

Important Roles of Rural Finance in Agricultural Development

~ Focusing on the experience over 1960s and
1970s in Japan ~

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What can be addressed by this lecture?

- ① Addressing some problems and challenges on rural finance in Sub-Saharan Africa countries.
- ② Describing the aims and means of agricultural finance and rural finance definitely.
- ③ Examining past experiences in Asian developing countries.
- ④ Reviewing rural finance policy and its successful impacts in 1960s and 1970s in Japan.
- ⑤ Pulling out some lessons from Japanese experiences on rural finance policy for Sub-Saharan Africa Countries.

1. Addressing some problems and challenges on rural finance in Sub-Saharan Africa Countries.

【Agricultural Problems】

- Specially in small scaled farmers
 - Lack of modernized agricultural technology.
 - Weak access to agricultural inputs such as good seeds, agricultural chemicals.
 - No wide spreading of proper solutions for rural finance.
 - Crucial shortage of specific knowledge and information in each stages from crop growing, harvesting to marketing and selling.

【Problems on rural finance】

- Unlikely establishing formally instituted rural finance organization. Formal money lenders both private and public sector are not necessarily effective due to high risk, uncertainty, and high transaction cost .
- Lower fund raising capacity of small farmers by reason of few collateral.
- Lower rate of return on finance.
- Greatly depending capital fund on foreign origin institutions.
 - ⇒Weakness of mobilizing save from the concerned persons domestically.
- Over commitment by government to rural finance market.
- Unbiased allocation of capital fund to land holders and large scaled farmer with vastly producing some commercial crops.
 - ⇒ Almost small farmers can't have access to formal finance. A great part of capital fund with interest subsidy provided by government is inclined to large scaled farmers.

- Capital fund is inclined to fields of processing and marketing rather than crop producing .
- Governmental regulated financial organizations are likely to finance to large farmer under conditions of middle and long terms, no interest or extremely lower interest.
- Semi regulated, like SACCO, or unregulated financial institutions, like informal micro finance, is considerably inclined to finance to small and middle scaled farmers under conditions of short term, high interest and small size.
- Semi regulated and unregulated financial institutions can't be covered necessary capital fund by only collected saving, which is serious problem in securing the fund.

(JICA, 2014)

【Challenges on Rural Finance】

- ▶ Establishing formal financial organization and co-existing indigenous small organizations and micro finance with it.
 - Mitigating fund constraint for small and poor farmers and leveling up their agricultural productivity as well as livelihood.
- ※ If credit were provided to the targeted persons with profitable investment opportunity, they could improve their economic position even without enough collastrals.

(Izumida,2003)

◆ Formal financial organization

Theory of Rural Financial Market (RFM)

- Putting emphasis on usefulness of market function and farmers' attitude with economically rational response .
- Adjusting demand and supply of rural finance in accordance with expected actual interest rate on market, eventually with good resource allocation.
- Substantial role of rural finance is to transfer the capital fund to persons needed it.
- Comprehensively understanding the interlink among savings mobilization, fund mediation and fund lending to borrower.
- Increasing the transaction cost when providing fund with low interest and using loan for targeted persons , district and works.
 - ☞Weakening saving mobilization in rural area.
 - ☞Increasing funding costs.
 - ☞Unable to specify the way of fund use due to its fungibility.

Micro Finance

- "Micro finance" means the small scaled finance aiming to mitigate the poverty, targeting on the poor, low income earner and extremely small enterprise. It contains the savings, insurance and remittance as financial service.
- The rural poor financed →investment →asset making →livelihood enhancement
- Micro finance institutions should aim at doing social business, solution to social problems, using the network of the poor class.
- Successful case of Grameen Bank.

(Hagiwara and Ohe,2013)

2. Describing the aims and means of agricultural finance and rural finance definitely

【Agricultural finance】

Lending and borrowing the capital fund with regard to agricultural production.

- Lending out the fund to enhance agricultural productivity by the promotion of agricultural investment embodied new technology.

【Rural finance】

Lending and borrowing the capital fund with regard to off farm activities in rural area, like processing and marketing of agricultural products.

【Farm finance】

Lending and borrowing the capital fund with regard to the economic activities consisting of farm, off farm and livelihood at farm household.

