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RURAL FINANCIAL SYSTEM STRATEGY PAPER

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ANNEXES

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1. Rural Financial System
Drafted by John W. Mellor after wide consultation

The Master Plan strategy gives the highest priority for aggregate farm income growth to the high value commodity sectors – specifically perennial horticulture and intensive livestock production. Growth in these sectors places very large demands on the credit system. The demand will be disproportionately large, compared to other sectors, for intermediate term credit, while the demand for operating and short term credit will also be high.

Rapid income growth in these sectors will soon generate large savings and demand for convenient deposit mobilizing financial systems. As long as poppy production is important there will also be large savings that can be mobilized as deposits to finance rural credit needs.

The importance of irrigated land; the cropping system, and the ready acceptance of fertilizer by farmers have resulted in rapid growth in fertilizer use, largely without a credit system. However, that growth appears to be entering a phase when lack of credit will slow the growth of both inputs and even more of output.

Those with very small land holdings can also benefit from intensification of wheat production with improved seed and fertilizer. Indeed, because of their abundant labor the response to fertilizer and improved seed is greater than on larger farms. Those small farms could also greatly increase their incomes with intensive livestock production and transferring area to high value crops like annual and perennial horticulture. But, just as much as those with larger holdings, they need credit to move quickly into these opportunities.

While the demand for credit is large and essential to agricultural growth, the recapitalization of the rural areas limits the scope for self-financing and traditional sources of credit. That same recapitalizing of financial, and human assets has resulted in virtual disappearance of rural financial markets which in the 1970's were commented on favorably, for example in the World Bank agricultural sector analysis of 1975.

That is the environment in which the Master Plan has considered the rural financial system. The analysis for this chapter starts from the necessity and the highest priority to developing a competitive rural financial system that is economically viable and serves the full financial needs of all farmers.

1. Types of Farmers from a Rural Financial System Perspective:

Farms of different sizes have somewhat different financial market needs, which have resulted in differences in the extent to which they are presently served.

1.1 Small farmers:

say with less than one hectare of land, are expensive to service because of the small average size of loan and many of them are below the poverty line, meriting special attention. These farmers represent only three percent of irrigated land (FAO 2002-2003 winter survey) but over a third of all persons holding land. That is this is a large number of farmers producing a small proportion of output.

Perhaps surprisingly, a system to service their needs is the most developed element of the rural credit system. That is the micro credit system, which with ample donor financing has expanded rapidly. That system has generally serviced the rural non-farm sector much more than small farmers.

Given the commodity priorities of the Master Plan, however, the micro credit system needs to give priority to fertilizer loans to small farmers and to the full credit needs, including intermediate term credit for the smallholder intensive livestock system. That sector is particularly important to poor women, a usual target of micro credit systems. Small holders could also benefit immensely from moving into horticulture, including perennial horticulture, but the financing needs would be large.

For the micro credit system to serve these small farmer production needs will require some reorientation in strategy, priorities and training of staff. Concentration of lending in priority areas for the Master Plan, the same areas that would most raise incomes of small farmers, will require attention to risk management in the context of concentrated portfolios. Technically knowledgeable loan officer's best do that with close loan supervision.

Given the coverage of the rural poor by MISFA and the Agha-Khan micro finance institutions and their plans for expansion it is reasonable to see complete coverage of the country within 5 years. This is an important contribution, particularly for poverty reduction. It is a highly desirable complement to expansion of the more commercial smallholder farming which provides the demand for much of the rural non-farm sector. In view of this, analysis is needed to ensure that the full national coverage actually occurs.

The micro credit field has received several donor initiatives, which in turn reached a scale to result in forming MISFA as an umbrella agency for micro credit. It is notable the MISFA analysis calls for additional funding for MISFA of $30 million (table 1.) Perhaps nothing could make the case more dramatically of the huge credit needs for agricultural growth than to see a figure of $30 million for micro finance that probably covers no more than three percent of agricultural production. Nevertheless that number, a well-researched calculation by donors and MISFA is included in the investment plan for the Master Plan.

As the total rural financial system develops new issues will rise for micro finance. Administrative costs are high because of the small size of individual loans and despite the highly participatory organizational structure and good risk management. At present in Afghanistan those high costs are being covered by very high interest rates.

As other parts of the system develop, which lower costs and interest rates the question will arise as to why poor people should be paying such high rates. That in turn will raise the issues of subsidies for micro finance – the norm in other countries, either hidden or open. In

anticipation of subsides it is probably best if Micro credit continue to serve those who fall below the poverty line.

