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## **Financial Liberalization and the Agrarian Sector: India and Kenya Compared**

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# **Financial Liberalization and the Agrarian Sector: India and Kenya Compared<sup>1</sup>**

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## **I. Introduction**

The agrarian sector in many developing countries has been going through a phase of slowdown, at times aggravating to a crisis, which has called for serious research and introspection into the policies and policy regimes that underlie their development trajectories. This paper looks at one set of important policies, namely the policies of financial liberalisation and traces its linkages with the agrarian sector. While no social science phenomenon has a unidimensional explanation, and one to one causality might be impossible to establish, the complexity itself makes it imperative to unfurl the different channels through which the impact might be felt. In Section 2, we address the conceptual framework within which the links between the agrarian sector and the financial sector supposed to serve the needs of the real economy are played out. Section 3 looks at the issue of farm credit, which has a direct bearing on agricultural production and prices, more closely. Section 4 uses the context of two developing economies, India and Kenya that were married to the idea of development banking in the 1950s and 1960s but have liberalized the economy since then, to understand the impact of financial liberalization on the agrarian sector.

## **II. Conceptual Framework**

In analyzing the effects of macroeconomic policy changes on agricultural development, it is usual to consider the changes in economywide structural adjustment and stabilization policies, and changes in sector-specific agricultural policies as both affect agrarian development. (See Oya, 2004) The impact of financial liberalization on the pattern of agrarian development can similarly be viewed as belonging to two distinct categories: financial policies that are an integral part of the structural adjustment and stabilization package but which have linkages to the development of the overall economy and therefore the agriculture sector; and financial policies that are specifically designed for the agrarian sector, like the rural banking policies. Liberalization in both types of policies must be evaluated for their impact on agricultural development. We shall consider each in turn.

Among the former we consider policies of external account liberalization – exchange rate and capital account liberalization – as well as non-credit aspects of deregulation of the domestic banking sector and monetary-fiscal policy mix, which link in the following important ways to outcomes in the agrarian sector.

- (a) As the stabilization and structural adjustment programmes in the developing countries follow external payments crisis, and therefore the need for a lender of last resort, one of the first conditionalities under SAP involves devaluation of the exchange rate of the local currency by a hefty margin and its liberalization so as to restore external

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account balance. The implications of devaluation and flexibility of exchange rate would be different based on the extent of openness of the economy and the agriculture sector to trade and capital flows. For open trade regimes, where primary exports are the prime foreign exchange earner, and account for a high share of GDP, fluctuations in exchange rate, due to factors external or internal to the economy, have significant impacts on agricultural trade and the overall economic performance. For any exporting nation the real effective exchange rate (REER) of the currency is an important indicator of the competitiveness of the economy, which in most flexible exchange rate regimes is targeted through adjustment in nominal exchange rate of the currency. Where nominal exchange rate is moved by factors beyond the control of the Central Bank, maintaining the exchange rate so as to retain competitiveness for exports becomes difficult. Thus uncertainty in the exchange market is transmitted to the commodity market. Also vice-versa, in such markets the changes in trade balances would affect the external value of the currency because of the thinness of the foreign exchange market.

Though the exchange rate liberalization initially corrects for overvaluation in domestic currency (in regimes that had up till now been following import substitution strategy) thereby benefiting agricultural exporters,<sup>2</sup> in most cases it is found that modern agricultural inputs like fertilizers and farm machinery have substantial import content in developing countries, whose prices shoot up with the liberalization of the exchange rate. For example, wide-scale experiences show that the farmers reduce their consumption of fertilizers after the rise in input prices, thereby affecting the production yields. (see the case study of Kenya below). Also as prices of imported farm machinery rise, import compression could lead to fall in gross capital formation in agriculture. The net benefit of the exchange rate correction is therefore limited.

In the case where the country is a net importer of food, depreciation of the domestic currency could lead to a crisis in the food sector, as illustrated by the large devaluation of the Malaysian ringitt during the Asian financial crisis. Malaysia is a net importer of most food items and the depreciation of its currency during 1997/8 was followed by large increase in the cost of production and the price of food.

Finally, many banks and other financial institutions might have borrowed in foreign currency under the pegged exchange rate era, when the exchange rate was stable. Their portfolio is suddenly exposed to exchange risk under free float. FAO and GTZ (1999) reports the cases of agricultural development banks which had raised offshore funds for local lending. The Nigerian Agricultural Cooperative Bank almost had to cease its operations because it assumed the foreign exchange risk of an African Development Bank loan. After the devaluation of the Nigerian Naira the repayment costs even on concessionary loans were several times higher than calculated a priori.

- (b) Capital account liberalization (CAL) is the process of removing restrictions on international transactions related to the movement of capital. It involves the removal of controls on both domestic residents' international financial transactions and on

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<sup>2</sup> Note that the improvement in trade balance with the devaluation of the local currency is likely to be limited for primary exporters as the price elasticity of demand for such exports, when developing countries are taken together, is low. Patnaik (2002) thus notes that 'not only are a host of third world countries competing for the export potential in this limited range of goods (exports of primary commodities and low-level manufactured goods) but the success of one group is invariably associated with the decline of another.' (p.99)

investments in the home country by foreigners. There are many possible channels through which CAL affects the agricultural sector.

The direct effects of capital flows as productive investment in agriculture is less initially as the home governments offer attractive terms, swaps and incentives on industrial investments rather than agriculture, as the former is perceived as 'modernising'. Thus very little investment flows into the agriculture sector. Even when foreign direct investment (FDI) flows into the agricultural sector, it would typically be channeled into *niche* sectors such as agro-processing, agro-exports, agro-marketing and crop insurance, which have high value added, high and quick rate of return and low risk. The pattern of FDI-led agricultural growth and its implications for domestic food security and employment generation would be dealt in .....

Foreign investment into the agriculture sector could indirectly be routed by the setting up of foreign banks and their providing financial services to the rural areas. However, it has been widely observed that the foreign banks, which usually take over the operations of a domestic bank through mergers and acquisitions, prefer to operate in the urban environment. Ramachandran and Swaminathan (1992) have shown that in India, foreign banks, even before the liberalization of the economy, had failed to meet their priority sector credit targets (although these were lower than for other banks in India).

In terms of the linkages of foreign capital inflow through the financial aggregates, capital inflows into an economy exerts an upward pressure on the exchange rate causing an overvaluation of the domestic currency, which in turn causes a deterioration in the competitiveness of the export basket and shift in production and investments from tradable to non-tradable commodities. Farm exports suffer as competing countries exports become cheaper, and imports rise. The Central Bank might try to prevent an appreciation of the domestic currency by intervention in the foreign exchange market and follow it up with sterilization of the foreign exchange inflows so as to offset the effect on money supply. The effectiveness of the central bank intervention and possibilities of sterilization through open market operations are however contingent on the state of development of the financial markets (positively related) and to the extent of integration with the international capital markets (negatively related).

The most pernicious effect of CAL, however, arises during situations of large scale flights of speculative capital in the form of portfolio investments, which result in the collapse of financial markets, erosion of asset values and deep recession in the real economy and problems of unemployment running through the entire economy.

- (c) Liberalization of the domestic banking sector involves removal of various kinds of existing regulations on the banking sector. It involves abolition of controls on the entry and exit of new financial firms including private and foreign firms. It involves reduction in controls over the investments that can be undertaken by financial agents. It involves the breaking down of regulatory walls separating the various sectors such as banking, merchant banking, mutual fund business and insurance. Financial liberalization involves the expansion of sources from and instruments through which financial agents can raise funds. There is also liberalization of the rules governing the kinds of financial instruments that can be acquired in the system. (see Chandrasekhar,

2003) This includes easing of controls on financial institutions to invest directly in the stock markets or lend against shares etc.

The effect of the reduction in controls essentially means that the choices to the banks have increased manifold, both on the asset and liability side of banks balance-sheets, and the attractiveness of extending agricultural loans or making organizational investments for deposit mobilization in the rural areas has shrunk considerably. This gives rise to two phenomena, one of financial fragility, as banks take on quick-return high risk investments notwithstanding the prudential regulations, and the other of financial exclusion, as a large proportion of the population loses access to formal financial intermediation. The process of financial exclusion is most visible in the rural sector, particularly for small and marginal farmers and the landless agricultural workers whose access to banking services is thereby severely constricted. We shall discuss the implications of altered incentives of banking on banks' credit functions in detail in the next section.

