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18320

Distr.
LIMITED

ID/WG.498/8(SPEC.)
2 January 1990

United Nations Industrial Development Organization

ORIGINAL: ENGLISH

Interregional Symposium on the Role
of the Industrial Co-operative Movement in
Economic and Industrial Development

Moscow, USSR, 11-15 June 1990

THE PRINCIPAL BANK FOR DEVELOPMENT AND AGRICULTURAL
CREDIT (PBDAC),
ARAB REPUBLIC OF EGYPT:
A CASE STUDY*

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INTRODUCTION

For more than two decades the Principal Bank for Development and Agricultural Credit (PBDAC) has dominated the Egyptian agricultural sector. It has controlled imports, credit, prices, and marketing. PBDAC's influence on the daily lives of farmers has been profound and, while it has to some extent provided a measure of economic stability, the Egyptian Government now realizes it has also discouraged innovation and potential progress. This paper deals with the background and organization of the PBDAC, analyzes its strengths and weaknesses, and provides a rationale for the privatization of the non-credit input supply functions of PBDAC. The paper is a summary of the Project Paper prepared for the U.S. Agency for International Development and the Government of Egypt (GOE) by The Center for Privatization (CFP), a Division of The Scientex Corporation, Washington, D.C.

BACKGROUND

There are approximately seven million *feddans* (6.5 million acres) of arable land in Egypt. Of this total, six million *feddans* are old lands of the Nile Valley and Delta, while another one million are lands reclaimed from floodplains. This total area must support four million farm holdings, the vast majority of which are less than three *feddans*. Farms are often fragmented, a serious constraint to mechanization, and all are clustered around 4,500 villages. These vary in population from 1,500 to 30,000 and provide differing levels of amenities and services.

All land is fully irrigated. In the old lands water is readily available, but adequate water management and associated difficulties of drainage and soil salinity pose problems. In addition, soils tend to be poor in phosphates, zinc, iron, nitrogen, manganese, and copper. In the reclaimed lands, these deficiencies are even more pronounced, and the soil itself is generally coarse in texture and, thus, incapable of good water retention.

Crop rotation is widely practiced, with two- or three-year cycles of cotton, wheat, maize, rice, Egyptian clover, beans, and other vegetables. Almost 300,000 *feddans* are devoted to sugar cane production, and an increasing area to permanent fruit trees, mostly citrus. The national cropping average for all agricultural outputs is twice per year, with some produce annually harvested in the winter, summer and fall.

To support the performance of the agricultural sector, the Egyptian Government adopted a policy of involvement which follows the cropping cycle from seedling to market basket. It has over the past 20 years controlled the manufacturing and/or importing of products needed by farmers; the distribution of these inputs; the establishment and assignment of cropping production plans; and the purchase of the final harvests. Since 1977, its major institutional mechanism for administration of this policy has been the PBDAC.

Originally envisaged as a support entity facilitating farm credit, corollary input purchases and distribution, and marketing services, PBDAC has over the years evolved into an elaborate network far surpassing its initial mandate. It offers a full range of banking services to farmers, and mobilizes savings for agricultural credit needs. It controls both domestic and overseas procurements of all agricultural inputs; it issues and awards tenders to suppliers; it arranges for landing, clearance and forwarding of inputs; and it acts as the purchasing agent for foreign and in-country acquisition of the outputs. Thus, to farmers PBDAC is the visible manifestation of the centralized Egyptian economy that functions almost exclusively through the use of state-owned enterprises in producing, transporting, and trading operations. This fact is paradoxical, since the farm land itself is largely in private hands.

The regimentation of farmers starts with the complex cropping plans developed in the Ministry of Agriculture. There, civil servants anticipate and try to control the intentions of millions of individual landowners by establishing production quotas for designated crops; e.g., cotton, rice and sugar cane. Land-use allocations and cropping plans set by the Ministry are girded by a costly and complicated system of production subsidies, which are intended to lower the cost of those farm inputs deemed necessary for the achievement of production goals. The harvest is then purchased at government-controlled rates and distributed to consumers at what is considered favorable prices.

The theory makes the system appear equitable and financially beneficial to all concerned. In practice, however, there are restraints which impede and sabotage the entire process. Two causes and two results of these are:

- Competing demands within the Government for the limited amount of foreign exchange available to pay world market price for products;
- Competing demands between agriculture and other sectors for goods and services;
- Substitution of cheaper, less desirable, goods to accommodate financial realities;
- Shortages in total supply, which give rise to black market operations.

