the borrower.

In the event of a default by the borrower, the lender would endorse its interest in the mortgage over to the guarantee fund, which would pay off the debt. It would be up to the fund, then, to attempt to collect from the borrower or to evict the borrower from the land and sell it. (Or, if land reform lands are involved to evict the first group of campesinos and bring in othe. ..)

2.8.3 The Problem of Collecting Loans Based on Land

Leaders of some of the campesino organizations, and of INA, stated that they are dedicated to restoring the good image and public credibility of their organizations. They thus assert that there will be no political risks, but they accept as a fact that in the past, land has been seized and the invaders were not in fact evicted for political reasons.

INA itself granted some small, short-term production credit in 1982, and is properly proud of its very high recovery on those loans. INA's current leaders assert that they will not hesitate to take necessary legal steps to enforce collection efforts. In addition, they aspire to expand the technical assistance function of INA. Borrowers will thus both earn more (and be able to repay), and be made more aware that INA is watching them and the debt will have to be repaid.

Any loan guarantee program will need to be drafted with care in order to avoid the problems which prevented the successful execution of such projects in several other Latin American countries. It will also be necessary that INA and the banks continue dealing directly with campesino organizations, based on mutual respect.

One problem with other guarantee schemes has been that the parties authorized to declare that a default has happened, and to approve disbursement of guarantee funds, often have little to lose and much to gain by being generous and quick to do so. This is likely to lead to the rapid depletion of guarantee funds. We here propose to make the decision to disburse guarantee funds be a genuine cost to those who may well have the power to prevent a default in the first place. In other words, the incentives would be structured to make the program work, and not to encourage any participant to default, nor any politician to encourage default.

2.8.4 A Possible Example of a Guarantee Mechanism

We would suggest that a further portion of the 8 percent now collected by the Central Bank on land market purchase loans be earmarked to create and help fund a guarantee program. Borrowers without substantial other collateral of their own would also be required to obtain the co-signature of one of the campesino organizations or of a private individual or company acceptable to the lending bank.

For this guarantee, borrowers would pay a premium -- perhaps 2 percent on the amount of debt outstanding each year for land purchase -- to the guarantor. It would be collected by the lender, as a surcharge on the interest rate, and would be placed in a savings deposit account in the name of the guarantor, in the lending bank. The bank would have the right to draw from that fund to make good on any payments in default; if the payments were subsequently made, the money would be redeposited in the account of the guarantor.

In the detailed "carpentry" of setting up the Guarantee Fund, one would set rules providing that the Central Bank, out of the interest it collects on the land purchase loans rediscounted, would reimburse the lending bank for shortfalls if the guarantee fund in each bank were insufficient to cover a default. Indeed, to help get things started we would suggest that the Central Bank match all payments of guarantee premiums, depositing a like amount in the savings accounts of each guarantor organization for the first several years. This would take another 2 percent on the value of each land purchase loan.

To make the incentives crystal clear to the campesino or other organizations providing guarantees, we would also suggest that at any time that the balances in their savings accounts were more than 20 percent of the loans currently guaranteed, but not overdue, then the organizations could draw the excess freely to use as they see fit. With the aid of the Central Bank matching deposits just mentioned, this would normally happen in the fourth year of the mechanism. The incentive could be made to work even sooner, if USAID or the Central Bank were to make an initial grant of, say, L/. 25,000 to open the guarantee accounts for each campesino organization when it co-signed its first land purchase operation at a given private bank.

The 20 percent rule would assure the banks that at least two year's worth of land payments could always be recovered easily, from a guarantee account in its own savings department. (These accounts would of course bear interest at the usual market rates for time deposits, and the bank would be lending the funds to other customers.)

In this way, each guarantor organization would have a tangible reason to want to exercise its own social and political pressure on its members, to be sure there was no default. And a campesino organization leader tempted to back members who wanted to default but to refuse to leave the land so others could come in, would have to recognize that it would cost his organization real money -- money that if there were no default, it could use for whatever it liked. This should increase responsibility in any organization that for whatever reason, might have lacked it in the past.

