Emmanuel Tumusiime-Mutebile: The challenges which will face agriculture in an oil economy

Speech by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the CEO Summit Forum, Kampala, 30 October 2012.

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1. Introduction

For a country with fertile land and abundant rainfall which give it a strong comparative advantage in agriculture, Uganda's agriculture performance is weak. Agricultural productivity per worker, at approximately $200 per year, is among the lowest in the world. Real growth in agriculture has averaged only two percent per annum over the last 10 years, less than a third of the average growth of the rest of the Ugandan economy. Productivity is especially low in the food crop sub-sector, which is dominated by smallholder farmers, because farmers use rudimentary farm technology and produce mainly for subsistence rather than the market.

The production of oil on a commercial scale will intensify the problems facing the agricultural sector. The spending of the revenues from oil in the domestic economy will inevitably bring about some appreciation of the real exchange rate. As a result food imports will become cheaper in real terms and agricultural exports such as coffee, tea and cotton will lose competitiveness. Higher wages paid in the non-traded goods industries such as services will pull labour out of agriculture. All of these effects have been observed in many oil producing countries around the world, including those in Africa such as Gabon and Nigeria; they are features of the phenomenon known as Dutch disease. Unless there are radical changes in our approach to agriculture, our agricultural performance will weaken further, with very deleterious consequences for rural poverty, employment, inequality, geographically balanced growth and food security.

The theme of my talk this afternoon is that it is imperative to implement a comprehensive strategy to support smallholder agriculture if we are to avert a long term decline in the agricultural sector; a decline which will be accelerated by the exploitation of our oil resources. If we can help the broad mass of farmers in this country to become more productive, raise their yields and sell more of their output on the market, it will be possible to create a more dynamic agricultural sector which is strong enough to survive despite the adverse impacts of oil on the real exchange rate. Furthermore, by supporting Uganda's farmers to increase their marketable output, we can boost agro-processing industries and thus promote industrialisation. Strengthening agriculture will not be possible without devoting more public resources to support the sector, but how we spend public resources is critical, as I will explain later in this talk.

2. What should be our strategy for agriculture?

The goal of agricultural strategy should be to support the modernisation of agriculture. Modernisation entails farmers adopting good agricultural practises, employing productivity enhancing farm inputs, making decisions about input use and choice of crops or livestock to maximise their profit and selling more of their output on the market. It will bring about a switch towards the production of higher value crops, as well as raising yields per acre and yields per worker.

A feasible strategy for agricultural development in Uganda must have at its centre support for smallholder farmers. Smallholders comprise 96 percent of Uganda's farmers. It is unrealistic to expect that Uganda's agricultural performance can be turned around by ignoring smallholders and focussing instead on large farms. Furthermore, small farms generate higher value added per acre than medium sized farms which in turn are more productive than large farms. Although large farms market a higher share of their output than small farms, the former are not very efficient.

On average, crop income per acre is four times higher on small farms than on large farms in Uganda.[1] With constraints on land availability tightening in Uganda, it is imperative to implement a strategy which makes more productive use of land, and this is most feasible by strengthening smallholder farming.

Smallholders in Uganda face a raft of constraints to commercialisation, including poor access to markets and lack of commercial and technical information, but with adequate support from Government policies to alleviate these constraints it should be possible to generate substantial improvements in productivity, output and incomes; improvements which will help to insulate agriculture from the negative impact of oil. How Government can best support agriculture is the question I turn to next.

3. Policy measures to support agricultural modernisation

Research carried out by Lawrence Bategeka and John Matovu of the EPRC, using a computable general equilibrium model of the Ugandan economy, examined how agriculture would be affected by the spending of oil resources. In their baseline scenario, under which oil revenues are simply used to fund an expansion of Government, the real appreciation of the exchange rate leads to a significant reduction in agricultural production, especially production of the traditional agricultural exports. However, Bategeka and Matovu find that, if additional budgetary resources are targeted at the agricultural sector, in ways which improve agricultural productivity, the negative impact of oil on agriculture can be mitigated, enabling the sector to avoid a decline in output. Moreover, they also find that investments which raise productivity in agriculture also boost manufacturing growth, because agriculture is an important source of intermediate inputs for manufacturing.[2] Uganda currently only allocates about 3.5 percent of the Government budget directly to agriculture. Raising budgetary allocations to agriculture and for investment in rural areas should be a strategic priority.

Whether or not public spending on agriculture actually contributes to improving agricultural productivity depends on the nature of the spending. There is strong empirical evidence from around the world to indicate that the provision of public goods and services, which are defined as goods and services which because of their character cannot be supplied optimally by the market, have a large positive impact on agriculture with potentially very high social rates of return, if well designed and implemented.[3] Examples of the type of public goods and services which are relevant for agricultural development in Uganda include:

i) Agricultural research and development, to produce improved farm technologies such as high yield seeds and to determine the optimal farm technologies for the conditions prevailing in Uganda;

ii) Agricultural extension services to provide information and technical advice to farmers to adopt good agricultural practises and to use appropriate purchased inputs; this can help farmers raise their yields;

iii) The construction and especially the maintenance of rural feeder roads to reduce the cost of transporting agricultural produce to markets and raise farm gate prices; in

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1 The data are from "Agriculture for Inclusive Growth in Uganda" Inclusive Growth Policy Note 2, World Bank, 2012.

2 Lawrence Bategeka and John Matovu (2011), "Oil Wealth and Potential Dutch Disease Effects in Uganda", Economic Policy Research Centre.

