UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNCTAD

No.46
FEBRUARY 2016

POLICY BRIEF

FINANCING RURAL STRUCTURAL TRANSFORMATION IN THE LEAST DEVELOPED COUNTRIES

For the least developed countries (LDCs) to reach the Sustainable Development Goals, their rural economies will have to undergo structural transformation, given that most of their population lives in rural areas and agriculture is a main contributor to their economy. To this end, UNCTAD proposes that LDCs engage in the poverty-oriented structural transformation, or POST, of rural areas. It should encompass the upgrading of agriculture, the diversification of rural economic activities and the strengthening of synergies between both. A major obstacle is the dearth and inadequacy of financing for rural economic activities. This policy brief discusses key policy measures and instruments that LDCs and their development partners can mobilize to widen the financing of rural economic activities.

Key points

- Microfinance in rural areas of LDCs is hampered by high interest rates and short maturities, which can be countered by interest subsidies and in-kind microgrants.
- Official development assistance and development banks can be used to finance the public investment required to fill infrastructure gaps, so that LDCs can reach the Sustainable Development Goals.
- Information and communications technology provides opportunities to broaden the reach of financial services to rural areas.
- Financial literacy and better management of collateral and risks will help finance rural structural transformation in LDCs.

UNITED NATIONS
UNCTAD

Introduction

More than ever, rural economic transformation will be central to the development of LDCs as they work towards the Sustainable Development Goals. These Goals signal both the need and the opportunity for a new approach to development policies, given the gap between the progress required by 2030 and that of recent decades. The focus on rural transformation is imperative for several reasons.

First, more than two thirds of their total population live in rural areas. This pattern is not expected to change substantially by 2030. Rural population growth will continue to be much faster, and the rural share of the population will remain much higher than in other developing countries throughout the achievement period of the Sustainable Development Goals (2015–2030).

Second, agriculture plays a crucial role in all LDC economies, accounting for 60 per cent of total employment and 25 per cent of value added. In many of them, it also represents a major source of export revenues.

Third, shortfalls in human development targeted by the Sustainable Development Goals are much greater in rural areas of LDCs. The proportion of people living below the national poverty line in these areas is generally about twice as great as in urban areas. Typically, rural people in LDCs are 50 per cent more likely than their urban counterparts not to have access to sanitation or to attend secondary school, twice as likely not to have access to electricity or to attend primary school, and more than four times as likely not to have access to clean water.

The performance of the agricultural sector in LDCs is unsatisfactory. Agricultural labour productivity in LDCs between 2011 and 2013 was 19 per cent of that in other developing countries and just 1.8 per cent of that in developed countries. Given the concentration of the labour force in agriculture in LDCs, this broader productivity gap is the major cause of poverty in these countries and of the income divergence between LDCs and these other country groups. The total food trade deficit of LDCs has widened dramatically, from $2 billion in 1995–1997 to $21.8 billion in 2011–2013.

How to achieve rural structural transformation

In order to overcome the development gaps of LDCs and their rural areas, UNCTAD proposes the poverty-oriented structural transformation of rural areas. Its objectives are as follows:

- Increase the overall level of labour productivity as a basis for a sustained development process;
- Provide productive economic opportunities for the entire workforce;

- Raise the lowest levels of labour productivity to a level that can generate an income that is above the poverty line;
- Ensure that such increases in productivity are fully translated into higher household incomes.

Alleviating capital constraints on small farms and rural enterprises is critical to transform the rural economy and achieve the objectives of poverty-oriented structural transformation. Access to financial services and credit is at best limited in most rural areas of LDCs, especially beyond the peri-urban areas. As a result, rural producers and consumers in these countries are forced to rely upon their own savings or informal financing mechanisms, such as money lenders, group savings or upon migrants' remittances.

In many LDCs, lack of access to commercial finance reflects both the underdevelopment of the financial system and a strong risk aversion in the banking sector, which skews assets towards safer investments such as government securities, and away from riskier activities such as lending to small and medium-sized enterprises and microenterprises. Banks are reluctant to lend to these businesses, largely because of the high risks and limited information about creditworthiness.