For individual campesinos not affiliated with organizations, INA might be the guarantor -- and even though INA is a national government agency, we would suggest that it participate in the same way in establishing guarantee accounts and that its director be equally free to withdraw and use "excess" guarantee funds at discretion for INA's programs. We would be equally willing to see the program structured to encourage private insurers to offer guarantees, though there should probably be a minimum size rule so that they would become diversified insurers, rather than just friends or relatives of one or two individual borrowers. Given the political nature of the problem as perceived by Honduran bankers, however, the campesino organizations seem to be the logical place to focus any effort to establish a Guarantee Fund that would be a positive element to encourage payment, rather than default, and yet would make it much easier for banks to lend to campesinos groups.

2.9 ELIGIBLE BORROWERS AND THE TARGET POPULATION

If the funds available to finance land purchase were sufficient to meet all the probable demand at the interest rates and other terms recommended, there would be no need to ration credit with rules defining who is eligible. However, it has been a long time since Honduras had long-term credit available for land purchase (except for foreclosed land which banks are trying to sell off). Many of our interviewees thought that the initial L/.4 million fund would be depleted in just a few months. We met trained professionals eager to buy land and go into farming; and we met with campesino federation leaders who assured us that they have long lists of groups that would like to buy land, as an alternative to waiting for INA to find some it can expropriate and pay for in bonds.

The land the campesinos want to buy is, in general, in parts of the country where there is no public land left that can be expropriated. It tends to be valley land, located along good roads, and to have fertile soils. When the campesinos are able to buy it, they will at last have reversed the situation in which the cattle of the wealthy fatten in the valley, while the poor eke out a miserable living trying to grow corn on the 45 degree slopes of the hills.

We did not find any banker (or anyone else) opposed to plans to help campesinos buy land, as opposed to expropriating or even invading it. We did learn that a few banks also see in the plan a method to reduce even the little long-term lending they now do for land purchase.

When a borrower defaults on a loan and the bank forecloses on land he had pledged as collateral, the bank is never able to find someone willing to buy the land for cash, in the amount owed on the loan. As a result, though the land is put up for auction, the bank itself is always the only buyer. It then looks for some other person willing to buy the land for the overdue debt -- and invariably finds that it must finance the deal for at least 3 to 8 years. It does so, reluctantly, and as there has not been any rediscount "window" at the Central Bank for land transactions, it uses its own resources.

It appears that one or two banks, at least, see the land market mechanism as a wonderful opportunity to unload these loans onto the Central Bank. They will find a qualified buyer. If the debt is too large for the L/. 50,000 and 25,000 limits, they will divide the land into parcels that fit under the limits. But the motivation will be to end the use of their own resources for long-term lending for land transactions, rather than solely to create more private farmers and other social goals of the plan.

We do not necessarily say that it is bad public policy to enable banks to get land they have foreclosed upon into the hands of other people who want to farm it. We merely wish to note that an unintended result of the plan may be that the banks make even fewer loans for land purchase out of their own resources, than they do now. With appropriate rules on eligibility of buyers (mainly, genuine campesinos and small farmers) we have no real problem with this, and expect that it will be a small part of the total use of the land market fund. However, the banks are acutely aware of their problem loans, and so some of the earliest applications may be of this type.

It is also possible that sugar refineries or other large commercial plantations will move to divide and sell parcels to their own employees (or others), and thereafter buy cane or other export products from them. Again, we see social and economic advantages from this and do not oppose it, though we would hope that participation could be broadened to include other landless persons in addition to the present employees of the companies.

It appears that the principal desired buyers are of three types: individual campesinos, campesinos working in groups, and persons with professional training or managerial experience in farming. These three classes will easily exhaust the present funds as well as possible additions, and it would appear to be a good idea to make sure that all three classes are among those who benefit from the plan. We would suggest that the banks be told to look for borrowers in all three categories, and that rules be published along something like the following lines. (These were mostly suggested by Central Bank staff during a meeting with us.)

- Be a Honduran citizen, and over 16.
- Obtain most (e.g., 75%) of one's earnings from some activity related to farming.
- Not have debts outstanding for the purchase of other lands.

