What is wrong with the concept of specialized financial institutions in the Hungarian agriculture?

Csaba Bálint¹, Tamás Tóth²
Szent István University¹,²
Institute of Regional Economics and Rural Development
1 Páter Károly Str.
Gödöllő, Hungary
e-mail: balint.csaba.hu@gmail.com

Abstract
In the second half of the 20th century, besides the positive benefits of intensively industrializing agriculture, social and environmental problems seriously threatening sustainable development appeared. By today, in response to the warning signals very strong expectations have been formulated regarding the agrarian sector – broadening its traditional roles. In summary, agriculture has complex productive, regional, ecological, social and cultural functions. The social utility of the above mentioned functions is indisputable, their fulfilment is the strategic interest of all countries, and it is also the key to their sustainable development. However, there are political, economic and social conditions and processes that impede the realization of these objectives, while at the same time urge conscious measures to this effect. The aim of our study is to investigate the possible financial resources of agricultural production taking into account to a maximum extent the ‘environment- and human-friendly’ aspirations and to find the factors which help or hinder the competitiveness and effective financing of the agrarian sector. We examine the possibilities of establishing and operating a state initiated agrarian bank, which up to now appeared only on a rhetoric level aimed at ensuring cheap and efficient financing of domestic agriculture, based on domestic experiences and international models.

Keywords: specialized financial institutions, agricultural bank, credit union

JEL Classification: Q14 Agricultural Finance

1. Introduction
In the second half of the 20th century, besides the positive benefits of intensively industrializing agriculture, social and environmental problems seriously threatening sustainable development appeared. By today, in response to the warning signals very strong expectations have been formulated regarding the agrarian sector – broadening its traditional role (van der Ploeg, et al, 2002). These include:

- production and processing of high-quality food and cheap raw materials
- provision of alternative sources of energy
- preservation and rational use of natural resources to protect the environment
- maintenance and development of the producers’ infrastructure
- responsible management of landscape
- (partial) provision of rural livelihood by production, processing and additional industrial and service activities, resulting in the preservation and renewal of rural communities and society

In summary, agriculture has complex productive, regional, ecological, social and cultural functions. (Takácsné 2007)
The social utility of the above mentioned functions is indisputable, their fulfilment is the strategic interest of all countries, and it is also the key to their sustainable development. However, there are certain political, economic and social conditions and processes that impede the realization of these objectives, while at the same time urge conscious measures to this effect. The aim of our study is to investigate the possible financial resources of ‘environment- and human-friendly’ agriculture and to find the factors which help or hinder the competitiveness and effective financing of the agrarian sector. We examine the possibilities of establishing and operating a state initiated agrarian bank, which up to now appeared only on a rhetoric level and aims the cheap and efficient financing of domestic agriculture, by drawing on domestic experiences and international models.

2. Data and methods

The aim of our article is to make an overview of the fundamentals of agricultural financing, regarding the main functions, specificities and risks of agricultural production, discuss the most important (political, economic, social) influencing factors, examine the (mostly European) models of agricultural financing and adapting them to the circumstances in Hungary. For these purposes we reviewed the international and Hungarian literature related to the topic, and used the data of the Hungarian Institute of Agricultural Economics to investigate the structure of agricultural financing in Hungary. In our concluding remarks we relied on the informations concerning the agricultural financing policy initiatives since the 1990 change of regime, and prepared a possible scenario for the actual introduction of specialized agricultural credit institution.

3. Results and discussion

3.1 Changing environment, new rules of play

First of all, it is important to recognize that the actors of agriculture around the world have to adapt to a rapidly changing global system of conditions (Csáki 2012). Due to the demographic explosion, the demand for food is rising (with regionally different needs), and the bio-energy production’s need for raw material has to be expected as well. Because of the energy-dependence of food production, the volatility of agricultural prices increased following energy prices. The importance of integrated vertical product chains is increasing, accompanied by the accelerating concentration of food trade. Especially in the developed and moderately developed countries the agricultural population is aging, and the gap between urban and rural incomes is growing. The production – particularly in developing countries – is accompanied by increasing environmental problems and the emerging threat of climate change.

