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Function and Scope
of
Agricultural Credit in Developing Countries

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for
Agricultural Credit Systems in Developing Countries

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Agricultural Finance Center
Department of Agricultural Economics and Rural Sociology
The Ohio State University

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Foreword

The Agricultural Finance Center of the Ohio State University, through a contract with the United States Agency for International Development is conducting a world-wide research project on "An Analysis of Programs for the Development and Improvement of Agricultural Credit Institutions and Services." This project is designed to develop principles and guidelines useful to AID and developing countries in the establishment and operation of permanent and effective institutions and systems for providing agricultural credit in developing countries.

This report, the first of a series, is based on a review and analysis of materials gathered in connection with the contract for research in agricultural credit, on interviews with credit leaders knowledgeable in the establishing of agricultural credit institutions in developing countries, on the experiences of personnel and on analyses of agricultural credit operations in developing countries. Abstracting of resource materials and preparation of the report was by C. D. Curry, H. D. Bauman, J. O. Early and D. M. Sorensen, of the Agricultural Finance Center staff, with direction from M. G. Smith and R. A. Bailey.

For further viewpoints and analysis on the subject of agricultural credit the reader is referred to the writings listed in AFC Research Publication 104 - "Bibliography of Agricultural Credit", July 1965, Agricultural Finance Center, The Ohio State University, Columbus, Ohio - USA.

Table of Contents

	<u>Page</u>
Introduction	1
Agricultural Credit Defined.	2
Agricultural Credit -- Its Function.	2
Economic Function of Credit	2
Socio-Economic Benefits	5
Agricultural Credit -- When?	7
Agricultural Credit -- Who?	8
Agricultural Credit -- How?	9

**FUNCTION AND SCOPE
OF
AGRICULTURAL CREDIT IN DEVELOPING COUNTRIES**

INTRODUCTION

Farmers in developing countries are operating generally at an optimum level in terms of efficiency and productivity considering their knowledge and given the resources at their disposal. Yet productivity continues to remain low. Frequently the existing traditional socio-economic system does not induce structural changes required for promoting economic growth in the agricultural sector. Capital investment, an integral aspect of agricultural development, is essential for modifying traditional concepts and procedures.

The potential contribution of credit to the development of the agricultural sector is difficult to overstate. In any country where agriculture is a major industry, an effective credit program is necessary if agriculture is to make its full contribution to economic development. However, agricultural credit, per se, is not a panacea for effecting change and improvement. Credit is a facilitating element of the agricultural business through which improved production and marketing may be achieved. Effective systems of agricultural credit depend directly upon effective systems of management, technical understanding, marketing, land tenure, available resources, government policy, and available supporting services.

Identifying the components of an effective credit system requires comprehensive study. It involves evaluation of the opportunities and benefits to be gained from investment in agriculture. It requires examination of the political, social, economic and cultural environment under which agricultural production, marketing, and credit institutions must operate. It requires analysis of the institutional framework of the system. The factors which effect the production and marketing of agricultural products affect the amount of credit required, the terms and conditions under which credit is extended, and the organizational structure and staffing of the credit institution itself.

This report, the first of a series, is based on a review and analysis of materials gathered in connection with The Ohio State University-Agency for International Development contract for research in agricultural credit. Subsequent reports will consider specific aspects of credit systems, their inter-relationships, their implementation and operation.

AGRICULTURAL CREDIT DEFINED

Credit is the ability to obtain a value in the present with a promise to pay later. Specifically agricultural credit is acquiring the use of inputs necessary for the production and marketing of commodities in exchange for a promise to return or to pay for their use.

Agricultural credit can and does take many forms; money, seeds, fertilizer, livestock, machines, land, improvements and services. Payments for these goods and services assume an infinite variety of forms, a common denominator being that credit extended be repaid.

