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AGRICULTURAL POLICY ANALYSIS PROJECT, PHASE II

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EL SALVADOR AGRICULTURAL POLICY ANALYSIS ASSESSMENT SYNTHESIS

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1. INTRODUCTION

The following Agricultural Sector Policy Assessment summarizes the work of more than ten consultants over a ten-month period between November 1992 and September 1993. The work was carried out through the Agricultural Policy and Planning Project II (APAP II) under Abt Associates, Inc. of Bethesda Maryland. The Salvadoran Foundation for Social and Economic Development (FUSADES) was subcontracted to work with the Assessment Team in the areas of Salvadoran law, banking policies, and logistical backstopping.

Quoting from the Scope of Work, the purpose of the assessment is to assist the Mission in the development of "...a series of ESF policy conditions to be presented to the incoming GOES after the 1994 elections. In order to assist the GOES to implement the conditions, an **Agricultural Sector Modernization Project** will be prepared and ready to strengthen the policy analysis, dissemination, implementation, monitoring, and evaluation capabilities of selected GOES and private sector institutions." Therefore, each component chapter, as well as this Summary, includes an analysis which responds to the tasks listed in the Scope of Work and policy recommendations which can be used by the Mission.

It is not a comprehensive assessment of the Salvadoran agricultural sector, but is rather targeted at four specific areas thought by the designers of the Scope of Work and the Mission's Agricultural and Natural Resources personnel to be the most significant to rejuvenate the sector after 12 years of civil strife. These components are: Agricultural Credit; Debt Overhang and other Barriers to Entry; Land Tenure; and Trade and Investment. (A fifth component concerning Privatization and Agricultural Input Markets was originally part of the Assessment but was dropped due to GOES progress in this area.) The four components were coordinated and supported by an assessment chief-of-party and an administrative assistant.

Each of the assessment reports is quite lengthy and therefore has its own Executive Summary. Additionally, an overall Executive Summary is offered for those desiring a general knowledge of the assessment, and a set of policy matrices is also included to allow for a quick appraisal of what is being recommended by the various component teams.

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Logistical backstopping, moral support, and continuity in our endeavors.

Ms. Blanca de Velasquez, FUSADES

2. METHODOLOGY

Within each of the four component teams the tasks, or portions of tasks, of the Scope of Work were divided among the members according to each individual's areas of expertise. A team leader was designated for each component to be responsible for coordination at the component level.

The principal methodology used by all teams included intensive interviews with key informants, field interviews with randomly selected farmers and others, and a search of the extensive libraries of the Mission and FUSADES. On two occasions various members of the teams were able to arrange for helicopter 'flyovers' of the agricultural regions of the country. This was important in that it gave the team members a better sense of the dramatic percentage of land left idle as a result of the war, a better idea of the country's different climatic regions and the crops that could be grown there, and information on the physical infrastructure that will be required to support agricultural development in the future.

With some planning, and a stroke of luck, the work of the teams was made more precise and up-to-date through the utilization of two important databases the agricultural sector. While no Agricultural Census has been performed since 1970, the Ministry of Planning over the past few years has been conducting household surveys and has recently expanded its scope to include rural areas and a sample size of 20,000. The raw data for the latest survey was provided to the Land Tenure team, which was able to analyze it in depth, thus providing a firm basis upon which to base policy conclusions. The results of this data analysis were also utilized by the other component teams.

The Land Tenure team was also provided with resources to contract out a survey of small farmers with particular emphasis on issues of land tenure, agricultural credit, and profitability in agriculture. The survey was directed at 1,200 randomly selected rural farm families and was divided into 4 strata: ISTA cooperatives and their members, FINATA land reform recipients, "tenedores" or squatters primarily resulting from the war, and a national category for those not belonging to any of the other categories and against which the team could compare the various types of land reform attempted against a national average. Of particular interest is the fact that with many of the key indicators both surveys yielded similar results. Likewise, the members of the other component teams utilized the data from this survey.

The availability of these two data sets is extremely important to this assessment. They provide sound and timely data, at times in stark contrast to widely held views, for the basis of agricultural policy by both government planners and donors such as USAID and its planned Agricultural Sector Modernization Project.

3. THE COMPONENT MATRICES

In an attempt to assist the reader, the following policy matrices are offered on a component-by-component basis. Each matrix represents the specific policy recommendations for each component in terms of the: goals/objectives; actions to be taken; the indicators which will measure progress given an established timeframe; and special comments.

3.1 Agricultural Credit

Action is recommended in five broad areas: ((1) macroeconomic policy; (2) organizational structure and rules; (3) credit operations; (4) banking infrastructure; and (5) client creditworthiness development.

TABLE 3.1

POLICY MATRIX TO IMPROVE THE FUNCTIONING OF EL SALVADOR'S AGRICULTURAL FINANCIAL SECTOR

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENTS
I. Maintain Adequate Macroeconomic Environment			
A. Encourage the Central Bank (BCR) to continue relying on Open Market Operations (OMO's).	<ul style="list-style-type: none"> ● Assist BCR in training staff in liquidity forecasting and OMO's. 		The BCR needs to rely on OMO's as the premier instrument of monetary policy and not the obligatory placement of bonds.
B. Encourage the Central the Bank to devalue the currency	<ul style="list-style-type: none"> ● Encourage the BCR to study the feasibility of intervening in the currency market in order to lower the value of the colón. 		Appreciation in the real effective exchange rate due to the influx of dollars from expatriate workers and donors is reducing export competitiveness. This phenomenon may be temporary, and a deliberately undervalued currency would help in the shortrun.
II. Improve Organizational Efficiency			
A. Reform antiquated BFA and Fedecredito creation or organic laws	<ul style="list-style-type: none"> ● Change loan limit authority for both institutions. ● Abolish Assembly of Governors. ● Change composition of Board of Directors for both institutions. 	<ul style="list-style-type: none"> ● Achieve within six months. 	Insulating the two institutions from undue political pressure as well as appointing persons knowledgeable in finance, banking, and business are essential.
B. Restructure BFA and Fedecredito	<ul style="list-style-type: none"> ● Further decentralize authority in BFA. ● Reduce central office staff in both institutions. ● Reduce the number of departments in BFA. ● Aggressively train, recruit, and retain high skilled workers. <p>Conduct employee satisfaction poll and exit interviews in order to determine the cause of high-personnel turnover.</p>	<ul style="list-style-type: none"> ● Formulate reorganization plan within 1 month after completing a strategic plan. 	Both institutions have overly large central offices, high personnel turnover rates, inappropriate skill distribution profiles, and high operating costs. Measures should be taken to improve the situation immediately.
C. Install performance-based personnel incentive program	<ul style="list-style-type: none"> ● Adopt more highly quantitative personnel evaluation systems, especially in Fedecredito. ● Emphasize "up evaluation," or line staff reviewing managers. ● Offer substantial bonuses to outstanding performers. ● Encourage agency and/or unit competition and reward winners in a tangible way. 	<ul style="list-style-type: none"> ● Adopt within a year. 	

