

THIRTY-THREE FACTS ABOUT PHILIPPINE AGRICULTURAL CREDIT

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Introduction

Public interest in government policy and programs in credit, particularly agricultural credit, has remained high since credit policy is popularly (and politically) perceived to be part of the solutions to development and poverty-alleviation problems. Much of the discussions about agricultural credit and rural finance, however, has taken place in contexts where information about actual credit conditions is lacking, thus, these are often dominated more by rhetoric than fact.

Yet the Philippine experience and those of other countries reveal that credit policies and programs, including their manner of implementation over the past two decades, are of doubtful value. Twenty years of subsidized, targetted credit, previously believed to solve development problems, have wasted the scarce resources of the public, engendered distortions in financial markets, and introduced confusion in the public mind about loans, subsidies, and even charity (Adams, Graham, and Von Pischke 1984; Tolentino 1986).

To put the issues in their proper context and to make for more informed discussions, this article provides some facts and observations about agricultural credit. They are derived from the ongoing program to rehabilitate the rural banks (Dominguez 1988), the effort to re-orient the

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concept of "Supervised Credit," and the creation of the Comprehensive Agricultural Loan Fund or CALF (Tolentino 1986). This paper also includes the 20-year experience in rural banking and agricultural credit of the Philippines and other selected countries (Von Pischke, Meyer, and Graham 1986). Reference is further made to a larger set of studies on rural finance undertaken, some jointly and some independently, by researchers and analysts at the Agricultural Credit Policy Council (ACPC), the Philippine Institute for Development Studies (PIDS), Ohio State University (OSU), and the University of the Philippines (UP).

The Status of Rural Banks

1. As of December 1987, there were 850 operating rural banks. This contrasts sharply with the peak year of 1981 when there were 1,167 existing rural banks. As the Philippine economy deteriorated from 1980 onwards, the government found that it could no longer afford to keep the subsidies and lending funds flowing to, and through, the rural banks. Simultaneously, rural bankers began to find it more difficult to secure funds and subsidies from the government. As a consequence, they could not roll over or re-finance existing loans. Finding that rural banking was no longer an easily profitable business, many rural bankers chose to close shop. Other rural banks that were seriously in financial trouble were also closed by the government as a matter of law and regular supervision (Dominguez 1988).

2. Of the 856 rural banks that were still operating by the end of 1986, 82 percent were behind in their repayments on their government loans at very heavily subsidized rates of one and three percent (Task Force 1986). Of these arrearages, 93 percent were past due for at least a year (Ad Hoc Committee 1986); most of these obligations were also uncollateralized and, as such, probably uncollectible. Many rural banks then bore heavy burdens of bills payable to the Central Bank and portfolios dominated by loans that were long past due.

3. Most of the rural banks are in trouble because of two major reasons. **First**, since their portfolios are heavily exposed to agriculture, they bear the burden of the generally greater risk involved in agricultural projects (Graham 1985). As a whole, 57 percent of the existing loans made by rural banks are made to agricultural projects, while only 7 percent of those made by non-rural banks are given to agriculture (ACPC 1988). **Second**, rural banks have become very dependent on the government for their supply of loanable funds and for management assistance (Tolentino 1986). Because of their ties to government

programs, they cannot diversify their portfolios and spread their risks (Dominguez 1988). Also, they have failed to mobilize savings as the source of lending funds, either because they neglected to generate deposits or because they are located in areas where savings are not forthcoming in the first place (Blanco and Meyer 1988). **In essence, rural banks do not operate like banks.**

4. Given the dependence of rural banks on government-supplied subsidies and funds, it is not surprising that rural bankers gave the loudest protests against the new policies which effectively reduce their access to the very low-cost government deposits and re-discounting funds. Yet it should be kept in mind that the intent of the new set of policies was not to help rural bankers alone; rather, the new policies are aimed at providing credit for the entire rural economy *over the medium and long-run* (Tolentino 1988)

5. The ongoing rehabilitation process for rural banks is **selective** in the sense that only those rural bankers willing and able to make a commitment to continued banking, and those rural banks still able to recover without long-term, continued subsidies from public resources will be able to participate (Dominguez 1988).

