Financing agriculture in West Africa – challenges and paradigm shift

The causal relationship between increased agricultural investment, agricultural development and economic development is a compelling finding from the agricultural revolutions in Europe, America and various parts of Asia. Reviewing the evolution of the agricultural financing paradigm, this article diagnoses the difficulties undermining agricultural financing in West Africa.

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Financing is a critical issue in agricultural development. Insufficient infrastructure that weighs on transaction costs, problems of covariance due to climatic risks, price and market risk, but also bankers lacking experience needed to assess the value of the products they are asked to finance, the low level of education of farmers and farm workers, as well as the problem of guarantees are among the barriers standing in the way of banking institutions.

Difficult, costly, risky

The supply of rural finance that integrates agricultural finance is often perceived as more difficult than the supply of urban finance for several reasons. Miller (2004) classifies constraints in rural finance as vulnerability constraints, including systemic market and credit risks; operational constraints due to low returns on investment, low asset levels and geographic dispersion; capacity constraints, including infrastructural capacity, technical capacity, social exclusion, and institutional capacity; and policy and regulatory constraints, such as political and social interference and the regulatory framework.

In rural areas, clients are more dispersed than in urban areas due to the lower population density. The financial services demanded are small amounts, so transaction costs per unit are high for financial institutions. With generally less developed transport and communication infrastructure, information costs for providers and users are higher.

Agricultural loans are also perceived to be riskier because of production and marketing risks. In addition, in rural areas, non-agricultural activities are invariably linked to agricultural activities, with rural households being subject to many of the risks that affect the agricultural sector, creating a covariance in outcomes. Concentration on similar agriculture-related activities in small geographic areas leads to a high covariance of farm household incomes. This situation is aggravated by the lack of formal insurance mechanisms to mitigate these risks. Informal insurance such as solidarity is inadequate to manage the systemic risks arising from income covariance. As a result, local financial institutions are vulnerable.

In addition, the weakness of human resources combined with the lack of appropriate guarantees complicates the development of a local service offer and weakens financial transactions. Moreover, in rural areas, loans are sometimes

Two women in the Tillaberi region of Niger whose husbands abandoned them to seek a better life in neighbouring coastal countries working in their market crops field to boost their income.

Photo: Arne Hoel/ World Bank

confused with grants because of poor management on the part of the public development banks and their frequently failing to adequately inform farmers about what are grants and what are loans, leaving them confused. These practices are widespread during election periods or in the populist positions of certain governments. All of these factors provide reasons why many commercial banks prefer the less arduous task of lending to the industrial and service sectors, and to urban consumers, rather than to the agricultural sector with its multiple difficulties and uncertainties.

Hollinger (2012) states that one of the risks financial institutions face when deciding to finance agriculture is the phenomenon of asymmetric information that may exist between lender and borrower. The information held by the lender regarding the specific elements that determine the feasibility of a potential investment or the financial context of a farm operation does not match that of the borrower. Neither does the lender know whether the borrower will use the funds in accordance with the originally stated objectives or genuinely intends to repay. This behaviour is a feature of opportunism in rural areas. Asymmetric information problems, coupled with problems in monitoring and enforcement, increase the risk of moral hazard. After signing a loan contract, the borrower may subsequently engage in behaviour detrimental to the interests of the lender.

Given the importance of the risks associated with agricultural activity, banks are not very involved in financing the agricultural sector. Over the period 2013–2015, the sector received only 2.61 per cent of the credit granted to the economy (BCEAO, 2015). Production credits are mainly granted to industrial farmers capable of producing guarantees, with priority given to cash crops, which are organised sectors where production revenues are totally controlled by a centralised sales network.

