Agriculture finance and credit infrastructure – conditions, policies and channels

Finanční a úvěrová infrastruktura pro zemědělství – podmínky, politické nástroje a možnosti

A. TRZECIAK-DUVAL

OECD, Paris, France

Abstract: Agriculture, like all sectors of the economy, needs credit for its development. Experience in OECD countries demonstrates that in a competitive financial environment, profitable agriculture can obtain the credit it needs. Due to the difficulties faced by farmers in transition economies in obtaining access to credit, the OECD has periodically called upon member and transition experts to reflect upon the issues at stake and to share relevant lessons and best practices in the field of agricultural finance and credit infrastructure. This paper reviews the key messages from past work on this subject, including some observations from the Czech experience. These messages pertain to: the essential framework conditions for access to credit; the role of government policy-making, and possible channels for financing the agriculture and rural sectors. The paper then briefly suggests some linkages and implications that may be drawn between the EU enlargement and these three themes.

Key words: European agriculture, agricultural finance, agricultural credit, sustainable rural banking, EU enlargement

Abstrakt: Rozvoj zemědělství, stejně jako ostatních ekonomických odvětví, se neobejde bez bankovních úvěrů. Zkušenosti zemí OECD ukazují, že v konkurenčním finančním prostředí může prosperující zemědělství získávat potřebné úvěry. Na těžkosti, kterým čelí zemědělci transformovaných ekonomik při získávání úvěrů, reagovala OECD pravidelnými schůzkami expertů členských zemí s experty ze zemí střední a východní Evropy (ZSVE), na kterých se projednávají nejdůležitější problémy, předávají relevantní zkušenosti a navrhují nejlepší řešení v oblasti financování zemědělství a volby co nejvýhodnější úvěrové infrastruktury. Příspěvek shrnuje nejdůležitější poznatky dosavadního výzkumu v dané oblasti včetně některých postřehů plynoucích z praxe ČR. Poznatky zahrnují: základní systémové podmínky přístupu k úvěrům; úlohu politických nástrojů a možné způsoby financování zemědělství a rozvoje venkova. Příspěvek závěrem stručně shrnuje některé vazby a důsledky, jimiž je proces rozšiřování EU propojen s uvedenými okruhy poznatků.

Klíčová slova: zemědělství, Evropa, zemědělské finance, zemědělský úvěr, trvale udržitelné bankovnictví, rozšíření EU

LESSONS FROM EVOLVING EXPERIENCE

Framework conditions for accessing agricultural finance and credit

A stable macroeconomic framework

Sustainable finance and credit systems flourish under the conditions of macroeconomic stability. Sound public finances and a stable currency are essential to allow private financial institutions to develop and function. A sustainable macroeconomic framework is also conducive to attracting foreign direct investment (FDI), which can be an important source of critically needed credit, as well as bringing access to markets, modern management and technology. In the agricultural sector, macroeconomic stability strengthens confidence and predictability for producers and facilitates risk assessment for lenders. In those transition countries where macroeconomic stabilisation has been achieved, the establishment of viable financial markets is the farthest advanced (OECD 2001a). Distortions in the economy will prevent a market-based agricultural credit system from evolving. Where the financial market is slow to develop, agriculture may be at the mercy of alternative arrangements outside the finance and banking sector, including protracted reliance on the state to provide credit – often with the expectation that such credit will be on preferential terms.

A strong institutional and legal framework

Even in situations where the macroeconomic framework is strong, the preconditions for functioning financial markets may still be inadequate. This is mainly due to

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insufficient focus given to developed institutions. The absence of appropriate institutions to enforce contracts, distribute information, and finance intermediation caused serious disruptions throughout the transition countries (Swinnen 2002). Although the importance of institutional reforms was recognised early in the transition, only in recent years have institution building and reform been given increased attention. In its review of regulatory reform in the Czech Republic, for example, the OECD notes that through most of the 1990s, economic reforms leaped ahead of institution building. Regulatory weakness and a failure to privatise banks resulted in overly easy access to credit and a lack of restructuring (OECD 2001b).

