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THEMATIC OVERVIEW

EASYPol Module 145

Investment and Resource Mobilisation: Sources and Uses of Financial Resources

Investment and Resource Mobilisation: Sources and Uses of Financial Resources

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for the

FOOD AND AGRICULTURE ORGANIZATION OF THE UNITED NATIONS

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1. SUMMARY

This document offers a syllabus for one component learning module in the FAO sponsored knowledge sharing series which deals with investment and resource mobilization in the rural economic space. This document outlines basic concepts and provides a framework for thinking about the sources and uses of financial resources which rural economies require for growth. This module both reviews recent developments in this topical area and suggests some new approaches to securing additional sources for funding rural investment. The module relies heavily on recent seminal studies which treat the topics briefly covered here in exhaustive detail[1]. Additional reference documents are listed in the annex.

2. INTRODUCTION

Objectives

The overriding objectives of public policy with respect to rural finance are three: i) sustainability of financial institutions; ii) increased breadth and depth of market coverage; and iii) increased welfare impact. Significant tradeoffs exist among these three objectives, which are tacitly set through policy making processes that provide the "North Star" of financial resource assess for the rural sector.

The aim of this module follows from these overriding objectives and includes the following:

- Characterizing the special problems associated with financing rural economies;
- Providing a framework for determining the adequacy of financial resources available to specific needs which emerge within agricultural economies;
- Describing recent institutional and financial instruments, innovations and new thinking with respect to incremental sources of rural financing;
- Explaining how public policy can influence, help to expand and deepen financial market coverage; and
- Summarizing lessons learned in the institutional planning, financing and implementation of reform of rural financing systems.

Readers can follow links included in the text to other EASYPol modules or references[2].

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[1] Including most importantly: *Successful Rural Finance Institutions* by Jacob Yaron, *Models of Rural Financial Institutions* by Manfred Zeller, *Rural Finance: Recent Advances and Emerging Lessons, Deepening Rural Financial Markets: Macro Economic, Policy and Political Dimensions* by Claudio Gonzales-Vega, *Debates and Opportunities* by Geetha Nagarajan and Richard Miller, Chapter 7 of the *World Bank Agricultural Development Handbook* (Investments in Rural Finance for Agriculture"), and several of the papers contained in *The New Public Finance* edited by Inge Kaul and Pedro Conceicao.

[2] EASYPol hyperlinks are shown in blue, as follows:
a) training paths are shown in **underlined bold font**
b) other EASYPol modules or complementary EASYPol materials are in ***bold underlined italics***;

See also the list of EASYPol links included at the end of this module[3].

3. Background

Financial resources are required in rural economies for multiple reasons: For example, to smooth consumption, to provide capital investment both for the undertaking of new value adding processes and for the completion of buy/sell transactions and to make long term investments both in productive fixed assets and in rural infrastructure. Demand for financing is highly segmented in the rural economic space. Moreover, specific segments of dormant rural financial markets are activated only when appropriate supply and policy conditions apply. Experimentation with new modes of financing often leads to the "discovery" of segments which had previously not been served and indeed which no one many have realized existed.

Much of rural finance is, moreover, "contextual." It depends significantly *not* only on baseline social economic conditions which prevail in rural economic space and just as importantly on the financial sector regulatory involvement, but also on the private sector business environment and on the public sector policy environment. Uses of financial resources in rural economies are significantly constrained by development policies and budget priorities which governments embrace on behalf of their rural populations because in most developing countries most capital investments are still made under the auspices of public sector budgets. It follows that different systems of federal/local control over budget resources have quite different effects on how financial resources under public control are allocated and on productivity they are used. Similarly, different systems of national budget allocation, monitoring and evaluation systems have quite different consequences in terms of how effectively budgeted resources are used.

With that said, it is also clear that the several different participants in rural economies require financing to satisfy their quite different needs. Said another way, the rural financial market is heterogeneous on its demand side. Some of this diversity of financial needs, particularly in poor countries, relates more to consumption than to investment and some categories of needs once satisfied are more likely to stimulate growth and improve productivity over the long term than are others. Hence, managing demand for financial resources is intimately related to success or failure of development policies. Households, traders, local service providers and governments themselves have very different needs for financing. Moreover, each of these financial market participants is either in or out of the market depending on prices and availability of funding. They operate, moreover, along very different planning horizons when it comes to planning for resource use. Even among households—depending on the starting conditions which apply within rural populations.....depending, for example, on whether farm households are food aid dependent or alternatively able to subsist based on their own farm production or, indeed, whether as a starting position they are still more

c) links to the glossary are in **bold**; and
d) external links are in *italics*.