6. Participation in the rehabilitation program is further selective since it is conditioned by the **stockholders'** infusion of fresh capital into their rural banks. The amount of fresh capital required for entry into the program is dependent, not only on the financial health of the bank, but also on the capacity of the rural banker to manage an extended, 15-year program to repay its obligations and write down the bad loans in its portfolio. The completion of the rehabilitation process should see the emergence of a smaller, but stronger rural banking system.

The Supply of Agricultural Credit

7. Of the total supply of formal credit to agricultural production in 1986, only about 12 percent was supplied through the rural banks. Commercial banks supplied the bulk or 82 percent of the loans (ACPC 1988b).

8. The total estimated demands for **agricultural production credit** in the Philippines in 1987 reached over ₱60 billion (Tolentino 1986).

9. The government had direct control of only about ₱1 billion in agricultural funds. About ₱700 million of these funds were consolidated

into the CALF. Thus, the government could only serve, on a direct lending basis, potentially not more than 16 percent of the total credit demand for 1987.

10. Even at the peak of the government's supervised credit programs in 1979, the government was able to supply only 24 per-cent of all bank agricultural production credit. In the past 20 years, the average proportion of total formal credit flows provided by government sources came to only about 12 percent. In 1986, the government-supplied proportion had dropped to **only two percent**. The private banking sector has always provided the bulk of formal production credit (ACPC 1988b).

11. The government has always subsidized the cost of credit heavily. In the period 1970-80, the government lent money to the Philippine National Bank and rural banks at one to three percent; unfortunately, it had to borrow these funds from abroad at open-market, commercial rates of thirteen and one-half percent (Ad Hoc Committee 1986).

12. While both the government and the rural banks are short of loanable funds, the rest of the banking system is very liquid. The estimated excess reserves of the system in mid-1987 was over ₱35 billion. It seems that the principal thrust of policy then must be to encourage banks to lend their funds to agriculture. **The government's role is to provide the incentives, risk-reducing mechanisms, and guarantees so that the banks with the funds will be willing to perform the required lending** (Dominguez 1988).

13. The CALF is designed to serve as a guarantee fund, not as a lending fund. Through this mechanism, the government hopes to reduce the risk of bank lending to agriculture as well as maximize limited government funds. The operations of the Quedan Guarantee Fund Board (QGFB) illustrates such leveraging of limited funds. While its guarantee base in 1986 and 1987 was only ₱95 million, QGFB was able to guarantee a total of ₱1.1 billion worth of loans in 1986 and ₱1.5 billion in 1987, achieving a multiplier effect **eleven times** its capital base for the former year and 15 times for the latter (Tolentino 1988b).

Informal Lenders

14. Two-thirds of all Filipino farmers who borrow, do so from informal lenders (Technical Board for Agricultural Credit (TBAC) 1986, ACPC 1988a). Compared to banks, informal lenders are very accessible

to borrowers, giving the loans at the farmer's house and collecting the repayment at the farmgate. They even accept payments in kind. Informal lenders also hardly demand processing and paperwork; they also lend not only for production but also for consumption purposes (Lamberte 1985).

15. In **nominal** terms, the borrowing rates charged by informal lenders appear to be much higher than those charged by banks. However, these nominal rates do not consider the borrowing costs involved in processing time, loss in production due to delays in the release of loans, transportation between the borrowers' home and the bank, paperwork, literacy requirements, and the need to repay loans in cash (Abiad, Graham, and Cuevas 1988). All of these factors translate into **added** costs (transactions costs) of borrowing. Thus when the **effective borrowing rate** is considered, the rates charged by banks become comparable to, if not higher than, those charged by informal lenders. This helps explain why in spite of the lower nominal borrowing rate charged by banks, most farmers still choose to borrow from the informal sector (De Jesus and Cuevas 1988, Lamberte 1985).

16. Government must provide an atmosphere wherein banks can reduce the effective borrowing rate at which they lend. Policies to reduce intermediation and transaction costs are therefore critical. These include the streamlining of the regulatory requirements imposed by government, increasing investments in rural infrastructure to lower the cost of transportation and communications in the rural areas, and providing guarantee schemes that decrease the bank's cost of absorbing defaults (Abiad, Graham, and Cuevas 1988, De Jesus and Cuevas 1988, Untalan and Cuevas 1988).