In building an institutional framework, effective legislation is the first order of priority to establish reliable ground rules for consistent and equitable application. Well-established property rights, particularly with respect to the use of land, are of particular importance to the agricultural sector. When this leads to improved security of tenure and the possibility of using land as collateral, the expected returns on investment can be increased and credit constraints can be eased. So, the existence of legal grounds for using land as collateral is an important, though not necessarily sufficient, basis for access to agricultural credit and finance. This aspect has received major emphasis in the transition economies of Central and Eastern Europe (CEECs). And newly established private farm owners have changed the structure of demand for credit in certain cases.

Another aspect of institutional development revolves around contract enforcement. By ensuring timely and just recourse against the failure to meet contractual obligations or other abuse, be it by providers of credit or borrowers, contract enforcement considerably reduces risk and uncertainty. This element of the institutional framework is necessary to allow the banking sector to operate effectively and, equally important, to allow other, non-traditional sources of finance to develop. Similarly, institutions that provide information and ensure transparency are of increasing importance to the agricultural sector. Sources of information are important to creditors, for example, to establish credit histories, and to borrowers, for example, to obtain market information and price data.

Societal and cultural values

As an integral part of the overall socio-economic framework, society values help to define its degree of confidence in the economy and its structures. Attitudes to debt and savings accumulation, as well as willingness to take risk or to offer land as collateral, are strongly linked to cultural values and core beliefs (OECD 2001a). They affect the speed and efficiency with which the institutions and processes needed to underpin financial markets develop. This is one reason why models that are successful in a given socio-economic framework may not necessarily work in another (OECD 2001a, World Bank 2002). Each of these aspects of the overall framework plays a role in establishing successful pre-conditions for access to agricultural credit and finance.

Profitable agriculture: farm structure, labour productivity and governance

The profitability of agriculture declined dramatically early in the transition process for a combination of well-known reasons: terms of trade for agricultural producers deteriorated significantly; subsidies were cut; traditional markets collapsed; linkages in the agro-food chain broke down. A period of structural and systemic change created additional problems for a number of countries, especially where fragmented ownership structures prevented the creation of economically viable farming operations. Thus, in general, the creation of a sustainable, restructured farm sector became essential to profitability.

The smallest declines in production occurred in those countries that underwent the least restructuring, like the Czech Republic and Poland, even though the types of farming structures in these countries were virtually at two extremes. Nonetheless, in the Czech Republic, as in four other CEECs, labour productivity increased as employment in agriculture decreased significantly. Research has shown that in those countries where labour productivity has increased the most, institutional reforms and innovations, like leasing and forward contracting, have advanced the most. The same countries have also attracted the largest flows of FDI (Mathijs, Swinnen 1999).

By 1999, about 40% of agricultural land in seven CEECs was in large-scale, non-individual farms. In four countries, including the Czech Republic, 90% of farming units are small household plots and family farms that control less than 10% of land, while the largest collective and corporate farms, the top 10%, control about 90% of land. In some countries, especially the Czech Republic and Hungary, new large-scale farms are profit-motivated corporations operating under hard budget constraints and managing labour according to normal business practices (Lerman 1999). Large-scale farms in the Czech Republic and Hungary were also observed to have the highest relative technical efficiency. Thus, where good governance practices in terms of consolidation, downsizing, reform of business management, and the resolution of large farm debt have been followed, the basis for sustainable profitability in agriculture seems well laid.

The above three elements – a restructured farm sector, increased labour productivity, and farms managed according to sound commercial practices – are essential to achieve profitability. Farms must also be allowed to operate in a policy environment free of systemic impediments to profit making through government intervention, like price controls, trade restrictions, or “tied” state credits.

Efficiency throughout the agro-food chain

A further set of conditions needs to be in place for profitable agriculture to exist. These conditions relate to the efficiency of the entire food chain. The adequate supply and timely delivery of farm inputs are essential. The establishment, sometimes re-establishment, of vertical linkages in the agro-food sector ensures sustainable co-operation between producers and processors. Vertical integration can help to ensure reliable product supplies, quality control and stable markets. The ability to attract investment, including FDI, is of particular importance for the restructuring and modernisation of the agro-food sector in transition countries. The emergence of quasi-monopolistic positions requires that attention be paid to market transparency and concentration issues. Attention must also be paid to infrastructural aspects, especially adequate marketing, storage and transport facilities. Current, timely information pertaining to market demand is essential.