- (d) Statutory liquidity requirements on banks had served as a steady, captive and cheap source of funds for the government, a substantial part of which was spent on development expenditure. With the lifting of the statutory liquidity requirement and other controls on banks' asset portfolios as part of domestic deregulation, banks are free to select their investments. With the result that the attractiveness of government securities is much reduced (particularly in a supply constrained situation) unless the returns on the gilt-edged papers rise commensurately, which automatically contributes to the overall fiscal compression already underway in the economy and reduction in public investments in agriculture.
- (e) A move towards market determination of the interest rates in the economy under financial liberalization is usually followed by a sharp rise in the rates of interest in the economy. The central argument of McKinnon-Shaw models, which underpin the logic of financial liberalization, is to predict an increase in savings and investment in the economy following deregulation of interest rates.<sup>3</sup> Large scale evidence proves that the effects of interest rate liberalization on savings and investments is at best ambiguous, and in most cases seen to decline, as public investments in the economy routinely fall following financial liberalization, while growth of private investments is only marginal.<sup>4</sup> The positive relationship of savings to higher real interest rates is also not empirically validated. On the other hand, the rise in real rate of interest by raising the real cost of funds discourages investment. Usually, it is the high risk-high return projects that are funded by the banks while a large number of productive investments which do not fit into the risk-return profile of the banks are refused external funding.
- (f) Finally, one of the overriding objectives of financial liberalization in developing economies has been to eliminate the interference of the Ministry of Finance in monetary policy making and its use of monetary policy to generate fiscal revenues through seignorage, which is alleged to have vitiated monetary discipline under the

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<sup>3</sup> Shaw (1973) had argued that increasing the returns offered to savers, financial intermediaries capacity to lend is increased and banks are able allocate these larger volume of investment funds. The real cost of borrowing to the investor decreases and the average efficiency of investment is raised as banks can now reap economies of scale in risk diversification, lending, operational efficiency and information costs.

<sup>4</sup> See Reinhart (2000) for a review of the empirical literature and recent evidence for Africa.

era of controls. Instead Central Bank autonomy is expected to ensure fiscal and monetary discipline, with the ultimate aim of achieving inflation control. While the causality running from monetary expansion to inflation implied in such policies is open to question both theoretically and empirically, it is evident that monetary policy is now, more than ever before, weighed by concerns about fighting inflation rather than objectives of promoting productive investment or fighting unemployment or giving these goals an equal weight with maintaining a stable rate of inflation. This categorical change in the priorities of the Central Bank which is reflected in its direction and supervision of the banking sector undoubtedly shapes the growth of output, investment and employment in the economy including the agriculture sector.

In addition to these causalities running from macroeconomy-wide financial policy shifts to agriculture sector development, the direct link between financial sector and agriculture sector springs from the role of the financial system in fulfilling the demand for agrarian credit, a key input in the peasants production and distribution process. Besides long-term credit for productive investment, financial institutions have a key role in releasing seasonal liquidity constraints of the farmers. The effect of financial liberalization mediated through credit therefore has the most direct bearing on the development of the farm sector.

### **III. Financial Liberalization and Farm Credit**

Historically issues on agrarian credit and agrarian credit policies have dovetailed into agrarian sector-specific policies, the basis for which lies in the specificities of development of the financial sector in the late industrializing countries along Keynesian lines.

FAO and GTZ (1998b) reports the experiences of Latin American countries where the banks and ministries formed supervised credit programmes that tied technical assistance and training to subsidized credit during the 1960s and the 1970s. In places such as the Philippines and Indonesia, major segments of the rural financial system were attached to crop production programmes. Seasonal credit constituted an integral part of a package of recommended technologies and agricultural inputs, and were often administered by extension services, while loan repayments were linked with public marketing facilities. In India, the introduction and the spread of high yielding varieties of seeds were contingent on the access to low interest loans, along with provision of other modern inputs for cultivation at subsidized rates, such as fertilizers and pesticides and the policy of price support to farmers.

The general motto of financial sector development during the 1950s and 1960s, viz. the post independence years in most of the developing countries, had been to ration scarce resources, and direct them to planned uses and to curb the power and socially damaging behaviour of foreign capital and monopoly houses. A number of regulations sought to delimit the fields of operation of the private and the public sectors, allocate investment and finance, and control the inflow and outflow of foreign funds. (Goldsmith, 1983) Credit aggregates were accorded greater importance than monetary growth both as indicators of the thrust of monetary policy and as proximate targets of the monetary authority. Within this framework, rural credit policies aimed to extend the outreach of rural financial system and to increase the level of credit flow to agriculture and poverty alleviation programmes.

The institutional structure of rural financial institutions (RFIs) displayed certain common characteristics: promoting multiples of RFIs, encouraging a variety of forms of organization

of these RFIs, ensuring vertical organization from local to regional and national levels; encouraging high geographical density; ensuring that a high proportion of rural clients were reached; promoting diversified and multiple functions that horizontally integrate agricultural production, input distribution, marketing and processing systems. (see Mellor and Desai; 1993) In addition, capital requirements were modest, interest rates had a ceiling and credit was to be targeted to socially desirable sectors.

State intervention in the financial markets particularly in rural areas was deemed logical due to: (a) the underdeveloped nature of the financial markets and absence of certain kinds of insurance markets dealing with risks, which meant limited access to credit for a large number of potential borrowers (b) market failure as private institutions failed to provide credit to certain kind of borrowers (red-lined) because of high default risk or because the banks found it difficult to filter out the risky investments from among the projects that these borrowers displayed; (c) market imperfections in the form of interlinked factor markets and/or product markets or segmented markets which gave the moneylender extra-economic power to influence the terms and conditions of loan-making leading to large-scale usurious debt; (d) limited success with land reforms which meant most agriculturists had little land that could be used as collateral for productive investments; and (e) *divergence between social returns and private returns to banking with social returns on projects far exceeding private return to the banker.*

An important financial intervention adopted by almost all late-industrialising developing countries, besides pre-emption of bank credit for specific purposes was the creation of special development banks with the mandate to provide adequate even subsidized credit to agriculture sector and to selected industrial establishment. According to an OECD estimate cited by Chandrasekhar and Ray (2004) there were about 340 such banks operating in 80 developing countries in the mid 1960s. Over half of these banks were state owned, the remainder had a mixed ownership or were private. Specialized development banks enjoyed access to central banks rediscount facilities for lending to target groups. In addition, commercial banks which were not involved in agricultural lending were required by law to lend a fixed quota of their total lending to the agricultural sector. Either they had to allocate this fixed share of their portfolio directly in the sector or indirectly through specialized banks which would on-lend these compulsory funds to the final borrower. These funds comprised a significant proportion of loanable funds of the development banks as was the case for the Agricultural Bank of Iran and the Bank for Agriculture and Agricultural Co-operatives, BAAC, in Thailand.

The stabilization and structural adjustment policies imposed under the IMF loan conditionality targeted this carefully laid financial superstructure of almost every developing country during the 1980s and early 1990s for fast track liberalization. The ostensible reason for liberalization was the inefficiency of the financial system. The piling up of bad debts and non-performing assets in banks portfolios were blamed directly to the repression of the financial system. Rural credit policies of directed and subsidized credit and the policy of bank branch expansion in the rural areas were particularly targeted for criticism. Directed credit programmes were blamed for giving rise to low efficiency, high operational costs, low loan recovery and non-availability of financial services as well as to an overall misallocation of financial resources. In addition, it was argued that the model of 'social banking' had failed the sectors for whom these programmes were originally meant. Though these efforts were aimed at improving the distribution of formal credit among the small borrowers including the

small and the marginal farmer, the reform lobbies both national and international claimed that bank credit had largely remained concentrated in the hands of the landed population.

The consequent market reforms of the rural banking and credit policy aimed at increasing operational efficiency and financial viability of the system have included: rationalization of the branch expansion policy, dilution and eventual elimination of directed investments and credit quotas for rural and agricultural development; liberalization of interest rates and abolition of differential lending rates for special categories of borrowers, privatization of parastatal banks and other development financial institutions (DFIs). Previously used yardsticks for rural banking such as *number of loan accounts, the amount of loan disbursed, crops planted, investment funded and size of the organization* were replaced by profitability and net worth as indicators of bank's performance.

