

Project no.
513705

Project Acronym
CEEC AGRI POLICY

Project title
**Agro economic policy analysis of the new member states,
the candidate states and the countries of the western Balkans**

Instrument Specific Support Action

Thematic Priority Scientific Support to Policies

Task 4-1
SPECIFICATION FOR THE SECOND RURAL VITALITY REPORT
Second report for Hungary
Due date of deliverable: 03.2006
Actual submission date: 05.2006

Start date of project: 01.05.2005

Duration: 24 Months

Organisation name of lead contractor for this deliverable:
Revision Final

Project co-funded by the European Commission within the Sixth Framework Programme (2002-2006)		
Dissemination Level		
PU	Public	
PP	Restricted to other programme participants (including the Commission	
RE	Restricted to a group specified by the consortium (including the Commission	
CO	Confidential, only for members of the consortium (including the Commission Services)	X

Acknowledgement

This report forms part of the deliverables from a project called "CEEC AGRI POLICY" which has been awarded financial support by the European Commission under the 6th Framework Programme.

The project aims to establish a network of experts involved in agricultural policy analysis and rural development in the New Member States, in the Acceding Candidate Countries and in the countries of the Western Balkans. More detailed information on the project can be found at www.agripolicy.net.

DOCUMENT HISTORY

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Date	Author	Description
22.05.2006	Martin Turner	Final review

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1 Introduction and background

1.1 An outline of rural credit facilities

Rural credit facilities have been in operation since the second half of the 19th century in Hungary (mutual funds, saving cooperatives). During the 20th century they have played an inevitable role in rural financing, even under the socialist regime. After the political changes, since 1993 the majority of the savings cooperatives have created an integrated institution and came together under an “umbrella” bank, the Hungarian Savings Bank. In 1993 the total credit financed by the integrated saving banks for agriculture was some 2,8 billion HUF but this has continuously increased since 2000 and stands now at more than 20 billion HUF. At the same time the savings co-operatives also took part in providing credit finance to other rural businesses and institutions: small and medium sized enterprises, local government, infrastructural investments (sewage, water pipe, roads, etc.). Taking advantage of “being on-site” they usually have administered the accounts of SME’s and local governments.

Nowadays the savings cooperatives provide about 18-19% of the total agricultural and rather more than 20% of the rural financing. They are present in each second settlement of Hungary (1600 branches). Practically each of them are dealing with both agricultural and rural financing. The remaining 80% of agri/rural credit is provided by the commercial banks. In Hungary there is some 40 commercial banks existing, none of them is specialized in agri/rural financing.

1.2 Major credit and rural policy developments in 2005

It is generally accepted that farm businesses are lacking working capital. The big farms ones are generally financed by commercial banks but the smaller ones are traditionally the partners of saving cooperatives. In the last year before EU accession (2003), and especially in the first half of 2004, the new credit facilities reached their historical peak due to the special circumstances: before the accession there was the last opportunity for national investment and interest support programs. The credit portfolio within the savings cooperatives climbed up to 91 billion HUF by the end of 2004, greatly exceeding the 40 billion HUF (up 78%) of the previous year.

However, in 2005 there was a sharp decline in the volume of new credit facilities. According to government policy many of the smaller farm producers cannot take part in EU supported development programs because the minimum viability criteria is much higher than that of the old member state’s standard.

Another reason for the decline in new loans is that after EU accession it is no longer possible to provide interest support by the national budget.

1.3 Access to rural credit – uptake and issues

Before the accession the structure of the credit portfolio was rather appropriate according to international standards: the dominant proportion of the credit finance was long term credit. In

2005 this trend has been reversed and nowadays only 20% of the total portfolio is long term in nature. This means that agricultural producers must finance their long term assets and investments partly by using short term liabilities, which is rather costly for them and also could lead to future instability if credit repayments were required.

The access to rural credit for smaller entities (producers, communities, individuals) is rather problematic because they do not have enough experience in preparing the documents for new loans, or in making business plans, etc. Although the savings cooperatives are ready to support them via their advisory services, they are mostly not able to absorb these services.

As for the agricultural producers, the smaller ones are basically excluded from EU support programs. The EU minimum viability requirement for arable land in old member states is roughly 10-15 ha (arable farming) while in Hungary this is 25-30 ha.

Another problem for them is that the decision on eligibility for support will be based on historical data of the farm, instead of taking into consideration the effect of the intended investment.

It is also a problem that the applications for support will be dealt with according to the arrival order up to the deadline date; since the smaller producers have disadvantages in preparing the necessary documents, their applications are therefore likely to be processed later than those of larger farms.

2 Availability and performance of rural credit facilities

2.1 Assessment of short-term credit sources

Generally the role of short term credit is very important in the financial management of farming, although this particular role has decreased in importance somewhat in 2005 due to a number of special reasons as follows:

- The use of long term credit for financing current assets seems to be advantageous for agricultural producers because of the specific nature of production (the expenses occur continuously, while the turnover just once a year). Therefore everybody strives for converting his/her short term credit into longer term borrowing.
- The EU area payment came in effect in 2005, which has improved the income status of the producers.
- Hungary experienced rather good wheat yields, and hence total production in 2005 (also in 2004) and due to the EU guaranteed prices it has also had a positive effect on the income status of the producers.
- The short term credit portfolio is very much influenced by the so called “Production Systems”. These types of cooperation involve a vertical integration of producers, based on common technological interests, and guided, advised and financed by a bigger producer. The integrator supplies the production inputs (seed, fertilizer, etc.) and technological advice for the producer and the latter pays it back via products (e.g. wheat). In these cases the integrator applies for short term credit on behalf of the joint enterprise but typically the aggregated demand is less than the sum of individual

requirements. Also, the credit conditions are better for the aggregated enterprise than for the smaller producers as individuals.

