Nearly 70 percent of the developing world’s poor live in rural areas and primarily depend on agriculture for their livelihood – rural development is therefore key to achieving the United Nations Millennium Development Goals (MDGs), which are described in the UN Millennium Campaign launched in 2002. This technical brief summarizes lessons from FAO work over the past years on how rural finance may facilitate poverty reduction. It target audience consists of development practitioners implementing related projects in the field.

**The role of rural finance**

In this context, financial services contribute significantly to poverty reduction. Although they cannot directly multiply the net assets of the poor, they enable the financial means for them to make important investments that help them take advantage of income generating opportunities. Without external finance, poor households would not have the means to realize their economic potential.
Financial services are vehicles for families to productively invest excess liquidity capital and reserves into feasible investment projects such as improved agribusiness practices related to processing, packaging, marketing or many other farm and non-farm rural economic activities. This will enable them, not only to earn, but more importantly, to build a savings reserve to deal with future needs and the risk of shocks, thus averting more costly future losses caused by crises. Investment, realized through loans or other financial instruments, is the engine of socio-economic growth.

Financial services facilitate investment and intermediate flows of funds between parties, but finance is only a tool - not an end-product - of wealth creation and direct poverty reduction. The MDGs will only be achieved when adequate financial services are available to stimulate growth and development, yet their effectiveness depends on conducive conditions and environment. Therefore, attention must be given simultaneously to increasing access to finance as well as to additional development support needs.

Financial services depend on geography, language, education, land titles as well as on the economic environment for investment and type of production. These constraints are greater in the rural areas where financial services and all types of investment are often severely limited due to highly correlated economic activities that increase investment risks.

**Beyond micro and beyond finance**

Finance for rural poverty reduction must not only target constraints of the poorest of the poor, but also recognize the importance of low-, middle- and even high-earning households given their role in driving rural investment and employment that can benefit the poorest households.

Rural poverty reduction requires investment in all aspects of rural development for creating the conditions and capacity needed to improve income and assets. Rural poverty reduction requires investment in all aspects of rural development - agriculture and non-agriculture - to create the conditions and capacity needed to improve farm and non-farm income and assets, including financial services and market development, human capital and policy development.

Rural poverty reduction implies increased incomes that can build assets and maintain them, even in the presence of negative household shocks. As shown in the figure below, Comprehensive rural investment, shows some key services that jointly determine a household’s profitability and resilience. Finance enables access to some of these services, which in turn allow incomes to grow and the household enterprise to be competitive. With more business activity, there is growth in complementary services and industries, also enabling greater access to finance in the future.

Increased business activity makes it feasible to build better roads and electrical lines, and improve schools and services in rural areas, all of which improve the competitiveness of agricultural production. They also open new market and production opportunities for farmers, as well as income stability and diversification through off-farm employment opportunities for their families.

Rural investment requires more than finance. To achieve it, a parallel development of support services to rural households is required, which then re-enforces further economic growth. It also needs for a stable macro-economy, which facilitates production and commercialization of food and agricultural products.

The required development support must come from various stakeholders – governments, donors, private investors and the communities. Its success over time depends on the involvement of both the rich and poor, who must recognize self-interest in such development.

**Financing business, households and communities**

Rural finance has been recognized as an important catalyst for rural investment. An important concept of rural finance is that the business/farm and household are intertwined; both need financial services for community investment.

Financial services for the non-agricultural activities in the community are as important as agricultural financial services. They may include financial services to be used for education, emergencies, housing, irrigation systems and other productive infrastructure.

**Key challenges in rural finance**

In the past, rural poverty reduction was often addressed through the stimulation of agriculture production and technology improvement; millions of dollars in agricultural credit were invested towards this. And yet, the benefits have eluded the poor: agricultural loans often went unpaid, and consequently, donors, governments and bankers became disillusioned with the results.

There are four categories of constraints that limit the benefits of access to rural finance:
The way forward

Today, there is renewed interest to draw lessons learned and build for the future, using a broader definition of rural finance, including farm and non-farm credit, savings, insurance, transfers, equity finance, and trader and value chain finance. The way forward for poverty reduction is, therefore, to embrace a multiplicity of financial service providers, approaches and products.

Some examples are:
• Financial linkages – formal-informal linkages for reaching remote areas with savings, insurance and term finance;
• Informal savings-based approaches – improved traditional systems that build savings-based loans and safety net resources for the poor;
• Value chain finance – finance linked with markets to reduce costs and risks;
• Collateral expansion – innovative collateralization schemes that embrace rather than penalize the social and physical collateral of the poor;
• Innovations – technology applied to reduce financial costs and risks for the poor, such as low-cost market information systems for rural providers and rural supervision, and internet kiosks for forward contracting of agricultural products to reduce price risk and related financial risk and costs.

Policy implications

Close public and private collaboration within and between countries is needed for effective financial services for rural areas that promote growth while reducing poverty. Policy makers need to focus on building support infrastructure (e.g. roads), developing capacity (e.g. drivers’ training) and a regulatory framework (e.g. rules), and providing access to higher-rent markets.

Rural finance alone does not alleviate poverty; it can only serve as a catalyst, and when used together with supporting policies, services, and capacity building, investment and income growth can be achieved.

vulnerability constraints: (i) systemic risk (i.e. risk affecting everyone in the region), (ii) market risk (i.e. risks in price, demand, production and post-harvest operations); and (iii) credit risk (i.e. risk of changes in ability and willingness to reimburse credit);
• operational constraints: (iv) slow rural investment returns; (v) low asset levels; and (vi) geographical dispersion;
• capacity constraints: (vii) poor infrastructure; (viii) low technical capacity and training; (ix) social exclusion of many; and (x) undeveloped institutional capacity;
• political and regulatory constraints: (xi) political and social interference; and (xii) an inadequate regulatory environment.

These challenges cannot be met by a single approach. In remote rural areas, for example, direct lending from formal entities is costly, and the expected returns to capital for borrowers can be too low and uneven to make it feasible, especially for the poor. The solution is not to subsidize the costs of lending, but rather, to adapt methods, structures and financial products to the cashflow dynamics of rural households and agribusinesses while improving the conditions and returns to investment.

RECOMMENDED READINGS