

# Agricultural credits and contracts

## *Poľnohospodárske úvery a kontrakty*

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**Abstract:** The paper considers contracting problems of the transitional period agriculture. The slow and inexperienced legal system makes third party contract enforcement non-viable. Market enforcement of contract is imperfect due to incompleteness of contracts and underdevelopment of informal features (institutions) of the society, such as codes of behaviour, low importance of goodwill, low adherence to ethical norms, inexperience with conflicts solving in market economy. The survey data related to contracting in transitional agriculture are presented.

**Key words:** contract, transition economy, farm

**Abstrakt:** V článku sa venujem kontraktným problémom v prechodnom poľnohospodárstve. Pomaly a trhovo neskúsený právny systém neumožňuje vymáhanie kontraktov treťou stranou. Trh túto funkciu neuskutočňuje dostatočne kvôli neúplnosti kontraktov a nerozvinutosti určitých neformálnych črt (inštitúcií) spoločnosti ako sú nedostatočné etické parametre správania, malá dôležitosť reputácie, neskúsenosť s riešením sporov v trhovej ekonomike. Článok zároveň poskytuje údaje týkajúce sa kontraktov získané dotazníkovou metódou.

**Kľúčové slová:** kontrakt, prechodná ekonomika, farma

Until the middle of 2000, the banking sector was controlled by the state in the Slovak Republic and banks were major financial intermediaries. The state had majority stakes in three biggest banks that accounted for half of all bank credits. Moreover, state-owned companies had stakes in other banks, making banking sector profoundly state-controlled. State ownership of the bank was a major cause of credit conditions deterioration, slow development of financial market institutions (including legislation), and minimal restructuring of enterprises. The upshot of not reforming of the banking sector was credit rationing, high real interest-rates, and a significant amount of bad loans. Agricultural sector suffered from unavailability of credits in the first 10 years of transformation.

Restructuring of the banking sector and the subsequent privatisation of the three biggest banks by foreign subjects established conditions for a turnaround. Concurrently, changes in legislation (new bankruptcy law, for example) strengthened the market orientation of the banks. In the short-run, it might have caused a recession, but in the long run, conditions for cheaper and available credits were established.

Restructuring of the banking sector together with fiscal tightening created a surplus of funds in the market. The required reserves declined from 6.5 to 5.6 per cent and interest rates gradually decreased to about 11 per cent from the heights of about 20 per cent. There is a surplus of funds in the banking sector while the enterprise sector (especially agriculture) is still under-capitalised. What is the explanation of this fact?

## THEORY

The aim of this paper is to present contracting problems as an additional cause of Slovak agriculture underinvestment in the transition period. Other reasons for low investment into agriculture are the declining terms of trade, weather disruptions, transformation of agricultural sector, which is accompanied by still not clear property rights in the interim period, distortions caused by privatisation and restructuring of the up and downstream industries, fluctuations of foreign markets, and low stability of agricultural policy.

The paper presents the theory and empirical evidence from the survey conducted in the Slovak Republic that sheds some light on this important aspect of the transitional agriculture.

Under the system of centrally planned economy, the exchanges with up and downstream industries were centrally regulated and enforced. A higher authority always solved a contracting problem. The situation has changed with the beginning of reforms.

In functioning market economies, exchanges are enforced by either legal system or by the market itself. Explicit contracts enforced by legal system are costly in market economy due to their incompleteness. Incompleteness of contracts stems from the impossibility to foresee all contingencies and the non-observability of outcomes. In the transitional Slovak economy, contract enforcement by third party became even more difficult because the legal system, which is under transformation too and relatively inexperienced with market transactions, works slowly.

Relying on markets rather than on legal institutions is a predominant way of enforcing long-term contracts. When implicit contracts are broken, the defector can be punished by the loss of reputation and subsequently by the loss of future business. This type of contract enforcement requires certain generally accepted trading rules that are not present in transitional economy. Transitional economy lacks the generally accepted codes of behaviour, adherence to ethical norms, and experience in solving the conflicts. All these factors make contracts less stable.

Incomplete contracts produce two types of problems: moral hazard and hold-up problem. The extent of these problems in transitional economy is bigger than in functioning market economies. Moral hazard occurs when one party undertakes ex-post, after signing of the contract, activities that are undesirable for the other party of the contract, such as debasing quality, shirking etc. Hold-up problem occurs when ex-post one party uses its power to change the contract in his/her favour. The power to renegotiate the contract comes from the other party investment of resources into the relation-specific capital, i.e. capital that can be transferred to a different use with a significant loss of its value only. When the investment into the relation-specific capital is sunk, it is expensive to reverse the investment or to transform it into another use. The difference between the intended use of the investment and its second best use is called quasi-rent. Renegotiations are in fact a struggle to extract quasi-rents. Hold-up problem, which is extensively present in agriculture, inhibits investment into relation-specific assets.

## SURVEY RESULTS AND DISCUSSION

Table 1 shows that the share of agricultural production in GDP exceeds the share of investment into agriculture as a share of GDP. This can be the result of both contracting problems of agricultural sector and to standard reasons like declining terms of trade, market uncertainty, transformation disruptions and world market instability.