TABLE 3.1 (cont.)

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENTS
<p>D. Build quality assurance/quantitative management culture</p>	<ul style="list-style-type: none"> ● Develop a strategic plan in each institution. ● Adopt Total Quality Management (TQM) techniques, or a similar participatory, team approach to management with feedback loops. ● Gather data on process time and costs for all job actions and operations. Strive to eliminate bottlenecks and cut costs. 	<ul style="list-style-type: none"> ● Develop strategic plan and timetable for implementation within 2 months. ● Select and train a team in TQM or other modern management techniques within four months. ● Initiate cost and efficiency studies within five months. ● Formulate recommendations and implement within year. ● Use a multitude of numerical measures to monitor progress such as productivity per worker, cost of intermediation, interest rate spread, subsidy dependence index, loan collection rates, etc. 	<p>Management based on the use of timely, reliable information and the creation of a strong sense of team spirit and dedication are essential if costs and inefficiency are to be reduced.</p>
<p>III. Improve Financial Viability</p>			
<p>A. Protect/augment capital base</p>	<ul style="list-style-type: none"> ● Encourage GOES to rapidly restructure Fedecredito's portfolio and recapitalize the Federation. 		<p>The quality of loan services of the two state-owned financial institutions is unacceptably low.</p>
<p>B. Increase outreach to poor</p>	<ul style="list-style-type: none"> ● Mount promotional campaigns that emphasize sustained access rather than low interest rates. See Section V.B. 	<ul style="list-style-type: none"> ● Develop a plan and implement it within a year. 	
<p>C. Lower operating cost</p>	<ul style="list-style-type: none"> ● Streamline the loan application process. Aim to reduce turnaround time to a matter of 3-4 weeks. ● Depend more on character references, advance deposit schemes, joint liability, and liens as opposed to mortgages. ● Develop and/or resuscitate modalities of credit delivery for the rural poor, possibly with the collaboration of selected NGO's. Innovations should include group credit, graduated lines of credit, mobile banking, use of food processors, mills, exporters as secondary intermediaries. 	<ul style="list-style-type: none"> ● Develop a plan and implement it within a year. 	
<p>D. Lower delinquency rates</p>	<ul style="list-style-type: none"> ● Use repayment incentives such as interest rebates and guaranteed access to graduated loans to encourage prompt repayment ● Employ aggressive loan collection techniques, including foreclosure, and reduce tendency to refinance bad debts. 	<ul style="list-style-type: none"> ● Develop a plan and adopt it within a year. 	

TABLE 3.1 (cont.)

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENTS
IV. Improve Banking Infrastructure [Should be done with Sector Modernization Project]			
A. Improve rural telecommunications	<ul style="list-style-type: none"> • Conduct needs assessment and coordinate with ANTEL and CEL to see how most pressing needs can be met. 		
B. Encourage continued computerization	<ul style="list-style-type: none"> • Fully computerize loan processing operations as soon as possible. 		
C. Promote development of a credit bureau	<ul style="list-style-type: none"> • Have BCR or SSF coordinate and manage client database integration for all financial institutions. • Conduct a feasibility study of creating a private credit bureau. • If feasible, publicize results and encourage private entities to establish one or more bureaus. 		
D. Encourage savings mobilization feasibility study	<ul style="list-style-type: none"> • Contract consultants to conduct a rural savings mobilization study. 		
E. Encourage training and exchange programs	<ul style="list-style-type: none"> • Develop training programs in management, financial analysis, deposit and credit operations, and computer literacy. 		
V. Improve Client Creditworthiness Development [Should be done with Sector Modernization Project]			
A. Coordinate with donors to strengthen MAG/CENTA	<ul style="list-style-type: none"> • Help CENTA to develop an effective agricultural research program aimed at medium and small farmers. • Help MAG/CENTA to develop an effective extension service. 		The World Bank has a project which aims to restructure and strengthen MAG. Currently the Israeli Government is providing assistance to MAG in extension. Reinforce what these two donors are doing.
B. Use NGO's to groom marginal borrowers.	<ul style="list-style-type: none"> • Develop a plan to identify a few competent NGO's to organize, train, and provide extension services to groups of small farmers who would be eligible for access to credit from BFA. After several tranches, the beneficiaries would be graduated from the program and other small farmers would enter. Operational subsidies will be necessary at the start but subsidy dependence should decrease over time. 		
C. Coordinate with other donors to improve post harvest handling and marketing problems	<ul style="list-style-type: none"> • Focus on reducing post-harvest losses through improved grain drying and storage and better packing for fruits and vegetables. • Investigate why contract enforcement is problematic between non-traditional exporters/brokers and producers. 		

3.2 Debt Overhang and other Barriers to Entry

The policy recommendations for this component can be divided into four critical areas: solving the debt-overhang problem; avoiding agricultural debt crisis in the future; improving agricultural profitability; and, ensuring that agricultural profitability is sustainable and equitable.