AGRICULTURAL CREDIT -- ITS FUNCTION

With programs of agrarian reform and land development enabling many families to become land owners for the first time, it is important to assist these families in becoming effective units in a society. Further, with an ever increasing urgency to provide more food and fiber in support of the expanding population, effective support of the total agricultural sector must be achieved. Of primary consideration to this is the development and implementation of effective programs of agricultural credit.

The function of agricultural credit is to provide a means whereby economically viable activities may be implemented. Through the effective utilization of credit a number of important secondary benefits accrue to the borrower, community and the economy. These secondary benefits, though vital to development, must be recognized as residual benefits to the intelligent use of credit, not a goal to be achieved without regard to or at the exclusion of economic considerations.

Economic Function of Credit

A basic premise to any business is its purpose or goal. In a society of private ownership this goal is to enhance the position of the owners. The owners of a business may also consider goals that enhance their position in society, but the immediate goal of business management must be directed to the financial position of the owners; therefore, the basic goal of a business must be to produce returns that justify the economic employment of resources.

Credit is one method whereby the inputs for an enterprise can be procured. Credit in itself is non-productive; but when used to acquire the factors of production, may contribute to the increased

productivity and efficiency of an enterprise. Credit, in order to be profitable to a business, must be used to acquire factors of production which when combined with other factors produce returns to the borrower in excess of the additional investment plus charges incurred during the life of the loan.

Natural Resources -- Acquisition and Development

Land acquisition may be one of the major uses of financial resources and therefore of credit. Land acquired through the use of credit must produce returns sufficient to repay loan advances, interest, and other costs incurred. Credit should not be extended for the purchase of land on which the repayment capacity is less than the terms of the contract repayments stipulated for that period. Particular care must be exercised when extending credit for land purchase in agrarian reform projects.

The value of land is influenced by location, fertility and productivity. The availability and location of effective markets, transportation, storage and processing facilities are also factors influencing the economic agricultural value of land.

Production

Production inputs should be employed only when there is an effective demand for the resulting output. Credit extended for the production of goods and services for which there is no effective demand is futile, making loan repayment unlikely. Further, the production resources employed: management, natural resources, productive chattels and labor must have the potential, capacity and quality for achieving an economically feasible production program. While agricultural credit concerns itself with the application of money or capital resources to the production process, it must be clearly understood that productivity, and, thus loan repayment, is not solely a function of production resources. Rather, if a rational application of credit is to be effected, the borrower must utilize his resources in such a way as to achieve an adequate level of productivity. The availability of technical counsel, guidance and other supporting services are requisites to the productive use of credit in a particular agricultural activity. Credit is not an end to production; credit is one of the means for financing inputs whereby production may be achieved.

It is comparatively easy and clear for competent credit technicians to establish credit goals, credit costs and credit repayment schedules based on existing or known production functions.

Utilizing the pertinent production factors, their time sequence and costs, it is simple to compute applicable rates of credit support. It is equally simple to determine and fix an effective repayment

schedule to insure an orderly and timely liquidation of the outstanding credit. It is perhaps redundant to indicate that crop and livestock loans have their greatest likelihood of repayments at the time of sale with the likelihood of repayment declining markedly thereafter.

It is thus clear that if credit systems are to function in an efficient manner, which specifically dictates the establishment of a revolving loan fund, production credit must be disbursed and collected in accordance with reasonable and timely rates and schedules. To do less greatly imperils the successful establishment of an effective system. Inasmuch as most agricultural credit is utilized for production loans, considerable emphasis must be given to the rational utilization and collection of this type of credit.

Marketing

An effective demand for agricultural commodities at the farm level in developing countries may well be hindered by lack of efficient and effective marketing systems. The development of improved marketing systems; that is, adequate storage, transportation and communication facilities, and processing facilities may well be considered in the allocation of credit funds in the extension of credit to agriculture. Investment in the marketing of agricultural products may make the use of production credit more feasible and repayment of loans more likely.

