



USAID
FROM THE AMERICAN PEOPLE

RAFI notes

A Fresh Look at Rural & Agricultural Finance

Issue I

USAID Promotes Rural Finance as an Integral Part of its Renewed Commitment to Agriculture

"We are now engaged in a major effort to revitalize our agricultural programs and develop a new and more effective agricultural strategy. . . . The lack of finance is a serious impediment to agricultural and rural development. Services are few, costs are high, and the proper incentives that would encourage the private sector to enter this field are generally lacking. Identifying the right policies and investing in the right structures is integral to the success of. . . USAID's mission to promote economic growth and development."

-- USAID Administrator Andrew Natsios

Opening Remarks at the Rural Finance Conference,

June 2, 2003, Washington, D.C.

In keeping with USAID Administrator Andrew Natsios' comments at the 2003 Rural Finance conference in Washington, D.C., USAID is developing a new agricultural strategy (see below). A vital component of this strategy, and of USAID's renewed commitment to agriculture, is improving access to demand-driven and sustainable rural and agricultural financial (RAF) services.

At the same Rural Finance conference, Manfred Zeller identified three principal motivations for renewed donor interest in rural and agricultural finance. First, the agriculture sector remains the most important economic sector, especially for the poor, in many developing countries. Second, improved financial markets accelerate agricultural and rural growth, leading to greater economic growth and less poverty. Finally, there is a growing sense of optimism that donors might learn from the failures of the past and the success stories of the present to launch a new wave of rural and agriculture finance in the future.¹

Introducing a Framework for Rural & Agricultural Finance

USAID's Rural and Agricultural Finance Initiative (RAFI) will produce a series of case studies, technical notes (of which this is the first), and practical guides and tools. These products will explore two separate but complementary approaches to rural and agricultural finance.

¹Excerpts are from Manfred Zeller's paper entitled, "The Decline in Formal Rural and Agricultural Credit Supply." At the same conference, Claudio Gonzalez-Vega elaborated, arguing that the increased interest in RAF is due to "a recognition that the largest incidence and depth of poverty is found in the rural areas . . . and that structural adjustment programs have not been sufficient to incorporate the rural poor and achieve rapid, broadly-based and sustainable economic growth.

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The first approach takes the financial sector as the starting point, emphasizing the important role of financial institutions in facilitating access to a broad range of financial services.

The second, the value chain approach, takes the production “chain” as the starting point, emphasizing the financing that is supplied within the agricultural value chain (e.g., input suppliers, processors, intermediaries and buyers.)

Both approaches are useful in understanding the complex array of actors and institutions, and in designing interventions to increase and improve the supply of rural and agricultural finance. The RAF Initiative and the RAFI Notes series propose a complementary approach that builds off of an understanding of the different actors in the value chain, while highlighting the current and potential roles that financial institutions play. Such an approach begins with existing relationships and finance flows. It then

Glossary of Basic RAF Terms

Value chain: the series of transactions necessary to bring a product from inputs to the final market, involving a process of adding value at every stage.

Financial institution: an entity – regulated or not – that specializes in the provision of financial services

Microfinance: financial services for lower-income households and micro and small enterprises; financial institutions that offer MF services include microfinance institutions (MFIs), commercial banks, credit unions and NGOs.

incorporates a clear understanding of all actors in the agriculture sector, and it recognizes the importance of long-term financial intermediation and the policy implications of potential interventions.

Key Assumptions. USAID’s interest in closing the rural and agricultural finance demand-supply gap stems from a series of assumptions about the role of agriculture and rural areas in broad-based economic agriculture and rural areas in broad-based economic growth, and the role finance plays in overcoming crucial obstacles to such growth. Specifically, the initiative is premised on the following key assumptions:

- Broad-based economic growth in developing countries will be achieved more effectively by improving economic opportunities in rural areas where the majority of poor live.
- The key to improving economic opportunities in rural areas is an improvement in agricultural productivity and more equitable and broad-based growth in the agricultural sector.
- The key to achieving these improvements is better access to financial services tailored specifically to rural households, rural enterprises, and the agricultural sector.
- In order to address this financing constraint, USAID should design programs that:
 - are built upon an **understanding of agricultural value chains and the supply and demand of rural**

financial services; and

- **assess and build upon the ability of existing actors and institutions** to deliver appropriate rural and agricultural finance services.

Why is RAF So Difficult?

There are a number of unique characteristics to rural and agricultural markets that constrain both the supply and demand for finance in those areas. These challenges include: high transaction costs for both borrowers and lenders; high risks faced by potential borrowers and depositors due to the variability of incomes; exogenous economic shocks and limited tools to manage risk; lack of reliable information about borrowers (also a challenge in urban areas); lack of adequate collateral; and inhospitable policy, legal and regulatory frameworks.

