Unit One: What is Rural Finance, and How Does it Fit into ´Development´?

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**UNIT INFORMATION**

**Unit Overview**
This unit introduces the subject of rural finance. We begin with a general introduction to the role of finance and financial services in the economy, and then look at how financial services matter in the lives of individuals. We then shift our focus to the financial lives of the poor, exploring how they manage their finances. This will inform the definition of ‘rural finance’ that we use in the module. One way to understand rural economies in a practical way is through a framework of rural livelihoods. We look at this as a way of thinking about where rural finance fits into a sustainable livelihood and, in turn, into the general topic of ‘development’.

**Unit Aims**
- To introduce the importance of finance in economic development, both at the macro-level and at the level of individual livelihoods.
- To consider the challenges of providing finance, given market failures, and specifically information asymmetries.
- To introduce the relevance of finances to the poor, and to introduce the ways in which poor people manage their finances, in the absence of access to formal services.
- To ensure that we are clear as to what we mean by ‘rural finance’, what can and cannot usefully be included within the term.
- To use the sustainable livelihoods approach to look holistically at rural livelihoods and to identify the various components that are needed to enable rural people to improve their livelihoods.

**Unit Learning Outcomes**
By the end of this unit, students should be able to:
- explain the connection between finance and economic development, both at a macro-level and using specific examples at the individual level, and to describe and recognise the effect of information asymmetries
- outline why finance matters to the poor, and to explain how they manage their finances, using the concepts of saving up and saving down
- outline how financial services are essential for rural economic development, and list some of the inherent problems of rural financial markets
- define ‘rural finance’ in a way that helps them to determine whether or not particular financial services and their potential users can usefully be covered by the term
- describe and comment critically on the five capitals of sustainable livelihoods and to identify the missing or deficient capitals in a given household’s livelihood
**Key Readings**


  This book is an effort to bring together insights from microfinance practitioners and academic economists. The author uses econometric models, but it is also accessible to those without a background in econometrics. This first chapter provides an overall introduction to the book, including a section on why intervention in financial markets is needed, the history of microfinance, and an introduction to some of the key debates about the success and future of the microfinance industry.


  The *Poor and Their Money* aims to provide readers with a better understanding of how poor people manage their money, recognising that the design of appropriate financial services for poor people must build on what they do already. Key to the book is the recognition that savings lies at the heart of financial management, and that useful financial services for the poor must focus on savings mechanisms. The first chapter explains that poor people can and do save in a variety of ways, and uses the concepts of ‘saving up’, ‘saving down’ and ‘saving through’ to explain that most financial services are essentially about saving money.
**FURTHER READINGS**


Chapter 2 of this course textbook focuses in detail on why financial markets do not work as well as they could (i.e., market failure), due to information asymmetries, and how intervention can resolve the problems. There is some algebra in this chapter, but you should be able to grasp many of the arguments even if you are not confident about the maths.


If you are unfamiliar with the sustainable livelihoods approach or want to refresh your knowledge of it, this is a seminal paper written in the early days of the development of the approach. The paper points out some of the deficiencies of earlier ways of looking at poverty which tended to be based on surveys and statistics, and focused narrowly on income and consumption. The sustainable livelihoods approach outlined in the paper offers a different way of thinking about and addressing poverty, based on the complex and multi-faceted lives of the poor.


Chapter 1 is available from: [http://www.portfoliosofthepoor.com](http://www.portfoliosofthepoor.com)

Based on research through detailed ‘financial diaries’ of poor people, including over 250 families from Bangladesh, India and South Africa, this book reports on the most minute financial transactions of the poor, showing that poor people ‘have surprisingly sophisticated financial lives, saving and borrowing with an eye to the future and creating complex ‘financial portfolios’ of formal and informal tools’.