Transportation and Communication

Transportation and communication facilities play an important role in the marketing process. Lack of adequate roads and railroads greatly retard the development of integrated marketing, processing and retailing systems, thereby reducing or stagnating demand for agricultural products between the consumption level and the producing farm units. Transportation of perishable farm products in developing countries tends to restrict production to close proximity of population centers.

Storage

Storage facilities that can be used to hold and maintain quantities of agricultural products from harvest time until periods of relative seasonal scarcity will be conducive to an orderly flow of commodities through the market system and remove a major cause of wide seasonal price fluctuations. The increased overall demand through prolonged availability and reduced spoilage should be reflected at the production level in increased demand and prices. The acquisition, improvement, expansion and operation of effective storage facilities requires a substantial amount of financing; a major portion of which must be provided in the form of credit. Credit may also be required to finance commodities in storage.

Processing

The development of processing facilities to handle agricultural products should increase the effective demand at the farm level. Processing to maintain or enhance commodity quality, i.e., canning, freezing, drying, etc., would spread the demand for commodities produced by lengthening the period of commodity availability. Processing that increases the acceptability of products for consumption through improved quality and convenience should result in an increased demand at the consumer level and be reflected in increased demand at the production level. Credit may need to be provided to finance facilities, operations and inventories for processing agricultural commodities.

Socio-Economic Benefits

Increased Returns to Borrowers

A primary goal of agricultural development programs must be to provide a means whereby production of food and fiber will provide increased financial returns to producers. These increased returns however must be sufficient to reimburse the costs of production which are normally also increased. Credit may enable the agricultural sector to implement improved techniques of production and marketing and thus achieve greater outputs, efficiencies and returns. Unless these credits are based on realistic economic functions, the intended improvements and returns do not occur and the borrower may be in a worse financial position than prior to his receipt of credit in that he now has outstanding debts or liabilities. In the disbursement of credit to various agricultural enterprises a primary consideration must be the amount of increased returns expected. Returns accruing to the borrower beyond production costs can generate further production increases and provide a base for improved social development of the family and farm unit.

Improved Utilization of Resources

Efficient use of resources is the keystone of economic development. Increasing population pressures make mandatory the accelerated improvement of resource use. In most underdeveloped areas the labor force is idle much of the time and the arable lands are poorly utilized. The increasing demands for food and fiber and the rising aspirations of people dictate that increased productivity be realized. In most cases the quickest and most readily available method of achieving this is through improved utilization of the available factors of production, i.e., labor and land. Credit is an important component of any program to bring into a more productive state these idle or

ineffectively utilized resources and thus expand the productivity of the country. Any productivity increases must be based on an effective demand structure and thus credit extended only to those economic functions which indicate credit feasibility.

Improved Social and Political Stability

Social and political stability are essential elements of economic development programs. Increasingly the aspirations and demands of the producing and consuming sectors are closely associated with the production and marketing of food and fiber. In many countries the majority of the people spend most of their resources for food; therefore, food costs and availabilities are of paramount importance. Conversely with the rapid evolution of agrarian programs producers have need of, in fact, demand higher returns from their productivity. Thus the food producing sector and the majority of the food consuming sector have conflicting demands. Increased production of commodities at greater efficiency is necessary to enhance returns to producers at lower unit cost to consumers. Credit is a factor of such a program.

Increased Gross National Production and Foreign Exchange Earnings

Developing countries depend to a large measure on the agricultural sector for most of their revenues. Improvements in agriculture are quickly reflected in the improved financial well being of the country. Thus while industrialization of economies must be achieved, in most countries agriculture will remain the primary employer of resources and the major producer of income for a significant period of time. It behooves planners and policy developers to achieve effective measures of support to agriculture. The agricultural sector is not only production oriented; it is concerned too with those functions which give time, place, and form utility to agricultural products. To this end, investment in a meat processing facility may be the catalyst needed for development of the livestock industry rather than investment in animal units. An effective credit program for the agricultural sector must service more than the producer if agriculture is to provide effective support to the development of the country.

