

**Agricultural Sector Credit and Structural Adjustment: Uganda's
Experience Under SAPs 1990/91 – 1996/97; and Beyond, Into
Poverty Reduction 1999/00 – 2003/04**

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Abstract

The purpose of this paper is to assess whether the agricultural sector under the SAPs regime (and the period immediately following that incorporates growth, structural change and poverty reduction objectives) is accessing the broad credit categories the sector requires to make its contributions to economic development.

The assessment is qualitative, based on: a number of surveys on the demand for credit by the Bank of Uganda, International Fund for Agricultural Development (IFAD), and the African Development Bank (ADB); key policy papers including the plan for modernization of Agriculture (2000) that incorporated specific proposals for small-holders to access credit through micro-finance institutions (MFIs); a review of financial sector reforms that broadly liberalized financial institutions, and enforced prudential regulations to strengthen confidence in the financial sector; and consultancy reports. The broad categories of credit were identified in figure 1.0.P.4

The assessment was divided into three policy periods: the early SAPs reforms 1990/91 – 1996/97 liberalized key prices and marketing institutions to permit the market mechanism to allocate resources efficiently, including credit. Whereas during this period agricultural producers benefited by receiving a larger share of the market price, this did not make the sector sufficiently profitable to compete for scarce and expensive credit at high interest rates, compared to other sectors.

The second policy period, which strengthened the financial sector through prudential regulations, indirectly made formal commercial banks more risk averse; they turned to short-term credit in trade and commerce, and the purchase of treasury bills, largely crowding the agricultural sector out of the credit market. Agriculture, which constitutes 38.5% of real GDP accessed at most only 10% of commercial bank credit; small-holders who form the bulk of farmers were practically rationed out of the credit market.

The third period, based on the Plan for Modernization of Agriculture (2000), advocated credit to retain small-holders to be promoted via MFIs, with comparative advantage in administering small loans based on trust instead of collateral, with broader outreach to small-scattered customers. However, since credit remained scarce, expensive, and since providers remained risk averse, this third policy regime only improved agriculture's access to credit marginally.

The policy recommendation is to design and efficiently administer strategic interventions that raise profitability, lower risks and address those specific constraints that prevent the sector's access to credit. The three policy regimes in Uganda were overall: although they improved the credit environment, they were not sufficient to impart comparative advantage to agriculture to enable the sector to compete for credit, along with other non-agricultural sectors.

1.1 Agriculture's Contribution to Growth and Poverty Reduction:

Agricultural sector policy analysts identify the sector's credit needs as part of the **required resource inflows** (Timmer, 1998), to enable the sector to contribute positively to economic development by providing: food to ensure food security, and as a wage good to keep the cost of labour affordable to the emerging non-agricultural sectors; raw materials for agro-based industries; foreign exchange earnings for essential consumer goods, and capital goods to expand the productive capacity of the economy; employment income as a base for purchasing power to raise aggregate demand for non-agricultural output, especially emerging import-substitution; and contributions to tax revenue for the treasury.

Despite the expected decline in relative share of agriculture in the economy during growth and structural transformation, the required **resource inflows (including credit)** are expected to raise factor productivity and the aggregate absolute size of agriculture, as the sector integrates itself into the economy. This increase in factor productivity, sparked off by favourable incentives that raise the relative profitability of agriculture, is expected to raise functional income distribution in the sector and reduce poverty.

Therefore, the question addressed in this paper is whether structural adjustment policies are promoting the **required resource inflows** (focusing on credit) to enable agriculture to make its expected contributions (using Uganda's experience as a case study).

1.2 Agricultural Sector Credit Requirements to Promote Growth, Structural Transformation and Poverty Reduction in SSA

By the mid 1990s, the emerging view among SSA agricultural policy analysts and practitioners was that the sector required a wide range of credit, the major categories of which are summarized in figure 1.0 (to save space). The durations: short, medium, and long-term, are rough indications of the times required from borrowing to repayments of each credit category (Republic of Uganda, 1994).

During the 1990, the term "agricultural credit" was broadened to "agricultural finance" to include two extra items; a saving facility, and a transfer payments mechanism.

The **saving facility**, it was argued, is required to enable agriculture:

- To deposit its lumpsum cash at harvest into the financial sector to earn a positive real interest rate;
- And to mobilize savings as a major source of credit financing, which would be cheaper than borrowing from the open market, and more sustainable than subsidized loans from the treasury or donors.

The rationale for a **payment mechanism** is that it enables agriculture:

- To received non-agricultural income into the sector on a timely basis, for example wages and salaries of rural public sector, NGOs, and donor-funded project workers;
- To transmit payments from agricultural sector agents to non-agriculture in a **secure** way, such as school fees, hire-purchase services payments, etc.