FAO and GTZ(1998b) describes this shift in policy frame from credit planning, credit directing and credit subsidies to one where the credit function has its sole focus on financial intermediation as a move from directed credit to financial market approach. Table 1 lists the differences between the directed credit approach and financial markets approach.

**Table 1: Differences between the Directed Credit Approach & the Financial Market Approach**

Elements	Directed Credit Paradigm	Financial Market Paradigm
1. Primary Problem	Market Imperfections	High transaction costs
2. Role of Financial Markets	Help the poor, Stimulate production, Offset distortions, Implement plans	Financial Intermediation
3. Users	Beneficiaries (borrowers)	Valued clients (borrowers and depositors)
4. Sources of funds	Governments and donors	Mainly deposits
5. Subsidies and taxes	Many (persistent)	Few (Transitory)
6. Information systems and evaluations	Dense, mainly for planners. Focus on credit impact	Less dense, mainly for managers. Focus on performance of financial intermediary and system

Source: Appendix 1, FAO and GTZ.1998b.

The post-reform experience of the developing countries shows that the liberalized financial sector has crowded out the rural sector very severely, particularly the farm sector and within the farm sector the small scale producers, resulting in disintermediation through institutional sources.(see case study of India) Commercial banks now have several choices for investment and avenues for lending, particularly among the service class, and de facto have little stipulations remaining on their portfolio that would necessitate affirmative action towards the rural sector. The new found freedom of the commercial banks have simultaneously been tied to competitive pressures to continuously book profits in the balance-sheets, to show clean balance sheets without bad debts or non-performing assets, which further cause banks to discriminate against the rural sector that has high information and transaction cost. Further, the new regulations on banks in the form of prudential requirements stipulate an ever increasing capital requirement. Given the higher risk-weight on loans vis-a-vis investments,



and very high risk-weights on uncollateralized credit, the incentives for banks to crowd out rural credit activities are only compounded.<sup>5</sup>

Agriculture development banks seldom had to raise deposits as they received concessionary funding either from international donor funds (multilateral lending institutions and bilateral development banks) or government contribution to equity and Central Bank refinance schemes.<sup>6</sup> International donor support and domestic state support have both dried up under neo-liberal reforms. Starved of financial support agricultural development banks are rescinding. In countries such as Peru and Bolivia traditional agricultural banks were closed down. In Gambia and the countries of former Soviet Union all or part of these development banks were sold and privatized. In still other countries these development banks and rural credit cooperatives persist but their financing activities have been sharply reduced, such as in Guatemala, Nicaragua and Uganada. Others like the Bank Rakyat Indonesia hailed as the most successful financial intermediary in the developing world have survived through radical restructuring by promoting non-targeted rural credit products, phasing out of most subsidized credit schemes, and paying market interest rates on deposits.

The privatization of parastatal banks have led to wide-scale closure of its rural branches. In the context of Sub-Saharan Africa, Frimpong-Ansah and Barabara Ingham (cited in Ssemogerere, 2002) indicate that the privatization has raised the risk of rural finance by reducing inter-bank information flow. It has also raised the unit cost of doing business and reduced the gains from economies of scale by lowering the overall volume of rural business.

Cooperative societies and producer organizations meet a substantial portion of the agricultural finance needs for small scale farmers in developing countries particularly where the rural financial institutions under the state sector have not emerged as a strong alternative, but also where the state-owned sector is considerably vast like in India. These organizations provide a variety of services such as collection, transportation, processing and marketing of agricultural produce, mobilization of savings by members, support of agricultural production through provision of inputs on credit, dissemination of technologies, and act as channels for flow of market information. In the recent years the health of these cooperative societies have been undermined in at least two ways. Firstly, concessionary rediscount facilities have been lifted or made discretionary so that banks are unwilling to lend to the cooperatives. Secondly, the agricultural cooperative societies are essentially producer cooperatives and many times consist of farmers growing a single type of crop like the sugar cooperative and the coffee cooperative for cash crops. The financial health of these cooperatives fluctuate in tandem with the profitability of its members: at times when farmers get remunerative prices, the loan repayment is high and the risks of default low, and vice versa. After domestic price decontrol and trade liberalization of the agriculture sector, the instability in the output prices have risen manifold. Particularly where crop insurance markets do not exist or are in an underdeveloped state, farm incomes witness huge year-to-year fluctuations, which in turn impacts the farmers profitability, and their repaying capacity. The loan default rate rise automatically in the cooperative societies and they turn into perpetually loss making entities. The attendant difficulties in running the cooperatives under such circumstances are however

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<sup>5</sup> See Jackson et al (1999) for a review of the effects of Basel regulations on portfolio allocations by the commercial banks. Much of the empirical research on balance sheet adjustment focuses on the “credit crunch” of the early 1990s, which has been attributed to the specific requirements of regulatory capital.

<sup>6</sup> The highest volume of international donor funds to agricultural development banks was received between 1975-89. Mexico, Peru, Pakistan and Morocco were the leading recipients of these funds among the developing countries.

treated by most mainstream observers as individual pathologies of mismanagement and irregularities commonly associated with the developing countries rather than consequences of the policy of market reforms.

Looking back it would be difficult to deny the presence of inefficiencies in the state led banking systems. There were legitimate concerns regarding political interferences in banks' decisions and bureaucratic inflexibilities that hampered banks' operations. The achievements of the state led development banking model however were too significant to be overlooked. This has come out sharply with the experiences of micro-credit programmes, which are anyway too small in size compared to the needs of the agriculture sector.<sup>7</sup> It's been increasingly felt that there were substantial economies of scale of the vast outreach and network of rural financial institutions, which can never be equaled by micro-credit institutions.<sup>8</sup> Elements of cross-subsidy across rural-urban sectors were important to cushion delays in loan repayment.<sup>9</sup> A specialized trained cadre with knowledge of the rural and the banking sector were essential strengths. But most of all, the guiding principle of macroeconomy-wide allocative efficiency for the banking sector made a substantial contribution to the economic and social growth of the developing countries. The blanket reforms have ignored all such possibilities and rejected the directed credit programmes in toto.

Besides the concern for operational efficiency and viability of the financial institutions, another reasoning that is used to legitimize market reforms of the agricultural financing institutions is the view that the directed and subsidized agricultural credit programmes were created to compensate for the urban and industrial bias in macro economic policies. This view is due to Dale Adams, the most ardent critic of state intervention in rural banking, and is now shared by FAO.

The starting point of this argument is that the early agricultural credit programmes were cast in a decidedly unfavourable market environment. They were directed to an agriculture sector that was experiencing strongly negative terms of trade. The combination of unfavourable exchange rate regimes, punitive export/import taxes and tariffs, as well as domestic commodity price controls depressed earnings in agriculture. Schiff and Valdes (1995) quote a 18-country World Bank study of price and other policy interventions in agriculture for the period 1960-85. The study shows that indirect interventions caused an average reduction in agricultural prices of 22 percent, whereas direct intervention caused an additional depression of 8 percent with a total negative effect of 30 percent. Such studies were conducted by most developing countries during their import-substitution development phase by the World Bank economists. It is to make up for the distortion in output prices in the farm sector, it is argued, that another distortion was introduced in the form of directed and subsidized credit programmes. With structural adjustment of the economies, as terms of trade for agriculture improve, and as many governments shift from 'import substitution' and 'punitive' policies

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<sup>7</sup> In the late 1990s, less than 1 percent of the rural credit supply in India was met by the NGO sector which is the main vehicle for micro-credit in India. (see Nair, 2000)

<sup>8</sup> In a cross-country study of rural financial institutions, Hulme and Mosley (1996), showed that the lowest cost of administration, 8.1 percent of the portfolio, were incurred by the Regional Rural Banks of India. (cited in Ramachandran and Swaminathan, 2002)

<sup>9</sup> The high repayment rates of certain micro-credit programmes, such as the Grameen Bank of Bangladesh are directly linked to the high administrative costs and the high levels of mobilization. Chavan and Ramakumar (2002) argue that the negative effect of these costs on the profit levels has been counterbalanced, first by raising interest rates on loans, and second, by relying more on subsidies. This exposes the fragile financial health of such programmes and institutions.

towards a more positive economic policy framework for agriculture, the need for state interventions through directed and subsidized credits automatically withers. With the movement towards freer agricultural markets through WTO and regional trade agreements, many market restrictions to the adoption of output increasing technology have already been removed.