PBDAC ORGANIZATION:

The PBDAC structure follows the classic patterns of a centrally-directed organization. At the top is the Principal Bank in Cairo. There are 17 provincial banks (provinces are referred to as *Governates*); 152 district banks (branches); 787 village banks; and 4,352 agencies, which are also local storage facilities or *mandubias*. Four other subsidiaries (in Alexandria, Cairo, Port Said and Suez) are apart from the rest of the pyramid and report directly to the Principal Bank. The geographic span of the PBDAC system is demonstrated by the fact that it extends into all villages of any consequence so few farmers are more than a few kilometres distant from a local *mandubia*. Credit applications move up the hierarchy, the decision-making echelon dependent on the amount and stated purpose of each loan requested. All policies emanate from headquarters, and there are central and subordinate agencies which regularly audit for fiscal and legal propriety of operations.

Functions:

PBDAC's activities comprise two major areas: banking and commercial operations. Its banking components consist of:

- 1) investment credits;
- 2) agricultural production credits;
- 3) other banking transactions of various sorts.

PBDAC's largest single category of banking activity is provision of investment credits. These are for such purposes as livestock, poultry and fishing projects, machinery, land reclamation, orchard planting, consumer durables, and others. Amortization duration and interest rates vary widely. For example:

<u>Type of Loan</u>	<u>Duration</u>	<u>Interest Rate</u>
Land Reclamation	15 years (4 years' grace)	6%
Subsidized (New Lands) (fisheries, livestock agricultural industries)	Unspecified	9%
Unsubsidized (livestock, poultry)	1 year 2 years	13% 15%

It should be noted that longer-term credits, especially for livestock, poultry and land reclamation, tend to have less satisfactory recovery rates. Apparently, the longer the repayment period, the more likelihood there is of default.

PBDAC's short-term agricultural production credits in calendar year 1987 amounted to 590 million Egyptian pounds (LE) due in 1987 and 263 million due in 1968. Including previous loans, the total due in 1987 was LE 624 million, of which LE 620 million (99.32%) was recovered. This exemplary performance is based on two major factors: (1) PBDAC controls distribution of agricultural inputs (e.g., fertilizer) at subsidized prices, and farmers cannot obtain additional inputs until they have paid PBDAC what they owe; and (2) the production credits are also subsidized by PBDAC with interest rates running only about 4% per season.

The third major category of banking transactions covers a multitude of miscellaneous services. Examples of these are: (1) opening letters of credit in commercial banks for importing machinery, pesticides, etc. (in cases like these, PBDAC recuperates 50 percent of the commission from the commercial bank); (2) maintaining interest free current accounts for farmers and other government agencies; (3) holding time and savings accounts.

In addition to its banking operations, PBDAC manages seven commercial activities in which it sells:

- 1) fertilizer
- 2) seeds
- 3) pesticides
- 4) feed
- 5) spare parts and sprayers
- 6) new jute bags
- 7) agricultural machinery and equipment.

Two other commercial interests which PBDAC controls are:

- 1) purchase of agricultural products for the Ministry of Supply
- 2) fumigation of warehouses for PBDAC and others.

Personnel

To perform so many functions over such a large geographic area and still remain in close proximity to all its customers, PBDAC necessarily has a very large staff. In 1989 there were 35,333 authorized positions. Functionally, these included: (1) 12,618 (35.7%) engaged in input supply; (2) 6,716 (19%) in banking; and (3) 16,000 (45.3%) in administration and management. Geographic distribution showed: (1) 2,392 employees in PBDAC's Headquarters (Cairo); (2) 1,466 in branches administered directly by Headquarters; (3) 4,317 in the 17 governate units; (4) 18,209 in village banks and *mandubias*.

It is estimated that, by the end of a five-year program of privatizing the non-credit functions of PBDAC, between 11,000 and 15,000 of these employees would become surplus. Redeployment would be necessary, either elsewhere in the Government or to the private sector firms taking over input supply responsibilities.

OPERATIONAL ASPECTS OF THE SYSTEM

PBDAC is structured to serve as a distribution and allocation control mechanism for Egypt's central Government and, as such, has prime authority for the policy of agricultural subsidization. Subsidies cost the Government hundreds of millions of LE each year. Although GOE has striven to reduce these costs, this has not been possible, in large measure because of the complexity of the subsidy system.

As an example, let us look at fertilizers for which there are six different types of subsidies:

- Indirect production subsidies via controlled energy prices
- Direct production cost subsidies
- Direct product distribution and freight subsidies
- Indirect freight subsidies via energy prices
- Indirect subsidies via preferential exchange rates for imports
- Direct distribution subsidies for cooperatives

All these subsidies come into play because the Government not only controls cropping assignments and distribution of fertilizer, but also domestic manufacturing and importation. Six separate public sector fertilizer companies operating nine nitrogen plants and three phosphate plants supply 85% of the country's nitrogen requirements and 100% of its phosphate requirements. The ammonium nitrate, ammonium sulphate, and sulfur needed to produce phosphate are imported, however, as is 100% of potash fertilizer.