- Not seek to obtain, in the proposed purchase plus any other land owned, more than the amount of land established as the family farm unit in the Law of Agrarian Reform and the Titling Project. For small commercial farmers, this would be not more than 50 manzanas (35 hectares) with good soil, or the equivalent in poorer land. For groups, it should be not more than the family unit in the land reform legislation. For that matter, the group should also promise not to divide parcels eventually assigned to its members, into plots below 5 hectares per family.

- Each applicant should indicate how the purchase will lead to the land fulfilling its social purpose: e.g., the land will be possessed by persons planning to work it directly and to increase its productivity, and the purchaser is not acquiring it mainly for speculative purposes.

- The applicant, and his or her bank, demonstrate that the bank is ready and able to provide appropriate production credit, or alternatively that the buyer has such resources of his or her own. The applicant should indicate either that he or she is qualified in technical and management matters, or that a provider of technical assistance acceptable to the applicant and to the lending bank, has been lined up.

3.0 THE FOUR MILLION LEMPIRA FUND TO STIMULATE THE LAND MARKET: SOME SUGGESTED MODIFICATIONS

A fund has been established in the Central Bank of Honduras, to rediscount long-term farm purchase loans made by the private commercial banks. The fund contains L/ .4 million of ESF money; at the time of our in-country work, no loans had yet been made. The present rules for the fund are set forth in section 3.1. Our analysis and recommendations appear in section 3.2; they are based on extensive discussions with representative bankers, plus the experience of other countries, and valuable information and insights gathered on field trips to the Northwest regions of Honduras, and in discussions with campesinos, campesino organization leaders, landowners, government functionaries, and others interested in a more healthy land market.

3.1 DESCRIPTION OF THE FUND

The present basis for this fund is set forth more fully in Implementation Letter #22, dated May 26, 1983, signed by Mr. Anthony J. Cauterucci, AID Mission Director, and addressed to Lic. Arturo Corleto M., Minister of Finance and Public Debt; to Lic. Gonzalo Carias Pineda, President of the Central Bank of Honduras; and to Lic. Ubodoro Arriaga Iraheta, Director of the National Agrarian Institute (INA).

1. Implementation Letter #22 replaced Implementation Letter #3, dated February 18, 1983. Nothing in I.L.#22 modifies the Agreement on the Program of Economic Reactivation, nor I. L. #2.

2. The funds are to be used to finance the sale of farm lands held in freehold tenure to small individual farmers or to cooperatives. Persons holding land under usufruct tenure may sell land under this program, by first converting their holdings into freehold title under existing laws.

3. These funds may be used to finance up to 100 percent of the land sale price, and the loans will be backed by a non-assumable first mortgage. The lending bank may demand other reasonable collateral, at its discretion.

4. The selling price for the land will be whatever price is negotiated between the buyer and the seller.

5. Upon request, INA will inform the private banks as to tenure status and as to whether a specific property is eligible for expropriation. INA will also help buyers of land under this program, to obtain a freehold title through existing legal procedures.

6. INA will not give any financial guarantee to the banks with respect to these loans.

7. The L/. 4.0 million available in the Special Account in the Central Bank of Honduras for this activity will be utilized to discount mortgage loans made by private commercial banks.

8. No farm family may buy more than one property under this mortgage program.

9. The mortgage loans will be made at interest of 16 percent/year to the buyers, and for terms not to exceed 10 years.

10. The lending bank may allow a grace period of up to one year, but only on amortization of the principal amount.

11. The lending bank may ask the buyer for a down payment.

12. The mortgage loan may not exceed L/. 50,000 per family, or if the buyers are a group or a cooperative, the loan may not be more than L/. 25,000 per family in the group or cooperative.

13. The Central Bank will discount the mortgage loan at 8 percent interest, for the same term as that established by the lending bank.

14. The Central Bank will place the entire L/. 4 million at the disposition of the private banks, as soon as Implementation Letter #22 is signed by the heads of INA and the BCH. The Central Bank will notify the private banks of this program, within 5 days of the time the funds become available.

15. All 15 of the private banks may take part in this plan, first come, first served, and no quotas will be established for any one bank. Every bank that finances a mortgage should report this action to the Central Bank within 7 days.