Table 1. Short Term Initiatives in Micro Finance, Dealer Credit, and a Commercial Bank

Short Term Expanded or New Activities	Coverage	Areas / Locations	Remarks	Required Short-term Funding
Additional investments in MISFA.	Up to 100,000 loans disbursed for micro-agricultural entrepreneurs	34 Provinces	Additional investments in MISFA would result in a 2.5 increase in returns. A $30 million investment = $85.2 million return.	$ 30 million
Additional investments in IFDC	Access to credit for 2,000 more dealers, supplying 200,000 farmers	34 Provinces	Expected increases in cultivated areas, productivity and rural employment	$ 10 million
Opening of AIB branches in Kandahar, Heart.	New loan capital required, to reach agribusinesses	Kandahar, Herat then to others		$ 1.9 million
TOTAL				**$ 41.9 million**

Source, courtesy of Ms. Toomey of RAMP

1.2 Large Farmers:

_are for this purpose best defined as those with more than 50 hectares of irrigated land. They represent one percent of farmers but 15 percent of irrigated land, so they are a consequential group in aggregate production. It is widely believed that these farmers can rely on the commercial banks for credit. That is questionable for the short and even intermediate run since the commercial banks have hardly expanded beyond Kabul and are not nearly serving the immense needs of the agricultural commodity exporters.

However, AIB has shown an interest in making agricultural loans. It has plans to expand to Kandahar and Herat. Probably it will lend mainly to agribusinesses, but it is conceivable it would expand to cover large farmers as well. Such large farmers may also have other sources of funding.

Donors have under consideration $1.9 million of funding for AIB (table 1.) For other commercial banks the effort will be for the next several years to get large financing of agribusiness, especially the immense and rapidly growing needs of the dry fruit and nuts exporters (see the Horticulture Chapter.) As pointed out below rural finance requires large numbers of conveniently located branches. It will be a long time before the commercial banks

are prepared to do that. They should however be seen in the long run as an important element in bringing competition to rural financial markets and should be encouraged in that connection, including by legislation.

1.3 Middle Farmers:

are defined for this purpose as those with between one hectare and 50 hectares of irrigated land. They represent 62 percent of all holders of irrigated land and 72 percent of the irrigated land area. This is the backbone of the agricultural growth effort and this is the group that is largely unserved by financial markets at the moment. The rest of this chapter is devoted to dealing with the financial market needs of these farmers.

2. Present Situation:

The middle farmers are, as above not served by the micro credit institutions nor at present or for many years in the future by commercial banks. Traditional moneylenders are available, but at very high interest rates that are not suitable for production loans. Traditional moneylender's interest rates come down substantially when competition from alternative lenders enters the scene (this and other general statements about rural credit systems are drawn from the IFPRI Report by Desai and Mellor which reviews a massive literature on rural financial systems, including a large literature from contemporary Asia.) Thus, major innovation is required to meet the financial market needs of Afghan middle farmers. Focus must be on what will work, not on what will not work – as tends to be the casein much of present discussion.

3. Fertilizer Dealer Credit:

IFDC has encouraged lending to farmers by fertilizer dealers. In that context it is providing training programs for dealers. Fertilizer is the dominant element of working capital for most farmers on irrigated land. It has grown very rapidly to current usage of about 400,000 tons – a quite spectacular growth. That growth has largely been without credit systems. But, IFDC field people believe that credit is about to become a constraint as those who can manage without credit are largely already using fertilizer at substantial rates.

A current program of providing fertilizer on vouchers is operated through fertilizer dealers. This is putting $25 million dollars into rural areas for fertilizer and seed purposes. It may serve to increase the experience of fertilizer dealers with some type of credit, but runs the risk of developing a culture of non repayment since the repayment plans are at best not in the normal confines of credit systems. It may also serve to increase fertilizer by lower income farmers, since they have been targeted in the program. However, that will further increase the demand for a viable credit system.

In view of this experience, donors have discussed a $10 million short term financing of lending through fertilizer dealers (Table 1.).

It is notable that an annual growth rate of 15 percent, consistent with IFDC analysis of long run potential, represents more than $15 million dollars per year of increments to spending on fertilizer. At a compound growth rate of 15 percent, in eight years time that would call for in excess of $60 million. Since credit would not go exclusively to increments to consumption the credit needs to finance fertilizer growth over the next several years will certainly exceed $100 million. Total expenditure eon fertilizer should be close to $200 million per year within five years.

Thus, fertilizer dealers represent an important and quick means of dealing with a major part of the operating capital needs of agriculture. It is not sufficient on two grounds. First, it is not a highly competitive system and we know that interest rates and margins are high in low competitive situations with consequent substantial reduction of farmer investment. Second, dealers will fail to reach a large proportion of farmers because of the exigencies of their own demands for risk reduction and intimate knowledge about their borrowers.

