

CHAPTER ONE

CONCEPT AND DIMENSIONS OF RURAL FINANCE

Chapter Objectives

- ❖ *To introduce the concept of finance and related concepts.*
- ❖ *To understand the concept of microfinance, agricultural finance and rural finance.*
- ❖ *To differentiate between microfinance, agricultural finance and rural finance.*
- ❖ *To know as to why rural finance is needed.*
- ❖ *To examine the characteristics of rural finance clients.*
- ❖ *To discuss the paradigms of rural finance.*
- ❖ *To discuss the challenges of rural finance.*

INTRODUCTION

Finance in agriculture is as important as development of technologies. The provision of affordable financial services to the rural population has been a prime component of any development strategy. Technical inputs can be purchased and used by farmers only if sufficient money (funds) is available with farmers. Most of the times, farmers suffer from the problem of inadequate financial state. This situation leads to borrowing from an easy and comfortable source. Systematic and efficient flow of finance is needed to efficient and effective management of a farm business. Arrangement of finance to required business concern should be properly maintained and channelized through regulated institutions and markets. Therefore, this chapter is intended to introduce students with rural financial concepts.

1.1.BASIC CONCEPTS

1.1.1. FINANCE

Finance is the raising and using of funds by individual, cooperative enterprises, firms and governmental organizations for the day to day running and management of their business undertaking. As a discipline, finance is merely a body of facts, principle and theories which deals with raising and using of funds by individual, enterprises, firms and governmental organizations for the day to day running and management of their business undertakings.

Finance is important to businesses due to, it is always regarded as the life blood of any organization, it provides basis for business planning, investment, diversification and cash flow statements, it provides the basis for control and employee maintenance, and it provides basis for business growth and expansion, through ploughing back profits.

Finance can be classified into two broad categories, namely: micro and macro finance. Macro finance relates to the financing decisions and practices of the entire economy. Micro finance relates to financing decisions and practices of individual households, businesses and non-business organisations.

1.1.2. FINANCIAL SYSTEM

The term financial system is a set of inter-related activities/services working together to achieve some predetermined purpose or goal. Financial system is the basic concept for the industrial development of the nation. Financial system provides adequate and smooth flow of finance to the needed parts. Financial system implies a set of complex and closely connected or intermixed institutions, agent practices, markets, transactions, claims and liabilities in the economy. Ethiopian financial system consists of the four important components such as: *Financial Institutions, Financial Markets, Financial Instruments and Financial Services.*

- *Financial Institutions:* Financial institutions are providing various services to the economic development with the help of issuing of the financial instruments. Financial institutions can be classified into banking and non-banking institutions.
- *Financial Markets:* Financial market is a market which deals with various financial instruments (share, debenture, bonds, treasury bills, commercial bills etc.) and financial services (merchant banking, underwriting etc). Financial markets can be broadly divided into money and capital markets.
- *Financial Intermediation:* Financial intermediation is the process through which resources are channeled from those who have a surplus to those who do not have enough to carry out an activity, in order that the activity can be carried out.
- *Financial Intermediaries:* Financial intermediaries are individuals or institutions whose business it is to act as the middleman between those who want to save and those who

want to invest, or to be the point person for many people who want to reduce their risks.

1.1.3. MICROFINANCE

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance products to the poor and low-income households, for their microenterprises and small businesses, to enable them to raise their income levels and improve their living standards.

Characteristics and Features of Microfinance

Characteristics	Distinguishing Features
Type of client	<ul style="list-style-type: none"> ➤ Low Income ➤ Employment in informal sector; low wage bracket ➤ Lack of physical collateral ➤ Closely interlinked household/business activities
Lending Technology	<ul style="list-style-type: none"> ➤ Prompt approval and disbursement of micro loans ➤ Lack of extensive loan records ➤ Collateral substitutes; group-based guarantees ➤ Conditional access to further micro-credits ➤ Information-intensive character-based lending linked to cash flow analysis and group-based borrower selection
Loan Portfolio	<ul style="list-style-type: none"> ➤ Highly volatile ➤ Risk heavily dependent on portfolio management skills
Organizational Ideology	<ul style="list-style-type: none"> ➤ Remote from/non-dependent on government ➤ Cost recovery objective vs. profit maximizing
Institutional Structure	<ul style="list-style-type: none"> ➤ Decentralized ➤ Insufficient external control and regulation ➤ Capital base is quasi-equity (grants, soft loans)

The main aim of microfinance is to provide small loans to poor people particularly living below poverty line, who are not able to raise loan for productive purposes from other sources and to improve their standard of living by increasing their earning and saving covering associated risks.