Of late, the term “agricultural credit” is being even more widened beyond “agricultural finance” to “**Rural Finance**”, largely by micro-finance practioners whose basic argument is that, given the **risk** and **seasonality** in agriculture, credit should be based on steady cash-flow from range of profitable rural enterprises, which cash flow guarantees steady and assured loan repayment across seasons and irrespective of risk occurances (MOFPED, 2003).

Although focus in this paper is on the narrow traditional “agricultural credit” which is enterprise-specific within the sector, the use of extensions to agricultural and rural financial services concepts will be indicated where appropriate.

1.3 Outline of the Paper

The purpose of this paper is to assess whether the agricultural sector under the SAPs regime, and the period immediately following (to incorporate growth, structural change and poverty reduction), is accessing the broad credit categories indicated in figure 1.0 that this sector requires to make its contributions to economic development.

The assessment is qualitative, based on desk work that covers; key policy documents, financial sector survey results, and key consultancy reports, using Uganda’s experience as a case study.

The outline covers 6 sections:

- 1.0 This Introduction.
- 2.0 Key Features of Uganda’s Agricultural Sector, and Implications for Credit.
- 3.0 The Early SAPs Regime 1990/91 – 1996/97.
- 4.0 The Financial Sector Reform Regime 1999/00 – 2002.
- 5.0 The Growth, Structural Change and Poverty Reduction Regime, Focusing on Micro-Finance in the **Plan for Modernization of Agriculture 2000** to-date.
- 6.0 Conclusions of the Assessment and Recommendations for the Way Forward.

2.0 Key Features of Uganda’s Agricultural Sector and Implications for Agricultural Credit

Agriculture is the **second** largest sector, contribution 38.5% to GDP in 2003/04 (second to the services sector which contributes 42.5%, having surpassed agriculture due to the emerging large informal sector since SAPs). The industrial sector is much smaller, contributing 19.4% to GDP.

The agricultural sector is dominated by food crops production for both own consumption and a marketed surplus; food crops contribute 55% to monetary, and 81% to non-monetary agriculture. The other components: cash crops, livestock, forestry, fishing, are much smaller, (as shown in table 1).

Of total agriculture, however, **42.5% is non-monetary**, to which credit is irrelevant until monetized through more broadly focused development policy; food for own consumption dominates this component.

Table 1.0 Structural Transformation Indicators of the Agricultural Sector Over the Recent 5 Years (% of Real GDP) 1990/00 – 2003/04

Sub-Sector	1999/00	2003/04
Monetary Agriculture	22.9	22.3
Cash Crops	4.6	4.1
Food Crops	12.2	12.4
Livestock	3.4	3.2
Forestry	0.7	0.7
Fishing	2.1	2.0
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Non-monetary Agriculture: Ow	18.1	16.2
Food Crops	14.9	13.1
Livestock	1.8	1.8
Forestry	1.1	1.1
Fishing	0.3	0.2

Source: Republic of Uganda, Background to the Budget 2004/05

Overall growth of monetary agriculture during the last 5 years is 4.8% p.a., which is less than overall growth of real GDP at 5.8% p.a. over the same period 1990/00 – 2003/04, implying that this is **not** the leading sector in the economy: it needs resource inflows (including credit) to make its contributions.

A comparison of the % contributions of the major components of agriculture to real GDP in table 1.0 shows a declining share of the non-monetary component from 18.1% to 16.2%: whereas this is a healthy trend reflecting increasing monetization, the cash crops component is falling due to the adverse collapse in the international price of coffee, the major export, from about US \$ 2.0 per Kg. clean to under US \$ 0.5.

Whereas diversification into non-coffee exports has started, covering vanilla, fish, cutflowers, palm oil, and some low value food crops (maize, beans, etc), **export-development financing in agriculture is expensive**, especially for small and medium size exporters who cannot borrow off-shore at 5-7%.

Uganda is exploring petroleum and is likely to start production by 2007: should this materialize, agriculture exports will face a possible “dutch-disease” unless export-development finance is forthcoming **now**.

Over 60% of Ugandan farmers are small-holders on scattered pieces of land 0.2 – 2.0 hectares, either inherited, communally owned, or held on verbal lease agreements; not only does the small-scattered size make supervision of credit expensive, the land ownership systems (while guaranteeing access to usufruct) cannot be offered for collateral. Borrowing by small-holders, therefore hardly occurs, and if at all, from very expensive micro-finance and other ad hoc sources, not the formal banking system, and on very short term.

Since small-holders hardly use purchased inputs, they could neatly transform themselves into “organic farmers”: currently, however, there is no credit directed to exploit this option. The key inputs are hoe, panga, rain, and household labour. This disadvantage of no purchased inputs could, however be turned into a fortune if small-holders could be trained to go “organic” and develop comparative advantage in exporting to “organic” market niches, assisted with small loans to become certified. Unfortunately, however, despite the fact that “organic” farming technological knowledge exists at the publicly funded research stations, and in both public and private extension provision networks, the option for small-holders to go “organic” is yet to become part of Uganda’s development policy, let alone credit policy (Isabirye, 2004).