DEFECTS AND WEAKNESSES OF THE SYSTEM - RATIONALE FOR DIVESTITURE

While the concept of the PBDAC is laudatory, in practice it is cumbersome, inefficient, and extremely costly to the Government. It encourages evasion of inflexible regulations, which in turn stimulates black market activities whose extent is unknown but whose existence is evident. Essentially, the shortcomings of the PBDAC system stem from the fact that it is geared to distribution and control rather than to marketing and profits.

Imports are limited by a critical shortage of foreign exchange; therefore, supply of agricultural inputs never meets demand. True production costs of domestic products are disguised by the subsidized defrayals for energy which mask expensive inefficiencies in manufacturing management, processes, and raw and finished materials. Finally, GOE has established uniform end-product prices throughout the country without considering actual distances and transport costs from port/factory to *mandubias*.

Because of the supply shortage, allocations are frequently inequitable and the rigid delivery schedules are often ill-timed. Because there is no competition in the market, PBDAC staff have little incentive to improve services to farmers, such as maintaining current inventories or verifying that the correct products are being stocked and delivered. This problem is especially applicable to fertilizers, but also applies across the board to other agricultural inputs.

Identifiable shortcomings in the delivery of fertilizers include poor product quality, particularly in the phosphates, and inadequate end-user protection. State-owned factories are assured of selling all their production and guaranteed a fixed profit; therefore, they have no incentive to introduce or enforce meaningful quality control procedures. PBDAC, on the other hand, has no authority to demand that they do. PBDAC does have some leeway with regard to inspection of imports, though even this is constrained by the USSR protocol trade. Given the shortages, PBDAC is much more concerned with meeting quantity goals rather than assuring the quality of the product delivered. Further, the subsidy systems favors nitrogen products, thereby skewing farmer's decision-making based on costs rather than appropriateness. On a micro level, therefore, the individual farmer may be forced to accept shortweighted deliveries of the wrong product in broken bags after his most urgent time of need has passed.

The system is further debilitated by the fact that there is no provision for analyzing transportation costs and determining the most cost-effective method. Significant savings could be realized by PBDAC if this procedure were followed.

It is clear to see that the black market thrives in this sort of environment. In addition to shortages and poor allocation practices, the direct delivery of fertilizers rather than the granting of cash credits encourages farmers to sell their allocations for cash rather than using the fertilizers on their fields. Farmers are often ignorant of the value of fertilizers because no technical advice has been given them on fertilizer use. The products, therefore, may not be utilized at all or applied in a wasteful, inefficient way.

PBDAC sorely needs up-to-date management information systems (MIS) for many reasons, some of the most obvious being:

- There is no reliable demand forecasting system; thus, planners and distributors operate with faulty, incomplete, and misleading information.
- There is no up-to-date financial management system to provide analyses of individual product profitability, comparisons of various distribution components, or cost/benefit/effectiveness assessments. This sort of data is lost in the maze of subsidy and commission calculations.
- There is no framework for adequate, systematic maintenance of existing storage facilities nor for optimal procedures for investing in new facilities. PBDAC is in the process of assuming enormous new debt obligations under a World Bank loan for new facilities that may not even be necessary, regardless of whether or not PBDAC continues to monopolize fertilizer distribution.

GOVERNMENT DECISION TO CONSIDER DIVESTITURE OPTIONS

The drive to reform was catalyzed by failures at both ends of the agricultural spectrum: administration of PBDAC and its inherent subsidy system were proving far too costly to the GOE; and the struggling farmer was not benefiting either in terms of increased production or improved quality of life. The Government has, therefore, adopted a policy of reducing subsidies and permitting prices of both input and products to gradually respond to a market-driven system.

Such sweeping reforms could not be undertaken without intensive and comprehensive studies of alternative options. Under the leadership of Minister of Agriculture Yussef Wally (who is also one of three ranking Deputy Prime Ministers), GOE has commissioned studies of the strengths and weaknesses of past and present policies and has dispatched high-ranking officials to various seminars and symposia on privatization.