Increased Consumer Demand through an Affluent Rural Sector

Little consideration has been given to the farm family as a consumer in the underdeveloped areas. It must be recognized that most people live in or are supported by the agricultural sector; thus the consumer potential of this sector is substantial. To the extent that income accruing to the agricultural sector can be increased these people will constitute a more effective market for all types of goods and services and thus provide a very real and substantial support for the economic development of the country. Much of the development potential of a nation must accrue from development of the agricultural sector. Credit is an essential component of this development.

Socio-economic benefits may well be as important as those activities which are strictly economic, but the function of credit must be identified with and justified by those activities indicating economic feasibility, i.e., repayment capacity. While short-run objectives in the socio-economic area may be achieved through external injections of capital or at the expense of existing capital loan funds it must be recognized that the results are transitory and do not result in changes necessary for economic growth. Credit extended for purposes which are economically unfeasible usually does not justify the means.

In those situations where it is determined that injections of capital are required which do not meet acceptable and normal standards for effective credit programs, it is better that other agencies or methods be devised for their support. The function of the credit system and the role of credit must remain that of a financial agent for the implementation of economically viable activities.

AGRICULTURAL CREDIT -- WHEN?

At what stage of development is a farmer ready to effectively utilize credit? Again the social requirements must be viewed separately from economic requirements.

In the initial stages of land settlement and agrarian development some type of "grubstake financing" may be required. If farmers are to produce enough for their domestic requirements, either farm consumption or cash, they must combine natural resources with capital, labor and management. If they are to expand production further, to enable them to enter the market effectively, financial and technical assistance requirements become greater and thus credit becomes a factor in production.

Credit extended during the initial period of agricultural development is apt to be absorbed for non-economic activities, thus rendering its repayment unlikely. During this period farmers are seldom credit worthy. It may be important that subsidies for these costs be a part of the development program; it is equally important that these costs not be a part of the operation of an institution or system which is predicated on economic factors, i.e., credit institutions. These costs are better met from agencies which are primarily oriented to support social development.

Producers are ready to receive credit at such time as they can demonstrate a capacity to implement and execute economically viable agricultural activities. This may be in the first year, the tenth year, or never. Before a loan can be repaid, the borrower must enter the market with either commodities or services. Credit should never be extended except under conditions which indicate a reasonable probability of repayment. The integrity of the credit system is of paramount importance.

Within an area, a state or a country there are credit worthy activities. An effective credit system must be concerned with these activities on an individual basis, not as a "pump priming" scheme for the development of some nebulous idea. If a credit system is to be effective and self-sustaining, it must be concerned only with fund disbursement in terms of its probability of repayment.

It may be well to require that any attempt to develop a credit program be accompanied by the development of a supporting infrastructure, i.e., land settlement, tenure, roads, technical assistance, or other essential facilities. It is an erroneous concept that simply through capital injections the fruits of production will be assured and loan repayments become automatic. To the contrary, there exists an abundance of evidence attesting to the inability of farmers to repay credit extended -- no matter what their intentions may have been -- due to lack of technical knowledge, ineffective markets, poor roads, restrictive taxation and myriad other reasons, all extraneous to the credit system itself. Thus, it may be concluded that the extension of credit is effective only in the presence of appropriate combinations of these essential factors.

AGRICULTURAL CREDIT -- WHO?

In defining who should be recipients of agricultural credit, one must, as always, restate the axiom, "credit is only for economically feasible activities." Credit could be for the small farmer as well as the large farmer depending on the individual loan proposal.

Credit must be concerned with facilitating production of food and fiber for domestic consumption and export. The productive capacity of a country may be concentrated in small holdings or primarily in large holdings. Keeping in mind productive capacity, care must be given not to allot available credit funds to one type of borrower at the expense of another. That is, "social credit" objectives must not be at the expense of the basic objective of feeding and clothing the nation.