[3] This module is part of the EASYPol Training Path: **Policy Learning Programme, Module 3: Investment and Resource Mobilization, Session 3: Sources and Uses of Financial Resources.**

productive and thus able to produce marketable surpluses—household needs for financing will vary from smoothing consumption to investing in assets which can enhance productivity.

An extremely important distinction can be made as well regarding the "appropriability of benefits" derived from different categories of assets which are being financed. In general, depending on whether assets fall into the categories of "private goods", "community goods," "public goods" or "global public goods" quite different modes of financing may be available. Thus, for example, financing may be easier to secure for investment in global public goods than for investment in private goods whose beneficiaries are local agribusinesses or individual farming households. In any case, quite different supply responses are appropriate for adequately investing in global public goods than for adequately investing in livelihoods enhancement for marginally self sustaining households. With that said, in general rural economies are under invested with respect to all four categories of assets. Different financial remedies, moreover, are available for correcting the problem of underinvestment in all four domains.

Sources of funding and modes of intermediating investments in rural spaces are likewise diverse. Thus, for example, financial resources required by rural economies may be self generated at the rural household level; others may be raised within local investors pools or from borrow owned micro financial institutions, still others may be mobilized from within a single country through financial institutions which serve an entire national market, still others may be provided by traders and agribusiness investors, while others may be provided by governments through annual budget financing, by donors through pledged aid support or though public private partnership special purpose investment vehicles. An open discussion will be organized to identify the kinds of funding sources/ mechanisms which are currently supporting whatever level of investment is currently being made within the countries represented by forum participants.

A defining structural characteristic of most agricultural sectors is the prevalence of both capital market failures and of funding and collection coordination failures. Both greatly affect financial resource intermediation into rural economies and both have led to the testing of various institutional remedies over the past half century. Market failures have led, for example, to the creation of specialized rural financing institutions, many of which were publicly managed whereas others were explicitly subsidized at least during their start up phase.

Much of the discussion which follows centres on the development of more robust matches between uses and sources of financing. Significant differences exist in how these matches are made and how they are institutionalized among countries and across various categories of financial needs. Moreover, a great deal of experimentation is currently underway in this arena. Indeed, the history of financial market development can be thought about in just these terms.... as an empirical testing and subsequent commercial working out of new funding mechanisms and new financial instruments. It is the history of new financing instruments and of new institutional arrangements designed to channel society's savings more efficiently into investment categories which offer the greatest social returns. It is also the history of increased integration.

Furthermore, recently a number of innovative financial instruments, management methods and new special purpose financial institutions have emerged which have improved the access of rural economies to capital. Likewise, new instruments and new institutional arrangements have recently emerged which offer to facilitate the intermediation of financial resources from outside rural sectors and even from outside the countries where investment is taking place. These are some of the subjects with which this module will deal.

4. BRIEF HISTORY OF POLICIES AFFECTING THE SOURCES AND USES OF RURAL FINANCE

The history of rural finance is the history of institutional experimentation. This history can be divided into several discrete epochs. The first epoch, of directed and subsidized credit, was designed to correct market failures through direct and active market intervention. In many cases, however, it only succeeded in substituting "government failures" for "market failures." This first epoch ended in mid-1980 with the imposition of structural adjustment programmes by Washington based development institutions.

The second epoch involved the liberalization of financial sectors, its broad opening to private sector investment. A subplot with respect to this epoch involved the implementation of prudential regulations and controls which were designed to assure financial sector stability. The result of the second epoch has generally been disappointing with few commercial banks actually venturing into rural finance with the result that rural populations were generally perceived to be underserved as a result of the replacement of specialized government credit institutions with private lending institutions whose tight regulations made them risk adverse conditions. The next epoch corresponded to experimentation with various micro financial institutions and with other modes of financial resource mobilization at the farm community level. During this epoch new insights have emerged about the willingness and ability of the poor to pay for financial services and about the viability of providing financial services in sustainable ways once governance, excessive transaction cost and information asymmetry issues had been dealt with institutionally.

