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VIEWPOINT: FINANCING SMALL

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"Why do you not seek the (financier) funding? We are afraid of

"I thought they would take crop failure into consideration when rep

"I think the loan was no good because there was not enough money

*"What is bad is that this money has a lot of interest. Many people
very scared because of others' bad experiences.....they harvested not
Some are just paying for the 'children' and they have not even sta
'children' - as long as you keep paying."*

(Quotes from DBSA, 1991)

1. Introduction

The agricultural sector in Southern Africa is in the process of change. These changes will hopefully at some future date culminate in the integration of all farmers into a comprehensive farm production and support system. In order to achieve this, all farmer support elements as embodied in different support institutions, have to be redefined in terms of target population. This is especially true with respect to the services provided by the agricultural finance sector. This sector can roughly be defined as that part of the broader financial sector that provides finance to the agricultural sector. This includes commercial banks, public sector parastatal institutions in the form of agricultural banks, certain government departments, co-operatives, traders, money lenders and other informal sources of finance such as family and friends.

If all farmers are to be served in an equitable manner, the participants in the agricultural sector and thus the target population of the agricultural financing sector will have to be broadly defined. These participants can range from full-time owner-operator farmers to part time farmers and farmers who rent the land they farm on. Within such a comprehensive support system it will however be necessary in the short and medium term to make special provision for small farmers if they are to emerge into fully fledged commercial activities. Although the targeting of specific groups of farmers is difficult it is known in broad terms that small farmers are those who receive only a portion of gross income from farming, who usually have production rights rather than ownership of the land, who mostly make use of family and casual labour and whose production objective can range from subsistence needs to infrequent or consistent surplus production for marketing purposes.

The financial needs of farmers, including small farmers, can be met in three ways. First, by using own funds (savings), second, by borrowing funds and third, by grants from governments and other bodies. The borrowing of funds can be from two sources, namely informal and formal. Most farmers in less developed areas make use of informal credit. This source meets the need for small scale agricultural operations where production for the market is not developed to its full potential. Where the aim is to expand farming operations to a scale to produce for the market, a formal, more stable and comprehensive source of credit is needed. This implies a source that will provide short, medium and long term credit.

International experience, confirmed in South Africa (Coetzee 1988), however indicates that factors other than interest rates play the major role in determining the effects of credit in the production process. These factors include the timeliness of the provision of credit, the opportunity cost of time in the credit procurement process, the cost of credit administration, the accessibility of institutions to applicants, the time it takes to make decisions on applications, the procedures and requirements of the credit institutions, the level of information on the applicants and the risk profile of farmers and the lending institutions. Economists lump all these factors together and call them transaction costs. Some of these costs are discussed in the next section.

2.1 Characteristics of small farmers and their financial needs

As already explained no clear definition of small farmers can be put forward. Certain characteristics of the broadly defined small farmer can however be highlighted. Financial institutions should take note of these characteristics as this will indicate the type of service or services that should be provided to meet the needs of small farmers.

Small farmers are mostly women and part time farmers who derive only a portion of their gross income from farming. This portion ranges from five to 30 per cent at the most (Coetzee, 1988; Cobbett, 1986). It also happens that funds obtained for agricultural production purposes are mostly repaid out of other sources of income. This implies that repayment of credit can be linked to income streams other than farming. Production credit may be repaid before the harvest or conversely, production credit may be repaid over a period longer than the production cycle.

In general, small farmers do not have title deeds to the land that they work. This implies no collateral for long term credit. In the absence of other financial information, these farmers can therefore only be considered for short and medium term financing according to the criteria of the commercial banking sector.

In South Africa, contrary to the traditional settlement pattern of smaller more intensive farms near urban areas and larger more extensive farms in outlying and remote areas, the majority of small farmers are situated on the geographic and economic periphery, where most of the necessary support services are lacking. This *inter alia* implies that inputs need to be transported over great distances and these farmers are removed from the markets.

Coetzee (1988) indicated that 55 per cent of small farmers that took part in a survey in KaNgwane had savings, and of these 66 per cent had savings accounts at commercial banks. The commercial banks only supplied loans to 7 per cent of respondents in this survey (Coetzee, 1988). The implication is that the commercial banks do supply a deposit facility but are more reserved in entering into loan agreements with their clients. It also implies that the savings accumulated in a specific rural area via commercial banks are invested in other areas (where people that qualify for loans at these institutions live) with concomitant leakages of economic opportunities. This is an important motivation for a rural savings mobilization drive. The provision of deposit facilities by rural credit institutions could therefore serve as a source of funds for these institutions. However, competitive deposit rates need to be offered to attract deposits.