This argument located in the urban bias framework, and fired by the logic of getting the prices right has scant empirical support. Oya (2004) referring to the 1992 study by Schiff and Valdes comments that the evidence from the experiences of African economies is partial, biased and clearly inconclusive on this score. Balakrishnan (2000) based on recent evidence from the Indian economy shows that the rise in agricultural prices during the 1990s and the so called 'corrections' in the terms of trade for agricultural commodities in the post-reform era was a result of 'intervention' by the government through procurement price policy. If one is to factor out the intervention induced price rise, not much improvement in terms of trade in favour of agriculture could be noted, which is nothing unexpected given that both industry and agriculture sector were protected under state planning. More suspect is the relation from improved agricultural terms of trade to farm output. Whether or not the terms of trade in the economy shifts in favour of agriculture would cease to matter unless there is a sufficient supply response to output price increases. Price elasticity of agricultural output in developing countries has been found to be small or insignificant due to structural bottlenecks, and agricultural production is known to respond much better to public investments in agriculture. (refer to the case study of India)

*FAO (1998a) notes, "paradoxically, when market conditions for agriculture to expand and to contribute significantly to overall economic development are increasingly evident, and at the precise moment when local financial institutions are gradually maturing and improving their ability to more adequately service the rural population, loanable funds for agriculture, in many countries have declined precipitously." (p.8) This paradox would not be resolved until a lens other than the neo-liberal market theory is used to examine the underlying macroeconomic relationships.*

#### **IV. The country Comparisons: India and Kenya**

Two countries, India and Kenya have been chosen for a review of their experiences of financial liberalization and the impact on the agriculture sector. The broad conceptual framework presented above shall be used to examine the evolution of the policies and institutions during the pre and the post-reform period.

India liberalized its economy in 1991. Faced with external debt crisis and prospect of default on external debt, India negotiated a stand-by arrangement with the IMF. The negotiation of a structural adjustment loan with the World Bank was almost a corollary, given the practice of BWIs to work in tandem in such situations (Bhaduri and Nayyar, 1996). Soon after the government set in motion a process of macroeconomic stabilization combined with fiscal adjustment and structural reform.

Structural adjustment programme in Kenya was implemented beginning in the early 1980s. The first phase was in 1980–1984 with the broad economy-wide approach and the second phase during 1985–1990 with the sectoral approach. The final phase of liberalization took place from 1991 onwards, and the liberalization of the financial sector of the economy including liberalization of the interest rate, exchange rate and capital flows were undertaken.

Like most other countries of Sub-Saharan Africa, Kenya has shouldered attempts at market reforms over a much longer period than India, though some of the reform measures were introduced almost at the same time as India liberalized its economy.<sup>10</sup>

India had one of the most developed systems of rural banking among the developing nations with a declared policy with respect to rural banking – what came to be known as ‘social and development banking’. This system despite its many inefficiencies had achieved an unprecedented growth of commercial banking in terms of both geographical spread and functional reach. Kenya though never had a comparable state-led rural financial structure, it had carefully build up mechanisms involving parastatals, cooperative societies, and commercial banks serving the farm sector. The Kenyan financial system, in general, was one of the most developed among the countries of Sub-Saharan Africa. Broad money to GDP, a rough for financial development of 40 percent (mid 1990s) was less than that of only South Africa.

### **India: Turning back on Development Banking**

After independence, India adopted a planned development strategy with state led growth of strategic sectors of the economy while the functions of the private sector were closely controlled by the state. Within this development model the task of rural finance in the formal banking sector was entrusted primarily with the cooperative sector until about the mid-1960s.<sup>11</sup> As technological change in the farm sector started gathering momentum, it was expected that commercial banks would play an increasing role in the rural credit market through branch expansion and directed lending. One of the major objectives of the nationalization of Indian commercial banks in two batches in 1969 and 1980 thus was to improve the flow of formal institutional credit to rural households, and especially to the farm sector. It was mandatory for the commercial banks to earmark atleast 40 percent of their advances for the priority sector – of which 18 percent was for agriculture and 10 percent for the weaker sections. In the 1970s, regional rural banks were created as part of the multi-agency approach to cater specifically to the rural sector, though they have played a marginal role compared to the commercial banks in the disbursal of credit. At the national level, National Bank for Agriculture and Rural Development (NABARD) was established by the government in 1982.

Between 1971 and 1991, the outreach of formal financial institutions in the rural areas improved considerably. The decadal All India Debt and Investment Survey shows that the share of institutional credit in cash debt of rural households increased from 29.2 percent in 1971 to 64.0 percent in 1991.<sup>12</sup> Over the same period, the flow of direct institutional credit to agriculture and allied activities increased sharply from Rs. 744 crores to Rs 9,829 crores registering a growth rate of 7.6 percent per annum. The share of rural bank offices in total bank offices jumped from 17.6 percent in 1969 to 36 percent in 1972. The share rose steadily thereafter, and attained a peak of 58.2 percent in March 1990.

The blueprint for reform of the financial sector in India following the adoption of macroeconomic stabilization and structural adjustment programme was contained in the of the Report on the Committee on Financial Systems (1991) whose recommendations closely

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<sup>10</sup> According to several World Bank reports, Kenya figures among the top three good adjusters in Africa, the other two countries being Malawi and Uganda. (Mkandawire,2002)

<sup>11</sup> Till then the presence of commercial banks in rural areas was mostly in agri-business and marketing.

<sup>12</sup> Quoted in Nair (2000)

mirrored the changes taking place elsewhere in the world, in countries which sought assistance from the IMF and the World Bank. The Committee recommended that directed credit programmes should cover a redefined priority sector consisting of the 'truly needy' and the necessity to bring down the credit targets for the redefined priority sector from 40 percent to 10 percent of aggregate bank credit. Though the GOI didn't follow the above recommendations, the coverage under priority sector lending was steadily widened. At the same time shortfalls relative to targets have been overlooked.<sup>13</sup> On the issue of unremunerative rural bank branches, the committee suggested that irrespective of the availability of banking facilities especially in the rural areas there should be a reconsideration of the future of these branches. In its view there was no further need for an activist policy of branch expansion and the judgements relating to future expansion should be left to banks themselves. Accordingly, the branch licensing policy was abolished. In the area of medium- and long-term credit to the rural sector, the operation of NABARD was crippled because of the withdrawal since 1992-93 of the concessional assistance given by Reserve Bank of India through its Long-Term Operations (LTO) Fund. On the basis of these funds NABARD refinanced, at concessional rates of interest, a number of agricultural and rural development projects. The ostensible reason for withdrawal of LTO Funds was the elimination of interest subsidies.<sup>14</sup> Finally, even the Regional Rural Banks which were set up with the exclusive objective of meeting the need for credit of the weaker sections (small and marginal farmers, SCs and STs and other beneficiaries of the official poverty alleviation programmes ) had to dilute their obligation to lend to these sections. In the early 1990s they were advised to lend 60 percent of their incremental credit to the target population, which was brought down to 40 percent and later to 10 percent by the end of the 1990s. The Reserve Bank of India now has permitted the Regional Rural Banks to invest in non-target sectors such as shares and debentures of corporates, and units of mutual funds and bonds of public sector undertakings, thus promoting a reverse flow of fund from the rural to the urban sector.<sup>15</sup>

The implications of these policies on institutional lending in rural areas have been the following:

- A gradual decline in the share of rural bank offices of commercial banks was seen from 58.2 percent in March 1990 to 50 percent by the end of the decade. In absolute terms, 2706 rural bank offices were closed.
- Pace of deposit mobilization in the rural areas declined.
- Agricultural credit as a proportion of total credit of commercial banks including RRBs decelerated from an average of 20.5 percent during the 1970s and 20.1 during the 1980s to 10.5 percent in 2001-2.<sup>16</sup>
- Three year moving average comparison of total credit-deposit ratio between 1988-1990 and 1996-1998 shows a decline from 64.4 percent to 57.8 percent, whereas the rural credit deposit ratio declined even more steeply from 62.7 percent to 45 percent over the same period.
- Share of priority sector credit in total credit outstanding declined from about 40 percent in the late eighties to less than 35 percent during most years of the 1990s.

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<sup>13</sup> See Chandrasekhar and Ray (2004) for a detailed account of the ways in which the definition of priority sector credit has been diluted.