TABLE 3.2

POLICY MATRIX FOR RESOLVING THE DEBT OVERHANG PROBLEM AND MAKING AGRICULTURE MORE PROFITABLE

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIME FRAME	COMMENTS
I. Solving the Debt-Overhang Problem			
A. Implementing Decree 292 with a perspective of agricultural growth and social equity.	<ul style="list-style-type: none"> The SSP (Superintendency of the Financial System) expands the operational definition of beneficiaries. 	Write of new instructions and communicate to BCR. One month.	Look at report for specific definitions.
	<ul style="list-style-type: none"> FOSAFI and BFA train and inform bank officers on the growth and equity criteria of Decree 292. 	Communications of FOSAFI and the BFA to bank-agency managers. One month.	Look at report for specific subjects of training.
	<ul style="list-style-type: none"> The Administration and the Congress don't change the dateline for applications pertaining to benefits of Decree 292. 	Letter from SSP to the Administration and the Congress explaining the reasons for not extending the application period again. One month.	
B. Complementing the mechanisms of Decree 292.	<ul style="list-style-type: none"> The SSP instructs FOSAFI, BFA, and other banks to sell land given up by owners to other farmers or persons intending to farm. FOSAFI and BFA establish a temporary mechanism for farmers who don't qualify under Decree 292 and need to give up their land in order to pay their debts. The land is sold to the Land Bank, and this bank rents back to the same farmer with an option to buy. These farmers will be eligible to receive credits protected by the Guarantee Fund. 	<p>Writing of procedures for selling collateral lands. Two months.</p> <p>FOSAFI and BFA write an agreement with the Land Bank. Two months.</p>	
II. Avoiding Agricultural Debt Crisis in the Future			
A. Developing private banks (including coops) to serve agriculture.	<ul style="list-style-type: none"> The BCR will prepare and implement a program based on the RIAS or similar recommendation. 	BCR starts the re-organization of BFA to serve as a non-governmental agricultural development bank. Six months.	
B. Eliminating credit subsidies to medium-size farmers.	<ul style="list-style-type: none"> The MAG will prepare a policy program stating the principle of no subsidies to medium-size farms, in particular for exportable commodities. 	Declaration of policy objectives of the Government. Three months.	The best that can be requested is a declaration of intention.

TABLE 3.2 (cont.)

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIME FRAME	COMMENTS
C. New Bankruptcy Law and Procedures.	<ul style="list-style-type: none"> The Technical Unit of the Justice Department (MJ) will prepare a new bill and an educational project targeted to business persons, lawyers, law schools, and judges, to communicate the new principles and possibilities. 	Submission of the Bill to Congress. Six months. Congress Law Another six months.	In the preparation of the terms of reference it is important to ensure the participation of modern and progressive business persons. To insist on the idea of reducing the cost of failures to individuals and to return assets into productive activities as soon as possible.
III. Improving Agricultural Profitability			
A. Land Property Security	<ul style="list-style-type: none"> Reinforce the programs for assignment of individual property rights to members of ISTA coops. All farmers who choose to do so will have the right to sell and lease agricultural land. 		Activities under the Land Tenure team.
	<ul style="list-style-type: none"> Continue process of title clarification and registration. 		Activities under the Land Tenure team.
B. Improving access to property and use of agricultural land.	<ul style="list-style-type: none"> Establish the right of all farmers with land titles to sell, mortgage or rent their land without restrictions. 		Activities under the Land Tenure team.
	<ul style="list-style-type: none"> The Technical Unit of the Justice Department (MJ), with the technical assistance of an agricultural economist contracted by the MAG, prepares a bill legalizing land renting according to market principles. The bill includes norms to prevent unfair agreements. 	Submission of the Bill to the Congress. Six months. Congress approval of the Bill. Another six months.	The participation of economists with a clear understanding of markets, institutions, and incentives is important. The main objective is to open opportunities for productive uses of land. Going beyond the old view of renting as a means of exploitation.
C. Enforcing contracts in the agricultural sector.	<ul style="list-style-type: none"> The Technical Unit of the Justice Department (MJ), with the support of agricultural economists hired by the Agricultural Department (MAG), will review the principles and process for execution of land rent contracts, contract farming, and credit and loan contracts with low costs and in short periods. 	Submission of a Bill to the Congress. Six months. Congress approval of the Bill. Another six months. The MJ and the MAG implement an educational project to inform and instruct farmers, bankers, and agricultural service industries about contracts and their enforcement.	
D. Investing in infrastructure for agro-industries	<ul style="list-style-type: none"> The BCR will prepare a credit program for investment in cooling systems, port and airport facilities, transportation, and communications for serving agriculture. The credit will not be subsidized. It will be supervised. 	The Central Bank opens the credit line. Four months.	This activity is developed with more details by the Trade and Investment Team.

TABLE 3.2 (cont.)

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIME FRAME	COMMENTS
E. Appropriate Real Exchange Rate	<ul style="list-style-type: none"> Avoid excessive overvaluation of the national currency, the Colón. 		
IV. Ensuring that Agricultural Profitability is Sustainable and Equitable			
A. Transforming small farmers and peasants into <i>stockholders</i> of agro-industries.	<ul style="list-style-type: none"> The ISTA and the MAG contract the preparation of a program to induce organizations of small farmers to become stockholders of agri-businesses. Look at IDB project prepared by Carlos Benito (1991). 	The ISTA and MAG launch an incubator type of project. Six months.	
B. Expanding credit for small farming.	<ul style="list-style-type: none"> The BCR prepares a program to reorganize the Cajas de Credito and FEDECREDITO into a (private) credit union system to assist small farmers based on the RIAS proposal. 	The BCR reorganizes the Cajas and FEDECREDITO. One year.	
C. Reducing off-farm chemical contamination.	<ul style="list-style-type: none"> The MAG commission with a consulting firm prepares a project to set standards for use of chemicals and to induce the adoption of sustainable practices. 	<p>The MAG announces the standards and the control system. Six months.</p> <p>The MAG hires non-governmental agencies to teach sustainable practices to target groups. Six months.</p>	These activities will be developed with more details by future PROMESA project.