Though, in addition to the difficulties listed above, perhaps the biggest challenge is the unavoidable liberalization of international markets. The agricultural sector’s food and energy producing, social, rural development functions are hardly compatible with the market competition, the liberalisation of external trade, the constraint of competitiveness and the principles of the World Trade Organisation (Nagy P. 2001) In order to enforce both criteria simultaneously and reach an acceptable compromise, the restructuring of interventions and policies which distort international markets is needed, together with the establishment of public and market institutions for the regulation and surveillance of market operations. (Valdes-Forster 2005)
3.2 Renewal constraint in the agricultural policy

In the case of Common Agricultural Policy – which serves as the framework of the Hungarian agricultural policy as well– we are witnessing a continuous learning process and transformation. Beyond providing viable rural area and relatively stable income for the agricultural population – especially in the EU-15 countries – in addition to safe food, by now its operation raises questions in the long run. European agriculture is still struggling with overproduction, while the proportion of community budget allocated to agricultural policy generates debates on several fronts. On the one hand between the countries (e.g. the biggest net contributor Germany and France, for which the support system is the most beneficial), on the other hand between other economic sectors (including the tax-paying households) and – from their perspective – the highly over-budgeted agriculture. “The Union was not created for the farmers! It was established to be able to supply its half billion citizens with a wide variety of products and services.” (Nagy F. 2012 in: Fehér et al. 2012 p. 56.)

Due to its protectionism and market-distorting interventions, CAP is the target of constant external criticism by the major agricultural producer nations, the developing countries and the WTO, despite the significant steps taken in tariff reduction, the decoupling of support and production, and the reduction of export subsidization. (Massot, 2013) The market protection favourable to atomized farms and the extensive subsidy system did not help the improvement of agriculture’s productivity and efficiency, coupled with the frequent use of opportunities for abuse hidden in the system. (Tracy 1997)

The 2014-2020 CAP clearly tries to meet the different expectations, as – in order to increase competitiveness and marketization – it includes the progressive reduction and capping of supports, the introduction of more efficient instruments of risk management, the encouraging of producer and interbranch cooperation, clustering and networking, the development of knowledge transfer and advisory activity, the promotion of innovative initiatives and the simplification of bureaucracy. At the same time, the CAP makes the transition easier by supporting the production in less favoured areas, giving subvention to young farmers and start-up micro-enterprises, proclaiming the fight against poverty and social exclusion, and the financing of local initiatives from multiple EU funds.

3.3 The fundamental problems of agricultural financing

Agricultural production has specificities that affect producers adversely in terms of financing. The production is linked to to immobile factors (land, labour), and is based on biological organisms characterized by cyclical growth and development requiring continuous expenditures, but having only temporary results. The profitability of the sector is low, volatile (Buday-Sántha 2001), its capital demand is high, the return on equity is slow and risky, the possibility of restructuring is limited (Burgerné 2002). Further organizational and financial problems are raised by weather, animal and plant health risks, market anomalies, as well as the seasonal nature of the utility of assets and labour. (Csete-Láng 2005)

The deterioration of the sector’s income position started after the 1990 regime change, due to the decline of the significance of agriculture in national economy, the loss of foreign markets, the decrease in domestic consumption, the deterioration of efficiency arising from fragmentation, the broadening of agricultural price gap and the overall financing difficulties. In addition, the income “flows through” the sector because of the land rentals and the prices of services (Udovecz 2000).

The accession to the European Union brought high hopes for all actors in the economy, so obviously for the agricultural sector too. Antal (2005) writes in her analysis:
“For the agriculture facing deep crisis since the regime change, the only possible alternative was to join the European Union. Despite the fact that the 100% support level will be achieved only in 2013 in case of direct payments, and international tendencies are heading to the direction of subsidy reduction, the community agricultural subsidies are the multiple of the amount that the Hungarian agricultural budget could provide.”

According to Borszéki (2000), the agricultural financing is determined by the self-financing (depending on the capital need, financial status and fundraising), the credit and support system as external sources, and the general state of economy, while the financing channels of agriculture are: internal capital formation, subsidies and loans.