The framework conditions listed as necessary for the development of agricultural credit and finance systems in the CEECs are extensive, cannot be fulfilled all at once, and are part of a continuum. Much progress has been made in their creation already. Indeed, their creation interacts continually with the provision of finance, the availability of which they are meant to enhance. As discussed further, the government bears significant responsibilities for creating and maintaining the appropriate pre-conditions or 'enabling environment'.

The role of government and policy-making

Creating an enabling environment

In theory, most governments accept that they should not intervene as economic agents in markets. For governments in transition countries, to accept and assume different roles from those they played in the past has been of critical importance. In the realm of building successful agricultural credit and finance infrastructure, governments carry multiple responsibilities that mesh closely with creating the framework conditions identified in the first part of this paper.

Government needs first of all to minimise uncertainty and create conditions that reduce transaction costs on financial and credit markets. The role of government policy is to create confidence, as well as rational production incentives. The most frequently encountered way in which government destroys financial sector confidence is through double digit or higher rates of inflation (Von Pischke 2001).

Governments should ensure competition in financial markets in order to drive innovation and efficiency and minimise the risk of monopolistic practices. As liberalisation of financial markets progresses, competition increases. By encouraging innovation, this will ultimately also have the effect of strengthening the debt capacity among borrowers. To ensure consistency with policies that strengthen financial markets and promote financial intermediation, the temptation to resort to subsidised, directed credit for preferred agriculture sector borrowers should be resisted.

In the area of institution building, the government needs to put into place an adequate legal framework and mechanisms to ensure the rule of law and contract enforcement. Governments should follow consistent policies and avoid discretionary action. Where debt must be restructured, the government needs to stipulate the rules and procedures to be applied. Of prime importance to agriculture in certain transition countries is for government authorities to follow through with land reform and institution of clear property rights.

Finally, governments need to invest in public goods and infrastructure that will enable agro-food producers to become profitable, including, where appropriate, to diversify their activities into such areas as agro-tourism. This includes adequate provision for research and extension and transportation facilities that enable efficient market linkages. It also includes the responsibility to ensure that rural populations have access to education.

Applying an appropriate policy mix responsive to the complexity of agricultural finance and credit

No single policy can meet the multiple needs of creating a viable, sustainable agricultural credit and finance infrastructure. Policies have multiple objectives and require multiple policy instruments. Experience has demonstrated that at each stage of the transition, different policy priorities emerge, requiring governments to sequence policies correctly, seeking options and building on the best practices. Diversified sources of finance will continue to be required to meet the heterogeneous, multiple needs of transition countries and different borrowers in each country. A serious environment of repayment discipline must be instilled by the avoidance of soft budget constraints. The phenomenon of 'moral hazard' created by expectations of automatic debt write-offs must be avoided. Adequate regulatory standards are indispensable to ensure the economic viability of credit and financing institutions and to protect savers and borrowers alike. Recent trends to minimise regulatory impediments in no way obviate the need to put adequate controls into place.

Not all policies will be effective for all situations, especially as businesses and markets evolve and needs become increasingly sophisticated. Therefore, governments must monitor, review and evaluate policies on an ongoing basis. Policies will have to be adjusted and, if necessary, discontinued.

Possible channels for providing credit and finance to the agriculture and rural sectors

Gradual evolution towards sustainable, multi-purpose rural banking

One of the strongest messages resulting from the OECD work on agricultural credit and finance infrastructure is that no one-size-fits-all approach is possible. Approaches to the provision of credit and finance must be tailored to the needs of specific clients. Increasingly heterogeneous conditions and needs call for a plurality of approaches. Taking the banking sectors in transition countries as the first example, banks that support the agricultural sector are often geared to large, collective enterprises and farms. They lack information and expertise to deal with the emerging small-scale farm sector, which exists even in a strongly dual farm structure like that of the Czech Republic. Risk assessment is relatively new and difficult in all cases, but even more so for the small-scale sector, where bank-client relationships are not firmly in place and various aspects of the loan application, evaluation and processing procedures are not yet well established. Transaction costs are perceived to be excessive.