1.1.4. MICROCREDIT

Micro credit is the provision of credit services to the poor people and is a part of Microfinance. It is the extension of small loans to entrepreneurs too poor to qualify for traditional bank loans. In developing countries especially, micro credit enables very poor people to engage in self-employment projects that generate income.

1.1.5. AGRICULTURAL FINANCE

Agriculture finance is defined as a subset of rural finance and a sectoral concept dedicated to financing for agricultural related activities viz. input supply, production, processing, and marketing. Agriculture finance is also defined as an economic study of borrowing funds by farmers, the organization and operation of farm lending agencies and of society's interest in credit for agriculture. Various scholars considered agricultural finance as under:

- “Agricultural finance is the economic study of the acquisition and use of capital in agriculture. It deals with the supply of and demand for funds in the agricultural sector of the economy.” *Warren F. Lee, Michael D. Boehlje, Aaron G. Nelson and William G. Murray (1980)*
- “Agricultural finance is the study of financing and liquidity services credit provides to farm borrowers. It is also considered as the study of those financial intermediaries who provide loan funds to agriculture and the financial markets in which these intermediaries obtain their loanable funds.” *John B. Penson, Jr. and David A. Lins (1980)*
- “Agricultural finance is a branch of agricultural economics which deals with the provision and management of bank services and financial resources related to the individual farm units.” *R.K. Tandon and S.P. Dhondyal (1971)*

Agricultural finance studied at both micro and macro level. *Macrofinance* deals with different sources of raising funds for agriculture as a whole in the economy. It is also concerned with the lending procedure, rules, regulations, monitoring and controlling of different agricultural credit institutions. Hence macro-finance is related to financing of agriculture at aggregate level. *Micro-finance* refers to financial management of the individual farm business units. And it is concerned with the study as to how the individual farmer considers various sources of credit, quantum of

credit to be borrowed from each source and how he allocates the same among the alternative uses with in the farm. It is also concerned with the future use of funds.

Therefore, macro-finance deals with the aspects relating to total credit needs of the agricultural sector, the terms and conditions under which the credit is available and the method of use of total credit for the development of agriculture, while micro-finance refers to the financial management of individual farm business.

Differences between Financing of Agricultural and Other Sectors: The important factors which differentiate farm finance from other lending are as follows:

No.	Financing Agriculture	Financing other sectors
1	Farmers are not aware of credit policies and procedures	They are aware of banking procedures.
2	Difficult to estimate the efficiency of farming in the absence of farm records.	Efficiency can be assessed as all returns are recorded.
3	Farming is exposed to natural calamities and uncertainties.	Risk and uncertainties involved in an enterprise can be foreseen and managed.
4	Frequent supervision and follow-up after loan disbursement are difficult as farms are scattered.	Monitoring is easy and less time consuming.
5	Land as major security being immovable is not highly liquid.	Apart from immovable assets, movable assets are also taken as security which can be easily liquidated.
6	Ownership of land is difficult to verify as land records are not updated.	Identification of ownership can be easily done by verifying records.
7	As farm products are perishable, they are subjected to distress sales.	As industrial products are non-perishable, producers can fix prices.
8	Long gestation period between investment and returns.	Very short gestation period.
9	Since income is seasonal, repayment schedule is drawn in accordance with income generation from investment.	As income generation is a continuous process, repayments will be made continuously.
10	Adequate infrastructural facilities are not available to implement new technologies.	Sufficient infrastructure is available to implement their schemes.
11	Farmers are susceptible to external influence and hence some vested interests exploit them and guide them in wrong direction.	Entrepreneurs are not usually misled by external influence as they are well organized.

Agricultural Microfinance : Agricultural microfinance can be defined as referring to the overlap of agriculture finance and microfinance dedicated to providing financial services to poor agricultural households.

1.2.RURAL FINANCE

1.2.1. Definition and Characteristics of Rural area:

Although ‘rural’ areas have been analysed in many countries for decades, there is no single commonly accepted definition. Some organizations use population density as the main distinguishing factor. For example,

- The OECD classifies a community as ‘rural’ when it has less than 150 inhabitants per square kilometre.
- The International Fund for Agricultural Development (IFAD) defines ‘rural’ in terms of two main characteristics. Firstly, rural people generally live on farmsteads or in groups of houses containing perhaps 5.000 – 10.000 persons, separated by farmland, pasture, trees or scrublands. Secondly, the majority of rural people spend most of their time on farms.
- According to the Small Enterprise Education and Promotion (SEEP network), a rural area is defined as: “an area in which the primary economic activities are small-scale agriculture and livestock rearing, although it also includes small-scale trade, service, and manufacturing activities. It is also characterized, in relative terms, by geographic isolation, low population densities, poorly developed infrastructure, underdeveloped market for goods and services, and high poverty concentration”.