The most recent epoch of development for financial services is defined by still more institutional experimentation and testing intended to find more effective business models which can further reduce transaction costs and formerly unmanageable risks. One of the insights that have emerged from this new epoch is that macro and sector level reforms need to precede financial sector reforms in order that specific categories of investments can be confidently undertaken. A stable, sustainable business environment and the effective implementation of supportive business services are prerequisites to the development of rural financial sectors.

Another insight is that more than a liberal market is needed to assure the sustainable delivery of financial services to rural economies. Institutional experimentation and the active, systematic testing of new business models are also required. A third hard won lesson is that that the entire commercial ecology within which financial services are

delivered needs to be reformed and not just the financial institutions themselves. Furthermore, private investment partners can significantly extend the limited budgetary resources available to government for investment in rural assets.

The overriding lesson however is that the benefits associated with finding better institutional models and developing more supportive commercial ecologies are public welfare benefits, which are widely distributed. Hence, some level of commitment of public resources, not in the form of subsidies or initial capital, but rather in the form of institutional learning and in terms of reforming the general business environment appears to be warranted.

5. Challenges which many Rural Financial Sectors in Developing Countries Face

Financial sectors which have been opened to competition, privatization and deregulation and for which subsequently prudential controls have been tightened to improve sustainability, increase liquidity and tighten risks, typically manifest a number of common characteristics with direct effects on the mobilization of funding for rural investment. These characteristics include the following:

- Reduction in the level of funding provided to agriculture.
- Reduction in the number of rural branch banks.
- Diversity of Lending Instruments designed for agricultural use if typically limited.
- Shake out of commercial banking sector.
- Concentration of investments in safe assets but unproductive assets i.e. government bonds.

Another problem which plagues many financial sectors as they emerge from a period of government directed lending within the agricultural sector, is the problem of adverse selection. Politically well connected, former beneficiaries of previous government directed lending programmes frequently stand first in line for new credits even once the financial system has been restructured and these borrowers frequently do not intend to make good their loan repayments. The bottom line is that underdeveloped financial markets limit the efficient reallocation of resources particularly to sectors like agriculture which are less well linked to the financial institutions.

5.1. Basic concepts

Most rural economies do not have the benefit of specially designed financial instruments or of special purpose financial structures which might improve the efficiency with which investments are made and assets and liabilities are matched. Most of them are dependent on three sources of financing: i) government budgets; ii) commercial bank lending, and iii) micro lending provided through an array of formal and informal institutions. The first set of funding sources is typically available for some combination of input subsidy, agricultural extension and output market support

programmes. The second set of funding sources are available primarily to large scale farm input providers, to agribusinesses and to large commercial farms. The later set of funding sources cover all other rural needs.

Rural financial institutions refer to the primary providers of financial services to farmers and agribusinesses. These include i) full service regulated banks, leasing companies and savings institutions; ii) regulated micro finance deposit taking institutions (MFI's); and iii) unregulated NGO's—MFI's, SACCO's, CBO's and other informal money lenders. The first set of constraints which typically limited the financial resources available to agricultural sectors of developing economies can be found in the financial sector itself. These constraints derive from both the regulatory and policy framework within which the financial sector operates macro economic balances within the larger economy and levels of competition and maturity within the financial sector itself. Some of the parameters which are useful in determining the level of maturation of a country's financial sector include the following: i) savings rate as a percent of GDP. The African average is 17.7 percent; ii) the monetized assets to GDP. Again, in Africa, a normative reference point is Kenya with an M2 to GDP ration of 40%; iii) Percent of farm credits provided by commercial banks.

Farming is a capital as well as a labour intensive activity. The primary asset which farm households own is arable land. In the US, for example, 70-80 percent of farm asset value is in real property. Holdings of financial assets are typically very small. Most farm operations are relatively small in size, they are invested primarily in illiquid assets which in most cases may not be collaterizable and they have capital structures which do not allow them to effectively pass risks on to stakeholders other than owners/operators.