However, short term credit is available for the participants in the rural financial markets without any limitations although, of course, the conditions (cover, interest, etc.) are different according to the individual applicants.

2.2 Assessment of medium-term and long-term credit sources

The availability of medium and long term credit finance is very much dependent on the accessibility of rural development programmes, whether they are financed through the national budget or EU financed. The running programs are as follows:

- Decentralized Local Governmental Development Programs
- National Civil Base Program
- Human Resource Development Operative Program
- Economic Development Targets
- Small Region Support Targets
- Spatial and Regional Development Targets
- Investment Initiation Targets
- Touristic Support Targets
- Regional Economic Reconstruction Targets
- Agricultural Investment Support
- Rural Development Targets
- Spatial Development Targets
- Information Technology and Telecommunication Development Targets

Each of the above programs can form part of the rural finance picture. The saving cooperatives are very much engaged in agricultural finance, as noted above. For machinery investment the producer needs to have at least 25% from their own financial sources and the rest can be financed by the bank. In case of land purchase, within the framework of Agricultural Investment Support 100% of the land price can be financed by the bank.

It is also rather common that the machine traders like the “Production Systems” method of financing the purchase of machinery and equipment for agricultural producers, and typically they pay it back in kind. This accounts for about 20% of total machinery sales.

2.3 Assessment of the adequacy of credit sources

At the beginning of the 1990s the lack of credit sources was widespread and rather characteristic of the post-socialist state. Nowadays the commercial banks supply a wide range of loans, but many farmers and individuals are either not able to, or are unwilling to, access this source of credit. The biggest problem with agriculture is the currently extremely low profitability of the production process. The danger is that credit finance will not be used for business development but instead will be used to meet current expenses.

2.4 Evidence of credit market failure

According to the survey of OTIVA (National Savings Cooperatives' Insurance Fund) the rural financing activity of the saving cooperatives is a bit less risky than that of the other parts of the credit portfolio. In the recent years there were only two examples for the saving cooperatives' bankruptcy.

In very line with the historical peak in 2004 in credit facilities the Rural-Credit Guarantee Foundation provided increased support compared to previous years for enterprises to have access to lending, which was mostly demonstrated by guarantees issued for 'Europe' agricultural loans and capital replenishment loans. Considering this, there was an estimation on an increase in guarantee claims in the 2004 financial plan. The estimate was based on the assumption that accession to the European Union would increase competition which would adversely affect small and medium-sized enterprises, sole proprietors and traditional farmers representing the overwhelming majority in the Foundation's portfolio. Macro-economic analysts forecast a wave of bankruptcies as a result of the deteriorating position of those enterprises. However, such phenomena were only marginally perceived in 2004; although guarantee claims increased, turning around the trend of the pervious years, they were still below the estimated rate.

In 2004, the Foundation recorded:

- credit guarantee claims to the tune of HUF 699 million (94 cases)
- claims of counter-guarantees of HUF 489 million
- recoveries of HUF 192 million.

Although they increased both in number and in value from the previous year (compared to 60 cases and HUF 497 million), guarantee claims were still below the average claim rate of recent years.

2.1 Overview and prospects

After the EU accession there was a special moratorium on paying back borrowd capital for 1 – 2 years. This year the government has extended the moratorium because of the impacts of flood and drought for one additional year. But, in any case, the peak in the burden of credit repayment (because of the credit peak in 2004) is expected to occur in the coming years. Because of the currently very low profitability of agricultural production there is an urgent need for some kind of agricultural credit programs, otherwise the sector – especially the smaller farmers – will not be able to survive this particularly difficult situation.

The commercial banks and saving cooperatives are ready to finance the development of rural Hungary, moreover it is expected that there will be an increase in the level of the competition among them. Although the bigger commercial banks in the past have partially withdrawn from financing farms and rural businesses, this was because the partners were too small in their sense. Recently, however, in this era of plentiful credit supply, they are re-evaluating their previous views in this respect.

Even so, although the bigger banks are again willing to finance bigger rural projects, they are unlikely to pay too much attention to the smaller ones. These will remain for the saving cooperatives to pick up.

There is an important underlying question which is ‘What does the government want to do with the rural areas?’ For example, if the kindergartens, schools and health care services in small villages are seen as being in need of so called “restructuring” (which the inhabitants in question interpret as pointing to closure), they will not be able to keep the rural population in the rural areas. In that case the future of rural development in Hungary is rather questionable.

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ANNEX

The breakdown of credit guarantee transactions by the number of employees

	2003		2004	
No. of employees	No. of guarantees	Guaranteed loan amount (HUF million)	No. of guarantees	Guaranteed loan amount (HUF million)
1	1.164	8.381	1.686	14.558
2 – 10	1.062	14.200	1.270	22.488
11 – 20	280	6.395	310	11.502
21 – 50	306	9.857	337	17.800
51 – 100	175	6.634	217	14.679
101 – 200	68	4.577	113	11.162
201 – 250	9	409	14	1.515
Total:	3.064	50.450	3.947	93.710

The breakdown of credit guarantee transactions by sectors

