

## Addressing constraints to agricultural finance to boost food production

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### Hunger stalks the land

In a survey conducted in 2009, the Social Weather Stations (SWS) found the proportion of families experiencing involuntary hunger at least once in the past three months of April–June 2009 rising to 20.3 percent or an estimated 3.7 million families, as compared with the estimated 2.9 million families (15.5%) in the previous quarter.<sup>1</sup> In terms of severe hunger,<sup>2</sup> meanwhile, an estimated 4.3 percent (790,000 families) experienced it in June 2009 (please see Figure 1 for a comparison of the state of hunger between the past Estrada and Arroyo administrations).

Discourse on food security has revolved around taking actions ranging from securing adequate arable land for crop cultivation to subsidizing the cost of inputs to farmers, repressing interest rates, protecting domestic producers through tariff policy, to controlling

the price of basic staples. Concern about the plight of the poor and the vulnerable has motivated governments to design interventions that seek to provide them adequate food safety nets. Invariably, the thinking is that governments should use a combination of instruments such as taxes, subsidies, incentives, tax breaks, and other policies and measures to motivate greater domestic food production.

Unfortunately, these interventions have been found wanting. What may perhaps bring us to

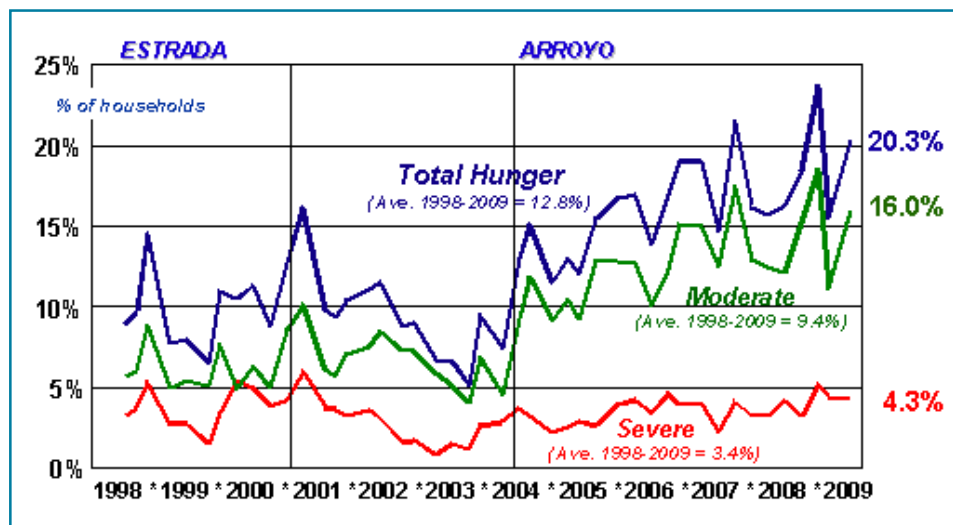
<sup>1</sup> Second quarter 2009 Social Weather Survey, fielded over 19–22 June 2009.

<sup>2</sup> "Severe hunger" refers to the condition of those who experienced it "often" or "always" in the last three months.

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Figure 1. Degree of hunger in households, Philippines, July 1998 to June 2009



the desired goal is a market-based approach that stimulates private investments in food production.

But to be able to effectively pursue this, an understanding of various constraints to agricultural finance and an identification of policy gaps, that is, areas where governments could intervene to enhance the workings of the market are appropriate. Efficient agricultural credit markets will be indispensable for raising resources for those investments.

In this regard, this *Policy Notes* discusses two constraints to agricultural finance: (a) high risk in agriculture and food production, and (b) high transaction and supervision costs. It then identifies policy gaps that need government intervention.

### Getting the private sector on board

Given the physical and environmental constraints on increasing land and water use for food production and other economic activities, agricultural productivity will have to substantially improve to meet the increasing demand for food. For this to happen, substantial investments would have to be made by both the government and the private sector. There is scope for governments and the private sector to work together to generate more investments in the food sector and thereby, increase the capacity to produce more food.