As a crucial element of proposed liberalization of agricultural policies, GOE was particularly interested in the options and consequences of privatizing the non-credit (input supply) functions of PBDAC. While experience consistently pointed out the benefits of reintroducing competition, the GOE sought more detailed assurances that the needs of farmers would be served equitably and efficiently. Several factors were of overriding concern:

- It was imperative that the program be carried out with minimum disruption to farmers and agricultural production and, above all, with avoidance of negative impacts;
- PBDAC financial viability and staffing levels had to be considered in conjunction with each option;
- An examination had to be made of the capacity of the Egyptian private sector to absorb the new responsibilities.

It was recognized that repeal or drastic revision of applicable legal codes would be required, because present regulations effectively bar the private sector from participating in the production, importation, distribution, storage, or sale of agricultural inputs.

The long legacy of the monopolistic structure had certain ramifications for the private sector. Businessmen, who might have been interested in entering the fertilizer business, for example, were faced with the facts that: (1) they had no entitlement to preferential exchange rates; (2) they were required to come up with a minimum of 25% of the foreign exchange for imports from their own resources as a mandatory advance payment; (3) they would not be provided any subsidies on imports to match the PBDAC subsidies; (4) their transport costs would not be subsidized; (5) they had no established distribution channels outside PBDAC; (6) they faced limited access to working capital for setting up potential national distribution and retail centers; and (7) they would have to surmount a daunting array of obstacles to obtain all the required permits, licenses, and approvals. Even if they solved all these problems, they would still be faced with the fact that potential buyers no longer had access to the accustomed purchase credits.

GOE undertook the study of divestiture options based on the premise that the Government could play a legitimate role in stimulating private sector competition, provided it also regulated its operation to protect consumer interests. At the same time, GOE decided to focus more attention on supporting agricultural research and extension services to farmers. To accomplish these goals, GOE determined that its role would have to be more clearly defined and publicized. Lingering doubts on the part of entrepreneurs would have to be allayed, along with any consumer lack of confidence.

CONCLUSIONS AND APPROACHES FOR IMPLEMENTING DIVESTITURE

Given the existing circumstances it became apparent that privatization of the input supply function could be a distinct improvement over the present system, provided basic pre-conditions were met. Included among these pre-conditions that would have to be attained were the following:

1. Subsidies on inputs would have to be removed to facilitate fair competition among distributors, be they public or private.

2. PBDAC would have to expand its role in providing credit to farmers for the purchase of inputs and must also guarantee financing to business firms prepared to engage in input procurement and distribution. As a corollary to this, PBDAC must be willing to grant cash, not in-kind, loans. Appropriate mechanisms for debt repayment would have to be developed.
3. Government policy must be one of complete impartiality and provision of equal opportunity among competing distributors, public and private.
4. Government policies must be clearly spelled out and followed without exception, e.g., "no surprises."
5. The Government must state and repeatedly confirm unwavering support for and dedicated commitment to the expansion of private sector investment.
6. PBDAC should freeze all hiring, and encourage early retirement and voluntary separations. PBDAC should also undertake training programs for employees designed to facilitate their entry into the private sector or into other divisions of PBDAC.
7. Government entities (e.g., Army, Ministry of Agriculture farms) that now receive input supply services from PBDAC should be required by law to obtain these on the open market.
8. The entire divestiture process should be scheduled and timed so that new private sector organizations can phase into their new functions while PBDAC is systematically phasing itself out.

The CFP team presented its findings and recommendations within the context of three major options:

- Closing down PBDAC's input supply functions and replacing this by a number of private firms.
- Divestment of PBDAC's input supply function within the public sector with some private sector competition, and
- Establishing a private corporation to take over all the input functions of PBDAC.

The CFP team's recommendation was to select option 1.

At the end of 1989, GOE was considering strategies, options, and implications for divestiture and blending these in to its overall program of agricultural reform.

Under the option 1 scenario, proposed implementation schedule for individual commodities (e.g., fertilizer, seed, pesticides, jute bags) varied from two to five years. It was clear also, that once PBDAC decided to divest itself of non-credit input functions, it would also have to restructure its entire credit program from the ground up. It would no longer be possible for PBDAC to "retail" loans to farmers; rather, it would have to finance commercial dealers and distributors of commodities. Part of this might include re-financing of lines of credit which these new private entrepreneurs would offer to their customers.

The Government would also have to accelerate the deregulation of its price-fixing and subsidy programs if it was to benefit from the program. Increasingly, prices for both agricultural inputs and products would have to be set by free market forces.

In conclusion, careful planning, systematic coordination, and optimal scheduling were critical to the smooth transfer of the bureaucratic PBDAC monolith to the diversified dynamic operation of the free enterprise market. The social impact on agrarian and village society must also be mitigated. Food supplies must be readily available, farm incomes must be sustained, and thousands of PBDAC employees must be redeployed to the private sector.

This is the challenge which Egypt faces today.