Estates of cut flowers, tea, palm oil, coffee, and sugar, constitute only 7 – 10% of Ugandan farmers: since these can raise formal credit locally, or off-shore cheaper finance, and donor-project funding, they are not part of Uganda’s agricultural credit problem.

Another 15 – 20% are “progressive farmers” who entered the sector with retirement or retrenchment packages from the army, civil service and/or private business. They hold substantial “social capital” from past work connection which enables them to supply lucrative-assured-institutionalized markets in schools, hospitals, army, prisons and major hotels etc.

The assured cash earnings enables “progressive farmers” to borrow formal credit at commercial bank interest rates. The same “progressive farmers” serve as “contact farmers” for NGOs and publicly provided extension services, from which they get free or subsidized inputs. This paper cautions against the often exaggerated claims of agricultural credit availability from this group, since their subsidized terms are **not** accessible to small-holders.

“Progressive farmers” who would be exporters, however, also face **inadequate** and expensive export-development credit problems.

3.0 Early SAPs Regime 1990/91 – 1996/97, Results and Lessons for Agricultural Credit for SSA:

3.1 Objectives

The early SAPs regime was guided by two policy documents; **The Way Forward I Macroeconomic Strategy 1990** and **The Way Forward II Sectoral Strategy 1991**, which focused on agricultural sector reforms.

The thrust of the SAPs was to **retreat** the state and **permit** the market mechanism to allocate resources more efficiently and to cultivate a macro-economic stable and conducive environment for the price system to function.

3.2 The Policy Reforms

Three key prices were decontrolled:

- (a) The fixed **exchange rate** that operated with a parallel market premium up to 300% in the late 1980s, was completely liberalized by 1993: this removed a huge **implicit tax** on agricultural exports; agriculture contributed over 95% of total exports at the time;

- (b) **Producer prices for export crops** which used to be fixed by government every fiscal year on budget day, for traditional crops (coffee, cotton, tea, tobacco), were completely liberalized, removing an **inflation tax** on exporters. This measure was enhanced by reform of crop **finance** to enable the private sector to borrow and procure agricultural produce while paying cash.
- (c) **Interest rates** charged by commercial banks, which were previously fixed, **with lower rates to agriculture**, were completely liberalized, leaving all sectors to compete for commercial credit on equal footing;
- (d) **Petroleum prices** were also liberalized, to economise on the consumption of this scarce resource (including diesel prices which, however, raised agricultural transport costs for trucks to up country).

Liberalization of the four key prices was enhanced by dismantling the marketing boards which used to operate on the basis of **fixed marketing margins**: Coffee Marketing Board (CMB), Lint Marketing Board (LMB) and Produce Marketing Board (PMB).

3.3 Results of the SAPs Regime and Agricultural Sector Credit Implications

Removal of the implicit and explicit taxes, plus liberalization of the marketing system, dramatically raised the producer's share in price of export crops from 9% up to 70% in some cases, especially coffee. This was expected to make agriculture sufficiently profitable to enable each producer to obtain own private sector credit.

However, coffee, cotton, tea and tobacco producers are small holders for whom an increase in producer prices was inadequate to provide **steady and sufficient** cash flow to qualify them for formal commercial bank credit. Furthermore, lack of collateral, from the land-ownership systems without individualized titles, also remained a constraint, so was the scattered settlement pattern of small-holders, that makes credit supervision expensive and risky.

Marketing liberalization led to a massive entry of private exporters using Commercial Bank credit at 20 – 28% interest rates. However, this upsurge was short-lived; the collapse of the international commodity prices (particularly after the coffee boom) in the later 1990s squeezed marketing margins so sharply that most private exporters went bankrupt; only a few exporters with foreign connections which enabled them to borrow crop-finance off shore at lower interest rates 4 – 7% survived. In coffee, for example, the number of exporters rose from 12 to 117 between 1991/92 and 1995/96; but by 2000/01 only 26 had survived of whom 10 controlled 87% of the export business (Nsibirwa, 2001). Since then, procurement, processing, and marketing agricultural exports has become **concentrated** into the hands of foreign connected firms, linked to “progressive” local agents with social capital.

Prudent budgetary management, reform of crop finance, and elimination of financing the fiscal deficit from the banking system, lowered inflation from over 200% p.a. to one digit 5 – 8% p.a. However, analysts need a general equilibrium model to trace whether this sufficiently improved the domestic terms of trade (PA/PNA) in favour of agriculture (PA) compared to non-agriculture (PNA) as assumed by SAPs: this would be required to make agriculture sufficiently profitable to compete for credit economy-wide.

The **lessons from Uganda's early SAPs experience** are that the **highly positive benefits**, in terms of higher producer prices directly passed on via liberalized exchange rate and marketing systems to small-holders, were insufficient to enable these farmers overcome the key constraints they faced in accessing agricultural credit: lack of collateral, scattered-expensive-to-supervise small-holdings, and high interest rates for both local and export credit.