Subjects Used by Agricultural Finance

- Consumption
- Land improvement
- Building
- Agricultural machinery
- Livestock
- Farm management

Unique features of agricultural finance

- ① Widely scattered location of farm.
(leading to difficulty to financial access and high transaction cost)
- ② Diversity of farm management (crop, animal, size and etc.)
- ③ Diversity of farm income consisting of various sources.
- ④ Lower profitability of agricultural investment (slow returns on capital fund)
- ⑤ High risk of agricultural investment (heavy fluctuation of crops and price).
- ⑥ Difficulty to set collateral in handing the loan.
- ⑦ Seasonality, locality and smallness for fund loan borrowed.
- ⑧ Long period on loan payback for investment of land improvement.
- ⑨ High market risk, moral hazard and risk for policy change.

(FAO and GDZ, 1999)

Difficulty of fund in-flow to agricultural sector.

→ Looseness in circulation of fund.

→ Taking long time on pay back of fund.

→ Seasonality of loan demand.

→ Smallness of loan demand per farm.

→ Occurring unbalance of fund supply by district.

- Heavy weight of funding for farmers' group.
- Importance of land as collateral .
- Fungibility in fund use.
- Strong request for low interest.
- Fund rationing .

marginal productivity for agricultural production

< interest rate for funding

Fund Rationing for Family farm

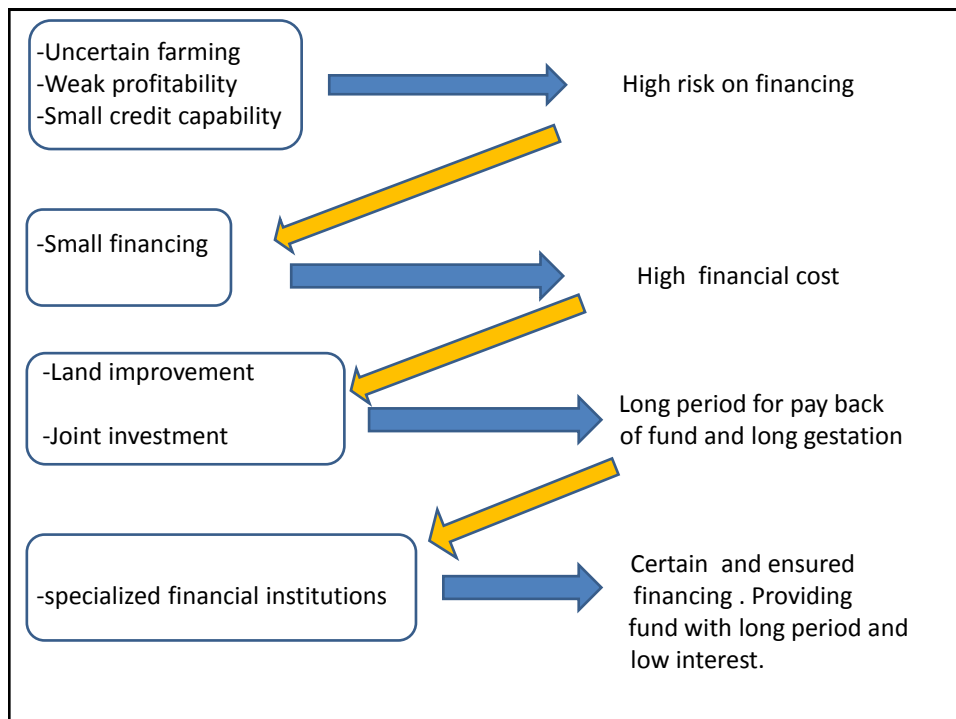
【Problems of limited Information and high transaction cost】

important information on financing,

- Capacity for pay back of loan decided by the level of income and asset holding
- Future overview for expected income from use of capital use
- Trust for borrower : personal and character

It is too costly and troublesome to collect information compared to requested small credit.

Fund rationing is attributed to such high risk for agricultural investment and low profitability of farming.