Thus, dealer credit is a potentially valuable addition to the array of competitive rural credit institutions, with the advantage that perhaps it can be implemented quickly and on a large scale. It is however only part of the solution and deals with only part of the financial market needs.

4. A Large Scale Rural Financial Institution:

It is essential that work begun immediately to establish a rural financial system that will eventually cover the whole country and efficiently provide credit and deposit facilities to the middle farmers. To cover overheads the system should make loans to non-farmers as well as farmers, with emphasis on the agribusinesses that will make up the bulk of the industrial sector for some time to come. Thus, the system could be restricted to agriculture – farmers and agribusinesses – without unduly circumscribing its financial viability.

To be efficient and effective it will have to expand with deliberate speed and so should concentrate first on parts of the country and commodities that offer high rates of return to loans. Even in systems with large overdoes, repayment by farmers who have made highly profitable investments is high.

The rural financial market issue is sufficiently complex and so much has been learned over recent decades about how to make rural institutional finance systems work that a team to study this situation and make recommendations for immediate action should be mobilized immediately.

The team should be a technical team, comprised of persons who have worked extensively in rural finance in countries that have successfully undertaken sustained economic growth; perhaps including one member who is a broadly based development person. The team should have substantial membership from Asian countries that have established large, nationwide, competitive systems and experienced all the problems associated with rapid expansion of such systems as well with the influence of political systems and means to deal with them.

India has probably, through the various Reserve Bank rural finance commissions, analyzed these issues most intensively. Other countries, such as Philippines and South Korea would have much to contribute. The analysis of the Agricultural Development Bank (Afghanistan) by the World Bank in the 1970's and the recent analysis of financial and other aspects of the ADB by the USAID team of Bankers should form part of the analysis.

Obviously the team must start from the position that agriculture cannot play its dominant role in the growth of the Afghan economy, reduction in poverty, and substitution for poppies, without such a system. Given the many successes in the world, the objective is to come up with the right system for Afghanistan. It would also assume that Micro credit; dealer financing, and gradual expansion of commercial banks into rural areas would be part of the competitive system required.

5. Outline of a Rural Financial System for Afghanistan:

Even though a major Commission is needed, the broad outlines of what a Rural Financial System would like in Afghanistan can be derived from experience elsewhere and widespread consultation about experience in Afghanistan.

As stated above, Micro Finance, dealer credit, and in the long run Commercial Banks would be a significant part of the whole system, providing competition and serving somewhat different parts of the market.

The Rural Financial System to be established would be an autonomous or semi autonomous body, in essence private sector oriented, unsubsidized, and running on commercial grounds, quite possibly with a foreign partner to bring skills and discipline. It might be named the Afghanistan Bank for Farmers Associations and Agricultural Business (ABFAAB.)

It would have an Apex body to receive capital, to connect the system with the national and global financial systems. The apex body would probably lend directly to large agribusiness entities, but its main business would be to wholesale to retailers of rural credit. Eventually the capital and management of the apex body should lie with farmers and the farmer's associations, but in the short and intermediate term outside capital and management would be necessary.

Given the huge potential for deposit mobilizing in rural areas it must mobilize deposits. That would serve to reduce the capital requirements and allow more rapid expansion of lending. Experience elsewhere is that in fact net transfer of finances out of rural areas would take place even as the full financial needs of the rural sector were being met. That is given adequate capital, the bulk of loans would be financed out of deposits in to the system – with of course different areas having different balances at different points in time.

The Apex body would presumably take over the physical assets of the old ADB. It would surely draw upon the experienced staff, particularly from Herat where the ADB has continued lending with a substantial capital infusion from the Governor of the Province. There may be other assets that could be taken on as well – see the USAID Bankers Report on ADB. It would however represent a fresh start with different operating mode, discipline and financing.

Farmers associations or cooperatives would be the retailers of credit, receiving funds from the apex body. There is generally good experience in Afghanistan with group credit guarantees, which could greatly reduce risks in the system. The farmers associations would become farmer owned and farmer managed although, as with the Farm Credit Administration in the United States, they might start out with an injection of government capital and government management, particularly to ensure high accounting standards.

Large-scale technical assistance would be needed if the system is to get up and operating quickly. That TA would take two forms.

Assisting with the setting up and initial management of the apex body. If a foreign Bank could be induced to become a partner that Bank might be the source of the TA. The TA would cover developing an overall business plan and the growth program for both components and training personnel for all aspects of managing such an apex bank. To cover all aspects of the TA including equipment would require $10 million.