At the same time, farm operations have significant cash requirements, not the least of which is the consumption smoothing requirements of farm households. Even subsistence farmers have needs for periodic cash outlays for food. Importantly as well, working capital requirements associated with providing inputs and services to support farm production are highly seasonal, with one or at the most two cash in/cash out cycles occurring each year. Many farm operators in both developed and developing countries alike depend on cash flow from non-farm income to assure liquidity and continued operation.

Importantly, the timely use of farm inputs determines to a significant degree the level of productivity which farm operations are able to realize. Much of the financing required to supply these essential inputs comes in the form of trade credits through supply chains. Peak seasonal working capital requirements can be smoothed to some extent through the strategic selection of crops and through the strategic timing of planting and harvesting. Other financing requirements must come from financial intermediaries. Providing financial resources to rural customers is inherently more costly and most risky for financial institutions than providing financial resources to urban customers. Moreover, the greater volatility of farm incomes implies higher transactions, enforcement and supervisory costs for financial institutions which target rural populations.

Agricultural economies support a number of public goods whose adequate investment materially determines the profitability and sustainability of core farm operations as well

as the condition of the natural environment. Some of the benefits which result from adequate investment in public goods are captured by farm households at least indirectly. Thus, public investment in transport, power, telecommunications infrastructure have a significant knock down effect on farm productivity and consequently on land values, as well. In this way some portion of public goods investment may be capitalized and captured by farm households.

Most of the financing resources which support public goods investment, however, come from government budgets and this source of financing is typically inadequate and inappropriate to the kinds of assets which rural economies require to develop productively and sustainability.

In general, long-lived assets need to be matched with long term liabilities and corresponding financing instruments and long term assets can only be found in financial markets which are larger, more mature and in which a diversity of financial instruments have been developed and tested. The simple logic here is the matching over time of benefits and costs which result from investment and the strengthening of linkages between local needs and more open regional or global supplies of financing. The fact is that today's global capital markets have a surplus of capital available for investment. What are missing are the instruments and institutions which can channel this surplus supply into rural economies.

In financial markets "size" appears to matter a great deal. Smaller financial markets entail higher transaction costs, higher costs for capital greater risks due to lack of diversification and typically entail lower rates of savings mobilization. Thus, increasing linkages between local rural needs and larger market domain of diversified financial resources is a worthy policy objective in almost all cases. In each individual country case, however, a distinct set of institutional and political economic constraints tie together specific beneficiaries, their specific financing needs and the sources and options which they have available to them for providing that financing.

5.2. Distinguishing features of rural economies which affects their financing

Some of the factors which distinguish demand for financial services in the rural space from the urban space within most economies include the following:

- ***Population dispersion:*** Rural economies are characterized by low population density, small scale individual farm entities, poor transport and telecommunications facilities and large distances which separate individual farms. Rural populations typically have lower levels of education, less access to information and less business experience. These conditions translate into higher loan origination costs for both financial institutions and for farmers/ traders.

- ***Poverty:*** The incidence of poverty is significantly higher in the rural space than in the urban space. Financial proceeds are more likely to be used to smooth consumption rather than to invest in productive assets in rural settings Farmers and rural populations, moreover, typically have fewer assets to offer as collateral

- ***Peaked seasonal cash flow***: Levels of income diversification are typically lower in rural areas and commercial activities typically concentrate in a limited number of commodity markets. Farmers experience cash flow cycles which are highly seasonal and which tend to coincide across households in terms of negative and positive cash flow peaks and valleys. Cash surpluses are typically accumulated after harvests and depleted to zero or negative levels just before harvests. Agricultural loans are large, stay outstanding for longer periods and entail repayments in lumpsums or in a minimal number of instalments. All of these characteristics increase systemic risks to lenders.

- ***Contract enforcement is typically more difficult in rural economies***. Informal laws and norms may differ from one ethnic area to another. Primary collateral available to farm borrowers is land, and it is difficult to secure and land markets are typically either non-existent, or transaction costs associated with securing clean titles and reselling farm properties are extremely high.