In many developing countries, private sector investments in agriculture are not found in the production of basic foods, e.g., rice, corn, or other staple products, which is oftentimes left to small shareholders cultivating small plots of land. Private investments of the

business sector could be found in cash crops, e.g., sugarcane, rubber, and palm oil destined for the export markets. The worldwide boom in the demand for energy fuels, encouraged by deep concerns about rising prices of petroleum and climate change, has also attracted substantial private sector investments in growing so-called energy crops.

The strategy of working with the private sector focuses more on motivating greater private investments in food production. Governments should take a different strategy to stimulate a significant private sector food security response. This is not to say that there are no incentives to invest in food production—real food prices are expected to remain high in the future—but the absence of an enabling framework for private business and small farmers and shareholders to invest in large-scale food production, and the disincentives to food production are strong reasons for the investment lack. The ‘knee-jerk’ responses of government in controlling the price of commodities, repressing interest rates and monopolizing the imports of grain during lean times are seen to be disincentives to private investment.

In order for the private sector to step up and make investments, the market environment should be improved by providing the necessary infrastructure, e.g., rural roads, electricity, and municipal ports (especially for an archipelagic country such as the

Philippines) and by developing regulations that support the workings of the market. Supporting and promoting innovative financing schemes could be an important part of that enabling environment for private sector investments in food production. Removing constraints to agricultural finance should figure prominently in the government’s reform agenda in agriculture and rural development.

### Removing critical constraints to agricultural finance

In many developing nations, however, access to agricultural finance is inhibited by two major constraints:

- *High risk.* This includes co-variate risks referring to price fluctuations and extreme weather events, including pests and diseases affecting farmers growing the same crop in the same area. The lack of information on borrowers’ credit histories, the lack of usable collateral due to ill-defined property and land rights, costly land registration procedure, and social constraints to foreclosure of collateral make credit risk assessment difficult and inaccurate.
- *High transaction and supervisory costs.* This constraint is also related to the risk, nature, and characteristics of the agricultural sector. The dispersal of the rural population over a vast area in the countryside, and poor transportation and communication infrastructure result in high transaction costs and make loan supervision expensive relative to lending to clients in the urban areas.

These constraints have made the access of rural producers to formal agricultural finance difficult, forcing said producers to concentrate on low-risk, low-return activities. The net result is limited investments in the agriculture sector and in food production on a commercial scale.


The challenge therefore to financial institutions and policymakers is to address the twin problems in rural financial markets of high risks and high transaction costs and loan supervision costs. The innovative financing schemes discussed in Llanto and Badiola (2010)<sup>3</sup> show particular approaches that seem capable of surmounting these twin problems. Much remains to be done, however, on the part of policymakers such as providing an enabling environment for innovations to be sustainable approaches, improving regulatory frameworks that would strengthen financial systems, and providing incentives for private institutions to develop better risk-reducing instruments and more effective institutions and credit delivery structures. More efficient rural financial markets will encourage more

private investments in food production and agriculture.

### What government can do

The government must effectively pursue the second-generation reforms in the agriculture and food sector to address agriculture risks and bring down high transaction costs. Doing the following will encourage greater private sector involvement in the sector.

- ensure that regulations, licensing, procedures, and standards are in place to help enhance market transactions;
- promote clear rules governing public and private sector responsibilities in food supply and distribution activities;
- enforce laws and regulations, particularly those concerning contracts;
- provide basic food production, market, transport and processing infrastructure, facilities, and services;
- promote efficient land and real estate markets as well as land tenure security; and
- develop and improve risk-reducing instruments, e.g., index-based rainfall insurance that has been used in other countries to address agriculture risks.

In tandem with all of these, the government should examine and address barriers to long-term finance in rural financial markets. 

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<sup>3</sup> G.M. Llanto and J.R. Badiola, Innovations in Financing Food Security, paper presented at the ADB-FAO-IFAD Investment Forum on Food Security in Asia and the Pacific, 7–9 July, Asian Development Bank, Mandaluyong City, 2010.