3.3 Land Tenure

This is a complex and broad topic, and as such, must be broken down into topical areas, each with its own policy matrix. The first chapter of the report, "Landless, Land Poor, and Unemployed Agricultural Populations in El Salvador, 1991-1992," is primarily a presentation of data and does not lend itself to a policy matrix. However, the other four chapters do address policy issues and are presented below: Small Farmers in El Salvador, 1993: A Comparison of Landowners, Renters, Cooperative members, "FINATEROS," and "Tenedores"; Agrarian Reforms in El Salvador: A Contemporary Assessment; Land Price, Land Markets, and Government Intervention: Post-war Adjustment and Policy Reorientation; and Legal Aspects of Land Tenure in El Salvador.

TABLE 3.3

POLICY MATRIX FOR RESOLVING LAND TENURE RELATED PROBLEMS

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENTS
I. Policies to confront the evolution of land tenure and changes in the rural population			
A. Improve profitability and sustainability by targeting small farmers (owners, renters, cooperatives) for agricultural/ecological programs to promote diversification and soil conservation.	<ol style="list-style-type: none"> 1. Implementation of MAG/CENTA program. 2. Technical and financial support for regionally-based schools, demonstration plots, experiment stations runs by farmer organizations. 	<ol style="list-style-type: none"> 1. Improved profitability of small farmers. 2. Greater frequency of soil conservation practices. 	Most small Salvadoran farmers have very low levels of formal education, which must be taken into account in the design of diversification and conservation programs.
B. Improve rural education	Funding of additional teachers' salaries and construction of additional schools.	<ol style="list-style-type: none"> 1. Achievement of targets for percentage of children finishing primary and preparatory schools. 	Because agriculture will be unable to absorb the whole rural population in the future, rural education must prepare students to work outside of agriculture.
C. Spur rural job creation.	<ol style="list-style-type: none"> 1. Explore expanded role for agricultural processing sector in rural areas. 2. Build on existing efforts by government and NGO's to help artisans and small-business development 	<ol style="list-style-type: none"> 1. Increased employment in rural areas, particularly among women. 2. Higher incomes for rural families. 	See the first chapter of the land tenure component for details on rural unemployment and underemployment.
D. Stabilize <i>tenedor</i> population	<ol style="list-style-type: none"> 1. Formalize land tenure arrangements in <i>tenedor</i> areas. 2. Improve quality of housing. 	<ol style="list-style-type: none"> 1. All <i>tenedor</i> land rights resolved. 2. Adequate housing obtained for all <i>tenedores</i>. 	The <i>tenedor</i> population is the most economically fragile and politically volatile of the landholding groups.
E. Facilitate a variety of tenure forms to satisfy needs of different groups.	<ol style="list-style-type: none"> 1. Create clear legal definitions of all tenure types within one legal construct, preferably the agrarian code. 2. Create "user friendly" public information describing land transactions in a step-by-step fashion. 	<ol style="list-style-type: none"> 1. Approval of the agrarian code with simplification and clarification of tenure arrangements. 2. Elaboration and implementation of a single coordinate-based land registry and information system. 	Demand exists for a wide variety of tenure forms, including different types of cooperatives, agricultural subdivisions, and agricultural condominium tenure.

TABLE 3.3 (cont.)

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENTS
II. Policies to consolidate Salvadoran agrarian reform.			
A. Decrease subsidies to ISTA and FINATA.	<ol style="list-style-type: none"> 1. Decrease AID support for these institutions. 2. Implement stricter repayment guidelines for loans to ISTA farms, such as renting out of the parcel of a member who is in default. 3. Reduce wage payment component of production loans. 	Improved record of credit performance in 1994	See Thiesenhusen chapter for details of stricter repayment policy
B. Diversify and intensify production on ISTA farms.	<ol style="list-style-type: none"> 1. Create an operational link between ISTA and CENTA. 2. Form multi-purpose cooperatives for dissemination of production techniques, purchase of inputs, and marketing. 	<ol style="list-style-type: none"> 1. A working relationship between ISTA and CENTA with measurable increases in profitability on farms working with the combined institutions. 2. The establishment of multi-purpose coops with demonstrable advantages for ISTA farmers. 	This collaboration would ensure that state-of-the art technological developments are transmitted to the cooperative members while avoiding duplication of effort by different branches of the GOES.
C. Regularize legal procedures for registry of ISTA farms.	<ol style="list-style-type: none"> 1. Establish policy to prevent sale of ISTA land to non-campesinos. 2. ISTA must register titles with the property registry after issuing them. 	<ol style="list-style-type: none"> 1. Delineation of a clear plan to prevent illegal land sales and national implementation of the plan. 2. Registration of all ISTA titles in the appropriate property registry. 	It is assumed that access to land in the reform sector should be offered first to poorly endowed farmers who meet the criteria for agrarian reform beneficiaries. The lack of registration of ISTA titles makes them worthless.
D. Revamp FINATA's financing.	<ol style="list-style-type: none"> 1. Cease current procedure of using collected land payments for FINATA's operating budget. 	FINATA land payments being used for other purposes, specifically new land purchases.	FINATA has become a self-perpetuating bureaucracy which has probably fulfilled its original mission.
E. Increase ecological sustainability on reform sector farms.	<ol style="list-style-type: none"> 1. Implement a program similar to Plan Sierra in the Dominican Republic. 	Implementation of an ecological sustainability project.	See Thiesenhusen chapter for details on what this type of program entails.
F. Reduce and change the role of ISTA.	<ol style="list-style-type: none"> 1. Limit ISTA's activities to collecting past debts, overseeing CENTA's programs, and fostering the development of multi-purpose cooperatives. 2. Make Peace Accords land recipients the focus of new ISTA activity. 	Elaboration and implementation of a new master plan for ISTA's activities.	