Another sector for which financing is sorely needed in LDCs is rural infrastructure, including both soft infrastructure – marketplaces, communications networks, education and health services, financial and payments systems and market information systems – and hard infrastructure – electricity and water supply, storage facilities and roads. Yet, the density and quality of infrastructure are crucial to access markets for output and inputs, reduce production and transaction costs, and thus ensure effective supply response. Moreover, the implementation of the Sustainable Development Goals will require massive investments in social infrastructure. Public investment will play a major role in expanding and upgrading economic and social infrastructure. Therefore, LDCs and their development partners will need to secure the financing of infrastructure investment.

Microfinance has been widely promoted as a means of financing small-scale investment in a context of poverty reduction. Several microfinance programmes have been initiated in developing countries, in particular LDCs, by international organizations, non-governmental organizations and donors. Nevertheless, it remains unclear under what circumstances microfinance can be of real benefit to poor people. Microcredit is characterized by high interest rates and short maturities, while rates of return on investment in rural areas of LDCs are highly uncertain, especially on the innovative investments essential to rural transformation. Often, such returns are relatively low. Additional risks can arise from several factors:

- The possibility of crop failure, affecting agricultural incomes and demand for non-agricultural products;
- Household income losses, for example caused by ill health;
- Diversion of funds to maintain a minimum level of consumption due to very low and unpredictable incomes.

Supply-side constraints on microfinance result from the high cost of reaching clients in widely dispersed populations and problems in enforcing repayment. High interest rates, short maturities and uncertain returns also limit investments, particularly in innovation. They also skew investment opportunities to better-off households and increase the risk of business failure.

Better financing for rural activities

Given the shortcomings of microfinance as a solution to the financing shortfalls of rural economic activities, alternative policy approaches to alleviating capital constraints on small farms and rural enterprises must be exploited. They include the options outlined below.

Credit subsidies. A possible approach is to provide conditional interest rate subsidies on microcredit. For example, where the market rate on microcredit is 40 per cent per annum, an interest subsidy of 30 per cent could be provided, provided that the interest rate to the borrower does not exceed 10 per cent. This could leverage private financing more effectively and greatly increase the uptake of microcredit, while minimizing its potential negative impacts. Use of microcredit to upgrade "survivalist" non-farm activities is not suitable in this case, given their low productivity and limited potential for expansion. Economies of scale in lending suggest that larger loans to small and medium-sized enterprises are likely to be more beneficial.

In-kind microgrants. In remote and isolated areas, economies are often oriented towards subsistence production, so that commercial activity and monetization are limited. In such conditions, microcredit is unlikely to provide a viable option, even with conditional interest rate subsidies. Here, there may be a case for in-kind micrograntsof productive inputs: Each household could be offered a choice of locally appropriate agricultural inputs, with advice on their use, or equipment or materials for non-agricultural production, up to a specified value, delivered annually ahead of the planting season. This would have the combined effect of financing investment in agricultural upgrading, which would otherwise be problematic in a largely demonetized local economy, providing access to technologies that would otherwise be unavailable, and engineering a selective opening of the economy to productive inputs.

Since the costs of such an approach would be substantial, the funding of such schemes could come from additional official development assistance. The net effect on the overall cost of achieving the Sustainable Development Goals could be reduced by combining input deliveries under microgrant schemes with other activities at the local level.

Official development assistance. Beyond its potential contribution to financing in-kind microgrants, official development assistance has an essential role to play in financing rural infrastructure and, more generally, the investments required to achieve the Sustainable Development Goals. In adopting these goals, the international community has committed to delivering the means necessary to their achievement. There is a strong case for increasing the target level of official development assistance from 0.15–0.20 per cent of donor gross national income to 0.35 per cent — half of the overall official development assistance target of 0.7 per cent to which donors are committed under Goal 17.[1] This would be commensurate with the LDCs' share of the human development deficits addressed by the Sustainable Development Goals, and with the increase in the rate of extension of access to rural infrastructure required to achieve them. It would lead to an increase in official development assistance to LDCs from $30 billion in 2013 to about $250 billion by 2030, while also allowing a sharp rise in official development assistance to other developing countries, provided the 0.7 per cent commitment is fulfilled.