4.0 The Financial Sector Reform Regime 1999/00 – 2002 and Lessons for Agricultural Credit

The overall key objective of financial sector reform was to ensure that a sound financial sector was put in place, as an essential institutional framework for the private-sector based price system to function efficiently and command overall confidence.

Two policy documents summarized the major reforms: first the **Medium Term Competitive Strategy for the Private Sector 2000/05**, outlines the private sector-led thrust of the financial institutions reforms; second, the **Financial Sector Reform Act 2003**, evolved the practical measures for prudential regulation and supervision.

It should be noted that the key objective and the thrust of the policy were overall enhancement of the financial sector; credit provision to agriculture, if at all, was incidental.

4.1 Key Success of Financial Sector Reform

- Prudential regulation and supervision curbed reckless practices and led to closure of 4 commercial banks: Ttefe, Cooperative, Greenland, and Commercial Bank of Africa. This sent the signal to the remaining commercial banks to enhance risk-consciousness in their practices; most of these banks maintain a 25 – 30% sound loan/to deposit ratio.
- Capital adequacy to ensure confidence in the banking system was raised from a 16% ratio of total capital to risk-weighted assets, to 24% between 2000 and 2002.
- Efficiency of credit management, enforced by the requirement to hive off non-performing loans to the newly created Non-performing Assets Recovery Trust (NPART), led to a reduction of non-performing assets as percentage of total private sector credit from 12.4% to 3.6% between June 2000 and 2002.
- The privatization of the largest Uganda Commercial Bank (UCB) signaled government's determination to have the financial sector private-led with enforced corporate governance, stressing efficiency and technological innovations in services provision, such as automatic teller machines (ATM) and electronic transfer of transactions on private customer accounts across the country. Stanbic Bank (U) Ltd which bought UCB has already embarked on these reforms and innovations.

4.2 Outstanding Post-Reform Problems and Lessons for Agricultural Sector Credit

(a) The Cost of Credit, Risk Aversion and Agriculture

Despite improved efficiency, as indicated by the reduction of non-performing assets, Uganda is a large recipient of Official Development Assistance (ODA) which poses a macro-economic management crisis. **Either** the effect of excess liquidity from ODA injections is partly sterilized by sale of Treasury Bills, which commercial banks prefer compared to risky

lending (thus crowding out the private sector, especially agriculture), **or** part of the ODA is sold as foreign exchange on the open market, which leads to appreciation of the exchange rate (that implicitly taxes exports, 70% of which currently originate from the agricultural sector). A summary of the macro-economic management problems of large ODA inflows into Uganda is given by the International Monetary Fund (2004).

In either case, agriculture suffers an implicit tax, or is crowded out of commercial bank credit which remains expensive and prefers to flow to risk-free TBs. Recently, government is floating long-term TBs. While this may succeed to lower interest rates, the riskless attraction of TBs, compared to risky agricultural lending is yet to be modified.

(b) The Scarcity of Credit and Agriculture

Past agricultural credit in Uganda was financed by donors or the treasury (Ssemogerere 2003). These sources by themselves cannot provide a sufficient and sustainable flow of credit required for agriculture, as detailed in figure 1.0.

Domestic saving, which SAPs reforms assumed would become the major source of affordable credit in a private-sector led economy, are extremely scarce. Domestic savings in Uganda constitute only 5% of GDP, which is too low even by COMESA (Common Market for Eastern and Southern Africa) standards which stand at 17% (MOFPED 2003).

Past high rates of inflation which made real interest rates on deposits negative, and the ongoing insecurity, particularly in Northern Uganda, provided disincentives to save.

The scarcity of domestic savings translates into excess demand for credit for the entire economy. **A Market Needs Assessment for Rural Financial Services Survey (May 2000)** in selected districts of Uganda, indicated that of the 56 bn Ug Shs. demanded for credit, only 3.7 bn was disbursed, or 5.7%, leaving 94.3% of the demand unmet, the highest unmet credit need in SSA; Kenya's figure for comparison, stood lower at 76%.

(c) Uganda's Narrow-Shallow Formal Financial Sector and Credit to Agriculture

The most recent data (MOFPED 2003), characterizes Uganda's financial sector to consist of: the Bank of Uganda, 15 commercial banks, 2 development banks, 8 credit institutions, 20 insurance companies, 76 licensed foreign exchange bureaux and 1 capital market security exchange.

Monetization of the Ugandan economy is progressing (with an increasing contribution of the monetary economy to real GDP). However, the Ugandan economy is still the least monetized in SSA; even by her neighbour's standards, the M2/GDP ratio of 10% is below that of 35% for Tanzania and 40% for Kenya. The formal financial institutions render financial services to only 10% of the urban and 5% of the rural population, leaving the bulk of the currency in circulation outside the banking system.