<sup>14</sup> See Majumdar (1999)

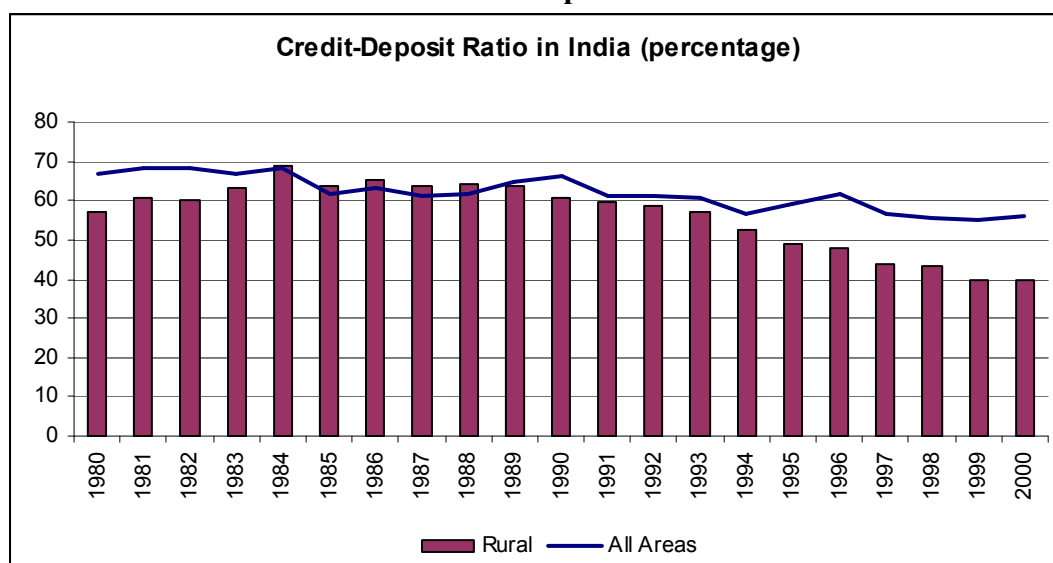
<sup>15</sup> See Bose (2005) on the state of the debate on Regional Rural Banks.

<sup>16</sup> See Handbook of Statistics, 2002-3, Reserve Bank of India.

Against a targeted 18 percent the proportion of advances to agriculture sector under priority sector lending declined from 16.9 percent in June 1990 to 14.3 percent in March 1996, despite including indirect advances for agriculture under priority sector lending from 1993-4.<sup>17</sup> The recent upward trend over the last five years is a reversal by definition: “priority sector advances now includes advances to newly created infrastructure funds, to non-banking finance companies for onlending to very small units, and to food processing industry. Loans to multinationals like Pepsi, Kellogs, Hindustan Lever and ConAgra now count as priority sector advances.” (Ramachandran and Swaminathan, 2002)

- Of the bank credit in the rural areas, in the year 1985 nearly 52 percent went to agriculture, bulk of it as direct finance. Industry accounted for 16 percent, trade 12 percent, transport operations and small scale industries 7 percent each. In 1998, the share of agriculture had declined to 38 percent. (Nair, 2000)
- In terms of composition of credit, while the decadal average growth rate of direct short-term institutional credit to agriculture and allied activities has been maintained at the levels attained in the 1970s and 1980s, the deceleration has come in the share of long-term credit, which directly impairs the pace of investment and private capital formation in these sectors.<sup>18</sup>

**Graph**



Source: Ramachandran and Swaminathan (2003)

- Data on the flow of direct finance to agriculture from commercial banks (including the RRBs) shows that while small farmers with landholdings upto 2.5 acres accounted for the bulk of the number of accounts, their share was only around a fourth of the total amount disbursed. Their share in total agricultural credit had declined from 30 percent in 1990-1 to 24 percent in 1996-7.<sup>19</sup> In 1997-8 in real terms, bank credit to small farmers was less than the amount advanced in 1984-5. Large farmers (with

<sup>17</sup> Indirect finance to agriculture includes lending to various intermediary agencies assisting the farmers as also investment in special bonds issued by NABARD and the Rural Electrification Corporation. It also includes deposits placed by banks in Rural Infrastructure Development Fund.

<sup>18</sup> Reserve Bank of India, Interim Report of the Advisory Committee on the flow of credit to agriculture (2004)

<sup>19</sup> Share of small borrowal accounts in total amount outstanding of commercial banks advances declined from 23.1 percent in March 1990 to 14.2 percent in March 1996.

more than 5 acres of land) on the other hand accounted for one-fourth of the total number of accounts and around 50 percent of the total amount disbursed. Their position got consolidated after liberalization. There is also clear evidence of growing regional imbalances in rural credit disbursal across the Indian states.

*Other aspects of Financial Liberalization and the Agriculture Sector*

Gross capital formation in the agriculture sector has declined over the 1990s, and reached a very low level of 1.3 percent of GDP in the triennium ending 2001-2. Particularly sharp is the fall in public gross capital formation. It has been long established that the growth prospect of Indian agriculture is crucially dependent on public investment in irrigation, drainage and flood control, in land shaping and land consolidation, in prevention of soil erosion and salinity, in the development of a widespread research and extension network, and in rural electrification and provision of production credit. All these programmes in agriculture make the role of the state absolutely indispensable, in what is otherwise a privately owned sector.<sup>20</sup> Private capital formation in agriculture, even if it were to make up for the decline in public investment, suffers from the drawback of going into 'high value crops that have a lower employment intensity than the more commonplace agricultural crops, notably foodgrains.'<sup>21</sup> It therefore follows that the decline in public investment had an adverse impact on agricultural employment via lowering growth rate not only of agriculture, but also of the employment-intensive crops within it. This is quite separate from its immediate demand-side effects.

**Table: Gross Capital Formation (GKF) in Agriculture In India (Annual Average)**

Period	Rupees Crores at 1993-4 prices			Total GKF as a percentage of GDP
	Private GKF	Public GKF	Total GKF	
1993-4 to 1995-6	9973 (67.7)	4754 (32.3)	14727 (100)	1.6 %
1996-7 to 1998-9	11498 (73.4)	4172 (26.6)	15671 (100)	1.4 %
1999-0 to 2001-2	13038 (75.2)	4312 (24.8)	17349 (100)	1.3 %

Source: GOI, Economic Survey 2002-3.

Figures in brackets are percentage to total.

With liberalization also came attempts at rationalization of input subsidies particularly on fertilizer prices which has rose almost every year over the decade. Allocation on agricultural extension services, a part of the rural development budget was heavily slashed.

The decline in public investments and expenditure on agriculture definitely has a political economy angle which explains why for instance certain types of expenditures, like social sector expenditure, and public investment expenditure have given way to increased defense allocations after the liberalization of the economy. Notwithstanding the political considerations and their effects on the budget, it is to be recognized that the compression in public investments in agriculture is a part of the general process of fiscal downsizing and

<sup>20</sup> Refer to Bardhan (1998) and Rao and Storm (1998) for a discussion on the importance and role of public capital formation for Indian agriculture.

<sup>21</sup> See Patnaik (2003)

retreat of the state from active intervention in the economy. Simple arithmetic says, pressures on fiscal authorities to reduce fiscal imbalances as part of fiscal reform are adjusted through compression in fiscal expenditure in the absence of a rise in fiscal revenue. Note that as a part of financial liberalization, statutory liquidity requirement on banks were brought down from above 40 percent to 25 percent and automatic monetization of deficit which entailed the Reserve Bank of India holding any amount of low-yield government paper issued by the Central government (ad hoc treasury bills) had been abolished during the initial years of reforms. The government therefore had to offer competitive interest rates in order to sell its papers. Whenever the short term interest rates went up due to heavy premium on liquidity, yields on government papers would also rise. As a result during the second half of the 1990s not only did interest payments reach historically high levels as percent of GDP, but they amounted to around 30 per cent of total government expenditure and more than 36 per cent of revenue expenditure.<sup>22</sup>

Later, this huge burden of interest repayment that had its origin in the liberalization of the financial sector, was used to justify the enactment on Fiscal Responsibility and Budget Management passed in the parliament in May 2003 which seeks to put a legislative restriction on the Government to eliminate revenue deficit by 2007-08 and to subsequently build a revenue surplus. This law, if seriously implemented would not only engender further compression in government's developmental activities including productive investments, the possible use of fiscal policy as a countercyclical macroeconomic policy tool shall be severely undermined.