The second chapter of this course textbook provides examples of the savings practices of the poor people, further illustrating the concepts of ‘saving up’, ‘saving down’ and ‘saving through’.
REFERENCES


Microfinance Gateway (2013) Rural and Agricultural Finance Glossary. CGAP
Available from: http://www.microfinancegateway.org/p/site/m/template.rc/1.11.48254/1.26.9209
[Accessed 4 November 2013]

[Accessed 2 October 2013]


**MULTIMEDIA**

IFAD (undated) *The Sustainable Livelihoods Framework.*


Also available in your e-study guide.

A PowerPoint presentation that summarises the concepts of the sustainable livelihoods approach.
1.0 FINANCE AND DEVELOPMENT

Section Overview
In this section we will begin by examining the role of finance in the development process generally. We will then bring the analysis down to the micro-level, using the idea of livelihoods, to consider how financial management matters to individuals and households. We will then consider the challenges of providing financial services, given market failures specifically information asymmetries.

Section Learning Outcomes
By the end of this section, students should be able to:

- explain the relationship between finance and economic development, both at a macro-level and at the individual level using the idea of livelihoods
- explain what market failures are, what information asymmetries are, and why they make it difficult to provide financial services

1.1 Finance and economic development

‘... poverty is not the result of rapacious financiers exploiting the poor. It has much more to do with the lack of financial institutions, with the absence of banks, not their presence. Only when borrowers have access to efficient credit networks can they escape from the clutches of loan sharks, and only when savers can deposit their money in reliable banks can it be channelled from the idle to the industrious or from the rich to the poor.’


Do you agree with the statement above?

In many contexts, terms such as ‘finance’, ‘banks’ and ‘financial institutions’ currently have something of a bad name.

- In many wealthy countries, dubious practices by inadequately regulated banks are blamed for current economic stagnation and austerity. A relatively small number of investment bankers and traders made large personal fortunes during a prolonged investment ‘boom’, but also progressively built up huge portfolios of bad debts. When the full extent of these debts became apparent, governments felt obliged to spend large sums of money bailing out the banks, with the result that other spending had to be cut. Meanwhile, the banks are still trying to restore their balance sheets, with the result that they are currently not lending much, thereby restricting economic recovery. This is compounding the budget deficits of governments as tax revenues fall and
welfare payments rise. Ordinary citizens feel that they are paying for the excesses of ‘rich bankers’.

- In some low and middle income countries, banks are seen as the preserve of the rich and powerful. Geographically and culturally, they are organised to serve the rich. State banks, in particular, may also be associated with corruption: the powerful use their connections to take money from these banks and some appear to have no intention of repaying what they have taken. More generally, in countries where governance is poor and political accountability is limited, banks may be seen to fund projects that benefit rich investors at the expense of poor citizens (for example, through dispossessing them of their land or creating environmental problems that affect poor communities).

- Specifically in rural areas of Asia, the notion of ‘finance’ may be closely associated with moneylenders who charge the poor high interest rates on loans taken in desperation, or with ‘tied loans’ from traders or landlords who then give poor prices to those in debt to them. Failure to repay a loan can mean loss of one’s land or other assets and hence worse poverty in future.

In the light of such observations, how can expansion of the financial system (more financial institutions!) be good for the poor?

Unregulated financial practices can undoubtedly be damaging to the poor and to others. However, that does not mean that all financial services are bad for them. In the second bullet above, inequality is reproduced not just by corruption, but also because the poor do not have access to valuable services that the rich and powerful enjoy. In the case of moneylenders and tied loans, the poor borrow because they need finance, but they are forced to do so on disadvantageous terms in part because there is limited competition in financial service provision. More financial institutions in competition with each other should mean better terms for the poor.

**Financial intermediation**

Finance is not just important at individual and household level; it plays a central role in the process of economic development. A well-developed financial market will ideally enable **financial intermediation** to take place. Financial intermediation, put simply, is the process through which resources are channelled 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.

Ideally, financial intermediation enables the most efficient allocation of resources in an economy so that those who want to invest are able to, and those who have capital but don’t want to invest personally can put their capital to good use via another person. Or, put another way, it means that one person’s savings can be invested productively by someone else without the need for a direct relationship between those two people.