Commercial banks coverage is **shallow**, with an average of 115,000 customers per branch, compared to a 7,000 average for COMESA countries. Over 2/3rds of this thin branch

network is **narrowly** located in urban and peri-urban areas, with limited rural outreach. Stanbic, with the largest branch network has only 66 branches.

The consequences of a narrow-shallow and urban based financial structure is the crowding agriculture out of the formal credit market, as illustrated in table 2.0, in favour of non-agriculture, particularly trade and commerce: the allocation pattern shows little change over the period following the vigorous financial sector reform 2000/02.

Table 2.0: Distribution of Loans and Advances to the Private Sector (%)

Sector	June 2000	June 2002	Change
Trade and other services	47.1	46.5	- 0.6
Manufacturing	31.2	32.4	+1.3
Agriculture	10.3	10.2	- 0.1
Transport, Electricity & Water	6.3	6.2	- 0.1
Building & Construction	4.8	4.2	- 0.6
Mining	0.4	0.4	0.0
Source:	Bank of Uganda		

5.0 The Growth, Structural Change and Poverty Reduction Regime, with Focus on Micro-finance Institutions (MFIs) and Implications for Modernization of Agriculture Under the PMA; 2000 To-Date

5.1 Introduction

Since the achievement of macro-economic stability in 1996/97 under SAPs, Uganda started evolving a policy regime, focused on growth to create wealth, structural transformation to raise productivity of the key sectors, and to reduce poverty to no more than 10% of the Head-count Ratio Po by the year 2017 (MOFPED, 2004).

The contributions of agriculture, detailed in section 1.1 of this paper, to the success of the new policy regime are critical: the sheer size of the sector is 38.5% of GDP; the sector is the largest employer of 79% of the entire labour force, originating 32% household income from crop-farming and another 26% from other agricultural enterprises; the sector has the largest concentration of the poor who are in rural areas engaged in agriculture, with over 50% head-count ratio, compared to the national average of 39% (Uganda Bureau of Statistics , 2002/03).

Awareness that during the SAPs experience agriculture was largely crowded out of the formal financial market for its credit needs, led policy makers to turn to MFIs in 2000 for the credit needs of small-holders under the PMA (2000).

5.2 Changes that Favoured Emergence of MFIs

Interest rate liberalization under SAPs created a conducive environment for MFIs to charge what it takes to serve small customers profitably; average annual interest rates for MFIs range between 36 – 48%.

Retreat of the state under SAPs, detailed in the **Medium-Term Competitive Strategy for the Private Sector** (MTCSPS) policy document 2000/05, enhanced the conducive environment for MFIs by removing distortions from credit provided by government/donor projects at subsidized interest rates, and for patronage or other non-economic motives which tolerated high default rates on loans.

The women’s movement gave further thrust to the emergence of MFIs, to grant credit to women on the basis of “trust” since most women lacked individual property ownership rights (particularly land) to provide collateral: Uganda Women Finance Trust, one of the largest MFIs, emerged in 1995 on this basis, encouraged by Women World Banking.

Government’s poverty reduction strategy, by encouraging NGOs at the grass roots to help the poor develop small and micro income generating enterprises, added to the voices that demanded MFIs to provide financial services, particularly credit, to boost these enterprises.

The Group methodology evolved by the Grameen Bank in Bangladesh and modified to suit Ugandan conditions, was utilized to establish comparative advantage of MFIs, compared to formal commercial banks; this was expected to dramatically lower transaction costs to providers for:

- identifying small and micro-enterprise credit worthy customers, at the community-level, through peer self-selection;
- retailing credit to small scattered customers using the group as the low cost disbursement vehicle;
- monitoring utilization of the credit and loan repayment through peer pressure.

Although the PMA (2000) policy document advocated adoption of the Group Methodology for providing financial services to small-holders, the methodology is general and was originated for the informal sector in Bangladesh, not agriculture. The methodology is most profitable with rapid turnover of mass-produced short-term loans.

5.3 Emerging MFIs Structure and Government Strategy

A proliferation of MFIs has blossomed, with 1,340 MFIs countrywide: however, this is fewer compared to Kenya with over 5,400, and most Ugandan MFIs are small in terms of volume of business. Table 3 summarizes the MFIs structural and governance characteristics.

Table 3.0 Ugandan MFIs by Number and Characteristics

Number	Characteristics
1,340	Total nationwide
867	Community-Based Organizations (CBOs), Multipurpose.
242	Savings and Credit Cooperative Organizations (SACCOs)
130	NGOs, Multi-purpose
101	Private Companies Limited by Guarantee

Source: MOFPED (2003)

Although outreach is substantially better with 1,100 customers per branch, compared to that of commercial banks with 115,000 customers per branch, most MFIs are also located in urban and peri-urban areas in the middle of the informal sector.