3.4 Sources and forms of agricultural lending

Agricultural loans take many forms. The credit institutions may finance the different points of product chain, and through the actor on the end of the chain (integrator) the whole product chain (vertical financing); the agricultural enterprise, regardless of the enterprise’s purposes, based on its economic situation (global financing); a specific transaction, examining its characteristics and the general economic situation of the company (transaction financing); particular projects, in which the sources of the return are generated by the project itself (project financing). (Francsovics 2005)

Among the institutional actors of agriculture’s external financing, the commercial banks, cooperative financial institutions, and the state funded investment, development and (short-term or long-term) working asset loans are the direct, while the suppliers, the integrators, as well as the factoring and leasing companies are the indirect financial sources. The latter banking kind of indirect financial transactions are more expensive, but establish a link between the commercial banks and the high-risk agricultural customers. The non-banking-type indirect forms, which enable external funds, are the supplier credits, customer advances and the companies’ loans from members. (Kemény 2010) The role of different financial organizations in agricultural lending can be seen on Figure 1.

In terms of the source structure of agricultural enterprises, the economic size and the type of company are determining. In the larger holdings the share of external financial sources is higher, and thereby the extent of indebtedness as well. In case of smaller farms, due to their small size, the opportunity of connecting to the capital markets is limited, so there is a constraint of self-financing (Varga et al. 1999). The corporate enterprises are rather characterized by bank and supplier financing, while the individual farms get financial resources from integrator firms or by own funds (Kapronczai 2010). In summary, the agricultural credit portfolio is growing, but it is far behind the other sectors of the national economy, and just one-third of it is foreign currency-based (Töröné 2012).
Figure 1: The importance of financial organizations in the agricultural lending

Source: AKI Gazdaságfejlesztési Igazgatóság, 2013

Just like on the scene of global trade between the various interest groups, conflicts of interest can be observed between the different sectors of national economy, since the profit-oriented banking sector does not consider the repayment of loan and its interests guaranteed in case of credits granted to agricultural producers, and consequently it can not have regard to the nature of public interest of food production (Fertő 2001). The decline in the share of agriculture to GDP caused uncertainty in the sector-financing banks, so the borrower can find itself in a credit assessment situation, in which its creditworthiness and possible guarantees are very strictly evaluated (Lentner 2004).

According to Kiss (2003) the risks of agricultural lendings can be reduced by proper collateral, loan guarantees, government guarantee, and lending with public warehousing. The reduction of risks results in easier and cheaper bank financing, as the value of land property increases due to the improving profitability, and the bank’s need for interest margin and surplus collateral decreases. Nevertheless, according to recent researches (Szűcs 2012), the interest support and the system of state guarantees decreased the compulsion of future risk assessment, increased the danger of non-market led development, and worsened the functionality and liquidity of farms by increasing the indebtedness of enterprises and excessive investment incentives. The public warehouse lending was undermined by global economic crisis: as a result of the 2008 price depression after the 2007 price explosion, the coverage disappeared from the credits of the ones who speculated on price increase (Kemény 2010).

3.5 European models of agricultural lending

Based on the conclusions of Tanka (1998) it can be stated that although the economic and financial systems are globalizing, various institutions and mechanisms of agricultural financing emerged in each countries. The main causes of differences – beyond the historical antecedents and traditions – are to be sought in the importance of agriculture in national economy, the type of operated system of financial institutions, the developed practice of
agricultural lending and the extent and methods of state interventions. Based on that, four main financing models can be distinguished in Europe, which do not exclude each other, but function as prevailing model in certain countries or country groups:

1. The major commercial banks with nationwide network lend: United Kingdom, Ireland
2. Network of cooperative agricultural banks: Germany, Netherlands, France, Belgium, Italy, Sweden
3. “Near-state” specialized financial institutions: Italy, Spain, Portugal
4. Corporate credit to finance the technically advanced and high-level intermediate consumption generating agriculture: United Kingdom, Denmark, Netherlands.

The so-called American model is also worth mentioning, in which the groups of institutions that implement the division of labor and at the same time compete with each other, constitute a complex system, thereby improving the farmers’ position on the demand side.