If small farmers are grouped in two groups, ie. those that produce mostly for own consumption and those that also produce for the market, a marked difference in credit needs for agricultural purposes are indicated (See Table 1). Farmers who concentrate on production for home consumption generally do not take up credit for agricultural purposes.

cash has an advantage over pay-outs in kind. The reason being that the economic effect may be larger as the borrower now has the choice or the controlling power over the allocation of the funds. Formal institutions invariably pay out credit in kind or in the form of a credit note whereas informal institutions pay out the major portion of loans in cash.

Table 2: Differentiation between formal and informal credit sources in KaNgwane

	Formal sources	Informal sources
Average:		
Distance to source (km)	39.7	33.6
Number of visits to source	6.4	3.1
Application time (days)	59.5	8.3
Size of loans (R)	1951.6	446.2
Pay out in:		
Cash (% loans)	19.0	94.7
Kind (% loans)	81.0	5.3
Deposit needed (% loans)	36.0	10.6
% of farmers who took up loans:		
KaNgwane	43.0	57.0
Lebowa	29.0	71.0

* From a survey in Lebowa (Fenyess, 1982)
Source: Coetzee, 1988

The two most important reasons why formal institutions such as commercial banks are apprehensive of getting involved in the financing of small farmers seem to be the lack of collateral (in terms of the normal requirements set by these institutions) and transaction costs associated with extending loans to these farmers (Table 2 shows the differentiation between formal and informal sources in KaNgwane). Informal institutions have more information on their clients and thus have an idea of the clients' ability to repay loans (an informal form of collateral). Formal institutions' collateral requirements do not apply *in toto* to these informal transactions.

Formal institutions are not as flexible as informal institutions in rescheduling loans or adjusting the payback period to suit the income stream of the client. In a number of cases in rural areas the purpose of the loan and the activities that generate funds for the repayment of loans do not correlate. In the case of the informal institution the lender relies on the rational decision-making of the client and the clients knowledge of his own cash flow position regarding the source of funds to repay a loan. Formal institutions are more inflexible and prescriptive in this regard. They are usually inflexible on regulations and procedure regarding loan repayment period and method of payment (varying payments etc). Further, decisions do not rest with the small farmer's contact person at the institution. This involves more time and inflexibility in the making of decisions. In turn, this increases the transaction cost for both the borrower and the institution.

A further difference between formal and informal sources exist in terms of level of interest rate charged (see Table 3). A stereotype view exists that the higher interest rates of informal institutions are exploitive and therefore rural people should utilize formal sources. Another interpretation is that these higher interest rates reflect the risk associated with these loans. The argument that interest rates alone do not play the major role in the decision to take up a loan is therefore supported.

Concerning the ability to save it was found in Africa and other less developed countries that rural populations can save. Savings propensities of up to 30 per cent in rural areas have been recorded, also in South Africa (Coetzee, 1988; Nieuwoudt, 1989). Savings mobilization by financial institutions in rural areas has the advantage that it serves as a major source of funds for on-lending and can be utilized for economic activities with the resultant potential economic linkages in these areas.

rest on the two traditional assumptions mentioned earlier, the provision of cheap credit and the inability of rural people to save. It was impossible for these institutions to provide a great number of small farmers with cheap credit, while they have to rely on donors for funding and had no other source of funds.

3.1 Demand driven service

The greatest challenge to specialised agricultural credit institutions is to swing their financial services policy away from supply-lending finance to a demand driven service. This can only be accomplished if these institutions can identify the nature of demand, their target clients and the characteristics of rural financial markets. This entails a flexible approach acknowledging the different services required for the broad spectrum of farmers in the agricultural sector. It also entails a deviation from the procedures and practices adhered to by these institutions in the past as well as most of the actors in the formal financial sector.

In terms of the discussion on the financial characteristics of small farmers (see Section 2.1) the specialised agricultural credit institutions have to strive to lower transaction costs for both the financier and the borrower. The specific characteristics of rural financial markets have to be taken into account during policy and procedural arrangements.