Understanding Demand and Supply of RAF

Designing effective programs to facilitate better access to rural and agricultural finance services begins with a clear understanding of the multitude of actors and institutions. One must also understand the relationships in rural areas and in agricultural value chains. Products and services need to reflect the diversity of clients served, ranging from poor rural households (which depend on agriculture to varying degrees) to sophisticated agro-industrial firms in urban or semi-urban areas.

The rural finance supply sector is often viewed in one of two ways: either through a **financial sector**

lens or through an agriculture **value chain lens**. The particular lens chosen to conceptualize the sector often has a strong impact on the way a program is designed.

Using the **financial sector lens**, financial intermediaries and other financial institutions such as commercial banks, credit unions and MFIs are seen as the most important providers. A key objective in utilizing this lens is to understand the strengths and weaknesses, opportunities and risks of each of the actual and potential provider of financial services. Interventions that build on this lens tend to focus more attention on building the long-term capacity of financial institutions and aligning the incentives for them to increase the provision of rural and agricultural finance.

The **value chain lens** emphasizes the array of value chain actors (buyers, traders, producer groups, input suppliers, etc.) that provide financing as the product moves from inputs to production to market. Interventions that build on this lens tend to focus more attention on the specific needs of the agricultural chain as a whole, and on quickly facilitating whatever linkages are needed to ensure the growth of that chain.

Below we explore two approaches to improving rural and agricultural finance, each emerging from analyses using the lenses described above. We will describe the principal actors, illustrative interventions, and key limitations of each approach. We then make the case for a complementary approach that draws on the strengths of both

while also addressing their limitations.

The Financial Sector Approach: Building Institutions

Interventions using the **financial sector approach** emerge from analyses using a financial sector lens, and prioritize building the capacity of financial institutions to deliver appropriate financial services over the long-term. Table 1 highlights the market segments of various types of these financial institutions.

Financial institutions, as a group, are theoretically well-positioned to be the primary providers of sustainable financial services because their core competency is the provision of a range of financial services.

outreach or even a wide range of products. Nonetheless, building a long-term financial intermediation system is important because it increases the outreach of those financial service providers with a comparative advantage. This comparative advantage stems from several characteristics of financial institutions:

- Financial institutions (especially formal financial intermediaries) are able to offer a broad range of financial services, including longer-term credit and savings (in reality, however, many have limited offerings);
- They have access to external capital and thereby are better positioned to take on new clients;
- They offer transparent credit

TABLE 1: FINANCIAL SECTOR SUPPLIERS OF RAF SERVICES

Institutional Type	Typical clients	Typical products	Potential market niche
Commercial banks	Medium to large enterprises	Short to medium-term loans, savings, others	Lending to exporters, agro-processors
MFIs (Commercially-oriented, or community-based)	MSEs, poor households, and some small farmers and producers groups	Short -term loans, savings	Lending to small and micro producers & producer groups; savings
Ag Coops and credit unions	Rural households, micro/small producers	Short, medium-term loans; savings	Lending to micro/small producers; micro-savings

However, because of the many obstacles and challenges to lending in rural areas and to agricultural enterprises (briefly described above), this generalization expresses an ideal rather than a reality. In reality, financial institutions' comparative advantage as providers of financial services rarely translates into deep

histories that are easier to take from one institution to another;

- Credit is generally not tied to a specific crop or product, so it is easier to continue after market conditions change;
- The more market-based structure tends to result in less mo-

nopolistic or predatory relationships.

Given the inherent theoretical advantages of financial institutions as providers of financial services to rural and agriculture-dependent communities, a financial sector approach is an attractive way to facilitate long-term access to appropriate financial services. Such an approach is based on a firm understanding of both the financial service suppliers and clients of a wide array of rural and agricultural financial services.

Promising models have emerged over the past decade using a financial sector approach to building long-term solutions to the rural and agricultural finance gap.²

In particular, efforts in Latin America and elsewhere have shown that adapting microfinance technology can greatly increase rural lending and deposit mobilization. Programs drawing on the financial sector approach might include some of the following components:

- **Capacity building of financial institutions:** institutional strengthening of rural MFIs or credit unions (e.g. introducing mobile banking, or teaching liquidity management), or teaching banks to price agricultural credit products;
- **Product development for financial institutions:** Helping financial institutions understand the needs of the agricultural

sector and how to adapt their products accordingly;

- **Risk mitigation techniques,** such as partial guarantee programs, index-based insurance; and
- **Policy reform,** such as collateral laws, land titling or bank branch regulations.