3 The evidence is surveyed in Enrique Blanco Armas, Camilo Gomez Osorio, Blanca Moreno Dodson and Dwi Endah Abriningrum (2012), "Agriculture Public Spending and Growth in Indonesia", Policy Research Working Paper 5977 World Bank.

terms of encouraging farmers to produce more output for their market, investment in rural feeder roads is more important than investment in main roads;

iv) The provision of veterinary services and the control of plant diseases; controlling animal and plant disease is an activity with very large positive externalities;

v) The provision of market information, for example price information, to help farmers make more informed decisions about which crops to grow and to strengthen their ability to negotiate prices with traders.

vi) Clarifying and strengthening land rights and the security of land tenure, to improve incentives for farmers to invest in land improvements, encourage land rentals and enable farmers to use their land as collateral for credit;

In contrast to the provision of public goods and services, the subsidised provision by Government of private goods, such as fertiliser and credit, has a much weaker impact on agricultural productivity. Such subsidies often simply transfer resources from taxpayers to favoured beneficiaries and encourage the inefficient use of subsidised inputs. When the opportunity cost of subsidising private goods from the Government budget is taken into account – the fact that the money spent on these subsidies could have been used more productively on public goods and services – the overall impact on agricultural productivity is negative. This means that the focus of agricultural extension services should be the provision of technical advice to farmers, rather than the sale of subsidised farm inputs. These cardinal principles which should inform the formulation of our agricultural strategy – to invest in public goods and services and avoid subsidising the provision of private goods – are of particular relevance for agricultural finance, a subject to which I will now turn.

4. Agricultural finance

Agricultural finance generates controversy in many developing countries, including Uganda. There is often an assumption that agriculture faces inherent difficulties in mobilising credit and that this is a binding constraint on expanding agricultural output which justifies government intervention to provide or subsidise finance. There is no doubt that providing credit to small farmers involves very large transactions costs and high risks for financial institutions, which means that most small farmers are excluded from formal credit markets. Formal financial markets are subject to failures when serving small farmers which, in principle, provide grounds for Government intervention to promote financial inclusion.

But market failures are much less pertinent for larger farmers and agro-processors who are able to access formal credit markets if they are creditworthy and have viable business enterprises. There are many profitable agro-processors and other high value agricultural producers in Uganda who are able to meet their requirements for financial services from the domestic financial sector, including the regional development banks which operate in Uganda, because these enterprises are well managed with a good track record. Market failures are much less in evidence in this segment of the financial market and hence calls for direct Government support are more difficult to justify. Government should avoid investing directly in production facilities, such as agro-processing facilities, or providing finance to private investors for this purpose. Decisions about investment in agro-processing are best left to the private sector, to be taken purely on commercial criteria, without being distorted by the provision of cheap credit or other forms of finance from the Government. Government induced distortions in financial markets will lead to the misallocation of resources, reducing the social rate of return to these resources.

Modernising smallholder farming will entail smallholders making greater use of purchased farm inputs. Hence modernisation will require smallholders having better access to finance. Nevertheless finance is unlikely to be the binding constraint on modernisation of smallholder agriculture and unless more important constraints are tackled, enhancing smallholders' access to finance will be ineffective. Policy measures to strengthen the provision of financial services in the rural areas must be part of a much broader set of interventions to support smallholders to adopt modern farm technology and produce for the market, of the type I have already mentioned. Unless smallholders have adopted good agricultural practises, such as the use of improved seeds, proper field preparation, timely planting, weeding and pest control, proper harvest and post-harvest handling, etc – practises which can improve yields significantly – they will not be able to utilise credit effectively because their farms will not be profitable.

How should Government support the development of rural financial markets? The key interventions required are to alleviate the market failures which impede the delivery of financial services to farmers. For example, it is necessary to strengthen the institutional environment for loan security to reduce the credit risks of lending to farmers. Strengthening land rights to allow farmers to use land as loan collateral would help to make farmers more creditworthy. The proposed establishment of a Collateral Securities Registry and the enactment of the Chattel Securities Bill, which is currently before Parliament, will help to widen the range of assets which are acceptable to lenders as collateral. Promoting the warehouse receipt system set up by the Uganda Commodity Exchange would also be a useful measure to support lending to agriculture.

Microfinance institutions (MFIs) and savings and credit cooperatives (SACCOs) are much better suited institutionally than commercial banks to serving small farmers, but they are often constrained by managerial and technical weaknesses. Hence there is an important role for Government to assist MFIs and SACCOs to strengthen their management and the professional skills of their officers. The Bank of Uganda is encouraging the larger tier 4 MFIs to upgrade to become licensed deposit taking MDIs. Assisting MFIs and SACCOs to strengthen their technical and managerial capacities so that they can mobilise funds from the communities that they serve and intermediate these funds to creditworthy farmers is a much more sustainable and effective approach to developing rural finance than providing them with funds from the budget for on-lending.

5. Conclusions

I want to end this talk by highlighting what I believe are the four key messages.

First, agriculture in Uganda risks being severely damaged when oil production comes on stream unless comprehensive measures are taken to modernise the sector, by raising productivity and promoting commercialisation.

Secondly, the focus of agricultural strategy must be smallholder farmers, who comprise the vast majority of farmers in Uganda, rather than large farms.

Thirdly, Government should allocate a much larger share of the budget to agriculture and investment in rural infrastructure, but this spending should be allocated to public goods and services, not the subsidised provision of private goods.

Fourthly, rural finance can contribute to agricultural modernisation in Uganda, but only if it is accompanied by effective measures to encourage farmers to adopt good agricultural practises, improve access to markets, improve control of animal and plant diseases and strengthen land rights.