To complicate the situation, in most transition countries, reforms have taken place in the financial and banking sectors at the same time. The requirements to introduce sound banking practices, greater commercialisation, stronger prudential supervision, and the cleaning up of bad debts have induced a reluctance to lend to agriculture. This stems from banks' increased aversion to risk and conservative, cautious approaches to lending. Their tendency to avoid exposure to a single sector and to diversify risk works against any focus on the particular needs of agricultural borrowers.

The OECD countries have been precursors of these trends. In most OECD economies, previously specialised commercial credit institutions, such as agricultural development banks, have all but disappeared. With the deepening of financial markets and increasing market integration, multi-purpose commercial banks began to supply credit to agriculture, supplanting both informal credit institutions and specialised agricultural banks. Following the same logic, many of the formerly specialised agricultural banks improved their financial viability by pooling agricultural risks with non-agricultural ones (World Bank 2002). Some of these banks, like the Crédit Agricole or Rabobank, have become major, internationally diversified commercial banking institutions.

This evolution is in line with the importance of providing finance and credit to address whole rural sector. As the rural population diversifies its economic activities or exits the primary agricultural sector altogether, clients in rural areas will seek a full range of financial services required by small and medium-scale clients. Experience in the OECD has shown that enforcement of repayment discipline is a realistic objective in the case of small-scale borrowers and that loan recovery rates can be high under such conditions.

A few options for developing financial infrastructure and bank restructuring

Various options have been suggested to help countries to move towards "all finance" rural banks. They are briefly described here:
– One stumbling block may be related to initial capitalisation. To solve this problem, loan applicants may be required to contribute to the equity base of the institution. This can be particularly effective if the institution is to evolve into a co-operative banking structure.
– Another approach can be to consolidate the existing, small stand-alone institutions into a network. In such cases, experts suggest that a two-tier structure may be appropriate. An apex can be created at the centre to serve the whole network in providing information technology, inspection, auditing, payment clearing, and product development.
– A third option is for commercial banks to establish specialised rural financing units.
– In several countries, the preferred approach has been to privatise and restructure large state agricultural banks. This has recently been the case in Lithuania and Romania.

In all cases, tension will remain between the pure profit maximisation objective and the need to service agriculture and rural areas. For this reason, complementary instruments, like guarantee schemes have been introduced, as in the Czech Republic. However, there is a reason to consider that such systems, if not properly conceived and run, may distort market signals and prevent the necessary farm restructuring (Doucha 1999).

Co-operative banking through a revival of credit co-operation

Part of the socio-economic legacy in transition countries may lead farmers to shun co-operatives due to their association with previous systems. Nonetheless, credit co-operatives offer many advantages, such as proximity to clients, integration into the local community and knowledge of local circumstances. They tend to be adaptable to changing needs. Their effectiveness is enhanced by the mechanisms of peer pressure. Their role in savings mobilisation and local networking should be emphasised. While there are numerous co-operative banking models in the OECD countries, the single-purpose co-operative is the preferred model. By concentrating on finance and credit operations, rather than diversifying into input supplies and marketing, the risks of conflicts of interest or complicated and costly administrative structures are avoided. Rather, expertise in savings mobilisation and credit services can be concentrated in such institutions, which can achieve economies of scale thanks to a clearly delineated, single-purpose function. Their acceptance by local populations remains the key to their viability.

Non-bank approaches, such as trade and industry credit

To meet the specific needs of certain borrowers, especially during transition periods when the financial and banking sectors are being reformed, alternative approaches to the provision of agricultural credit may provide significant benefits. One such alternative is to call on input manufacturers or suppliers and on processors and retailers as sources of funding and/or in-kind supplies. These sources have close relationships throughout the agro-food chain and can assist farmers in numerous ways. The experience has not been universally problem-free and can be costly. However, these agents have been shown to play a catalytic role for recovery and further development of the farm sector, especially in the early stages of transition, and have brought innovation to the search for working capital in particular.