Short term interest rates have emerged over the period as an important monetary policy instrument, replacing other direct instruments of monetary management. During the first half of the 1990s, interest rates were vigorously used for combating inflationary pressures in the economy and fighting exchange market pressures. The later were episodes where banks actively joined the FIIs in speculating on the possible fall in the value of the Rupee and arbitraging between the domestic and the international money markets. However, as the real economy slowed over the second half of the decade and inflation rates came down, the financial system faced a demand constraint. And interest rates fell. Occurrences of excess demand conditions in the forex market and speculative attack on Rupee were also relatively less over this period. Thus, for the Reserve Bank of India a set of fortuitous circumstances combined to make monetary management easier, and allowed low interest rates to prevail in the economy.

External account management had to mainly contend with capital inflows during the later half of the period, which was facilitated by the constant supply of government securities under its market borrowing programme. The Central Bank could sterilize the dollar inflows, prevent any major appreciation of the domestic currency, and at the same time achieve a very comfortable forex reserve position. Thus for India, financial liberalization of the external sector did not have major disruptive effects on the economy.

An estimated \$ 30 billion of FDI has flown into India since 1991, with the peak achieved during 1997-8, and a slowdown thereafter. Within the agriculture sector, FDI has mainly flown into tea and rubber, grown in large-scale plantations in India. These are also the major export crops for India.

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<sup>22</sup> See Fiscal Responsibility for whom? Feb 18, 2001.  
[http://www.macrosan.org/fet/feb01/fet180201Fiscal\\_Responsibility\\_1.htm](http://www.macrosan.org/fet/feb01/fet180201Fiscal_Responsibility_1.htm)



Banking sector was opened to FDI soon after liberalization. In the annual budget of 2003, there was a major revision of the upper limit of FDI flowing into the banking sector. Instead of the existing limit of 49 percent, FDI up to 74 percent would be allowed in Indian private banks. Interestingly, the same budget allows the merger of private banking companies with nationalized banks. Patnaik (2003b) notes that 'these measures open the way for the takeover by foreigners of Indian banks, and the takeover by the private sector, whether Indian or foreign, of nationalized banks, i.e. for both the de-Indianization of private banks and the privatization of nationalized banks.' With the rise in the control of private and foreign owned banks on the financial sector, the bias against rural banking activities shall be accentuated in the future.

Trade liberalization of agriculture has been limited. Certain cash crops sectors have been fully opened to trade with the fortunes of the farmers fluctuating wildly so that the government has constituted a Price Stabilization Fund of Rs.500 crores for tea, coffee and rubber sectors.<sup>23</sup> Food crops have been afforded protection thus far from trade so that the food sector was not affected by movements in external financial variables. The system of procurement of foodgrains and thereby price support to farmers has continued, and so has the distribution through public distribution system albeit in a much more diluted form than before.

The overall picture of the agriculture sector after a decade of reform shows: (a) slight deceleration in the growth of agriculture in the 1990s; (b) significant slowdown in the growth of foodgrain production which accounts for more than 40 percent of the share in total value of the crop production; (c) a decline in the share of agriculture in GDP from 34.9 percent in 1990-1 to 22.2 percent in 2003-4; and (d) a decline in usual status agricultural employment growth (-0.34 percent) over the period 1993-4 to 1999-2000 as compared to 1.51 percent employment growth during 1983 to 1993-4. The prognosis of the reforms are thus clear. The two main channels through which financial sector liberalization might have contributed to the travails of the agriculture sector is (a) by essentially curtailing the flow of credit; and (b) by depressing public investments and public expenditure in the farm sector. Liberalization of the external sector didn't cause major disruptive effects for macromanagement in India in the period under review, which could otherwise have undermined the competitiveness of the economy through the real exchange rate variable. Trade openness in the crucial foodgrain sector is as yet limited.

**Table: Trend Rates of Growth in the Agriculture Sector (per cent per annum)  
(at 1993-4 prices)**

	1980-1 to 1990-1	1990-1 to 2000-01
Growth of GDP of Total Agriculture and Allied Activities	3.07	3.05
Growth of GDP of Agriculture and Livestock	3.24	3.09
	1980-1 to 1990-1	1990-1 to 1999-2000
Growth of production of cereals	3.11	2.26
Growth of production of pulses	1.68	1.15

Source: Economic Research Foundation Data (2002)

<sup>23</sup> See GOI, Annual Budget, 2003.

## **Kenya: A case of Radical Economic Reforms**

The growth of the financial sector in Kenya after independence (1963) followed the state-led development model with government controls on portfolios of financial institutions. Interest rates were administered through a regime of fixing minimum savings rates for all deposit-taking institutions and maximum lending rates for commercial banks, NBFIs, and building societies. Financial institutions were segmented in terms of economic activities, sources of funding for institutions and asset holding, so that commercial banks concentrated on short-term loans and agricultural loans for seasonal credit for farmers, mortgage banks concentrated on residential and commercial construction, and development banks provided long-term loans. Government borrowed generously from the financial sector for its development activities. The exchange rate of shilling was pegged and there were strict controls on capital movement. The strength of the financial sector, which compared favourably against most African economies, was visible in the significant financial diversification and financial deepening that Kenya had attained by the early 1980s.<sup>24</sup>

The period of financial control, to be distinguished from the subsequent period when the government controls were removed and markets were liberalized, coincided with a period of active state intervention in the agriculture sector. Direct government controls and participation dominated agricultural production, marketing and investment activities. These included improvements on land, types of livestock and crops raised, methods of cultivation, provision of extension services and credit, and marketing of commodities. The government had a major role in deciding which commodities to promote and to this end, it created incentive structures that favoured particular commodities. As part of this state planning, tea and coffee were promoted as major export crops and maize as the staple food crop. Formal responsibility for controlling and implementing these policies was vested in the Ministry of Agriculture and many public institutions were created to fulfill the state functions.

For provision of rural credit, Agricultural Finance Corporation (AFC), a state owned financial institution that had been in existence during the colonial period became the channel for all public supplies of agricultural credit. After independence, AFC operated with the mandate of enhancing agricultural lending through provision of short and long term loans and thereby alleviate the working capital constraints that had been a key impediment to agricultural development. The Land Agricultural Bank was responsible for mortgage on land and played a crucial role in the land transfer programme in the post independence years. It was realized that resettlement of the land previously owned by the white settlers could not occur effectively without extensive credit for the purchase of land to the native Kenyans. After the land transfer programme had been implemented, Land Agricultural Bank was inducted within the AFC.

AFC was the main source of farm input credit for maize, wheat and dairy farmers. There was a tripartite arrangement between Kenya Farmers Association (KFA), National Cereals and Produce Marketing Board (NCPB) and AFC. These three organizations worked closely to support farmers. Kenya Farmers Association (KFA) had been formed by farmers themselves

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<sup>24</sup> Kenya had a well developed financial system by 1996, made up of 51 commercial banks, 23 nonbank financial institutions, 5 building societies, 39 insurance companies, 3reinsurance companies, 10 development financial institutions, 1 capital market authority, 20 securities and equities brokerage firms, 1 stock exchange, 12 investment advisory firms , 57 hire purchase companies, several pension funds, 13 foreign exchange bureaus, and 2,670 savings and credit cooperation societies (Development Plan, 1997/2001).

and was the most important supplier of agricultural inputs - fertilizers, pesticides, seeds, equipment and machinery. It had a large number of outlets and was the backbone of input distribution in the country. Farmers could access inputs in kind from the KFA after guaranteeing of the same by AFC. In other words, AFC would extend loans so that farmers could receive inputs from KFA through input voucher system. National Cereal and Produce Marketing Board (NCPB) responsible for maize and wheat marketing bought the produce for cash from the farmers. This arrangement had several virtues: the provision of inputs and output marketing channels solved the cash flow problems for the farmers, it ascertained that the use of credit was for production activities through the purchase of modern inputs, simultaneously this arrangement reduced loan defaults by the farmers.

In addition, AFC also offered crop insurance scheme through guaranteed return for large scale maize and wheat production called the Guaranteed Minimum Return (GMR) programme, which was later replaced by a seasonal credit programme that had a component of subsidy for the small farmer.

The commercial banks in Kenya had a minimum lending requirement to the agriculture sector, which stood at around 17- 20 percent for commercial banks and 10-15 percent for NBFIs.<sup>25</sup> Commercial banks were encouraged to extend credit for rural operations through branches in the rural areas and designing programmes specifically tailored to the needs of agriculture. The government guaranteed availability of funds to the institutions lending to the agriculture sector.