- ***Heterogeneous farm-level activities:*** Rain fed and irrigated agricultural activities have very different risk profiles. Agricultural activities conducted near to transport, telecommunications and power infrastructure has again a very different risk profile than agriculture conducted at some distance from these infrastructure elements. Subsistence farmers, marginal commercial farmers and commercial farmers have very different risk profiles and very different financing needs. Distinguishing them effectively is difficult and costly. Different financial products are required for each set of heterogeneous needs. Thus, heterogeneity increases transaction costs. Investment of complementary donor and government funds, moreover, are unevenly distributed with much of these funds that cluster around improved roads where competition among donors and government programmes is most intense.

- ***Diverse credit cultures:*** Different communities and different ethnic peoples may have very different repayment cultures which in any case may be conditioned by previous experience with state sponsored financial institutions which may or may not have been rigorous with regard to enforcing collections and repayment.

- ***Commodity price instability:*** Farmers are always price takers and typically have only limited ways to manage price and production risks. Production scheduling affords limited opportunities to reduce covariance risks among different crops and husbandry activities and natural disasters require long periods of time for productive assets to be recouped.

5.3. Debunking micro myths

Profound misunderstandings about the nature of demand for financial services in rural economies is one of the primary reasons for the persistence of subsidized, directed credits targeted at farm households. Serious empirical studies undertaken in several countries confirm that:

- The poor who are able to save, are credit worthy.
- Moreover, they are able to pay for financial services.
- They are able to put the assets which they secure with external financing to productive use.
- Subsistence farmers, marginally commercial farmers and commercial farmers have very different needs for financial resources.
- The boundary between formal and informal lending institutions is more than anything else defined by the state of institutional development within the financial sector.
- Most importantly, those institutional innovations in micro finance have rarely been the pure result of market forces.
- With that said, it is also true that government failures have more often than not been the primary reason for the failure of innovative financial institutions.

5.4. Sources of innovation in micro finance

Some of the lessons learned from experimentation with micro lending include the following:

- Lending among families, neighbours and friends depends on social capital and on local social enforced sanctions for non performance.
- Rotating credit and savings associations can be an effective way for mobilizing financial resources and for beginning the process of capital accumulation.
- Donor and/or government sponsored demonstration projects are more often than not the "seed" from which successful financial institutions emerge.
- Multiple reviews of "best practice" and of "lessons learned" have emerged from donor sponsored programmes.
- Financial services are more likely to succeed if they are embedded in the provision of other business support services or if they are tied to the provision of farm inputs.
- Micro innovation is not the same as long term institutional sustainability. Sustainability requires a level of adaptive behaviour and of networked sources of ancillary financial support which many micro financial institutions simply do not possess.

5.5. Debunking macro myths

The relationship between development financing and growth is particularly problematic, especially in Africa.

- Macro conditions directly affect the strength, depth and breadth of rural financial markets; many developing economies have systematic biases designed into their tax systems against agricultural production and in favour of urban food consumption. Efforts to protect agriculture, moreover, from foreign imports frequently backfire.
- Sector level financial sector regulatory conditions (flexible prudential controls, deregulated interest rates and open entry) have a magnifying effect on the sustainability of institutions and on the security and consequently the overall level of mobilized savings.
- Linkage between rural based financial institutions and non-rural institutions is essential for sustainability.
- Investing in institution building in countries with repressive regulatory systems is a waste of resources.
- Larger financial networks are generally more efficient and more risk resilient.
- The business/ecological/development environment directly determines risks associated with rural sector investment

5.6. Sources of macro innovation

Some of the lessons learned from experimentation with macro lending include the following:

- Securitized user fees or government payments for services rendered can serve as the basis for issuing bonds.
- Project finance can tap nations as well as regional and international financial markets.
- Public/private partnerships can engage the entrepreneurship of private parties to support the financial needs of public undertakings.
- Special purpose investment facilities are typically more attractive than general purpose government financing in attracting private capital

5.7. Integrating rural financial markets with larger ones

Expanding financial networks reduces transaction costs, facilitates cross border transactions and generally improves the governance of financial institutions. In general, three approaches are available to expanding financial markets:

- Draw in foreign investment, technology and human capital and facilitate cross border capital flows.
- Facilitate the entry of foreign financial intermediaries.
- Expand financial space to develop integrated regional capital markets.