Despite the advantages of the financial sector approach, there are several limitations important to remember when designing interventions, especially those aiming to increase agricultural credit. Specifically:

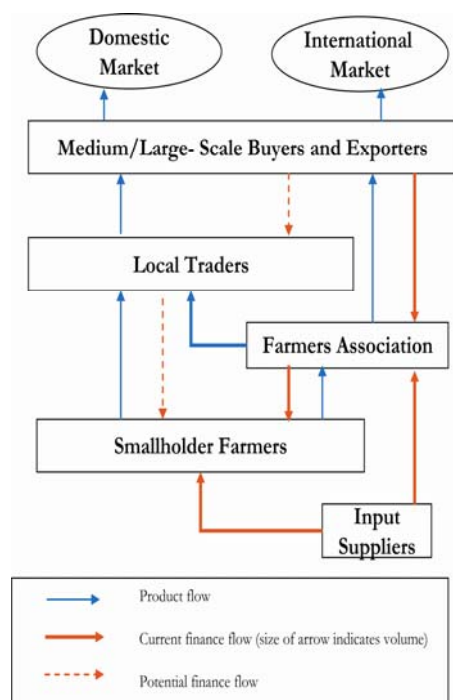
- An exclusive focus on financial institutions as providers of credit for agricultural value chains ignores the reality of how the majority of such financing currently occurs. An intervention that does not build off and learn from existing relationships and models risks being out of touch with the “real world” of the agricultural sector.
- Often, past negative experiences in agricultural lending contribute to elevated perceptions of risk, making financial institutions reluctant partners in promoting greater investment in the agriculture sector.
- Weak systems of land titling, collateral laws, and judiciaries represent serious constraints to lending, since lending by financial institutions is generally on the basis of hard collateral. The most common solutions to this constraint – policy reform and/or innovations in lending methodologies – are often time-consuming processes.

- Financial sector development can be a long, drawn-out process. Donor programs interested in quick results may become frustrated.

The Value Chain Approach: Building Off of Interlinked Transactions

The value chain approach, which emerges from analyses using a value chain lens, is represented in Figure 1. This graphic is a generic illustration of how financial services might flow to an agricultural value chain. It highlights the array of value chain actors that provide financing as the product moves from inputs to production to market. Non-financial actors such as processors, exporters and traders are seen as providers of financial services as well as their core role as actors in the product chain.

Programs interested in improving market opportunities for agricultural market chains, and in linking smallholders to such opportunities,



² The financial sector approach will be explored in further depth in a forthcoming RAFI Note on the same topic

may find that using a value chain approach would allow them to better assess the market for rural and agricultural finance. Assessing the supply and demand for financial services from a value chain lens provides a clear description of the multitude of actors involved in extending credit through the chain. Often, such an analysis reveals a high degree of informal arrangements and interlinked transactions (e.g., inputs sold on credit and advanced purchases of products) between buyers, input suppliers, traders, producer groups, and producers themselves.

Such arrangements have a number of inherent advantages. In particular:

- They build on existing relationships and reality;
- They overcome information gaps, because of the familiarity and trust between actors;
- They have easy “embedded” repayment mechanisms (good for cash-strapped farmers);
- They facilitate the provision of technical assistance to producers; and
- Often, buyers, traders and inputs suppliers are the only actors in rural areas willing to extend credit.

The phenomenon of interlinked transactions has been the private sector’s answer to the historical reluctance of banks to lend to rural and agriculture dependent communities and the collapse of unsustainable state-run agricultural development banks.

Some examples of value chain financing mechanisms include trader credit, outgrower schemes and contract farming, and warehouse receipts lending.³

Just as the financial sector approach has its limitations as mentioned above, the value chain approach is not a panacea. Some limitations of the value chain approach include:

- Actors that do not specialize in financial services generally only offer relatively short-term credit. A project that does not engage financial institutions will ignore the supply of crucial services such as long-term investment credit, savings, and insurance.
- Without increased access to capital from a financial institution, a value chain actor will have a difficult time expanding lending operations. This can limit

potential outreach.