16. These resources will be used for the purpose described until AID and Government of Honduras agree otherwise in writing.

3.2 RECOMMENDATIONS AND SUGGESTED MODIFICATIONS

In previous sections, we have presented a number of specific recommendations. Some are for general application, and others refer specifically to the ESF fund of L/ .4 million. All, however, refer to the creation of a mechanism that would strengthen the land market, now extremely inadequate. In this section, we propose modifications to allow better functioning of the L/.4 million fund. (References to clauses by number refer to the numbered clauses in Implementation Agreement #22, unless it is otherwise stated.)

- Clause #3 states that these funds may be used to finance up to 100 percent of the land price. We have suggested that it is good credit policy to encourage a down payment, so that buyers will be more involved with their farm operations, and more likely to honor their debt obligations than with 100 percent financing. Thus we suggest a higher interest rate for loans at this level, and a lower rate for loans to buyers who make a down payment out of their own resources. We realize that otherwise eligible buyers may for various reasons not have funds for a down payment, and we do not wish to exclude such persons. Thus we need to find funds for 100 percent financing, which in principle is not allowed under the banking regulations.

- Clause #6 states that INA will not give any financial guarantee to lending banks. However, our own analysis concludes that various entities could co-sign for groups, so they too could finance their credit needs. In fact, we suggest that AID (or someone) make grants to the guaranteeing institutions. Most of these are campesino organizations, but we suggest that INA could well serve as guarantor for individual campesinos and small commercial farmers who are not affiliated with any organization.

- Clause #7 states that the 4.4 million will be used to discount mortgage loans, but it is not yet clear what procedures will be followed to make the rediscount operation function well. As a result of our discussions with Central Bank staff, we recommend further consideration of this issue as soon as possible to decide the requirements and procedures to be followed, and to communicate these to the banks.

- Clause #8 bars any farm family from acquiring more than one property under this program. We agree fully, but would like to see other limits as well, as shown in 2.9 above.

- Clause #9 specifies the interest rate to borrowers (16 percent) and the maximum term of the loan (not more than 10 years). After listening to many viewpoints, and considering the social and economic condition of rural Honduras, we believe that this level of interest is too high. We propose a rate of 13 percent for the rest of 1983 and for all of 1984. We even suggest that this rate could be lowered or raised according to the amount of any down payment that buyers made. We also suggest that the interest rate for new mortgage loans vary from year to year, according to market conditions at the source of funds.

We do agree that 10 years is the upper limit. We believe that this is a breaking point, and that if the time limit is higher this only benefits the seller (see Table 2.1).

- Clause #10 allows the granting of a grace period of up to one year. We would limit this to only a few special cases, and would never waive payment of interest. If the borrowers are poor, then 'Establishment Grants' to deal with the costs of moving and setting up one's new household are more appropriate than grace periods.

- We favor down payments whenever possible, as mentioned in Clause #11. If the down payment is high enough, we would give the loan at a lower interest rate in recognition of the buyers' commitment and the resulting greater security for the lenders.

- Clause #12 specifies money amounts that can be financed. We suggest that the limits also be stated in terms of the amount of land that can be bought with the credit. This should be spelled out for individual campesinos, members of a group, and commercial farm operators.

- Clause #13 refers to the interest rate of 8 percent, which the Central Bank applies when rediscounting mortgage loans. Under this program, lending banks make a 'spread' of 8 percent. This is the difference between the 16 percent paid by the borrower, and the 8 percent charged the lending bank by the Central Bank. If the interest to borrowers is cut as we suggest, and if the spread is to be kept at present levels, then the share of the Central Bank will have to be cut. That share now goes mainly to increase the fund. We feel that the fund should be increased with other resources, rather than continue interest rates that buyers cannot afford.

- Clause #14 states deadlines for putting the fund into operation. For reasons not at all clear, these were not respected. The bankers with whom we spoke were in general quite interested in using the fund. They also informed us in detail on the capital market in Honduras. Some of the interviewees had not paid much attention to the Central Bank's mailing, but thought about it at some length when we came calling in person. (Although our purpose was to get information, the very act of making an appointment says "This is important" to the banker. We thus may have caused some private bankers to think about the Fund even though we were just seeking information -- "Hawthorne Effect." Many of the bankers came up with ideas during our visits, and we expect them to take advantage of the land market fund in coming weeks.