Special Features of Agriculture

-Background as Unique of Rural Finance-

【On farming】

- Producing food
- Difficulty quality of products keeping
- Land as basic resource
- Diminishing return of crops
- Severe natural constraint on farming

【On agrarian structure】

- Predominant of extremely small farmer
- Existence of subsistence farmer
- Smaller potentials for agricultural development
- low profitability based on lower agricultural price and productivity

3.Examining the past experiences in Asian developing countries

【Present status】

- Provision of rural credit by means of formal institution is tendency to increase.
- Works on rural credit are carried by government financial institution.
- Funding is carried by government and financing for investment and loans is conducted.
- Role of financing under government is to handle loan investment (intervention by low interest).
- Managed fund is provided from government as well as commercial bank and foreign loan.
- Percentage of informal finance is still high(almost 30%).

【Problems】

● Shortage of mobilized saving

Lending out fund beyond the saving. It is impossible to keep financing without input of capital fund from non government institutions.

- Impossible to mobilize affordable saving from farmers due to low interest, not enough access to finance institutions, high transaction cost and immature financial market.

● Low rate of pay back

This is attributed to farmers' low and unstable income, natural disaster, long distance between financial institutions and farmers, heavy punishment for default on a debt.

● High transaction cost

- Fund supply smaller than potential demand,
- Strictness of the judge for farmer resulting from risk avoidance of finance institutions.
- Inadequate financial infrastructure- number of institution, traffic and communication, staff -training, education and knowledge for farmer.

● Unbiased fund allocation

Access to formal financial institutions is greatly constrained from small farmer and landless farmer more considerable than large farmer and landholder.

(Izumida,2003)

4. Reviewing the rural finance policy and its successful impacts in 1960s and 1970s

【Rural finance before agricultural modernization】

- Overwhelming rice farmer with small field was in center of agriculture.
- Farming was considerably subsistence level.
- Income level of farmer was significant low with small saving and asset, being difficult to get financial services from formal financial institutes.
- Fundraising strongly depended on informal sector and small scaled credit cooperatives.
- Credit cooperatives existed in trust relation with farmer as users.

【Background of rural finance in the period of high growth economy】

- Increase of farm income → Increase of saving → Dissolving of capital fund shortage.
- Mixing of activities of farm and off-farm in rural area → Diversified sources of farm income → Establishment and extension of guidance policy finance.
- Occurring of fund surplus in rural area → Co-existing and complement of policy financing and agricultural cooperative financing.

Features of Agricultural Finance in the Period of High Growth Economy

- ① Main provider of agricultural finance used to be non-commercial institutions such as government and agricultural cooperatives.
- ② Provided fund was policy oriented.
- ③ Financial institutions was not so competitive each others .
- ④ Agricultural finance was formed under relatively closed system, apart from overall financial system.

(Saito, 1971)

Agricultural Finance System

【Fund Provider】

- Agricultural Cooperatives
- General Financial Institutes – Bank, Credit Cooperatives
- Agriculture, Forestry and Fisheries Finance Corp.as governmental Institution
- Central and district government as fund provider, which can also play a role of giving the subsidy for interest.

【Fund User】

- Farmer
- Agricultural Cooperatives
- Farmers' Group for Land Improvement
- Other Farmers' Groups

● **Composition of Outstanding Loan in Agricultural and Rural Sector(2002, 2.3 billion yen)**

- Agricultural cooperative financing(for use of farming and livelihood) ▪ ▪ ▪ 85.4 %
- Policy financing (for use of farming) ▪ ▪ ▪ 9.3%
- General financing(for use of farming and livelihood) ▪ ▪ ▪ 4.9%

● **Agricultural finance is basically identified with two types of policy financing and agricultural cooperative financing.**

Features of Agricultural Finance System

- Specific fund lent out by agricultural cooperatives is used in order to materialize the policy purposes with government support.
(Fund for agricultural modernization , Fund for disaster restoration)
→ This is one of important financing means that central government aims at materializing policy purpose(policy financing).
- Policy financing has two functions , policy materialization and support for private financial institutes.
- It is impossible that private financial institutes like agricultural cooperatives completely meet with users' requests resulting from some risks and uncertainty resulted from agricultural sector.

【Policy Financing】(1970) long term and low interest

● **Government Fund**

Agricultural cooperatives is trusted in terms of financing under government control.