Financial intermediation does not simply entail the allocation of one person’s savings to another person’s loan. Insurance mechanisms are also a form of financial intermediation, whereby people are able to share the risks that they face with large groups of other people, so that they can invest their savings in productive uses rather than keep cash aside to use in case of emergency.

For effective financial intermediation to take place, we need **financial**
intermediaries; 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. In a well-functioning system, these financial intermediaries do not simply act as neutral channels, shifting money from saver to borrower. They can actually improve economic development by making sure that those who borrow are making the most productive investments. That is, they don't just lend to anyone who comes along, they have expertise in assessing loan applications and ensuring the loans are for good investments.

Financial intermediaries that deal with a large number of clients over a large area also enable investment in riskier, but potentially more productive investments. This is possible because they are able to spread the risk through diversifying their portfolio; that is, in the case of lenders, lending to a large number of different types of borrowers. As long as the vast majority of these borrowers repay their loans on schedule, and as long as the banks are earning enough from the spread of interest rates between what they pay to savers and what they get from borrowers, banks can afford to make some riskier loans. Those investments can play a crucial role in taking an economy forward, and opening up new opportunities for more people in the future.

Note that many people also manage their money in ways that do not involve financial intermediation, or that only involve intermediation on a very small scale. For example, they may save their money in various ways at home, or their saving and borrowing activities might take place among just a few other people. These forms of financial management are, in fact, the norm among poor people, who are typically not served by large-scale financial intermediaries. Indeed, they are crucial for poor peoples’ survival. However, they also have their limitations, both for poor people themselves and for wider processes of economic development.

We know that financial development is a crucial component of successful economic development. While there is no clear evidence that increased financial activity leads to economic development, the two are clearly correlated; they serve to promote each other, with variations from country to country (King and Levine 1993, Arestis and Demetriades 1997). The question for us here is: what is the best way to develop financial systems that not only promote economic growth, but specifically promote more equitable growth? This does not mean that everyone has to make use of financial services in exactly the same way, but it does mean:

• that those who can make use of financial services must have access to services that are suited to their needs and

• that the overall distribution of economic growth that results from the more efficient allocation of resources is relatively equitable

1.2 Finance and individual livelihoods

In the past, people trying to understand the problem of poverty used to think mainly in terms of income and consumption. Poverty was measured by a lack of income or food, which could be resolved by raising their income through getting better jobs, or through increasing the amount of food available. While this idea of poverty is not exactly wrong, it does not capture the much more complex reality of the lives of poor people. Efforts to help people out of poverty have to take this complexity into
account, otherwise they risk failing to address their underlying problems.

The idea of a livelihood, which comes from an old English word meaning ‘a means of keeping alive’ captures the complex reality of poor peoples’ lives more than just a job, or an income. For example, in reality, many people, and most poor people, do not make a living through a single source of income – or ‘livelihood strategy’. They may produce some of their own food or other things that they consume, and they almost always rely on multiple sources of income at any one time. The reasons why the poor are poor, and why they stay poor, are much more complicated than a lack of jobs. We need to understand the constraints they face in getting and keep jobs or other sources of income. We also need to understand issues of vulnerability; poverty is not just about lack of income, it is about unpredictability of income and lack of assets (both material and social) to fall back on.

The idea of sustainable livelihoods was developed in the early 1990s in an effort to capture all of this complexity, and is now widely used in understanding and formulating responses to poverty in developing countries. We talk about sustainable livelihoods to capture the importance of a livelihood being one that can sustain itself in the long term, even in the face of shocks, and that does not compromise the access of others in the world, or of future generations to the resources they will need to survive.

This comprehensive definition of a sustainable livelihood was developed in a seminal paper on the subject:

'A livelihood comprises the capabilities, assets (stores, resources, claims and access) and activities required for a means of living: a livelihood is sustainable which can cope with and recover from stress and shocks, maintain or enhance its capabilities and assets, and provide sustainable livelihoods opportunities for the next generation; and which contributes net benefits to other livelihoods at the local and global levels and in the short and long term’


Livelihood vulnerability and financial services

Many better-off ‘modern’ people have only one means of living. This is their job, or a business that they own and manage. It is fairly unusual for one person to have more than one significant livelihood.