Such credit sources may be complementary to and coexist with more formal finance. While they are primarily a means to overcome the problem of scarce credit, they provide numerous other advantages. The client relationship is reinforced and mutual risks can be reduced. Due to the close commercial relations, transaction costs are lowered for all involved. For the farmer, there is a guaranteed outlet for products with prompt payment, as well as the possibility of access to production technology. To avoid potential abuses, effective contract reinforcement and full transparency are of paramount importance for non-bank approaches to credit.

Recourse to micro-finance

For countries that have a significant small-scale farm population, the social objectives of poverty reduction and development of rural areas may call for yet another approach. In these circumstances, which continue to challenge certain transition economies, like Russia, the requirement is to create a self-sustainable financing facility. Recourse to micro-finance has been tried in some cases. Experience shows that it is best to create an adaptive and flexible financing vehicle with potential for innovation. While such approaches invariably necessitate trade-offs and are often subsidy-dependent and short-lived, they offer another transitional measure that should be part of the range of options.

RELATION TO THE EU ENLARGEMENT

Possible effects on macroeconomic conditions of countries acceding to the European Union

For all candidate countries, the process of accession to the European Union is providing an invaluable external anchor. Many beneficial institutional and policy changes are being introduced as part of the process. Nonetheless, the very process of accession is creating certain pressures that can have an impact on the macroeconomic situation. Pre-accession requirements involve significant budgetary outlays to achieve compliance with the EU legal and institution building requirements, as well as environmental standards. This imposes a burden on the fiscal position. At the same time, the process entails inward capital flows, not only from the Commission, but also from foreign investors taking a certain view of developments over the coming years. These inflows, provided they are for the medium to long-term, cushion the current account deficits, but create inflationary pressures. If they are of a volatile nature, they also raise the spectre of sudden outflows, thereby making the current account deficits unsustainable (IMF 2000).

Once countries become members of the European Union, a key question that arises relates to their strategy towards the European Monetary Union (EMU), which they are obliged to join at an unspecified point in time. Since the convergence requirements are stipulated in the Maastricht Treaty, the uncertainty creates potential for speculative actions related to the timing and effects of convergence. In addition, meeting the convergence criteria puts pressure on resolving fiscal deficits, which are a problem in the Czech Republic, for example. A rising general government deficit is due in part to the one-off effect of cleaning-up the Czech banking sector, imposing forceful and rigorous implementation of prudential regulations on the financial sector in the future (CEC 2001).

These are just some examples of the issues at stake in the macroeconomic framework. Their eventual effects should strengthen the condition of the financial sector, thereby meeting and improving the framework conditions for availability of sustainable sources of agricultural credit and finance. However, before these pre-conditions can be met, the need to strengthen regulation, supervision, and risk management in the financial sector may constrain availability of credit to agro-food activities, which may be perceived as too risky or costly.

Linkages to institutional framework

Institution building has been a strong focus of the pre-accession efforts. The veterinary, sanitary and phytosanitary chapters of the accession negotiations have been among the most stringent and costly to apply. Yet, once the requisite standards and grades have been established and can be independently certified, they should widen credit options and facilitate access to credit, through the use of warehouse receipt schemes, inventory credit, and commodity exchanges (World Bank 2002). Support for institution building to the Czech Republic through the EU Phare programme amounts to about € 79 million. This includes support to agriculture in the fields of veterinary supervision, oversight in the phyto-sanitary sector and preparing for the Common Agriculture Policy (CAP) through restructuring of the Czech Ministry of Agriculture and the establishment of a Market Intervention Agency. Progress in institution building should be seen as a significant strengthening of the framework conditions for access to finance and credit by the agro-food sector.

Cultural and societal attitudes

With respect to cultural and societal attitudes that are part of the overall framework, certain factors related to accession also come into play. Evidence from Poland suggests that the high level of uncertainty about macroeconomic conditions may discourage farm households from seeking credit. The lack of a predictable economic environment concerning conditions of the EU accession is part of this overall uncertainty (World Bank 2001). Similar attitudes could be at work in other countries as well.

Effects of the EU enlargement on competitiveness and efficiency

In an environment of strong foreign capital inflows, the Czech koruna has continued to appreciate against the Euro. This is not seen to have adversely affected the competitiveness of Czech exports so far, but merits close watch, particularly with continued inflows expected. While labour productivity has grown in the Czech agricultural sector by 10% annually since 1998 and the sector has registered net profits in two of the past three years, this uncertainty related to competitiveness may have a bearing on availability of finance. On the other hand, the pre-accession process is bringing efficiency gains to certain parts of the agro-food sector that should contribute to strengthening competitiveness.