To improve outreach and raise the volume of Rural Business, the government has put in place the following strategies:

- Capacity building grants to assist in the training of personnel of MFIs who venture to go rural, in developing suitable products, and training customers in utilizing MFI facilities (especially learning to identify rural credit worthy enterprises);
- Mobilization of donor grants for onlending rural, to help MFIs scale up lending capacity, given their lower saving mobilization compared to urban MFIs;
- Improvement of infrastructure and security to lower transaction costs and raise profitability of rural lending;
- Workshops, seminars, etc to improve coordination among stakeholders country-wide for smooth information flow.

To improve governance, prudential regulation and supervision, government in **dialogue** with MFIs, categorised the financial institutions into four tiers:

- Tier 1: Commercial Banks, to be regulated and supervised as noted in section 4.0 of this paper;
- Tier II: Credit institutions to be increasingly subject to prudential lending regulations under the same Financial Institutions Act 2003;
- Tier III: Deposit taking MFIs, about 10 in number of the largest MFIs, also to be regulated under the 2003 Financial Institutions Act, with special focus to protect depositors funds;
- Tier IV: Semi-formal MFIs which do not take savings from the public, but provide credit from own-member funds (CBOs, SACCOs, Companies Limited by Guarantee). Currently, government lacks, but is however in the process to develop institutional capacity, together in dialogue with these stakeholders, to regulate tier IV, and promote as many of its members as increasingly qualify to Tier 3.

5.4 Emerging Results from the Current Policy Regime with Focus on MFIs and Implications for Credit in the PMA (2000)

Table 4.0 summarizing the sectoral distribution of MFIs credit provides a starting point to discuss the possible likely results of the current policy regime.

Table 4.0 Share of MFI Credit Borrowers by Economic Activity (%)

Economic Activity (Sector)	Share in MFI Credit (%)
Commerce	72
Services	11
Crops Production	9
Animal Husbandry	4
Manufacturing	3
Agro-processing	1
Total	100

Source: MOFPED (2003), From a Survey of MFIs in two sub-countries per each of the 56 Districts of Uganda (2003)

(a) Agriculture’s share of MFIs Credit

Despite the focus on MFIs with the said comparative advantage that can be adapted to provide credit to small-holders, noted in section 5.3 of this paper, agriculture’s share of MFIs credit is only 14% (crop production 9% **plus** animal husbandry 4% and agro-processing 1%): this 14% represents only a meager improvement, compared to the share in formal commercial bank credit to the private sector of 10% in table 2.0.

(b) Risk aversion of agricultural credit remains: the response of MFIs is to provide rural finance, to mutually supportive enterprises from which a steady flow of earnings constitutes the base for assured loan repayment, regardless of seasonality or risk occurrences in agriculture. MFIs argue that eventually 40% of rural credit finances agricultural activities: there is a need for careful study to document exactly which these activities are, and the extent to which the financing meets which credit requirements in figure 1.0.

Overall **women’s share of micro-credit** across the 56 districts surveyed is 63% on the average: this is a welcome commendable result showing the determination of MFIs to provide:

- Learning experience to women to develop a credit taking and repayment culture based on “trust”, without collateral;
- Skills to identify and manage credit-worthy small and micro-enterprises.

However, women largely remain **smaller** borrowers compared to men, with difficulty to graduate to larger MFI loans which require collateral, and whose risk cannot be guaranteed by the group methodology. Despite women’s higher involvement in agriculture, the fact that their credit-taking capacity is **smaller**, keeps the flow of credit to the agricultural sector, via women clients, small.

(c) The Scarcity and high cost of credit to agriculture under the MFIs focused experience and the PMA (2000)

The policy thrust focused on MFIs assumed that relatively low cost loanable funds would be generated from four potentially sustainable sources: MFIs own customers savings; depositors funds from those MFIs allowed to mobilize deposits from the public; bulk wholesale borrowing from commercial banks for retailing to MFIs customers; and donor funds to those MFIs who ventured to expand rural outreach.

Estimates by the Bank of Uganda survey (2000) suggested that small rural savers could provide up to 20% of their credit requirements if properly mobilized. Currently, MFIs collect “compulsory savings” either as down-payments for loans, or for insurance against loan default. Since “compulsory savings” are not available on demand, MFIs customers tend to form an impression that saving ties up funds. Most MFIs are only beginning to develop “voluntary savings” that are accessible to customers when required, and at attractive returns compared to saving in kind or other alternative uses of such funds.

Large MFIs have just qualified to take deposits from the public in 2003; their potential comparative advantage, relative to commercial banks, to attract and retain savings from rural areas which could be on lent to agriculture, is yet to be explored.

Loanable funds from commercial banks as whole sellers to MFIs for retailing to rural customers are forthcoming only at average interest rates of 17 – 18%, to which MFIs add their own profit margins, with the final interest rates to customers rising to 30 – 48%. Commercial banks view MFIs just like any other customer competing for their funds.