Think about yourself, for instance; do you earn significant amounts of money, or other benefits, from more than one source? Do you intend in the future to do so, to diversify your sources of income, or do you envisage that you will progress from one job to another, within the same institution or in different ones, and that increases in your total income will come from higher earnings from your principal activity, or livelihood?

Now think about the household to which you belong. Do all its members depend on one earner, perhaps you, for their livelihoods, or do different members of the household have different livelihoods, whose earnings or other benefits are (partially or fully) pooled for their common good?
Using the table below, make a note of your household’s approximate total annual income, insofar as you know it. Include income in cash or in kind (such as the value of free or low-cost housing, or health benefits, or other non-cash remuneration). How many different sources are there which account for 10% or more of the total? If there is more than one income in the household, make a separate column for each of them.

<table>
<thead>
<tr>
<th>Income source</th>
<th>Approximate annual income</th>
<th>Vulnerability H/M/L</th>
<th>Probability per cent of reduction/loss</th>
<th>Net value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary from employment</td>
<td>$12000</td>
<td>Low</td>
<td>10%</td>
<td>$10800</td>
</tr>
<tr>
<td>Salary from employment</td>
<td>$4000</td>
<td>Medium</td>
<td>20%</td>
<td>$3200</td>
</tr>
<tr>
<td>Rent received for land in village</td>
<td>$1000</td>
<td>Medium</td>
<td>40%</td>
<td>$600</td>
</tr>
<tr>
<td>Total</td>
<td>$17000</td>
<td></td>
<td></td>
<td>$14600</td>
</tr>
</tbody>
</table>

Look again at the figures and rank them high (H), medium (M) or low (L) in the ‘vulnerability’ column according to their vulnerability. By this we mean how secure are the various incomes? How likely is each income stream to disappear or to be substantially reduced?

Make a very rough estimate in per cent of the likelihood of each income source being eliminated (50% meaning there is a 50:50 chance of it being lost in a given year, 10% meaning that there is a one in ten chance, and so on), and multiply this by the income to get the corrected income in the last column. (A completed example is shown below but be sure to use or estimate your own figures).

Now consider what sources of ‘fallback’ funds you or the main breadwinner have. This means where you could raise cash if you need it unexpectedly; say if someone in your family got sick, a storm damaged the roof of your house, or your car was damaged in an accident. Fallback funds might also be needed for happier reasons; your daughter might announce that she has met her ideal partner and wants you to pay for her impending wedding. So think about ways in which you can pay for such things. Do you have insurance? Items you could sell to raise money? Pension funds? Support from other family members?
Use the table below to enter the main sources of fallback funds. Make approximate estimates of their 'true' value and an estimate of their 'rapid realisable value'. By this we mean what the value of those funds would be if they had to be used at short notice. That is, how much could be raised from this source if the money was needed immediately, in say one week or less, which is the 'realisable value'. It is often less than the value of those funds if they could be used at the best time, rather than in an emergency.

<table>
<thead>
<tr>
<th>'Back-up' source</th>
<th>'True' value</th>
<th>Rapid realisable value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pension fund</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Savings deposit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sell village land</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Borrow from relative</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

For example, the value of a fixed deposit or insurance policy or pension fund will be greatest if the fund is allowed to mature fully. If you take out the money early, you will not get as good a return on it. Banks and others managing such funds usually charge penalties for early withdrawal, as they prefer that the funds are left in for the full term so that they can make long-term investments. If you make a claim to an insurance company, you may find that your premiums will rise in the future, or will not decline as much as they would have if you had not made a claim. Some insurance companies reduce the deductible you have to pay on a claim for each year you make no claim. Even if you take a loan from a relative, she will be able to give the largest loan when she has just been paid, or has just received a windfall from somewhere. Add up the total fallback available. (A completed example is shown below but be sure to use or estimate your own figures).