Of course, it is crucial to take into consideration the specific conditions when designing the domestic agricultural credit system. Decision makers should not make the mistake to apply in its entirety the financing model of another country without adapting it to local conditions.

3.6 Doubts about the concept of agricultural bank

In Hungary, the concept of specialized financial institution had repeatedly failed, so – in our opinion – its ‘resurrection’ needs careful, detailed and objective analysis and planning. Until the mid-‘90s, the so-called Mutual Support Fund (Kölcsönös Támogatási Alap = KTA) was the main source of agricultural financing, functioning from the financial contributions of cooperatives and large state farms, generally providing lower credit interest than the applicable central interest rate. The banking service background of the credit-outsorcing was assured by Agrobank, but the suspension of KTA (repayment to the capital owners) in 1995 prevented the further operation of the financial institution and led to its merging into the mostly state-owned Mezőbank. Under the pressure of the commercial banks opening branches following the 1996 OECD accession, and as a consequence of the volatile performance of the agricultural sector, Mezőbank could not avoid its fate. Because of its not sufficiently diversified portfolio and risky lendings, the bank was forced to get capital injection from the state, and later a tender was announced for its privatisation in 1998 which was won by the Austrian Erste AG.

The concept of a state-owned agricultural bank has been a recurring idea since the early ‘90s, in general carefully planned, when it became obvious that it was still much more economical for the state to finance specific loan schemes, financial products and packages than setting up and maintaining a complete banking network. In the latter case, buying, rebuilding and supplying the real estate with the proper IT and communication infrastructure would generate very high costs, not to mention the training and the proper wages of the required staff, and the corporate identity and marketing expenditures related to the products.

4. Conclusions

We believe that such a financial institution would be exposed to high risk due to its specialized unilateral portfolio, thanks to the specificities of the agricultural sector characterized by a slow return on investment, seasonality, the uncertainties resulting from its
biological nature and the generally characteristic low income levels. Thus, so far, the agricultural lending has been carried out by the Hungarian Development Bank, for the sake of easier and faster communication with the clients through the mediation of commercial banks, in agreement with those on the issues of risks and benefits (lending costs, interest income etc.)

The proposal of the so-called ‘green bank’ (published in April 2012) refers to a state property of 51% (so majority, but not exclusive ownership), and business investors with market financing according to their proportion. The government should be very careful to avoid the influence of different companies and interest groups on the bank’s operation, business policy and thereby the position of clients.

In our view, the ‘bottleneck’ is the future client: a bank gladly negotiates if it has information on the turnover of the preceding years, the current financial situation and the future plants, so overall about the chances of return and repayment. A client without a bank account, proper accounting, elaborated business concept (like so many primary producers and family farmers) may not be creditworthy. As long as the financial and ‘self-management’ culture does not change in a positive direction, it is exactly those who need it most that will not benefit from the agricultural bank’s advantages.

In addition to the aspects above, it should be also taken into consideration that a new, state support-dependent bank may not solve the problem of agricultural financing in a socially sustainable way, because other sectors already consider agriculture as overcompensated and oversupported, while the contributions (payments) of agricultural actors may not not cover the crediting of medium or large investments, thus, new social tensions may arise, because the required money has to be taken from elsewhere.

According to a possible scenario (pessimistic for most of the agricultural actors) in the long run the European agriculture is expected to move towards a competitive, in-market direction. At the expense of agricultural subsidies, an increasing priority will be given to technological research and development and other areas of industry and services, and, as a result of the occuring market clearing mechanisms, the disappearance of the small and uncompetitive farms, and the financing needs of the investments of farms with - due to the concentration into bigger farm sizes – decreasing number, but growing size, will encourage the commercial banks to expand their activities in this direction. But if the ‘race’ starts between the banks for competitive and creditworthy farms of economic scale, adapting modern technologies, then the legitimacy of the agricultural bank, which originally was intended to help the small, undercapitalised farmers who were not able to be equal partners with the commercial banks, bevomes questionable, since its target group partially disappears, partially transforms and ‘outgrows’ the framework provided by the agricultural bank.

**References**