17. The lender's cost of absorbing such defaults is critical because the lender, informal or formal, also **shares** the risks in lending. In many cases, the basic collateral that the lender exacts is the condition that when a borrower defaults, he cannot borrow again (Floro 1986). The cost of such risk-taking translates into higher lending rates by the banks and the informal lenders (Untalan and Cuevas 1988).

The Government's Performance as a Banker

18. Aside from lending funds via the Central Bank, government departments, particularly the Department of Agriculture, assumed the role of a bank during the past two decades. But government's performance as a banker has been dismal. The average repayment rate on the

government-run programs is about 49 percent. This effectively makes the government give away half of the money. Furthermore, the government's administrative cost of almost eight centavos per peso lent out was about three times the administrative cost of the private sector (Tolentino 1986, Soberano 1986).

19. Until the creation of CALF, the government managed a total of 39 separate, commodity-targetted, subsidized credit programs for agriculture. (Note that only 17 of the 39 programs were consolidated into the CALF). These programs were run by management committees whose members were part-time detailees from the various departments. Ironically, each of the committees' and administrative budgets, averaging half a million pesos per year, principally consisted of the committee members' honoraria (Tolentino 1986).

20. The fact that the government was a direct lender put a great deal of discretion in the hands of the bureaucracy which had little or no capacity to perform banking functions. Such discretion gave rise to patronage powers and relationships in allocating credit; it then opened the possibility of corruption. It also created a perception in the public mind (buttressed by observations of actual cases) that borrowers could go direct to the offices of the Department of Agriculture and leave with checks in their hands (Tolentino 1986).

Subsidized Credit as "Assistance" to Farmers

21. Even if government made "cheap" credit available, it did not really help the small proportion of farmers who actually were able to get them. The cost of credit in proportion to the farmer's total production cost is only about six percent. The critical costs are those for fertilizer, 35 percent; pesticides, 15 percent; seeds, 9 percent; and labor, 35 percent (Caneda 1986). Therefore, government assistance focused on lowering the cost of these critical inputs will go a lot farther than support in terms of cheap credit. **Even if credit were available to farmers at no cost, the effect would at most be only a six percent reduction in production cost.**

22. The subsidy element in concessional credit is tied to the size of the loan. **Small loans provide small subsidies while large loans generate large subsidies.** As such, the larger farmers always ended up getting the large loans, and therefore the greater subsidies. Credit-based subsidies then become regressive.

Subsidized Credit and the Banking System's Efficiency

23. The government cannot force banks to charge the lowest borrowing rates and accept the most defaults on the smallest, riskiest loans. Unless the government is willing and able to absorb the cost of such policies, to require that banks act accordingly would be tantamount to forcing banks to commit **financial suicide**.

24. In the same vein that government cannot force banks to act against basic banking principles, the government cannot force borrowers to apply the loans they receive to pre-determined uses. Indeed, loans may be released in kind. But the farmer may have borrowed for rice not because he perceives that rice production is profitable, but because loans for rice production were available. **Credit is fungible**: that is, the farmer can receive the loans in kind, sell the commodities, then apply the proceeds towards the investment he perceives to be profitable. Nor can the supervision of the farmer by the extension agent prevent "loan diversion," since it is impossible for the extension agent to be on hand 24 hours a day.

25. The bureaucratic structures and procedures built around the supervised credit schemes transferred the responsibility for the decision-making on loans from the banks to the national, department level where the "guidelines" for loan programs were formulated. Unfortunately, the guidelines did not often correspond with local realities; yet they had to be followed or no loan funds would be released. The basic function of loan appraisal was then subverted and shifted away from the professional lenders to the Manila-based bureaucrats (Tolentino 1986).

26. A specific case of a guideline not corresponding to actual reality is the limitation on loan sizes according to national standards. Yet the limits barely covered commodity input costs. Labor costs were supposed to be equity-sourced. Yet the new technology for high-yielding varieties make the use of hired labor almost compulsory. Thus the farmer has to borrow additional amounts from the informal market to cover the cost of labor. For obvious reasons, he also pays the informal lender **first**.