TABLE 3.3 (cont.)

GOAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENTS
III. Land Market Policies			
A. Improve intensity of land use and profitability of agriculture.	Municipal land taxation based on potential use.	<ol style="list-style-type: none"> 1. Functioning system of land tax assessment and collection. 2. Improved use intensity and profitability nationwide. 	AID's Office of Democratic Initiatives has studied land taxation in detail.
B. Promotion of long-term leases to encourage conservation practices by renters.	Concomitant with and tax policy would be tax breaks for long-term leasing with evidence of soil conservation.	<ol style="list-style-type: none"> 1. Functioning land tax policy. 2. Measurable increase in long-term leases and soil conservation practices. 	Given the high incidence of rental tenancy and rising land prices, policy focus should be on ameliorating the negative externalities associated with renting.
C. Promotion of partnerships between owners and renters for specialty crops.	Tax breaks for the creation of partnerships in a selected group of high-value but risky crops.	Measurable increases in the production of selected specialty crops.	

3.4 Trade and Investment Promotion

This matrix is divided into the following policy areas: Maintenance of a Macroeconomic Framework Consistent with the Agricultural Sector Program; Enhancing Commercial Policies; Improving Agricultural Policy; The Institutional Environment; Export Incentives and Investment Promotion; Economic Integration; A Balanced Development Approach.

TABLE 3.4

POLICY MATRIX FOR TRADE AND INVESTMENT PROMOTION

GLOBAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENT/RISK
<p>I. Maintenance of macroeconomic framework consistent with agricultural sector program.</p>	<ul style="list-style-type: none"> • Institute sound and supportive fiscal, price, trade and exchange rate policies. • Devaluation of the color will be necessary. • Strengthened tax administration and control is critical. 	<ul style="list-style-type: none"> • For the next 4 to 5 years to support positive real protection rates in agriculture. 	<ul style="list-style-type: none"> • Special attention must be paid to the impact of economic adjustment in the agricultural sector, particularly on the poor. • Institutions are weak. Economywide and sectoral policy formulation and implementation must be improved.
<p>A. To attain greater fiscal discipline.</p>	<ul style="list-style-type: none"> • Increase the tax base and develop stable revenue sources. • Appropriate more money for capital investment in agriculture. 	<ul style="list-style-type: none"> • Government's expenditures directed to the sector to reach about 10% of GOP by 1997. • Timely funding to implement infrastructure projects 	<ul style="list-style-type: none"> • Delays fiscal reforms. • The combined deficit of the public sector may not reduced as planned.
<p>B. A more flexible monetary policy.</p>	<ul style="list-style-type: none"> • Legal reserve requirements should be monitored. • Financial institutions must pay/charge equivalent rates of interest. 	<ul style="list-style-type: none"> • Legal reserves fluctuate with the economy. 	<ul style="list-style-type: none"> • Tight monetary policy, if prolonged, may have contractionary effects.
<p>II. Enhancing commercial policies.</p>	<ul style="list-style-type: none"> • Maintaining a viable exchange rate while seeking reasonable exchange rate stability over the medium term. 	<ul style="list-style-type: none"> • Export-import procedures streamlined. • Financial resources augmented to support trade and investment. 	<ul style="list-style-type: none"> • Remittances will continue to have a strong influence on the economy.
<p>A. Trade deficit to be reduced.</p>	<ul style="list-style-type: none"> • To increase export value and diversify the export base, agroprocessing and value-added are called for. • Protection of agriculture could be increased over-time to about 15%. • Increased investment in import substitution. 	<ul style="list-style-type: none"> • Improved management practices in agricultural enterprises. • More investment in export activities and rural infrastructure 	<ul style="list-style-type: none"> • Improving quality and productivity are risk factors that should be considered.

TABLE 3.4 (cont.)

GLOBAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENT/RISK
<p>B. A twin strategy of investing in traditional crops while promoting non-traditional ones.</p>	<ul style="list-style-type: none"> • Investment in domestic infrastructure to lower the cost of exporting. • Investment in research and technology to be gradually increased. • Financial support for technology change and education in agro-diversification. • Continue to reduce trade restrictions. • Centralize all investment registration activities in one office. • Conduct a cost-benefit study of the current duty drawback system. 	<ul style="list-style-type: none"> • Volume, value, and quality of exports increased/improved. • Making the economy more liberalized and competitive. • Trade distortions reduced to a minimum. 	<ul style="list-style-type: none"> • Institutional changes/reforms could be slow to implement.
<p>III. Improve agricultural policy development.</p>	<ul style="list-style-type: none"> • To formulate a clear concept of the role that agriculture is expected to play in the economy's development • Assemble a policy implementation team. • Involve the private sector in the process of working out policy options. 	<ul style="list-style-type: none"> • The anti-agricultural bias in macro-economic policy eliminated. • Agricultural policy properly integrated with policies for the rest of the economy. • Timing: formulation and review of policies and strategies mid-1994. 	<ul style="list-style-type: none"> • Budget, human capital, and political will are some of the main problems.

TABLE 3.4 (cont.)

GLOBAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENT/RISK
<p>A. Pricing policy in line with the country's comparative advantage in production.</p>	<ul style="list-style-type: none"> • The principle of border pricing should be adopted for domestic prices of grains and other agricultural products. • The current price band policy instrument should be continued. • To open the channels of free trade so that agricultural produce can be imported or exported in a timely fashion. • To establish a security fund plus a quantity reserve, and the associated operating rules. 	<ul style="list-style-type: none"> • To be adopted in 1995 • Until crop alternatives have been found or technical change has taken place. Late 1996. • Larger sector output is expected in the longrun, because supply is price-responsive. 	<ul style="list-style-type: none"> • Institutional capacity is a problem. • Policy reforms require consistency and time. • International grain prices experience large year-to-year fluctuations. • The rural poor, farmers' income, and food security to be protected. • Information on market prices is a problem.
<p>B. Marketing policy to reinforce the orientation of macroeconomic policy.</p>	<ul style="list-style-type: none"> • Government intervention is abolished. • An agency is created to analyze price bands, manage security stocks and funds, and possibly become a domestic marketing agent of last resort. • The establishment of a market information data service. • Liberalized import policies to be maintained. • GOES to have a unified and better coordinated information front comprised of FUSADES, MAG, COEXPORT, FOMEX, and ME. 	<ul style="list-style-type: none"> • Food reserve has two components: a commodity reserve and a monetary fund. 	<ul style="list-style-type: none"> • Poor marketing systems and institutions. • Concern that poor families have access to sufficient food to avoid malnutrition.
<p>IV. The legal regime (or institutional environment) governing export, investment, and commodities providing order and stability in economic relations.</p>	<ul style="list-style-type: none"> • Laws, rules, and conventions well defined, ratified, and enacted concerning permissible and non-permissible forms of competition and cooperation. • Laws and rules in place defining, allocating, and enforcing property rights. 	<ul style="list-style-type: none"> • All commodity systems operate within an institutional environment, consisting of a set of fundamental political, social, and legal ground rules. 	<ul style="list-style-type: none"> • Lack of integration between the policy environment and the legal environment. • The most serious legal problem for producers of export goods is the risk of contract non-compliance.

TABLE 3.4 (cont.)

GLOBAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENT/RISK
<p>V. Export incentives and investment promotion environment to stimulate domestic and foreign investment.</p>	<ul style="list-style-type: none"> • To pursue export promotion policies with consistency and effectiveness. • Conduct a cost-benefit study of the current duty drawback system. • To mount a strong anti-corruption campaign. 	<ul style="list-style-type: none"> • A clear strategic vision and quantitative knowledge about El Salvador's comparative advantage, 1995. • Effective coordination procedures in place, 1996. 	<ul style="list-style-type: none"> • FOMEX and FUSADES to become more effective, especially in reaching a wider clientele. • Low salaries and work environment continue to hinder performance. • Attracting and retaining better trained human capital is critical.
<p>VI. Economic integration to be achieved.</p>	<ul style="list-style-type: none"> • Trade agreements established first within the CACM, then with South American countries, then with NAFTA. 	<ul style="list-style-type: none"> • Negotiations with each group taken step by step. 	<ul style="list-style-type: none"> • Value-added foods hold greatest potential. • Training in both agronomic and business skills is needed.
<p>A. Participation in the CACM is an important first step for El Salvador.</p>	<ul style="list-style-type: none"> • Enhancing gains of efficiency from specialization. 		<ul style="list-style-type: none"> • Market potential is limited, especially for agriculture.
<p>B. Accession to NAFTA would expand markets. Greater discipline over domestic policy reforms.</p>	<ul style="list-style-type: none"> • To be pursued as a coordinated effort with the other countries of Central America. However, the effort/approach can be implemented independently. 		<ul style="list-style-type: none"> • Infrastructure should become more competitive.
<p>C. To maintain a more open economy within the Protocol of GATT</p>	<ul style="list-style-type: none"> • Include MAG in future negotiations. • More work needs to be done on the list of exceptions. 		<ul style="list-style-type: none"> • The agreement is an important step in bringing El Salvador into the more liberalized regime of world trade.
<p>D. Integration of sanitary and phytosanitary regulations.</p>	<ul style="list-style-type: none"> • Increased coordination at the airport and at border crossings for agricultural diseases. • Improve monitoring of imports from non-OISA countries. 	<ul style="list-style-type: none"> • Unified agrochemical registry system in place. 	<ul style="list-style-type: none"> • Budget constraint a major problem.

TABLE 3.4 (cont.)

GLOBAL/OBJECTIVE	ACTIONS	INDICATOR/TIMEFRAME	COMMENT/RISK
<p>VII. A balanced economic development approach based on both traditional and non-traditional markets and crops.</p>	<ul style="list-style-type: none"> • El Salvador competes using its comparative advantage in the production of traditional exports. • Programs to overcome domestic production constraints and increase domestic profitability, international competitiveness, and export volume in non-traditional commodities. • Studies on competitiveness of exports and potential supply response analysis are implemented. 	<ul style="list-style-type: none"> • Technological developments taking place. 	<ul style="list-style-type: none"> • The international market for primary commodities going through shorter cycles. • For non-traditional crops the European and U.S. markets offer supply opportunities for a whole range of specialized off-season horticultural commodities. • International quality standards are rigorous and increasing, and there is little room for substandard material.

4. AGRICULTURAL CREDIT

4.1 The Current Situation

This component examines the impact of El Salvador's monetary and financial regulatory policies on the rural sector, analyzes the financial health of the two remaining state-owned rural financial institutions (Agricultural Development Bank and Federation of Rural Credit Funds), and identifies the main constraints to more effective small farmer credit delivery and recovery. The motivation for the study is the concern of policy makers about maintaining and improving credit access for small-scale producers and entrepreneurs in a liberalized financial marketplace.

Since 1989, the GOES has adopted far-reaching economic and institutional reforms aimed at achieving macroeconomic stability and restoring economic growth. In 1991, the banking system was largely privatized and credit controls were lifted. To a large extent both the economy-wide and the financial sector reform programs have been successful. Inflation has been controlled; the currency, although devalued, has remained relatively stable; the massive amount of capital that has entered the country has significantly increased the volume of bank deposits; and real output has expanded. However, it is still possible that recapitalized and profit-oriented banks will abandon high-cost, high-risk, small-producer borrowers and thereby thwart rural economic development. Therefore, identifying and ameliorating policy, informational, and organizational impediments to better rural credit service is a critical follow-on activity. The reforms to date were necessary, but alone they are not sufficient to guarantee sustained economic growth and income distribution improvements.