Massive organization of farm credit associations would be needed and perhaps grafting on to the water users associations and high value commodity marketing associations a credit component. MAAHF has a cooperative department and will expand that to cover cooperatives and farmer' associations. It would need large scale TA comprised of technical people who would perform these tasks in conjunction with counterpart staff, leading to the counter part staff taking over the functions. It is quite possible that existing NGO's that are doing such organizational work could be enlisted in this effort – but they would have to work through the MAAHF department to ensure capacity building. MAAHF might also contract out some of this work, but again in the context of building MAAHF capacity to provide complete national coverage.

Given the necessity of a rural financial institution, the Master Plan, arbitrarily, budgets $50 million for initial capital of such an institution. That is somewhat larger than more careful analysis has turned up for Micro Finance. A more calculated number would come out of the working team recommended above.

The TA requirement to cover all aspects of TA would come to roughly $20 million for five years.

The following section provides key lessons that can be drawn form the vast experience with rural financial institutions that should guide the team.

6. Lessons from Experience in Rural Financial Markets with Applications to Afghanistan:

The huge experience of similar organizations needs to be tapped. The team recommended above would tap into these and other sources of information.

6.1 Interest Rates:

Interest rates are a complex and important issue. The basic rule is that credit institutions must have sound business plans so that they can grow and expand the credit base. Interest rates must cover costs.

In contrast to high-income countries, in low-income countries the elasticity of farmer demand for loans is much more elastic than for the supply of savings. That is high interest rates in rural developing countries greatly inhibit borrowing and hence production and have little impact on savings. Thus, there is a special interest in developing countries to keeping interest rates as low as possible and still have a sound banking system.

In this context it is desirable to keep the "pure" (central bank determined) interest rate low. Risk must also be reduced by careful supervision of loans and preventing intrusion of political influence into loan repayment. Most important, administrative costs need to be kept low. The latter has two critical aspects.

For all businesses, start-up administrative costs are high while volume is built. Consideration should be given to subsidizing administrative costs when branches are being expanded rapidly. Such a subsidy has its own exit strategy related to time or the building of volume.

The most important means of reducing administrative costs per unit of loans is through multiple functions. Most important, lending institutions should receive deposits as an important source of spreading overhead. Other functions should be considered as well.

6.2 Expansion Rate:

It is essential to agricultural growth, to say nothing of political exigencies that the credit system expands rapidly. Most Asian systems have expended rapidly and the result has been reduced management oversight and loan discipline with consequent large overdues. Keeping overdue down (which are not synonymous with bad debt) requires good management, which is difficult to maintain in rapid expansion.

Thus, there is a difficult problem of balancing speed of expansion, required for agricultural growth, and maintenance of discipline. From an overall returns to the economy point of view the balance should be on the side of rapid expansion.

The best way to manage the expansion rate problem is to commence operations in areas and with commodities that have particularly high rates of return. In Afghanistan that would mean opening branches (organize farmer's associations) rapidly in areas with high potential for perennial horticulture and concentrating initially on horticulture loans. Fertilizer loans, in competition with fertilizer dealers would be another high return area.

Perhaps a reasonable target would be to start with an effort to reach 10 percent of the geographic area with the first effort in perennial horticulture and expand the geographic coverage by ten percentage points each year to reach full national coverage in 10 years. Whether such a deliberate pace would be politically practical is an important question.

It should be noted that the Horticulture plan in the Master Plan includes matching grants to farmers planting orchards and vineyards. That is justified partly by farmers in general requiring higher discount rates than the social discount rate for long-term investment in such orchards. It is also a partial compensation for the lack of credit institutions.

7. Convenience of Branches:

All studies of rural financial systems show that the most important concern of farmers is convenience of location of the lending and deposit receiving facility. This presses for a very large number of branches or farmer's association. It presents a conflict between convenience and spreading overheads. Small associations that are conveniently located have low volume and hence high overheads as a percent of loan volume. This problem is exacerbated by the importance of competition to keep down interest rates and increase service. A careful balance must be struck in this connection.

8. Sound Legal and Regulatory Framework:

As part of the total picture for establishing a rural financial institution, the full legal and regulatory framework must be examined, and improvements developed.

9. Conclusion:

There is great urgency in developing an efficient, self-financing, competitive national system for rural finance. Meeting the targets for fast growth of horticulture and horticulture exports demands such a system. But, continued progress on food security and direct reduction of poverty also depend on it.

At present the poor and by extension for small farmers with less than one hectare of irrigated land are best served by the micro finance system. Large farmers could conceivably soon be served by commercial banks. There is a complete lack of financial system coverage for the middle farmer who must be the backbone of agricultural growth and rural prosperity.

To meet this gap a large scale, geographically pervasive rural credit institution must be developed. It is best built on a network of farmers associations building up into an apex body that connects farmers with national and even in international financial markets. To build this institution requires an immediate commission to develop the details of that system and provide the analytical basis and credibility for provision of large capital and technical assistance to get it off the ground.