Therefore, A rural area can be described as *a non-urban area that is an area that is not urbanized or that does not have the types of infrastructural, social and other services associated with urban centres.*

1.2.2. Definition of Rural Finance (RF)

Rural Finance is defined as the provision of financial services to a heterogeneous, rural, farm and nonfarm population at all income levels through a variety of formal, informal, and semiformal institutional arrangements and diverse types of products and services, such as savings, loans, insurance, leasing and remittances.

Rural finance is a spatial concept, which encompasses the financial side of almost all economic processes in rural areas. These include: everything which involves savings, financing and insurance of financial risks. It encompasses the provision of different financial services to households and enterprises in rural areas for both productive and consumptive purposes. Rural financial services include loans, savings, payment and money transfer services, and risk management (e.g. insurance, hedging and guarantees).

Rural finance, as defined by the World Bank (2004), includes a range of financial services such as savings, credit, payments and insurance to rural individuals, households, and enterprises, both farm and non-farm, on a sustainable basis. It includes financing for agriculture and agro processing/ agribusiness. Microfinance only partly overlaps with rural finance given that most microfinance customers are in urban areas. But rural finance includes agriculture finance, micro finance and is a subsector of the larger financial sector.

Rural financial infrastructure or rural financial system: includes all savings and financing opportunities and thus the financial institutions which provide saving and financing opportunities as well as valid norms and models of behaviour related to the financial system.

Rural Financial Services: Rural financial services is about providing financial services - secure savings, credit, money transfer services for remittance and insurance in rural area. The ability of rural households to make long term investments to ensure time-patterned income flow is shaped by an economy's financial services. The efficient provision of loans, deposits, payments and insurance services encourages rural entrepreneurship, helps the rural economy to grow and reduce poverty.

Unique Features of Rural Finance

- High financial transaction costs of serving dispersed and small farm households
- Heterogeneity, seasonality, and duration of farming and non-farming loan needs
- Lower profitability and higher risk of on-farm investments
- Lack of loan collateral
- Need for training/informational needs of bank staff and farmer clients
- Politically sensitive environment

- Low loan repayment discipline

Objective of Promoting Rural Finance

There are primary objectives for promotion of rural finance by donors, agencies, banks, NGOs, agro-processing firms, micro finance institutions, input suppliers, co-operatives, informal savings and lending groups, for finance is the key to enhancing economic development and reducing poverty in rural area. These objectives are summarized below:

1. Development of accessible financial institution.
2. Maximizing outreach building up existing institutions.
3. Achieving sustainability in order to make the greatest possible impacts on the lives of the rural people, through increase in local income and creation of more savings.
4. Improvement in the supply of financial services to the target group.
5. Financial infrastructure in rural areas can help to the advantage of rural development.
6. Creates linkage between the informal financial institutions and formal financial institutions i.e. The deposits of the funds of informal savings association in a bank could provide association members with an indirect interest income on savings.

Rural Financial Products: Given that rural households have diverse strategies for accumulating assets and minimizing their vulnerability, the following rural financial products are need to rural areas:

- **Savings mobilization** Safe, liquid and convenient savings (deposit) facilities.
- **Intermediation**, which involves mobilizing and transferring of savings from surplus to deficit units.
- Access to credit facilities tailored to the needs of rural population.
- Systems for effecting **payments** and **transferring** remittances as well as general insurance cover against variability in output, price and market uncertainties
- **Leasing:** A method of financing the acquisition or use of fixed assets, predicated on the concept that the value of the asset is in its use in the business rather than through ownership.
- **Insurance:** Agriculture (indexed weather based instruments), Health & Life.

- **Credit Enhancement:** The process of reducing credit risk by requiring collateral, insurance, guarantees or other agreements to provide the lender with reassurance that it will be compensated if the borrower defaulted.

Characteristics of Financial Products that rural finance Clients Want

- Quick service
- Flexible loan amounts and terms
- Cost effective
- Diversity of products
- Serve household and business needs

1.3.RURAL FINANCE EVOLVING PARADIGMS

Several paradigms and policies have been used in developing countries to address the difficult and costly problems of providing financial services in rural areas. The old rural finance (RF) paradigm dates back to 1960s and 1970s. Based on lessons learnt from the old paradigm and revised financial systems approach, the new RF paradigm merged in the late 1980s which gained a broader consensus in the 1990s.