The review of monetary, credit, and exchange rate policies indicates that the implications for rural borrowers and savers are mixed in the short run but should be beneficial in the long run. There have been seven major financial and monetary developments: (1) interest rate liberalization and elimination of lending quotas, (2) rehabilitation of a sizeable portion of the bad debts in the banking system, (3) adoption of flexible exchange rates, (4) increased discount rates and fewer special lines of credit, (5) uniform legal reserve requirements, (6) increased capital requirements, and (7) increased use of loan-loss reserves. Most of these developments clearly strengthen the banking system and enhance depositor confidence. In the short run, however, some of these changes, will make access more difficult for high-risk, small borrowers, which emphasizes the need to separate financial objectives from social objectives.

The recurrent issues in formal Salvadoran rural finance have been borrower access, lender viability, savings mobilization, and the contribution of credit to economic growth. In recent years, while total credit has steadily expanded, agricultural credit as a share of total credit has remained relatively constant at 17 percent. In real terms, agricultural credit has experienced a marked decline. Despite efforts to increase the supply of formal rural credit, loan delivery and recovery remains very problematic.

Historically, access to rural credit has been limited due to a lack of clear titles to land and high borrower transaction costs. Only 11 to 27 percent of the rural population receive credit, but banks do not reject many applicants (93 percent of those who apply for credit are approved); self-selection is more important. A strong positive relationship exists between farm size and credit application/receipt. The larger the farm, the more likely that it produces one or two traditional exports (coffee, sugar, cotton, cattle) or a mix of grains and one or more export crops. Thus, coffee and livestock are the most readily financed activities, and the western and central regions of the country, where most of the coffee is grown, are the most favored regions for credit.

In the 1980s, when the banking system was nationalized, crop liens were used extensively in lieu of property titles as collateral. This allowed small borrowers greater access to credit, but the politization loan program, the effects of war, low international prices, and lax loan collection practices combined to result in extremely high delinquency rates. The small-farmer programs were more prone to default than any other lending programs in the two banks studied. In general, high operating costs and high delinquency rates reduced lender viability and forced a number of bank liquidations and mergers in 1990-91. With bad debt rehabilitation, publicly owned banks seem more cautious and, in the case of the Federation of Rural Credit Funds, mortgages on real fixed assets are now preferred to liens or joint liability contracts.

The two institutions studied were designed initially as credit disbursement windows under the assumption that the rural poor cannot save. After years of heavy dependence on soft external funds and a change in development thinking, the two institutions have been forced to mobilize their own funds and become multiple-service intermediaries. The Agricultural Development Bank has succeeded in capturing substantially more savings deposits since 1990, but it lacks a feasibility study, a plan, the proper equipment, and the trained personnel to make a sustained, focused effort. The Federation of Rural Credit Funds, on the other hand, only has six large institutional investors and is currently insolvent, which makes launching a savings mobilization campaign unlikely in the near future.

The financial analysis of the Agricultural Development Bank using the CAMEL (Capital adequacy, Asset quality, Management assessment, Earning generation, and Liquidity) methodology clearly shows the bank's strengths and weaknesses. It has a very strong capital position (41 percent capital-to-total assets ratio, compared with the minimum 8 percent required by law). Despite the rehabilitation of bad debts in 1991, the bank still has 322 million colones of uncollectible loans. The overall loan collection rate is 73 percent, considerably lower than the collection rates of successful Asian institutions, which range from 80 to 98.6 percent. Also, the delinquency rate on loans less than 12 months old is 21 percent.

The financial analysis of the Federation of Rural Credit Funds shows that it is in a very precarious situation and needs immediate and massive amounts of financial and technical assistance. The Federation is a two-tier institution composed of a central office that lends funds to 54 affiliated, autonomous credit cooperatives, who in turn lend to individual borrowers. The Central Office is technically bankrupt, with negative equity or capital (-47 million colones) in

1992. Currently, the Central Bank is studying how to best recapitalize the institution. Of the 51 credit funds operating in rural areas, 32 have capital-to-assets ratios greater than the minimum 8 percent stipulated by law. A process of triage is under way to identify the credit funds that are salvageable; those that are not will be liquidated.

In assessing the critical constraints to effective rural credit delivery in El Salvador, three general classes of impediments were identified: access problems, delivery and recovery problems, and externalities.

In conclusion, current macroeconomic policies are generally favorable to financial intermediaries and agricultural producers. The banking reforms of 1991 have improved and will continue to improve the integrity and efficiency of the entire system. Whether the macroeconomic program of tight monetary policy and stable currency is maintained depends on the central government's success in controlling the fiscal deficit. At the microeconomic level, there is a clear challenge to improve the organizational efficiency of the two remaining state-owned financial institutions and to devise effective small-farmer outreach programs. While high-risk borrowers are increasingly being excluded, it is not sound policy to weaken financial institutions in order to satisfy popular demand. It is more important to have sustained access to credit than episodic access. To this end, bank managers need to be convinced that it is possible to have profitable, small-farmer credit programs through proper borrower and personnel incentives and tight cost controls. More emphasis ought to be placed on improving the efficiency of the organizations in question that on procuring more computers and vehicles. Accordingly, institutional strengthening, targeted credit, and integrated rural development programs need to be designed and launched in order to remove the chief impediments identified. These impediments include: a lack of strategic planning and weak bank management practices; cumbersome, rigid loan approval processes and antiquated governing laws; lack of personnel accountability; lack of agricultural extension services; unenforced marketing contracts; lack of marketing loans; lack of loan roll-over flexibility; and inadequate resources devoted to loan collection efforts.

4.2 Policy Recommendations

4.2.1 Action Priorities

Rural credit in developing countries has been problematic due to the inherent riskiness of agriculture and organizational weaknesses. Credit, nonetheless, facilitates rural economic growth and development. Its effective delivery, use, and recovery can best be guaranteed only in the context of a well-designed, coordinated, and executed program of integrated rural development.