The role of government and government policies

In terms of the role of the government and government policy-making, the EU enlargement will necessitate further changes. One example refers to support to agriculture provided through interest rate subsidies and credit guarantee schemes, which continue to be widely used in the CEECs. In the case of the Czech Republic, the OECD's annual monitoring of agricultural policies and support indicates that payments based on input use are mainly credit subsidies and loan guarantees available for investment as well as working capital. These payments, administered by the Support and Guarantee Fund for Farmers and Forestry (SGFFF), are declining. The government also continues to write-off or extend repayment periods for loans extended during the period 1991–93 (OECD 2002a). The EU practices in this area may require further reductions in these types of policies.

Linkages to channels of finance

Conditions for own financing under the SAPARD

Under the SAPARD, the Czech Republic will be eligible for € 22.4 million per year, with 49% of the first annual allocation eligible to be tapped immediately. A large number of projects have been submitted in both the primary and agro-processing sectors. In certain candidate countries, there are already signs that, despite sizeable demand for projects to be funded, the ability of providing the requisite co-financing will be a stumbling block that may delay absorption of these funds. Borrowers need to be able to prepare viable projects for financing, disclosing all necessary information. Banks and other providers of credit will need to be willing to enter into co-financing arrangements to provide the local own fund component. If not, accession candidates will lose significant opportunities to modernise their agricultural and rural sectors to meet the EU requirements and to improve their competitive positions in the run-up to accession.

Access to rural development and structural funds

Once it has joined the European Union, the Czech Republic is slated to receive nearly 10% of the EU Structural Funds under Objective 1, which covers the least developed economic areas. Under Objective 2 provisions, the Czech Republic would be eligible for nearly 50%. With a total budget of over € 7 billion set aside for Structural Fund payments to new EU members in 2004 and rising to € 10.35 billion in 2006, the amounts to be made available to the Czech Republic will be significant. However, to draw upon these funds, the beneficiary country will have to provide a local share of around 50%. While there are some uncertainties related to implementation, the provision of counterpart funds will call for a significant domestic agricultural credit and financing capacity.

CONCLUSIONS

This paper has summarised the framework conditions, government roles and possible channels for building adequate agriculture finance and credit infrastructure, especially in transition economies. They cover a wide range of macroeconomic, institutional and micro-level considerations. In many ways, developments and current conditions in Czech agriculture present a favourable outlook for access to the sources of credit, finance and investment that are needed for agriculture's continued modernisation and growth. The pre-conditions in terms of macroeconomic stabilisation appear to be strong, particularly in the light of corrective measures to the financial sector introduced following the 1997 financial crisis. In terms of attaining profitability, the Czech farm structure includes a high proportion of large-scale, commercially based and technically efficient farms. Labour productivity is high and the sector has realised net profits in recent years. Institutional underpinnings are being strengthened by the EU pre-accession requirements.

The EU enlargement should largely enhance these favourable conditions, especially with respect to institutional strengthening. Some aspects of enlargement also create some uncertainty that may have an effect on agricultural credit and finance infrastructure and the overall availability of finance and credit:

– In relation to future macroeconomic stability, budgetary expenditures and large capital inflows create uncertainties for fiscal and monetary management.
  Furthermore, stability may be affected by the conver-

gence criteria and timing questions for joining the Euro zone.
- Competitive pressures may increase with the continuous appreciation of the Czech currency.
- Matching funds will be required for the disbursement of the SAPARD funds and later, to a much larger extent, to allow candidates to make use of sizeable flows of structural and rural development funds.
- Current support provided to the Czech agricultural sector through credit subsidies may not be in line with the EU policies.

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Contact address:

Alexandra Trzeciak-Duval, Head of Division, Agricultural Policies in Non-Member Economies, OECD, 2, rue André Pascal, 75016 Paris, France
e-mail: Alexandra.TRZECIAK-DUVAL@oecd.org