Interest-free scaling up funds from donors are largely available for capacity building: loanable funds from the same donors are on lent to MFIs at average interest rates of 13%, to which the MFIs add their own retailing expenses and a profit margin.

Overall, therefore, the results from the MFI focused experience under the PMA (2000) has **neither** increased the availability of loanable funds **nor** lowered their cost, **nor** made them more accessible for agricultural credit.

6.0 Conclusions of the Qualitative Assessment and Recommendations for the Way Forward to Address Credit Needs of Agriculture in SSA

Given that liberalization and privatization have been in place in Uganda for over a decade 1990/91 – 2003/04, the question of market failure to meet the agriculture’s credit needs can no longer be assessed in terms of whether or not to return to public provision of credit: the institutions and procedures to resort to this approach are no longer feasible or practical. Instead, our assessment is adopting a less antagonistic, but more complementary approach by S. Lall (1997) who groups policy regimes in terms of what they can achieve, and how the persistent market failures in developing countries should be addresses, into three categories:

- (a) The first category is what Lall **calls permissive policies**: these policies focus on removing controls, liberalizing key prices, and reducing the role of the state in direct interventions to provide private goods and services. The objective is to **permit** the market mechanism to allocate resources efficiently. In Uganda, permissive policies were used to liberalize key prices (interest rates, exchange rate etc), dismantle marketing parastatals and government/donor funded direct credit provision schemes.
- (b) S. Lall’s second categorization is that of **functional** policies, which enable the market mechanism, once in place, to function better. In Uganda, prudential regulatory and supervision improvements strengthened the entire financial sector; incentives encouraged MFIs to emerge, with comparative advantage to provide financial services and raise outreach to small-scattered customers, including women. These policies were welcome,

and should be strengthened to improve the environment for the provision of financial services: however, these policies only marginally raised the flow of credit to agriculture; they were largely **overall**, their impact on agriculture was **incidental**, not focused on the key constraints;

- (c) Lall's third classification is that of strategic interventions to address specific market failures, particularly in the development context. The debate over strategic interventions in Uganda is focused on the exports sector: the recommendation in this paper is that there are critical market failures that also need strategic intervention in order to raise the flow of credit to agriculture. In formulating efficient criteria for strategic interventions, credit to agriculture should also be considered. The recommendations fall in the following specific areas:

- (i) The externality to raise profitability and reduce risk in the case of agriculture arises from the need for lumpy investment up front into enterprises with long gestation periods (Coloman and Young 1989). In Uganda, for example, since the collapse of coffee prices, farmers are looking for high value alternative tree crops. The National Agricultural Advisory Service (NAADS) and some private sector agents have identified a number of such crops: Pyrethrum, Aloe Vera, Semi-Temperate Apples etc. Farmers need public intervention to access credit to establish plantations and acquire the required farming practices.

Irrigation networks by reducing risk from drought, and by enabling farmers to adopt higher yielding enterprises, which however, require controlled moisture growing practices, also fall in this category, particularly for small-holders; they need lumpy investment upfront and have a long gestation period before pay – off.

Small holders consignments would be more profitable if marketed in bulk, sorted for quality, with prices negotiated to access off-season markets. Credit to finance these activities, however, is lumpy upfront and requires high collateral backing and insurance by private –sector providers.

In all three cases, government intervention is required to provide either risk guarantee, or other incentives to private providers to enable agriculture to access the lumpy credit upfront for enterprises with long gestation periods but capable of lifting the profitability frontier of the sector outwards to the right .

- (ii) A second set of instances constitutes a case for public intervention because of substantial externalities passed on between farmers via pests and diseases. Current research results in Uganda rank pests and diseases as the highest source of risk in agriculture (Nabbumba and Bahiigwa, 2003). The risk is likely to increase as new crops and livestock types are introduced into an unfamiliar ecological system.

Government policy is to regard this type of risk as private until it assumes epidemic proportions: this makes would be credit providers averse, even to estate and progressive farmers, as risk is perceived to make agriculture less profitable. Small-holders who cannot even finance chemicals and pesticides are avoided by credit providers altogether, including MFIs, particularly for enterprises undertaken for food

security for own household consumption. Yet lack of pests and disease controls by small-holders impart negative externality to all farmers. The recommendation in this paper is that government should take an active role in pests and disease control through:

- direct training via publicly provided extension or availing incentives to credit providers to lend to farmers for pests and disease control activities
- directly enforce or assist farmers to enforce pests and disease control regulations to avert the spread of this risk.