The cooperative societies have been an important source of input financing for the small-scale farmers. The growth in the number of cooperatives have been quite significant in the past: in 1963 there were only about 1000 cooperatives, in the year 2000 there number had grown to 9400 with a membership of about 5 million. The cooperatives account for a substantial percentage of gross earnings in agriculture, their combined production accounts for 75 percent of the country's total agricultural production and 50 percent of the marketed production. Functions of cooperative societies in Kenya include collection, transportation, processing and marketing of agricultural produce, mobilization of savings by members, support of agricultural production through provision of inputs on credit, dissemination of technologies, and finally to act as a medium for flow of market information. Agricultural cooperatives were dominated by coffee cooperatives which were organized into factories: these cooperatives have combined the role of processing with that of financing production. Dairy cooperatives are second in importance after coffee. Others are the sugar, pyrethrum and fish cooperatives that have been assisting farmers by providing them with credit and other services like land preparation for the case of sugar cooperatives.

Kenya implemented the structural adjustment programme in spurts through the 1980s (possibly because of strong internal opposition) and then succumbed to pressures from the BWIs for complete restructuring during the early 1990s. The process of liberalization of the agriculture sector had been laid down in the Sessional Paper No. 1 on Economic Management for Renewed Growth (Republic of Kenya, 1986). The specific reforms involved were:

- Deregulation of markets to provide market based incentive system to channel resources into the most productive uses;
- Liberalization of trade and marketing policies and removal of price controls to make the economy more competitive;

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<sup>25</sup> See Nyangito and Kimenye (1995)

- Removal of government support on most essential services (extension, research, veterinary services, etc.) with a move towards cost-sharing whereby the beneficiaries would contribute increasingly to the cost of the services.

Thus during the late 1980s the government of Kenya had started introducing market reforms aimed at liberalization and privatisation. Specifically the reform process involved divestiture of the government from the state corporations that hitherto served as the main marketing outlets for agricultural commodities, removal of price controls and the removal of grain movement barriers, privatisation of government services such as the provision of Artificial Insemination and cattle dipping, deregulation of domestic and external trade.

Liberalization of the financial sector has followed the neoclassical format with the ostensible aim of improving efficiency of financial intermediation by removing distortions in financial resources mobilization and allocation. There was a move toward use of indirect monetary policy instruments, including reserve ratios, variable liquidity ratios and liberalized market based interest rates for monetary management. Reducing budget deficits and government reliance on domestic bank borrowing received the top priority and so did containment of inflation. Exchange rate was floated and capital flows were liberalized during the early 1990s.

In the rest of this section, we discuss the implications of the financial sector reforms for the agriculture sector. However, as we shall see below, it is not enough here to look at the linkages arising from the financial sector reforms and mapping them to the agriculture sector, as the reforms of the agriculture sector in Kenya have intersected in important ways with the financial sector reforms to shape the outcome for the farmers. There are processes arising from the within agriculture sector policy reforms which have worked so as to threaten the existence of the various institutions and mechanisms serving the needs of rural finance.

- Commercial bank's direct lending to the agriculture sector has become very small and is declining further. This is due to both demand and supply side factors. Interest rates on loans in Kenya had risen to abnormal levels during the first half of the 1990s (yield rate on 3 month treasury bill of the government was 33 percent in 1993), and though there has been a decline in the interest rate levels over the years, the spread between deposit and lending rate remains still very high. The decade of the nineties was also a period when the non-performing loans on banks asset portfolio continuously climbed up as only the very risky projects could afford to bear such high interest costs. Banks accumulated non-performing loans averaging 30-40 percent, with public sector banks having even higher non-performing assets on their balancesheets. In a self-reinforcing loop, the commercial banks continue to charge such high interest rate margins so as to make up for their losses. It is evident that except for large scale farming with extremely remunerative prices, no farmer can afford these high interest rates.

Also, as many of the public sector banks in Kenya were privatized after the reforms, it is expected that the rural loans by these banks would decline.

The latest Kenya Monthly Economic Review published in September 2004 shows that the commercial banks' credit to the agriculture sector as a share of the total outstanding credit stood at 10.5 percent in 2003, which came down to 9.0 percent in

2004. The share of agriculture in the incremental credit between 2003 and 2004 was a mere 1.67 percent!<sup>26</sup>

- In the early 1990s, maize, wheat and dairy marketing were liberalized and their influences were deliberately reduced. Private traders were allowed to compete with NCPB in the purchase of maize and wheat, and private milk processors emerged to compete with Kenya Cooperative Creameries Ltd. In addition maize imports were liberalized, and private traders could import grain at much cheaper rates from other African countries. No permission from the government was needed for this.

Now, as marketing was no longer centralized it was no longer possible to guarantee that the credit provided to farmers would be repaid and the mechanism for repayment was no longer guaranteed. Thus, the tripartite arrangement that had served well in extending credit to farmers growing food crops was no longer tenable. The private sector was also unwilling to provide farmers with working capital in the absence of guarantee that the output would be sold through them. For a while, AFC received funding from international donors, once the international donor funds dried up, lending operations of AFC were severely curtailed, as the internal finance of the government was under serious pressure.

- The coffee sector, the principal export crop of Kenya before tea became the leading export commodity, was adversely hit when international price of coffee fell. This in turn impacted the profitability of coffee producers, who were forced to curtail their use of production inputs substantially. The decline in fertilizer use by coffee farmers is also a part of the wider phenomenon of squeeze in fertilizer consumption due to rise in fertilizer prices after its decontrol. A comparison of input and output prices shows that in 1990 the cost of one bag of fertilizer was the same as one bag of maize. But by mid 1990s this ratio had become one bag of fertilizer costing three bags of maize thus making fertilizer use unprofitable for many farmers. In response to the high fertilizer prices it was found that farmers applied sub-optimal levels of fertilizer that combine poorly with hybrid maize varieties. (see Karanja et al, 2000)

The flagging fertilizer use by coffee farmers is reflected in the declining yield on coffee production particularly that of small-scale producers. While the decline in yield extends to the large-scale coffee farms as well, it's been much sharper for small-scale farmers resulting in the closing of the yield-differential for the two types of coffee producers.<sup>27</sup> The squeeze in profitability of the coffee producers has automatically meant that a large number of producers have been unable to repay their debt, so that producer cooperatives have accumulated huge unpaid debts, which in turn affect future viability of these institutions.

The sound health of the cooperative societies is particularly important as cooperatives serve a predominantly large proportion of the farm sector, and with state retreating from this sector, cooperative societies would be the single most important source of farm credit in Kenya. A recent survey found that 67 percent of all farmers do not

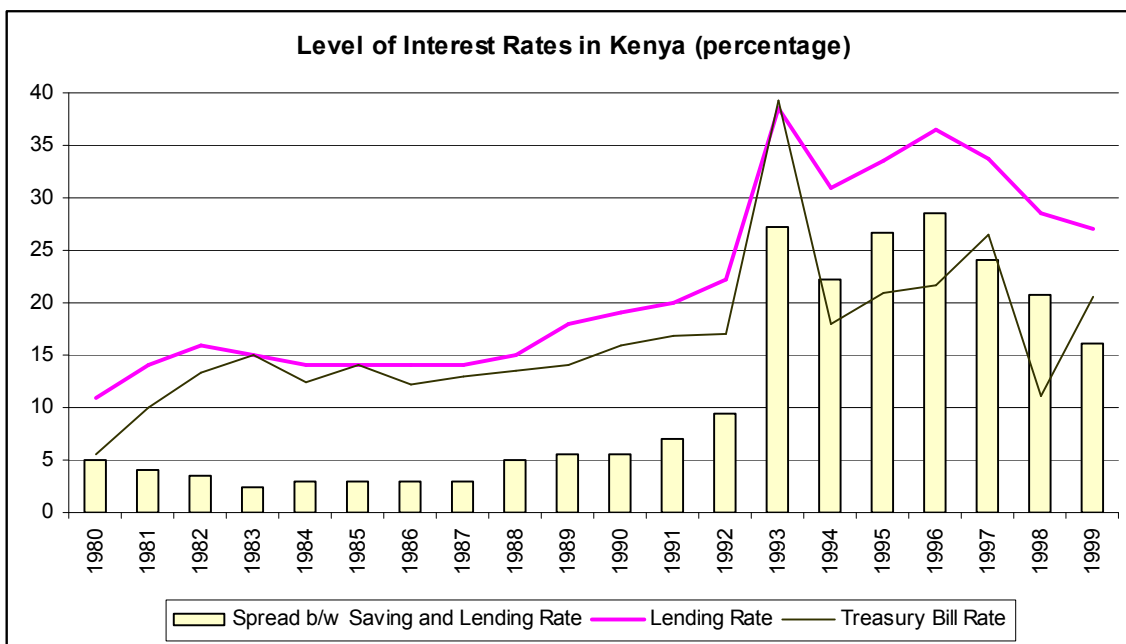
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<sup>26</sup> Available at <http://www.centralbank.go.ke/cbk/MonthlyReviews.html>