3.2 Reducing transaction costs of financial intermediation³

Transaction costs have been identified as the major influence on the viability of financial institutions as well as the decision and situation of the borrower. The reduction of transaction costs of financial intermediation in developing countries requires improving information systems, reducing financial regulations, and implementing risk reducing mechanisms so that procedures and practices in financial transactions can be streamlined and simplified (Meyer and Cuevas, 1990). Several types of improvements both external and internal to financial intermediaries are suggested by Meyer and Cuevas (1990) along with some examples of how they are being implemented in selected countries.

Improving the economic environment

In order to ensure that small farmers are in a position to take up the challenges of commercial agriculture several improvements in the economic environment in which they operate is needed. Improved transportation and communication systems can help increase the efficiency of financial institutions. Market information will help both borrowers and bankers to better project the returns and risks associated with different types of investment projects.

Overall measures may include the provision of elements that will influence the access of small farmers to the market (Van Rooyen *et al*, 1987). Resultant improvements in farmer income will make farmer borrowers more attractive, less risky customers for loan and deposit services.

Improving banking regulations

Cheap credit policies do not benefit the farmers, nor does it benefit the credit institutions. Interest rates at very low levels force financial institutions to ration credit to their target client group and contribute towards the inability of the institutions to recoup lending costs at these low rates. This rationing is often accomplished by creating additional procedures and delays in loan processing which raise transaction costs. Borrower transaction costs are also increased. Cuevas (1984 in Meyer and Cuevas, 1990) found that borrowing costs and interest rates were negatively correlated in Honduras suggesting that as interest rates were allowed to rise the lenders found ways to improve lending efficiency for the borrower. Likewise, it was

Expand the banking network or bringing the service to the borrower

Greater accessibility of institutions to prospective borrowers is one of the prerequisites to decrease borrower transaction costs. The use of mobile banking units, to increase accessibility of the financial institutions, were tested in several less developed areas with mixed success (Coetzee, 1988).

Group lending

Group lending is often recommended as a way to reduce transaction costs. The following advantages are claimed for group lending (Adams and Ladman, 1979 in Meyer and Cuevas, 1990). For the lender, 1) default risks are reduced because of joint liability, 2) loan transaction costs are reduced per unit of money lent by making one large loan to the group rather than several small ones to individuals, 3) scarce manpower can reach a larger number of clients through groups, and 4) technical services can be provided more cheaply to a few groups than to many individuals. For the borrowers, the transaction costs per unit borrowed may be reduced compared to individual loans. Mixed results have however been experienced with group lending (Bratton, 1986; Desai, 1983).

Improve internal operations

Time to take decisions is one of the limiting factors of formal financial institutions. Operating costs are reduced through decentralized decision making. Loans to farmers and small enterprises are sanctioned by the branch managers with the advice of technical staff (Meyer and Cuevas, 1990). Reporting procedures are confined to collecting and documenting information relevant for decision making either at the branch or the head office. In addition micro-computers could be utilized to administer the deposit accounts, develop lists of past due loans, print demand letters, prepare *ad hoc* reports, and generally rationalise the Bank's daily office routine.

Link informal finance with formal finance

In many parts of the developing world, informal financial services provided by money lenders, commodity traders and landlords have been perceived at best as inefficient and unproductive, and at worst as usurious, monopolistic, and prejudicial to rapid, broad based development. Savings groups and ROSCAs⁴ have been seen as mere precursors to more formal credit unions. Pawnshops have been viewed simply as sources of high priced consumer credit for the urban poor. This negative view of informal finance is being replaced by a more positive interpretation, especially in the light of the major problems experienced by formal financial institutions in developing countries (Adams, 1989 in Meyer and Cuevas, 1990). There is recognition of the fact that the practices and technologies that contribute to strengths and advantages of informal finance, often in spite of many efforts to replace it, may provide suggestions on how to improve formal finance. There is also greater recognition for the need to tap the strengths of informal finance by linking it with formal finance.

By linking informal with formal finance, all the participants in financial transactions may experience a reduction in transaction costs, and/or they may be a transfer in transaction costs from the participant less able to absorb them (usually the financial institution) to the one more able to do so (usually the borrower or saver). Linking savings clubs with financial institutions, such as is being done in Zimbabwe with great success (Chimedza, 1984 in Meyer and Cuevas, 1990), represents an example largely oriented towards savings. These clubs are formed mostly by small groups of peasant farmers from the same village or cluster of villages. Similar arrangements are popular in South Africa, and are usually called stokvels. It is estimated that these stokvels mobilize about R50 million per month in the urban areas alone (Lukhele, 1990). Many of these stokvels

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