(iii) A third instance for strategic intervention is to promote capacity building via improved access to software. Government and donors are assisting MFIs to raise accounting standards to internationally acceptable levels; to adopt best practices for operational self-sufficiency and financial sustainability. Whereas these interventions should be strengthened, they pay off only at high volumes of business as MFIs handle many micro account (Ssemogerere, 2003). For small MFIs the software required to handle a large volume of micro accounts is extremely expensive, and unless publicly assisted the cost makes this technology inaccessible. Yet, achieving the high volume of business would enable the small MFIS also:

- to speed up credit procedures and lower transaction costs to micro borrowers;
- to make access to “voluntary” savings on short notice possible thus improving the incentive to save and contributing positively to raising the volume of loanable funds;
- improve overall access to financial services and prospects for access to credit for small-holder agriculture.

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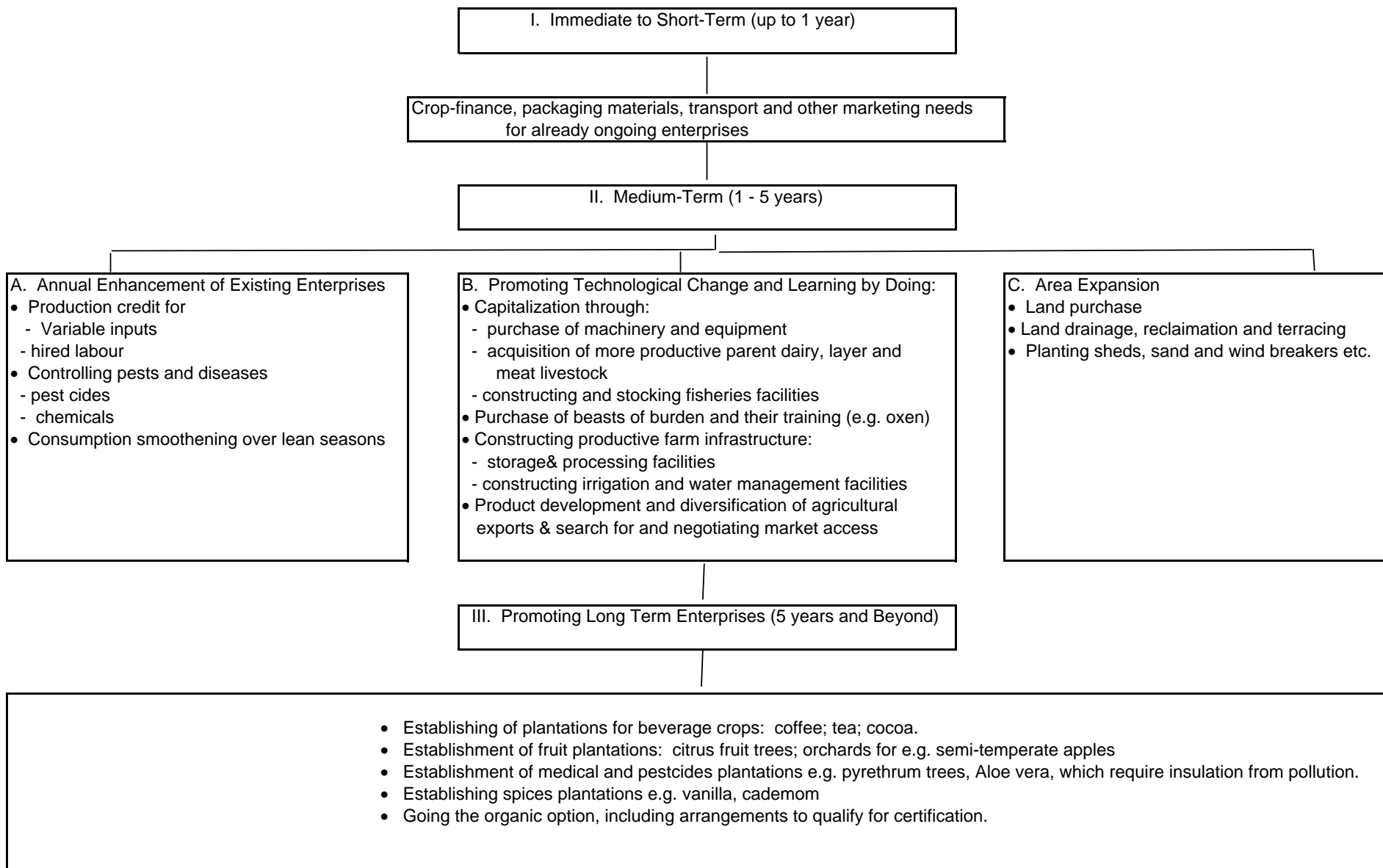
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**AGRICULTURAL CREDIT REQUIREMENTS IN SSA (BY TYPE)
FOR GROWTH, STRUCTURAL TRANSFORMATION AND POVERTY REDUCTION**



Source: Republic of Uganda, Agricultural Policy Committee (1994), Cotton Sub-Sector Development Project: An Appraisal of Rural Finance and Credit Schemes, Vol. 2: Working Papers. Agricultural Secretariate. Bank of Uganda. This appraisal summarises a wide range of SSA agricultural credit experiences under the FA0, World Bank and other Donors during the SAPs period.