<sup>27</sup> Nyoro (2002) notes that current coffee yields on small-scale production is 44 percent of what they were in 1987/8 so that proportion of small scale coffee production decreased from 60 percent to less than 50 percent in 2000 without any change in area under the coffee crop.

receive any form of cash or in kind credit. Of those receiving, a majority 52 percent got credit from their cooperatives.<sup>28</sup> Thus many researchers have looked at the precise causes of ill-health of the cooperative societies. There is strong evidence emerging that shows that non-repayment of loans to cooperative societies under the liberalized era is due to diversion of credit to other uses. A substantial proportion of production loans are being diverted to uses unrelated to production. Ombuki (2004) has shown that about 38 percent of the loans taken by coffee producers are in fact spent by farmers in paying their children's school fees. As the government has slashed social sector expenditure in order to balance its fiscal deficit, private resources are being diverted to meet these needs. This also explains the low productivity of agricultural investments.

GRAPH



Source: Central Bank of Kenya, Statistical Bulletin (various issues) cited in Ngugi (2001)

Other Aspects of Financial Liberalization and the Agriculture Sector

Over the past two decades, government expenditure in agriculture has fallen sharply in Kenya. Nyoro (2002) reports that the total government expenditure in agriculture dropped from about 11.2 percent in the 1980s to about 4.7 percent in 2001 (revived slightly after touching a low of 2.5 percent in 1997-8). Allocation of public expenditure between recurrent and capital expenditure reveals that a large proportion of the budget goes to the payment of salaries in the ministry and the parastatals within agriculture thus leaving very little money for capital expenditures. In fact, public sector gross capital formation for the economy as a whole fell from about 10 percent of GDP in the early 1990s to just 5 percent of GDP in 2001. Private sector gross capital formation also fell from an average of 11 percent achieved in the early part of the decade to about 9 percent of GDP in 2001. Both private and public gross

<sup>28</sup> See Argwings-Kodhek (2000)

capital formation in Kenya is currently below the average for Sub-Saharan Africa. (World Bank, 2003)

Fall in public expenditure in Kenya over the decade is directly related to the policy of fiscal compression. International donor funding had become very marginal and even the little that came could be refused when specific donor conditionalities were not met. In the absence of external funding, it was only through internal funds that budgetary allocations could be met. The government of Kenya applied two options: to reduce fiscal expenditure, and to raise funds through market borrowing, a substantial portion of which was picked up by the banks. The heavy market borrowing by the government would have contributed to the upward pressures in interest rates. The promulgation of the Central Bank of Kenya Act in 1996 limited the government's access to central bank credit to a maximum of 5 percent of the government's gross recurrent revenue. Further, there were constant efforts to restrict commercial banks' lending to the government. The squeeze in the government programmes was inevitable.

As part of the downsizing of the government budget, 36,000 civil servants were retrenched from the government's payroll, many through voluntary early retirement. These included a large number of agricultural extension workers, who had played an important role particularly in disseminating knowhow on technological innovations and providing market information. The new policy specified one extension worker per district, which meant most farmers did not have access to these services. Many, unaware of the change in policy, simply assumed that the government was no longer providing extension services. Thus the entire agricultural support structure - agricultural marketing, agricultural credit and extension services for farmers had collapsed. Even supporters of liberalization, like Nyoro (2002) are of the view that "liberalization in Kenya resulted in an institutional vacuum in the provision of services as a result of this unrealistic assumption that as soon as the government exits from the market, the private sector would automatically fall in place irrespective of the conditions prevailing. The transition was more complicated than imagined and required appropriate public policy both during and after the transition. A gradual liberalization was therefore necessary in order to allow the sector to build up competitiveness in a progressive manner."

It is usual for economies facing debt default, to experience high inflation rates during the crisis period due to the lack of minimal import support.<sup>29</sup> Kenya experienced very high inflation rates, as high as 46 percent in 1993. Monetary policy was immediately tightened and inflation was sought to be brought down through indirect monetary policy instruments, relying primarily on short term interest rates. Banks responded immediately by raising interest rates on loans. The high interest rate had the ostensible benefit of attracting capital inflows, which essentially entered the Kenyan economy as short-term capital flows to take advantage of the high yields on risk-free government securities. However, when the Central Bank of Kenya later wished to reduce the interest rates in the economy to reasonable levels, there arose the dilemma that reducing interest rates would lead to capital flight.

Foreign direct investment in the economy was a mere 0.4 percent of the GDP during the 1990s. Whatever little FDI came went to the mobile telephone sector. (World Bank, 2003) Short term capital flows continued through the decade, probably because of the high interest rates, but escaping once conditions in the domestic economy became worse. Real effective exchange rate (REER) of the currency, the index of competitiveness for exports, appreciated

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<sup>29</sup> See Bhaduri and Nayyar (1996) pp. 28.

by 35 percent over the decade, despite depreciation of the nominal currency. The increasing demand for export of Kenyan tea made up for the deleterious impact of exchange rate appreciation on the overall export growth.

During 1990-2001, agriculture growth fell to 1 percent, compared to a growth of 3.5 percent during 1980-9. Overall, the real per capita income in Kenya in 2001 was below its 1990 level. Poverty ratios witnessed an increase over the decade.

In effect, the financial liberalization impinged on agricultural sector performance in the two ways we noted in case of India, viz., (a) by curtailing the flow of institutional flow of credit; and (b) by depressing public investments and public expenditure in the farm sector. However, the liberalization of the agriculture sector was more drastic in case of Kenya than in India, and these forces from within the agriculture sector weakened the rural credit delivery mechanisms, which were as it is struggling without state support. The macroeconomic conditions in the economy, particularly the formal banking system left a lot to be desired. Capital flows were volatile, and little came in as productive investments. The food sector facing competition from imports, and losing all state support, suffered the most. It might be said that food prices declined over a period, which it really did. But this was at the heavy cost of giving up the goal of food self-sufficiency in the economy.

**Table: Growth of Agricultural GDP in Kenya (percentage)**

	Growth of GDP in Agriculture	Share in GDP of Agriculture
1980-89	3.5	31.8
1990-93	-1.0	28.9
1994-97	3.4	27.3
1998-2001	0.5	26.7
1990-01	1.0	27.6

Source: Central Bureau of Statistics.

## V. Conclusion

The impact of financial liberalization on the pattern of agrarian development can be seen as belonging to two distinct categories: macro-financial policies that are a part of the structural adjustment and stabilization package and have linkages to the development of the overall economy and therefore the agriculture sector; and financial policies that are specifically designed for the agrarian sector. Liberalization in both types of policies must be evaluated for their impact on agricultural development. Examples of the former include policies in respect to public investments and public expenditures; exchange rate and interest rate policies, etc.; whereas rural banking policies would comprise the latter.

An analysis of the two country cases reveal that the financial sector liberalization has adversely affected the agrarian sector in these economies in a number of ways. The movement away from the dirigiste regimes has left an institutional vacuum that could never be replaced through the market forces. By curtailing the flow of institutional credit and the channels through which it flowed, both investments and outputs in the agrarian sector have been adversely affected. The liberalization of the agriculture sector, say to external competition, was more drastic in case of Kenya and these forces from within the agriculture



sector have weakened the rural credit delivery mechanism, which as it were, was struggling without state support. The macro-financial management added to the hardships through higher rates of interest, particularly in case of Kenya. Public investments in agriculture, a major determinant of agrarian growth and also of private investment, have declined in both the economies further worsening the chances of the agriculture sector and the livelihoods of people dependent on it.

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