<table>
<thead>
<tr>
<th>'Back-up' source</th>
<th>'True' value</th>
<th>Rapid realisable value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td>$500</td>
<td>$400</td>
</tr>
<tr>
<td>Pension fund</td>
<td>$40000</td>
<td>$20000</td>
</tr>
<tr>
<td>Savings deposit</td>
<td>$5000</td>
<td>$4600</td>
</tr>
<tr>
<td>Sell village land</td>
<td>$10000</td>
<td>$5000</td>
</tr>
<tr>
<td>Borrow from relative</td>
<td>$20000</td>
<td>$15000</td>
</tr>
<tr>
<td>Total</td>
<td>$75500</td>
<td>$45000</td>
</tr>
</tbody>
</table>

What have you learned from this exercise about the ways in which financial services can help us manage our livelihoods?
Answer

We all need access to financial services at different times in our lives. Even those of us who have relatively secure sources of income cannot be entirely sure that they will last into the future, and unexpected expenses, or ‘shocks’, can happen to anyone. Financial services are absolutely key to enabling us to manage uncertainties and shocks, even if we sometimes have to compromise on the value of the funds we have available.

It is important to note that people in most rich countries have some form of state provided insurance to fall back on in times of trouble, such as unemployment benefit, or free or reduced cost health care for those with lower incomes. By contrast, although poor people typically have greater problems than richer people in managing their finances, and face serious challenges in ensuring that they can cope with shocks, state-provided safety nets only exist in a few poor countries.

1.3 Market failures; information asymmetries and transaction costs

In an ideal world, banks and other providers of financial services would emerge wherever the need arose to provide those services, and those financial services would be so efficient that everyone who needed services would get them when they needed them. People who wanted to save their money would be able to open a savings account, people who wanted to take a loan would be able to take credit, and people who wanted to insure themselves would find an insurance product that would address their particular risk.

Free market theorists believe that in a perfectly functioning free market, where a service is in demand, the supply will arise to meet it. According to this theory, the balance between savings and loans will be maintained through the use of interest rates. The theory goes as follows:

- When there are more opportunities for productive investments in an economy, there will be a higher demand for credit, as people look for money to start businesses.
- In order to raise funds to lend to potential borrowers, banks will raise interest rates to encourage more people to save (they will save more because they will get more profit on the money they save).
- As the banks will be paying more to savers, they will need to charge higher interest rates on the loans that they give, to cover the costs of the interest paid to savers, their administrative costs, and their profits. Borrowers will be willing to pay these higher rates for loans because they can use the money productively to earn enough profit to cover their costs, make a profit for themselves and pay back the loan with interest.
- In case demand for goods and services in the economy goes down, and there are less opportunities for investment, so banks will lower interest rates, which means that people will still be able to borrow money and start businesses, even though their expected profits are not as high.
Market failures

In practice, letting banks set their own policies, including setting interest rates, does not always produce desirable results. If the market is left to itself, many people do not get access to the financial services that they could benefit from; most often it is the poor, particularly the rural poor, who have the least access of all. One of the reasons for this is that the connection between interest rates and savings is not as clear as it might seem. Increased interest rates do not always lead to higher savings rates. Savings are not determined simply by the profit that can be earned; they also depend on how much income someone has. Higher interest rates may, in some cases, lead to lower savings rates as people can reach their target savings goal more quickly. Also, with the development of other types of financial intermediaries, particularly insurance companies, people may choose to save less if they know they are protected against future risks (Pagano 1993). We cannot assume, therefore, that financial markets can 'self-regulate' to maximum efficiency through adjusting interest rates.

There is another even more important reason why financial markets, left to themselves, will not necessarily result in the most efficient allocation of resources. This is because of what are known as market failures. Market failures refer to situations when the market alone does not produce the most efficient outcome.