1.3.1. The old Rural Finance paradigm

The old Rural Finance (RF) paradigm dates back to 1960s and 1970s. Rural Finance got momentum in 1960s and 1970s all around the world, particularly in Asia and Latin America. Many rural credit projects were taken up under public sectors. Since the special costs and risks were involved in RF that made formal financial institutions reluctant to extend & expand credit facilities in rural areas, therefore, governments and donors were urged to intervene in rural financial markets. Following types of interventions were advocated by the researchers/practitioners under this paradigm:

- Lending quotas on banks and other financial institutions,
- Refinance schemes,
- Loans at preferential interest rates,
- Credit guarantees,
- Targeted lending by development finance institutions (DFIs)

The interventions were intended to increase rural lending by reducing the costs and risks to lenders that made loans to preferred rural clients and sectors. Subsidized interest rates, Loan waivers and forgiveness programs were also used to reduce the debt burden of priority - sector borrowers, especially following floods, droughts and periods of low farm prices. Credit was considered an important means to speed agricultural development, expand exports, promote small farmers, reduce poverty, and ensure cheap food supplies to urban areas. Multilateral and bilateral donor invariably supported the approach taken by many governments and funded many of the targeted supply led projects. This approach helped some developing countries, especially in Asia, to improve agricultural yields in the short-term. But it was not sustainable over the long term. It was also costly, and failed to reach the majority of rural households. As such:

- It was unable to achieve the intended objectives of increasing rural incomes, reducing rural poverty and stimulating asset formation. The focus on lending to agriculture sector, for farming purposes only, ignored the potential benefits of supporting growth intensive investments in rural areas which would be more appropriate for the rural poor or small non-farm rural enterprises/ activities.
- Subsidized interest rates did not cover the costs, as such rural financial institutions (RFIs) became unviable and they lost the confidence of depositors.
- There was a huge buildup of non-performing loans since cheap credit encouraged unprofitable investments and led to a concentration of loan portfolios in hands of the rich and powerful.
- Subsidized agricultural credit often resulted in production inefficiencies by targeting the wrong products and creating artificial preference for capital-intensive investments that “crowded out” abundant labor in rural areas.
- Financial discipline was damaged and intermediaries weakened.
- Several development finance institutions became insolvent and were closed or had to be reorganized.

1.3.2. The New Rural Finance Paradigm

After the ill-fate of majority of the RF programs under the old paradigm, microfinance providers, such as NGOs and credit unions emerged in the late 1970s. They targeted the

unbanked poor, who had been left out by the huge investments made in financial market under old paradigm. These microfinance institutions in fact brought about the revolution by proving that the poor are bankable, but the customary banking system had failed to serve them appropriately. Based on the lessons learnt from the old paradigm and the emerging microfinance revolution, the new RF paradigm began to emerge in the late 1980s which gained momentum in the mid-1990s.

The new paradigm adopts a financial systems approach, using market principles to deliver financial services in rural areas. This system is aimed at facilitating rural development that, in turn, will promote asset creation and poverty reduction. The new paradigm treats finance as a way to expand and integrate markets, rather than as a policy tool for targeting a specific segment of the market. The new RF paradigm is based on the principle that a commercial and market-based approach is most likely to reach large numbers of clients on a sustained basis. It recognizes that financial services are part of an interactive system of financial infrastructure and social and cultural norms. Government has a role to play in establishing a favorable or “enabling” policy environment, infrastructure & information systems, and supervisory structures to facilitate the smooth functioning of rural financial markets, but it should play a more limited role in direct interventions.

1.4. CHALLENGES IN RURAL FINANCE

Generally, it is recognized that supplying rural finance is more difficult than supplying urban microfinance. There are 12 constraints which are classified into four groups - *vulnerability constraints*, *operational constraints*, *capacity constraints*, and *regulatory constraints* summarized as follows.

➤ *Vulnerability Constraint*

- Systematic or covariant risk - same risk at the same time.
- Market risk - fluctuation of prices
- Credit risk – lack of collateral.

➤ *Operational Constraints*

- Investment returns - seasonality gives non-constant cash flow.
- Low investment and assets - weak safety net.

- Geographical dispersion-high dispersion and low population densities.

➤ ***Capacity Constraint***

- Infrastructural capacity
- Technical capacity and training rural population is less skilled.
- Social exclusion - cultural, linguistics, etc., affects market and financial integration.
- Institutional capacity.

➤ ***Political and Regulator Constraint***

- Political and social interference - subsidized and/or directed credit from state-owned banks.
- Regulator constraints - Regulations and/or lack of enforcement in rural environments.