5.8. Conclusions: Take away findings

The following set of takeaway messages are most likely to emerge from this session:

- There is no single solution to the challenges of rural finance. Institutional experimentation and testing is the key. Institutional diversity is desirable not only to increase competition but more importantly to match specific needs with customized sources.
- In order to satisfy the diversity of needs which exist in rural economies, a diversity of specialized financial products are required. Again, commercial experimentation is key.
- However, opportunities exist to tap additional resources available within the private sector particularly on a project by project basis and to expand financial market boundaries to include international as well as local sources of funding.
- Bigger financial networks are better. Facilitating the development of regional networks, regional bond markets and cross border mergers and combinations of financial institutions begins with the harmonization of regulatory controls.
- Rather than investing in stand alone financial institutional designs more resources and more thinking needs to be invested in how best to extend and strengthen financial systems which serve rural economies but perhaps not exclusively. Large size and greater diversity are essential for managing the covariant risks associated with rural economies.
- Improving access to rural finance offers only a partial solution to the challenge of improving live hoods for rural households. Rural financial development efforts need to be teamed with other efforts to diversify crop and product dependencies and to improve infrastructure, enhance access to markets and to agricultural technologies.

6. READERS' NOTES

6.1. EASYPol links

This module belongs to a set of modules which are part of the EASYPol training path **Policy Learning Programme, Module 3: Investment and Resource Mobilization, Session 3: Sources and uses of financial resoures.**

Readers can follow other EASYPol documents under Module 3, which is structured as follows:

Module 3: Investment and Resource Mobilization

Session 1: **Investment in agriculture & rural development**

Session 2: **Environment for private investment in agriculture & rural development**

Session 3: **Sources and uses of financial resources**

Session 4: **Strategies for increasing farm financing resources**

Session 5: **Risk mitigation in agricultural investment**

Session 6: **Sector-wide approaches (SWAps)**

Session 7: **Socio-economic & livelihood analysis**

7. REFERENCES AND FURTHER READINGS

World Bank, 2004. Chapter 7: Agricultural Investment Sourcebook.

http://www.worldbank.org/agsourcebook

MODULE METADATA

1. EASYPol module	145

2. Title in original language	
English	FAO Policy Learning Programme
French	Programme de formation aux politiques de la FAO
Spanish	Programa de aprendizaje sobre políticas de la FAO
Other language	

3. Subtitle in original language	
English	Investment and Resource Mobilisation Sources and Uses of Financial Resources
French	Investissement et mobilisation des ressources: sources et emplois des ressources financières
Spanish	Inversión y movilización de recursos: Fuentes y usos de recursos financieros
Other language	

4. Summary

This document offers a syllabus for one component learning module in the FAO sponsored knowledge sharing series which deals with investment and resource mobilization in rural economic space. This document outlines basic concepts and provides a framework for thinking about the sources and uses of financial resources which rural economies require for growth. This module both reviews recent developments in this topical area and suggests some new approaches to securing additional sources for funding rural investment. The module relies heavily of recent seminal studies which threat the topics briefly covered here in exhaustive detail, including most importantly: Successful Rural Finance Institutions by Jacob Yaron, Models of Rural Financial Institutions by Manfred Zeller, Rural Finance: Recent Advances and Emerging Lessons, Deepening Rural Financial Markets: Macro Economic, Policy and Political Dimensions by Claudio Gonzales-Vega, Debates and Opportunities by Geetha Nagarajan and Richard Miller, Chapter 7 of the World Bank Agricultural Development Handbook (Investments in Rural Finance for Agriculture"), and several of the papers contained in The New Public Finance edited by Inge Kaul and Pedro Conceicao. Additional reference documents are listed in the annex.

5. Date

January 2008

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7. Module type	☒ Thematic overview ☐ Conceptual and technical materials ☐ Analytical tools ☐ Applied materials ☐ Complementary resources

8. Topics covered	☐ Agriculture in the macroeconomic context

by the module	☐ Agricultural and sub-sectoral policies ☐ Agro-industry and food chain policies ☐ Environment and sustainability ☐ Institutional and organizational development ☒ Investment planning and policies ☐ Poverty and food security ☐ Regional integration and international trade ☐ Rural Development
9. Subtopics covered by the module	Rural Finance; agricultural investment; sources and uses of finance
10. Training path	FAO Policy Learning Programme
11. Keywords	rural finance, rural investment, sources and uses of finance, agricultural finance