Evolution of the agricultural financing paradigm

Agricultural finance policies in West Africa can be categorised in four major periods:

Agricultural credit policies (before the 1970s)

Since independence, the economy of West Africa has been essentially based on agriculture. In order to meet both the imperatives of food self-sufficiency and those of the international market, which had to provide the foreign exchange needed for development, the sector had to be modernised. But due to the low monetarisation of the economy and the practice of subsistence agriculture, most of the peasants did not have the means to finance modern equipment and inputs. Banking channels were therefore needed to play this role. However, the commercial banks at the time preferred to intervene in the trading economy. Therefore, banks entirely devoted to the agricultural sector were created by the States in most countries of the subregion.

Adopting such agricultural financing policies was inspired by Keynesian economic theories. Rural and agricultural underdevelopment was analysed as the result of the inability of poor peasants to save and invest; credit was then used as a necessary lever to initiate the "virtuous circle" of development. Public credit should promote technical change, the financing of innovation and the development of agricultural production. It was also a means of reducing the usurers' hold on rural economies. As a result, low, subsidised interest rates were to stimulate the demand for credit by rural populations and the use of inputs, and support the development of farms.

Governments were not concerned with the profitability of financial institutions. Faced with non-payment, they managed poor-quality portfolios that jeopardised their sustainability. Indeed, many agricultural credits were granted in the context of poorly designed development projects. As a result of these poor performances, both in terms of clientele and the viability of these directed credits, most of these credit programmes were interrupted and several rural development banks went bankrupt. The poor results obtained, combined with the failure of the public structures involved and the generalisation of liberal economic thinking, led to the abandonment of this approach (Lapenu, 2008).

Questioning agricultural credit policies (1970-1980)

Neo-classical economists have questioned agricultural credit policies based on Keynesian policies, maintaining that state intervention through the control of interest rates and keeping them artificially low and the support provided by public banks to failing public enterprises limited the functioning and efficiency of the financial system. These practices contribute to low savings mobilisation and government levies detrimental to investment. The difficulties encountered by agricultural credit programmes during this period reinforce this theoretical criticism: losses linked to unpaid loans are considerable, many agricultural credit institutions are in difficulty, and the entire financial system is highly dependent on external aid.

The track record of development agencies heavily involved in agricultural financing highlights the mixed impact of these credit programmes. Evaluations show that this approach has helped some developing countries to improve their agricultural yields in the short term. However, these studies also highlight many negative effects of these credit programmes. More generally, the size of the volumes of financing disbursed is not correlated with a significant and systematic increase in agricultural productivity and income. In addition, the savings capacity of rural households has not increased and the hoped-for "virtuous circles" of private investment remain virtual. In many cases, state-owned agricultural credit institutions have compromised the development of private financial institutions. The informal sector that these policies aim to reduce remains very active. The public institutions created to spread credit in rural economies are proving to be weakly effective. The capital mobilised reaches only some of the farms, the institutions are poorly managed and lead to losses and embezzlement, repayment rates are low, and little attention is paid to savings mobilisation. All this compromises the viability of financial institutions, as does the political use that is often made of them. In sum, the benefits achieved have largely failed to achieve the objectives of increasing rural incomes, asset formation and rural poverty reduction, among others.

At the beginning of the 1980s, financing policies will change as a result of the debt crisis in developing countries. In order to overcome the difficulties, it is recommended to remove all constraints limiting the development of financial markets. In West Africa, this liberalisation has resulted in the restructuring and reorganisation of the banking sector (privatisation, liquidation or restructuring of public banks, rationalisation of interest rate policies, devaluation of the CFA franc, regional financial integration, etc.), the introduction of new regulations and the emergence of institutional innovations in the area of decentralised financing.

Emergence of rural financial markets (early 1990s)

With the rise of liberal theories, public intervention in the promotion of access to financial services for populations excluded from them has been strongly criticised. The inability of the interventionist logic to take into account realities, its cost and finally its inefficiency in the face of real needs have been widely pointed out. The trend towards regulation by the market as the better vector of social justice than public action has therefore naturally imposed itself. Credit is a financial operation that meets banking requirements. It must be repaid and the risk covered by material guarantees: buildings, equipment, property deeds, stocks, herds, etc. The interest rate must at least cover management costs and risks and, if possible, make a profit. The objective is no longer to promote sectoral credit, but to foster the development and fluidity of a rural capital market in which "rural credit" is no longer just one of many financial instruments, constituting a less constrained, sustainable, more widely developed system of global financial intermediation, linking households to the macroeconomic sphere.

