Financing of Agri-Food Value Chains in Asia

Enjiang Cheng

May 28-29, 2015

Manila, Philippines

An Outline

- Main Content
  - Small Farmers and Agri. Value Chains in Asia
  - The Financial Mechanisms for Agricultural Value Chain Development
  - Key Lessons Learnt
  - The presentation is based mainly on the cases from China, India and Bangladesh, and on the literature review and some of our field investigations

Small Farmers and Value Chains in Asia (1)

- Motivations of the Study
  - To share experience and learn lessons from the improvement in agricultural value chain (AVC) finance in Asia, to be inclusive of smallholders, so as to increase the access of smallholders in Asia to financial services. We start the study from Bangladesh, China and India.
  - The agricultural economies in Asia, especially in South Asia, ASEAN and China are under the process of transformation from traditional to modern agriculture, driven by the process of urbanization and a change in the demand for farm products, following income growth; such a process of transformation is at a different stage for different Asian economies, based on their income and speed of urbanization.

Small Farmers and Value Chains in Asia (2)

- Such a transformation is signalled by the development of AVC
  - Small farmers could be missed out in such a process due to their lack of physical collateral and the higher transaction costs in serving smallholders;
  - It is important for the developing Asian economies to support smallholder farmers, given the population density and the unemployment in the urban areas;
  - Small farmers make large contribution to high value farm production and exports; the lack of access to sound financial services has prevented many smallholders from joining agricultural value chains, due to their lack of physical collateral and higher transaction costs for serving smallholders;

Small Farmers and Value Chains (3)

- The Welfare Effects of Agricultural Value Chains (AVC) to Small Farmers
  - Potentially market access, higher farm prices and higher returns to producers, from contract farming and from joining farmers' cooperatives or associations integrated in a AVC; farmers gain mainly from an reduction in transaction costs, from higher prices, or from an improvement in production efficiency due to flow of information, technology, etc.
  - Value chain is capable of sharing production and market risks, such as contract farming, through the input supply, technical training and the purchasing of farm products

Small Farmers and Value Chains (4)

- Models of value chains in China and India
  - Producer-driven value chains, driven by co-operative, association or self help groups;
    - India’s dairy cooperatives, AMUL; cooperative society for cotton farmers Koutla-B, Guhe Swine cooperative in Jiangsu of China
  - Buyer-driven value chains, organized by processors, or traders, or exporters;
  - Facilitator-driven value chains: facilitated by the governments or NGOs. It is more common in China than in India, usually by local governments;
  - Contract farming in both China and India, some risk transfer from farmers to buyers; Nestle dairy value chains. For potato market in Bangladesh, contract farming is emerging.

Financial Mechanisms for Value Chains (1)

The Traditional Theory on Value Chain Finance in Asia

- the hypothesis of exploitative grain trade – high rates of interest for grain trader credit, similar to the approach for informal finance.

Financial Mechanisms for Value Chains (2)

- **Changes in the Demand for Financial Services from Farmers, our surveys show**
  - The demand for credit from small farm households for farm production declines due to their small piece of land and rising cash incomes from migrant workers and off farm activities; however,
  - The demand for loans for farm production increases following enlarged farm scale for cropping, following intensive cropping (such as a shift from grain to vegetable or fruit production), and following increased animal production and fishery;
  - The demand for loans for other links than farm production in AVC increases, such as agro-processing, cold storage, transportation and trading.
  - The demand for financial services increases for farm machinery.

Financial Mechanisms for Value Chains (3)

- Is AVC finance necessary for the Developing Asian economies?
  - Low access of small farmers to institutional finance in all the three countries: India (about 21%) and China (about 10%), higher transaction costs in accessing formal finance, kick-backs and commissions to the loan officials or agents though the official rate is not high;
  - In general, the rapid development of microfinance has failed to address the demand for loans for agriculture in Bangladesh, China and India: (i). Loans are designed mainly for trading and commerce activities with frequent cash flows; weekly or monthly loan repayments and frequent center meetings are not consistent with farm production and income cycles; (ii). The real effective rate in some case higher than what the smallholder farmers are willing to take, with no profitability in agricultural production.

Financial Mechanisms for Value Chains (4)

– The land tenure and distribution system in many Asian countries has prevented farm land to be used as loan collateral;
– The changes in the demand for financial services indicate we need new approaches for designing and developing financial services for farm production, input supply and marketing.

Financial Mechanisms for Value Chains (5)

- The issues facing credit contract: credit screening, monitoring and enforcement.

    - Availability of collaterals reduces the costs for screening, monitoring and enforcement, hence lowers the lending rate of interest and improved credit access for farmers and others.
    - The value chain itself could be an effective substitute for physical collaterals and could be used to reduce the costs for servicing smallholders.

Financial Mechanisms for Value Chains (6)

– Internal finance
  - Internal finance found common in the three countries: mainly by processing, cold storage or exporting firms, in cash or in kind (input and services in trader finance), linked to the sales commitment, examples include
    – Contracting farming in China: usually buyers use a purchasing contract with the supply of farm input on credit and technical support to guarantee the quality and quality of the farm goods to be procured and marketed; some mechanisms to lock in the producers: (i). higher input and higher output prices; (ii). Joint ventures with local community leaders and farmers in the form of a farmers' cooperative; (iii). Joint venture with community leaders

Financial Mechanisms for Value Chains (7)

- Agri. businesses (Nestle) provide equipment credit for improving product standard and provide credit to the agents in India and China.
- Agri. Businesses facilitate credit from formal financial institutions, and engaging in financial leasing and leasing in kind in India and China;
- Financial leasing through the suppliers of farm machines in China;
- Cold storage owners to provide loans to potato growers using potato at the cold storage as collateral in Bangladesh;

– External Finance
  - Government or government project supported agricultural value chain financing;
  - Agri. business oriented microfinance institutions, BASIX in India;
  - Purchase contracts, warehouse receipts as guarantees for loan access from formal institutions.

Financial Mechanisms for Value Chains (8)

- Risk management through value chains
  - Inter-linked market, VC and credit screening: personal and industry knowledge; credit monitoring: loans for specific uses and better control over loan uses; loan contract enforcement: direct deduction of sales proceeds, cut off of future links and transactions, esp. by the leading participant who guarantee the loans;
  - VC mitigates credit risks through the provision of input and technical support to smallholders for more efficient farm production, through the provision of market access; risk sharing between producers and buyers through contracting, esp. for price risks; Linked credit and insurance contracts to mitigate natural risks (crop and life insurance);

Financial Mechanisms for Value Chains (9)

- External Financial institutions manage risks: use the guarantee provided by a leading chain participant, usually a processing or marketing firm, to provide loan guarantee for small producers; banks deduct the sale proceeds directly for loan repayments;
- Risk management funds using surplus and savings by cooperatives and associations to provide guarantee for loan repayment

Lessons Learnt (1)

- AVC is capable of mitigating credit risks and reducing transaction costs for the service providers and expanding the access of smallholders to financial services as a substitute for collateral, through improvements in credit screening, monitoring and enforcement;
- Some forms of collective actions are necessary for smallholders to join and benefit from the value chain development in agriculture. Government and NGOs can play an important role in collective action; Smallholders can become involved in the value chain through cooperatives or associations;

Lessons Learnt (2)

- Formal financial institutions and MFIs can improve their financial services to smallholders by taking advantage of VC mechanism in credit screening, monitoring and enforcement, and these institutions can do so through external VC financing and by tailoring their financial products and services to the demand of those in VC
- Possible China and India lessons for Bangladesh: collective action and farmers cooperatives, contract farming.