As often happens in development projects, we believe that it is important that USAID assign followup tasks to someone, if this Fund is ever to get off the ground. There is agreement in general at the Central Bank about who ought to be eligible, for example, but it hasn't yet been put in writing and sent out to the member banks as guidance.

Finally, we recommend that the L/. 4 million be divided among several groups of eligible beneficiaries. In our opinion, a significant fraction should be earmarked for campesino groups. We suggest that 50 percent would probably be an appropriate fraction. INA's leadership stated that L/. 2 million would about cover the present demand and that which is foreseeable in the near future, for credit to groups. The balance should be split between small commercial farmers and individual campesinos, to ensure that each group is represented among the beneficiaries of this program. Of course, the suggested allocations could be changed each year or whenever new resources become available.

4.0. CONCLUSIONS

As a result of our stay in Honduras, the team would like to draw three general conclusions concerning the implementation of a land finance mechanism. These are briefly presented below:

4.1 RELATIONSHIP BETWEEN THE TITLING PROJECT AND A PROPOSED LAND MARKET MECHANISM

On the surface it might appear that the two programs, Land Titling and Land Marketing, would not necessarily have the same objectives, and would therefore not be easy to integrate. We nevertheless believe that the considerations listed below would argue for the contrary.

The Titling Project has already begun activities in Santa Barbara, which is one of the most densely populated regions of the country, where there is almost no land available which can be expropriated. This augurs well for the selection of this department as a priority area for the initiation of the land market program. The same target population and the same geographical location make for a logical combination of efforts.

In order to implement the Titling Project, INA has established several field teams of multidisciplinary composition. These teams work at the field level collecting data, informing the population as to the activities of the project, and documenting disputes. As such, they have become quite knowledgeable on the socio-economic status of the region and would be an invaluable source of information in the monitoring of a land market program. We therefore recommend that INA perform a coordinating role, both within the proposed land market program, and between that program and the Titling Project.

Lastly, the Titling Project is in the process of converting thousands of small coffee growers into rural land owners. However, many of these campesino farmers will be owners of one or more extremely small parcels of land, often too small to provide for family subsistence. These farmers have, and will continue to have, a strong desire to increase their land size in order to improve their standard of living. A land market program could concentrate part of its efforts on this group of unorganized, independent producers of an export crop, so that they could gradually 'trade up' to family sized units. In other words, the coffee areas, and their individual farmers could receive priority attention under this program.

4.2. WHERE TO GO FROM HERE?

As might be expected, various of our suggestions and recommendations have have been left at the general level, and therefore can not be implemented immediately. This is perhaps justified, however, by the complexity of the subject and the shortness of our stay in Honduras.

We would see the next few months as a period of negotiations during which various decisions will have to be made quickly, since they could facilitate implementation of the already initiated L/. 4.0 million fund. These would include: interest rate, spread and its uses, the actual rediscounting procedures and elegibility criteria. On the other hand, there are other issues which can wait for further study. An example from this category would be the creation of loan guarantee funds. The decision points for this issue would be: how they would be managed, the premium to be paid by borrowers, the size of the reserve to be required, and the rules of qualification for guarantor organizations.

4.3. MONITORING AND EVALUATION REQUIREMENTS

What is being proposed here is a relatively new attempt at relaxing at least one of the constraints to agricultural development in Honduras. As such, problems in its implementation stage must be anticipated, if not always identified beforehand. This would require the establishment and implementation of an information system which will allow for the continuous monitoring and evaluation of the project. Periodic review and analysis of project progress will allow for timely adjustments in implementation procedures.

The methodological design of such a system should include: 1) an institutional analysis component which would measure the effectiveness and sustainability of the institution eventually chosen as the implementing agency, and 2) a field activity which would monitor the impact of the project on recent land purchasers. These beneficiaries could be grouped into the three small farmer categories: individual campesinos, campesino groups, and small scale agricultural entrepreneurs.

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