With the rapid evolution of land distribution and settlement programs a large number of small, and as yet inefficient, farm units have come into existence. There is a propensity on the part of planners, and others, to put primary emphasis on this group. Yet, this group due to lack of an existing infrastructure or experience may not be ready for the effective utilization of credit. Inasmuch as credit requirements always exceed available credit funds, the programming of funds must be concerned with facilitating the maximum economic impact.

Larger landholders may or may not be effective credit users. Logically, through economies of scale, experience and available resources it may be that this grouping is the one which must be initially responsible for producing most of the food and fiber of the nation. Judicious use of credit by this group of landholders, if not diverted to purposes outside agriculture, either directly or indirectly, is apt to provide the greatest agricultural support of national economic development. Credit defined as a means of obtaining economic factors of production must be disseminated to those who have the capacity to utilize it profitably.

At this point, it is essential to differentiate "on farm" credit and "off farm" credit. All too often credit concepts evolve from and center on the producer. However, the basic economic justification for production to occur beyond the subsistence level is vested in off-farm enterprise, herein referred to as agricultural industrialization.

Production beyond the subsistence level requires various forms of off-farm assistance, such as transportation, storage, processing or sales since most agricultural products are changed in form, time and place when sold. Milk to cheese, fresh to preserved, cane to sugar, wheat to flour are examples. It is through these processes that an economic justification, i.e., an effective demand for an expanded production is established.

The size of agricultural industrial activities need not be large. A small local meat packing plant or canning facility, though of limited cost, may well serve several hundred farmers. A creamery may service thousands of farmers yet not have an excessive cost factor. Since production intensity increased adjacent to markets, the development of markets is effective and essential in stimulating production.

Ownership of these "off-farm" facilities may be either by cooperative groups, individuals or corporations. Again, credit must be concerned with the activity itself rather than concern for a particular group or type of operation. The objective of agricultural credit remains, to finance, stimulate and facilitate the economic production and marketing of food and fiber. Thus agricultural credit systems must concern themselves with the total agricultural sector, both on-farm and off-farm.

AGRICULTURAL CREDIT -- HOW?

Recognizing the need of and role for credit in the development of the agrarian sector, how should credit systems evolve? Credit is not a new concept but old as civilization itself. Within the reference of current situations, what type of system or systems are required?

The most important and largest source of credit serving the agricultural sector are individuals. They may be merchants, exporters or money lenders. Without them agricultural activities in most developing countries would be impossible. In virtually every country in the world they are the backbone of the agricultural credit system. Is this an effective method for providing credit to agriculture? Does it facilitate agricultural production? Does it restrict and retard it? It is often believed that through usury, restrictive covenants, or outright fraud this is indeed a poor source of credit. Further, that credit from these sources has und continues to retard agricultural development. However, recognition of the problems facing this large and vital source of credit is not only proper but essential. Many of the experiences of this source of credit are applicable to other sources or types of credit programs. Many of the techniques which have evolved in the financing of agriculture by this private sector are sound, effective and essential. Thus, rather than a condemnation and discard of those principals which have with the passing of time proved effective, they should be examined closely and if found viable transferred to and made a part of other programs of agricultural credit.

Government or quasi-government sponsored credit programs are relatively new concepts. This is reflected in their continuing struggle to evolve and establish effective programs of support to agriculture without losing their continuity and solvency. To date, this has not been widely achieved as evidenced by the high loss and delinquency rates in credit extended in developing countries. Improved systems of agricultural credit are essential if the rapidly evolving agrarian sectors are to be effective contributors to the development of countries.

It is the intent of the studies now being conducted by the Ohio State University to provide guidelines for the development and implementation of effective systems of agricultural credit. Subsequent reports will analyze the various aspects and components of agricultural credit systems from both the institutional and sociological points of view.