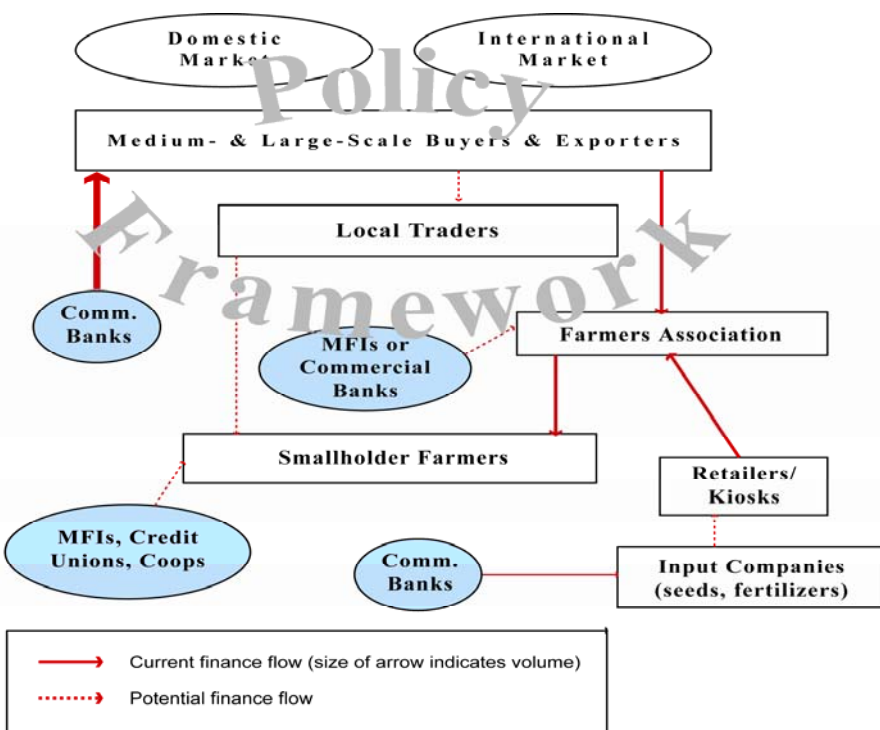
- Credit from a value chain actor is often tied to a specific crop. When market dynamics change, the lending relationships often disappear. Further, producers develop a dependency on the buyer/lender that can (in some cases) become harmful to the producer.

The Case for Adopting a Complementary Approach

The overarching goal of the RAFI is to encourage innovative approaches that address the constraints inhibiting the flow of finance through rural areas. The aim is to foster broad-based economic growth with significant smallholder participation. Recent achievements have shown that there are promising models for achieving this.

Initiatives using a long-term financial sector approach have shown us

FIGURE 2. COMPLEMENTARY APPROACH



that financial institutions, given the right mix of incentives and guidance, can profitably serve rural areas and can become key partners in fostering growth in agricultural value chains. Initiatives using the value chain approach have demonstrated that building off the private sector relationships in agricultural value chains can quickly inject needed capital when financial intermediaries are reticent to lend; that they can provide natural channels for provision of technical assistance to producers; and that they can serve as important “stepping stones” to more formal credit relationships – all contributing to more broad-based growth in the agricultural sector as well as rural financial deepening.

We believe one of the most promising ways of addressing the rural

and agricultural finance gap is to draw on both of these perspectives in a complementary way. Figure 2 is a graphic representation of this approach. It builds off of an understanding of the different actors in the value chain – much as Figure 1 does – but also highlights the roles that different types of financial institutions currently play, and their potential role. Such an approach is based on a number of principles, such as:

- Build on existing relationships and finance flows;
- Start with a clear understanding of all actors in the agriculture sector, including financial institutions that are either current or potential providers of financial services;
- Recognize the importance of long-term financial intermediation; and

- Understand policy implications of interventions.

The RAFI Notes Series

USAID’s Rural and Agricultural Finance Initiative (RAFI) Notes will inform USAID Missions and partners about the critical questions and potential solutions related to rural and agricultural finance services. RAFI Notes will be informed by recent thinking, but will be practical and concise. Several overview pieces will begin the series, to be followed by technical notes on topics of interest ranging from the role of government in rural and agricultural finance, to focused topics such as warehouse receipts systems. RAFI Notes can be found at www.microlinks.org

Box 3: A Central American “Stepping Stone”:

A pilot program using a complementary approach

Research currently underway in Central America is examining ways in which relationships between buyers and producers can serve as a “stepping stone” to more formal credit relationships, by building or improving the real and/or perceived creditworthiness of the borrower, from the viewpoint of formal financial institutions. In one pilot initiative, the buyer (a private distributor of fruits and vegetables) initiated an agreement with producers and a local commercial bank. The bank agrees to finance most of the growers’ needs without hard collateral, and the buyer guarantees the purchase, at a predetermined price, and provides quality oversight. The technical assistance that occurs as part of this relationship can also play a role in improving the capacity of the borrower to repay loans, and, consequently, it can be a complementary way of facilitating farmers’ “graduation” to more formal credit arrangements. The case study will be available in April 2005 on www.microlinks.org.

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