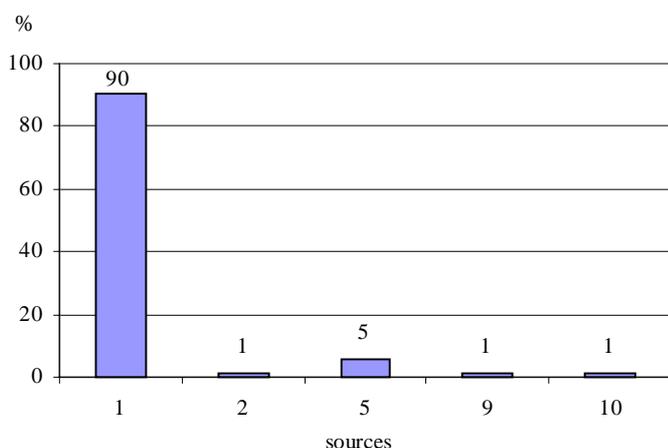


Figure 1. Source of money for investment

1 – own resources, 2 – credit from relatives, 5 – credit from financial institutions, 9 – subsidies from the state, 10 – leasing

Table 1. Agricultural production and investment as a share of GDP

Indicator	1997	1998	1999
Share of agriculture in GDP	4.84	4.40	4.26
Share of agriculture in investments	3.31	2.89	2.47

Source: Ministry of Agriculture of the Slovak Republic

The instrument choice of the Slovak government considers contracting problems and attempts to specifically target it. The government adopted the following measures related to contracting:

- low interest rate credits used for specific purposes from the State Support Fund for Agriculture and Food;
- provision of collateral for credits from commercial banks;
- investment subsidies;
- fixed prices for sectors where highly specific assets are employed. This is an additional way to cope with the hold-up problem. An example is a fixed price for milk.

Based on survey data, 18% of the sample of *private farmers* invested into machinery and equipment in 1999, mostly from own resources (Figure 1). 8% of rural households have outstanding loans. 95% of farmers were not interested in obtaining credit from financial institutions at the current interest rates.

Most private farms are labour intensive compared with commercial farms and therefore they have low investment. High real interest rates slow the investment activity too.

Most private farms in Slovakia cannot rely on bank credit. These farmers cannot get credit because they are high-risk customers of banks. The situation is the result of the fluctuations and unpredictability of agricultural markets and due to declining of the agricultural sector.

Majority of private farms sell their produce directly to processor and/or to a specialised trader.

According to our survey, farmers sell their produce (wheat) on contract because it guarantees them that it will actually be sold, it reduces price risk and the third

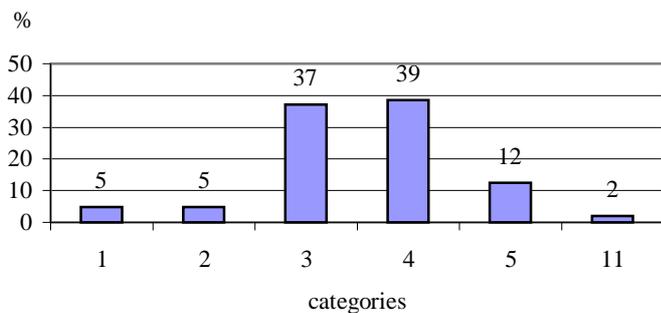


Figure 2. Buyers of production (wheat)

1 – sold through agricultural production co-operative or company of which some household members are members, 2 – sold through specialised marketing co-operative or company of which some household members are members, 3 – sold to processor, 4 – sold to trader, 5 – sold in the local market or farm, 11 – other

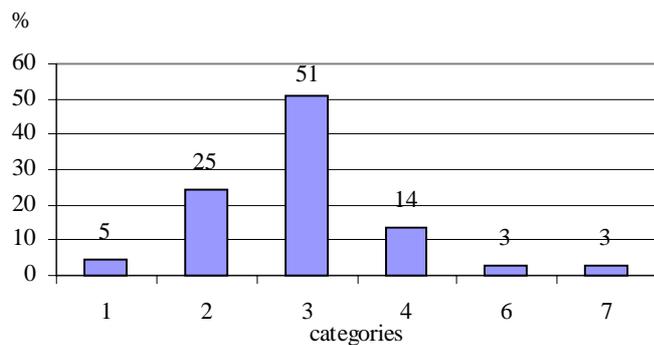


Figure 3. Reasons for sale on contract

1 – contract price was higher than the expected future price, 2 – to avoid future price uncertainty, 3 – guarantee that products will be sold, 4 – to get immediately money for part of production, 5 – easier to get credit, 6 – buyer will provide some inputs or technical assistance, 7 – other

Sale of animal products.

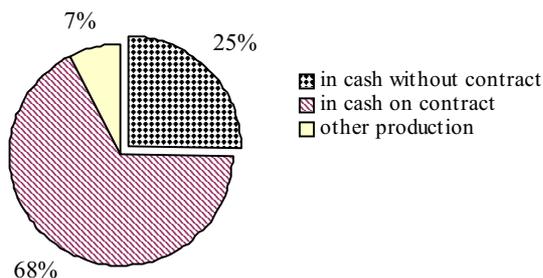


Figure 4. Use of animal products

reason is that part of the money will be obtained in advance (Figure 3). Contracts therefore reduce future price and risk. Contracts are also substitutes for bank loans. That is, both declining terms of trade, surplus of agricultural produce in the market and financial considerations are important for contracting arrangements.

Similarly in animal production, 68% of all products sales were based on a contract with purchaser. Only 7% of sales was conducted for cash (Figure 4).

## CONCLUSIONS

Investment into agriculture has been low in Slovakia during transition period. There are two explanations for this fact: worsening of agricultural terms of trade (coupled with other transitional and weather disruptions) and contracting problems. Both reasons are important.

Slow and inexperienced legal system makes a third party contract enforcement non-viable in the transition agriculture. On the other hand, market enforcement of contracts is also imperfect due to incompleteness of contracts and underdevelopment of informal institutions (codes of behaviour, low importance of goodwill, low adherence to ethical norms, inexperience with solving conflicts in market environment).

Most private farms in Slovakia cannot rely on bank credit. These farmers cannot get credit because they are high-risk customers of banks. Contracting problems also prohibit investment. The instrument choice of the Slovak government considers these problems and attempts to target them specifically.

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