- Financing from Central Government

Lending out the fund for forming up fixed assets with long term, 25 years for pay back and extremely low interest 0.8~1.7% per year.

- Financing for agricultural modernization
(no interest and 10 years for pay back)
- Financing for new farmer

Basic Roles of Policy Financing

【Revising the market failure】

- Serving the under supply with positive externality.
- Politically intervening in phase of cost diminishing for agricultural production .
- Reducing the increased transaction cost(asymmetric information and uncertainty).

【Complement for private financing】

- Qualitative complement(profit. period. risk. credit capacity)
- Quantitative complement(redressing fund misallocation. large scaled investment)

(Bessho, 2007)

【Problems on Policy Financing】

- ① Policy financing is effective and efficient or not?
- ② Extent of support for private financing is good or not?
- ③ Is it desirable to solve the market failure by means of politically intervening?

(Bessho, 2007)

【Private financing】

→ complementing the policy financing

Fund supplier ··· Agri.coop, Private local bank

Used way of fund ··· Loan for farming

(short term: under 1 year)

Loan for daily life of farm family

(proper fund provided by agri.coop.)

- Insurance system for guaranteeing the agricultural credit
(aiming at financing smoothly for farmer to recover his credit capability)

(Bessho, 2007)

Agricultural Cooperative Financing

Lending out fund needed on farming and daily life to cooperative members as sourcing his saving.

-Fund for agricultural modernization

(Long term loan, paid back within 15 years and low interest with subsidy from government 0.8 – 1.7% . Agri.coop. is in charge of this financing operation)

- Fund for restoration from disaster

(Coordinating the financing needs of farmers faced with disaster)

- Fund for breeding out farmer combining crops with animals on farming business
- Fund for breeding out new farmer

Economic Impact over Agricultural(Rural)Financing

● Establishment of Agricultural Basic Low (1961)

- Aims: - Creating out high productive farmer.
- Equalizing income between farmer and non farmer.

Targets:

- ① Enlargement of farm size → Raising self-sustained farmer
- ② Land base fulfillment → Up-lifting labor productivity of agriculture over mechanization and intensification
- ③ Expansion of agricultural products with high added value → Strengthening of fruits & vegetable growing, animal raising.

【Impact of Policy Financing and Agri.coop. Financing】

- Land improvement and agricultural mechanization made a great progress.
- High added value crops and animals were introduced.
- Newly productive technology was used effectively.
- Farm income was increased (owing to selected kinds of valuable crops and animals and price support policy).

As this result,

Farmland base was developed → Fixed capital for farming was formed → Progressive technology was introduced effectively → Farm income was increased → Farmers' saving capacity was enhanced.

- Enhanced saving capability made farmers' credit worthiness increased.
 - Increased farm profitability
 - Increased off- farm income
 - Increased income by means of farmland selling
- Farmers' earnings was saved to his/her account of agricultural cooperatives.
- Fund borrowed by farmer was switched from individuals to institutions.

This reasons is

- Enhancing of farmers' credit worthiness
- Great support by means of policy financing
- Seasonality of financing and difference of credit provision by district have gradually been smaller.

- Increase of farm income → Increase of saving in account of agricultural cooperatives
→ Increase of lending out to agricultural sector (later rural sector).
- Increase of fixed liabilities of farmer (particularly in animal sector like feeding dairy and beef cattle with higher ratio of saving / borrowing).

(Higurashi, 2003) (Baba, 1993)

5. Pulling out some lessons from Japanese experiences

- Making use of policy financing in accordance with policy targets.
- Making use of policy financing to revise the market failure.
- Government supporting private financing in terms of quantity and quality.
- Modifying the finance conditions by way of use (at short term of finance for running operation and at long term and low interest of finance for forming the fixed capitals).
- Supporting financing capability of farmers with arrangement of institutions building like ensuring of credit guaranteed insurance system for farmers.

- Making up saving capacity of farmers through up-stage of agricultural productivity and farm income under pursuit of agricultural modernization policy.
- Pulling down financial transaction cost by effective combination on business of selling, purchasing and financing in agricultural cooperatives.
- Enhancing the effectiveness on rural finance by combination of policy financing, agri.coop. financing and micro financing.

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