27. Subsidized interest rates may also act as a disincentive to deposits. Since banks are intermediaries, they must mobilize deposits as their primary source of funds for relending. With the operation of legal ceilings on interest rates, borrowing rates on loans were held down, and the interest rates paid on deposits also had to be depressed since banks

have to make a margin, a spread between their borrowing and lending rates. To the extent that the saving public is sensitive to incentives and changes in deposit interest rates, then savings are kept away from banks as deposit rates fall (De Jesus and Cuevas 1988, Rodriguez and Meyer 1988). The cap on interest rates, in tandem with the available low-cost funds from government, thus help explain the dependence of rural banks on government-supplied deposits and loanable funds (Tolentino 1986).

28. Although P.D. 717 (the Agri-Agra Loan Quota Law) mandates that banks allocate a minimum of 25 percent of their loans to agricultural projects and agrarian reform beneficiaries, in practice, banks have lent only an average of less than ten percent of their loans to agricultural projects. Banks hesitate to face the greater risks and transaction costs inherent in agricultural projects; and so they take the safe way out: they invest in government securities. But since such securities earn at much lower rates, PD 717 in effect raises the intermediation cost of banks, a cost which in effect further reduces credit flows and increases borrowing rates for the financial system and the public as a whole.

Subsidized Credit, Agricultural Profitability and Agricultural Production

29. **Cheap credit cannot make an unprofitable project profitable.** The critical elements that will ensure the positive profitability of agricultural projects are those that will enhance the viability of agricultural projects; improve the credit-worthiness of agricultural borrowers; reduce the prices of critical inputs like fertilizers, pesticides, and seeds; and raise the prices of agricultural outputs.

30. The burden of supporting agricultural profitability falls not only on the effectiveness of the Department of Agriculture but also on the other government departments and agencies to:

- a) provide the critical support infrastructure for efficiency, productivity, trade and commerce – irrigation, roads, ports, bridges, electrification, storage, and transport;
- b) increase the productivity of agricultural labor;
- c) ensure the adequate supply and reduce the prices of fertilizer, pesticides, and seeds;
- d) improve the effectiveness of the government, principally through the National Food Authority, in stabilizing the prices of *palay* for farmers and rice for consumers; and
- e) reform the trade policies which decreased the income realized

both by the country and by the farmers from our agricultural exports.

31. It is often claimed that the scarcity of agricultural credit has led to production shortfalls, particularly in rice. Data on available bank credit and agricultural productivity show that the relationship between rice production and bank credit (if a causal, however tenuous, relationship is to be presumed) is negative. While the average flows of rice production credit from banks have been decreasing at a rate of over 14 percent per year, **palay production has consistently increased** at about two percent. Even in 1984, when the flow of credit from banks for rice production fell by 65 percent, *palay* production still grew by 1.3 percent.

32. Furthermore, should any relationship between credit flows and farm income levels be presumed, the data on available **bank credit and the incomes** of agricultural families is also worth noting. Indeed, the flow of bank credit has been decreasing at a rate of about 1.4 percent per year. In contrast, per capita income in agriculture still **grew** by 0.3 percent per year.

33. **Finally, when the profitability of agricultural projects is assured, then credit would flow towards it without the need for a specialized credit program.** Farmers who are able to repay their living costs will also pay off their loans. Bankers and farmers are more astute and trustworthy than what is often assumed by traditional credit programs. They will invest in projects that they think will bring them adequate returns on their investments. They do pay, but only after they have assured that the basic needs of their families have been met.

Conclusion

It is clear that the adequate availability of finance is a must for growth. Yet the means to enhance financial flows is unclear. The good intentions behind many government efforts to channel credit to agriculture were eclipsed by the actual, adverse effects of the programs and policies. The lessons of experience, painful and expensive as these are, now tell us that undue intervention by government in the financial market can lead to undesirable results. The critical elements which enable and attract finance to agriculture are often not found in the financial system, but in the infrastructure, agriculture, trade, and monetary systems. These systems interact, and in the context of appropriate policies, serve to create a dynamic, resurgent rural economy - the medium within which the financial system and the rural dweller can thrive.

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