Programs in rural credit that increase loan supplies without improving the creditworthiness of the small farmer target population are bound to fail, as has been shown repeatedly in the literature. Such programs contribute to the diversion of funds to nonagricultural end-uses; tend to be exploited to a greater extent by better-off farmers, which

worsens income distribution; and tend to contribute to high delinquency rates, which weakens the lending institutions and creates the need for periodic bailouts. Promotion of new cultivation techniques and high-valued crops will only be successful if the necessary ingredients of adequate technical assistance, secure marketing, and timely credit are present. Thus, a two-pronged approach is needed. Lending institutions need to be strengthened by the adoption of sound policies, recapitalization, and investments in personnel and infrastructure. Borrowers, especially low-income, small farmers, need to be made creditworthy through management training, technical and marketing extension programs, and public investments in agricultural research and infrastructure.

The following actions are recommended to banking officials and central government authorities, principally the Minister of Agriculture:

- Depend more on group credit and personal references to attend to marginal farmers. Through a promotion campaign, careful member selection, and close monitoring, the program has the potential to perform well, as it has in certain parts of the country. Collateral-based lending is not a viable alternative for these types of farmers.
- Lower the borrower transaction costs significantly through a streamlined and computerized loan application process; disburse monies on time; and offer greater repayment and disbursement flexibility in the case of multiple loans when the situation warrants.
- Implement mobile banking to facilitate document processing. Agents of the Agricultural Development Bank should visit designated outlying towns on their market days to receive applications and check character references, especially in the slack summer months. When security improves in the countryside, armed trucks capable of disbursing and receiving funds could be considered.
- Process loans for repeat clients in a matter of days with a fully computerized data bank. Investment plans, income updates, and verification of guarantees should be the only items that need to be updated. Clients with good records should be granted automatic lines of credit that grant them the flexibility to make withdrawals as they desire, as long as their payments are made on time.
- When the client's business grows, a new detailed analysis will be made and a larger line of credit could be granted. This service would be ideal for a loan class risk type A client involved in a micro-enterprise, agro-industry, cattle, poultry raising, or intensive vegetable production, where capital turnover is high and cash flows are substantial and relatively constant from month to month. The current tedious loan procedures chase good clients away. The state banks need to attract and retain as many Type A clients as possible.

- Avoid politicization of lending programs at all cost. Credit disbursement activities should be based on financial and risk management principles.
- On-lend to food and agricultural processors/exporters who in turn can lend to contracted farmers. This type of lending reduces repayment risk, since loan payments can be deducted when the farmer delivers his/her product to the processor/exporter.
- Improve the quality of general banking services by offering a marketing line of credit and further modernizing banking communication and record-keeping systems.
- Use repayment incentives such as interest rebates for early repayment, loan amount ratcheting based on the amount of savings deposits, and guaranteed access to credit in graduated amounts as long as repayment is prompt.
- The Central Bank should stop fixing limits on crop loans on a per manzana basis. Allocation decisions should be based on the debt capacity of the individual, his or her character, his or her management ability, and the proposed investment plan.

4.2.2 Possible Roles for the Private Sector in Rural Credit Delivery to Small Farmers

Private commercial banks and nonprofit, nongovernmental organizations including churches play a significant role in disbursement of rural credit. The prospect of enticing private banks to better attend the small-scale producer is not very encouraging at the present time, however. The private commercial banks attend large farms and well-administered cooperatives involved in traditional exports. Two private bank officials interviewed expressed little interest in directly attending small-scale, high-risk producers. The majority of their clients are loan class risk types A and B, and the banks naturally seek to increase profit rates and further lower their delinquency rates. These sentiments are believed to be representative of the sector.

A private credit bureau would facilitate the timely evaluation of potential clients, but in the short run it would only benefit urban, salaried workers, formal businesses, and large-scale farmers. The limited extent of computer record keeping, fragile telecommunications integration in the country, and the unwillingness of individual businesses to share or sell information inhibit the establishment of a broad-based, high-quality credit bureau at this time. It would be prohibitively expensive to track down small farmers and gather the data on personal characteristics, income, assets, liabilities, and spending patterns that would permit the development of credit-scoring indices. At present, a database at the Superintendency on outstanding bank debts is widely used by all commercial banks to verify an individual's credit history.

Nongovernmental organizations (NGOs) proliferated in the 1980s and filled the void in food assistance, health care, women's development, and credit disbursement created by the poor functioning of the public agency sector and the dislocations caused by the war. Many of the NGOs are grouped under the umbrella of Catholic Relief Services (CRS); however, there are

many European-sponsored NGOs that do not fall under the CRS umbrella. At present, CRS and its affiliates plan to disburse C/34 million colones in 1993. Some 41 NGOs are known to be actively disbursing credit. The principal credit delivery modalities they are using are group credit (village banking) and revolving credit funds. These two modalities reduce borrower transaction costs significantly, but may or may not reduce lender transaction costs.

4.2.3 Possible Role for Informal Intermediaries in Rural Credit Delivery

The most likely informal suppliers of credit willing to cooperate with a public sector initiative to increase credit supply are food processors, wholesalers, and exporters of nontraditional products. These entities should be interested in particular because it would allow them to attract suppliers and to better guarantee that they can meet projected demand. Moreover, default exposure is reduced through the use of irrevocable marketing contracts wherein debts are subtracted from final payment. This is a perfectly incentive-compatible scheme: producers get needed credit and have a guaranteed market outlet; buyers can attract and retain the best producers with ample financing and can more effectively compete in international markets on a volume basis; and banks reduce administrative costs and default exposure.

4.2.4 Recommendations Concerning Private Sector Lenders

Enlisting the support of private commercial banks to better attend the small-farm sector is not feasible in the short term. Rather, efforts should focus on developing the creditworthiness of a sizeable segment of the small-producer sector through a segmented market approach to rural finance. Formal banks will be allowed to attend the segment of the market that their cost structure permits. Nongovernmental institutions with operational subsidies will attend the poorest, highest-risk segment and over time will graduate a sizeable proportion of their beneficiaries to state and private financial institutions. The Government and donors should instill improvements in operational efficiency for both banks and NGOs, and should wean the banks from subsidies over time.