Financing agriculture in West Africa is still difficult.

Photo: Arne Hoel/ World Bank

This new paradigm, while based on the needs of farmers, focuses on improving the supply of financial services, using financial market principles to provide not only credit but also other financial services to the rural world. The system promotes financial intermediation, which improves the provision of resources to investors via the savings collected. Hence there are no longer any specific credits aimed at the poor or loans at subsidised rates. The interest rate served on financial operations is a matter of matching market supply and demand.

This paradigm is seen as a means to enable more efficient financial market development and integration rather than market segmentation policies. Financial market efficiency ensures the availability and productivity of production factors, while promoting inter-temporal resource allocation and risk management. Thus, for the followers of this school, financial development promotes economic development, not state interventionism in the financial sphere.

According to the neoclassical economic theory underlying this approach, for the market to function efficiently, the price must be able to vary according to supply and demand. This is why interest rates must be liberalised. This interest rate must cover the costs of the resource and the financial transaction. Also, it is argued that the free functioning of the market will favour the allocation of financial resources to those agents and activities with the best capacity to make them profitable. This is the optimal allocation of the resource.

The shift from agricultural credit to rural financial markets has led to a rarefaction in the supply of agricultural financing. The agricultural producers' organisations that are developing in many West African countries are acutely confronted with this paradox. They are solicited by their members to meet their financing needs. The integration into the rural financial market predicted by theory is struggling to be achieved and the partnership between the agricultural and financial sectors is far from being spontaneous. At the same time, profitable agriculture in structured channels demonstrates financial needs that microfinance is unable to meet. These include investments in heavy agricultural equipment requiring substantial medium- or long-term loans. As a result, these reforms have not produced the expected results, particularly the substantial increase in agricultural growth to reduce rural poverty. The private sector has not moved into the vacant spaces left by the state, and agricultural markets have not developed as anticipated by the macroeconomic stabilisation and structural adjustment measures put in place.

Back to the state's public intervention in agriculture (from the 1990s onwards)

In this increasingly complex agricultural financing landscape, following the Addis Ababa Conference on Financing for Development in July 2015, the call for the public sector to build effective agricultural financing strategies has become louder. In West Africa as a whole, recent studies reflect an overall increase in the amounts mobilised for agriculture. This increase is not attributable to a single group of actors, but results from a joint effort by governments, donors and the private sector.

The commitments made by African governments relate to legislative and fiscal measures favourable to the private sector and aimed at improving the business environment, as well as the construction of community infrastructure to improve market access, storage and the valorisation of agricultural production, rather than to amounts of public spending on agriculture. There have also been changes in the institutional landscape of financing that are reflected in an evolution of the instruments used and an increasing orientation of public funds in financial packages on attracting private investment. Thus, African states and donors have gradually become involved in financial instruments such as guarantee funds, investment funds, banking integration in agricultural value chains and the establishment of agricultural engineering companies.

On the right way?

Public investment in agriculture is necessary to provide the public goods that can enhance the dynamism of the agricultural sector. Syed and Miyazako (2013) show that investment in public goods has much higher returns than other expenditures. Jacquet and Guillermo (1988) argue that in most regions where agricultural production is efficient and better developed, capital and input intensity levels are higher. They are supported by Hoff and Stiglitz (2002), who argue that in the search for the best productivity, capital accumulation becomes indispensable. Individuals with few or no assets will be relatively unproductive compared to what they would produce if more wealth allowed them to work under more stimulating conditions. These authors hold that agricultural intensification by capital is more suitable for increasing productivity; hence state intervention to allocate enough funds to the agricultural sector in order to reduce poverty appears to be the right way.

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