Development banks. Development banks can play an important role in mobilizing resources for productive investment. They can promote investment in activities with high social rates of return and encourage complementary and interdependent investments. Many LDCs, however, lack the resources to establish national development banks. In these cases, regional development banks and development banks from other developing countries can play a major role in closing the financing gaps of these countries.

Collective action. Cooperatives, producers' associations and women's networks can help improve access to credit and reduce its cost by acting as intermediaries or guarantors for borrowing by members, or through credit-and-loan arrangements among members. These activities can also provide an important mechanism to leverage and strengthen such networks.

Mobile banking. The rapid spread of mobile phone coverage in rural areas of most LDCs helps to spread financial inclusion and reduce transaction costs. Combined with increasing investment opportunities through rural development, this could contribute substantially to increasing the scale of lending opportunities to a level sufficient to attract commercial lenders to rural areas, potentially reducing the cost of microcredit to a more sustainable level. Such systems can also enhance business viability by increasing access to market information and facilitate and reduce the cost of remittances from migrants in urban and other rural areas and abroad. In peri-urban areas and an increasing proportion of intermediate rural areas, the availability of mobile phone coverage allows the use of mobile phone-based banking services.

Overcoming gender-based constraints. Ensuring equal access to finance for women and men is key to overcoming gender constraints in rural development. However, the primary means of doing so is to mainstream gender into core programmes and policies, as schemes that target women exclusively arbitrarily exclude vulnerable men. Targeted interventions may nonetheless have a role in specific contexts where women are a marginalized social group, and the establishment of publicly backed schemes oriented towards women, though important, is not sufficient. Effective targeting of rural women may also require measures such as informal guarantees – for example, group lending and liability and other trust relationships – or collateral and more lenient repayment terms.

Financial literacy. Training in financial literacy and business skills and assistance in preparing viable business projects are an essential precondition to credit-based financing, particularly where education is limited, so as to limit risks to creditors and borrowers and

1 Strengthen the means of implementation and revitalize the Global Partnership for Sustainable Development.

increase returns on investment. Credit-based schemes should therefore be closely linked with training and/or mentoring. Some good practices can be learned from initiatives such as the microfinance consumer education programme in Uganda and financial education for young women in Zambia, which have had a positive impact on savings behaviour and financial awareness.

Collaterals and risk management. Financing of rural transformation will require better management of collaterals and risks. While land can be used as collateral, this results in a risk of dispossession, seriously impairing the borrower's ability to emerge from poverty. Warehouses issuing negotiable receipts for crops, which can be used as collateral for short-term finance, could provide a more satisfactory alternative. As rural development takes place, LDC farmers will be able to make greater use of risk management instruments, such as forward contracts, futures, options and agricultural insurance.

Achieving development goals

In their pursuit of the Sustainable Development Goals, it will be crucial for LDCs to tackle the financing constraints faced by rural producers and rural infrastructure developers. The policy alternatives proposed above should be implemented by LDCs and their development partners, thereby allowing these countries to embark on poverty-oriented structural transformation and achieve the Sustainable Development Goals. This will be especially challenging, given the circumstances in which they will implement the 2030 Agenda for Sustainable Development. In particular, LDCs will be among those most vulnerable to climate change and will be the least able to recover from climate stresses, which will further raise the challenges of achieving rural structural transformation. At the same time, the international context in which the LDC economies evolve will be more conducive to their development if these countries' concerns are adequately addressed by the international trading system.

Contact

Taffere Tesfachew
Director
Division for Africa,
Least Developed Countries
and Special Programmes
Tel. 41 22 917 5606
taffere.tesfachew@unctad.org

Press Office
Tel. 41 22 917 58 28
unctadpress@unctad.org
unctad.org

UNITED NATIONS
UNCTAD

Note: Further details and analyses on the issues discussed in this policy brief can be found in UNCTAD, 2015, *The Least Developed Countries Report 2015: Transforming Rural Economies,* available at unctad.org.

UNCTAD/PRESS/PB/2016/2 (No. 46)