Market failures arise for a number of reasons. These include, among others:

- when there is not perfect competition (which of course is much of the time)
- when human beings do not behave as purely rational agents seeking to maximise their interests (which also, of course, happens much of the time)
- when there are externalities. This means when there is a cost to something that nobody pays for, such as keeping the air free of pollution or the roads well maintained
- when there are high levels of risk
- when there are high transaction costs
- when there are what are known as information asymmetries

The most significant reason for financial services not being provided to everyone who could make use of them are the interrelated problems of information asymmetries and high transaction costs.

Information asymmetries refer to the fact that, in the real world, information does not flow smoothly. Some people have access to information that others do not. In the case of financial services, this means that those providing the financial service do not always know as much as they would like to know about the person to whom they are providing the service. When lending money it is important to know something about the person borrowing, to make sure that they spend the money in such a way that they will be able to repay the loan, and to keep track of them and make sure they don't run away without repaying. Because of this, they do not provide financial services to everyone that needs them. That is, even though they might have enough funds at their disposal, they choose not to disburse them to potential borrowers whom they don't know enough about, especially when it is too expensive to get the information they need. Thus we have credit rationing, even without any government intervention (Stiglitz and Weiss 1981).
The two most important results of asymmetric information relevant to financial services are known as **moral hazard** and **adverse selection**.

**Moral hazard** can arise when someone’s behaviour changes based on their access to financial services. For example, a business person may make a riskier investment after taking a loan with a high interest rate (to try to get a higher rate of profit and so repay the loan more easily). So, in this case, high interest rates can cause risky behaviour. Another example is when a person who has taken out insurance against their car being damaged will drive less carefully because they know they will not have to pay for it in case of an accident. Those providing the financial services have to work out ways to prevent the users of the service acting in this way. They may require other information about the clients that can reassure them that they will not do risky things, they may require certain forms of assurance (for example, collateral for loan takers, or a deductible for someone taking insurance) or they may simply decide not to lend to certain clients about whom they are not confident.

**Adverse selection** refers to the fact that it is often people whose activities are particularly risky who take high interest loans, or buy insurance. As it is not possible for lenders or providers of insurance to be sure how risky their customers’ behaviour is, they have to use various mechanisms to screen potential borrowers. These methods are inevitably imprecise, which means that some potentially sound customers are rejected.

List one example each of moral hazard and adverse selection that you are familiar with. How might banks or insurance providers try to reduce the likelihood of these particular things happening?

**Answer**

**Moral hazard**: a homeowner does not bother to install smoke detectors because they have insurance in case their house burns down. The insurance provider can offer cheaper premiums to people who can prove they have smoke detectors installed.

**Adverse selection**: a person who knows that early fatal heart attacks run in their family buys a life insurance policy to ensure that their family will be financially secure in case of their death. An insurance provider can require medical records and make those with illnesses running in the family pay higher premiums.

In practice, it is often poorer and less-well-connected people who are not given the financial services, as lenders or insurance providers will prefer to lend to or insure those who have more money to start with, and those who can provide collateral. They also prefer to lend to those about whom they can easily collect information. Often this means they lend to people who are ‘like them’ and so they feel they know better, or those with whom they actually have personal connections. They ‘trust’ such people more and, in financial service provision, when there are no formal systems in place to verify someone’s honesty, then trust becomes central to any transaction.

Another reason why poor people, particularly the rural poor, might not be provided with financial services is because they demand services on such a small scale, be those savings deposits or loans. It is more difficult for those providing the services to make a profit on such small transactions, because each transaction has an
administrative cost. The rural poor often live in areas with poor transport and communications infrastructure, where it is particularly expensive for both service providers and the poor themselves to reach each other, and is also particularly difficult and expensive for financial service providers to get the information they need about potential clients to provide them with services. These are what are known as **high transaction costs**.

Given information asymmetries and high transaction costs, the best allocation of resources may only come about through some type of government or other external intervention. Governments are responsible for putting infrastructure in place that will reduce the transaction costs associated with providing services in rural areas. Governments can also take risks that private lenders may not to ensure that everyone who can make good use of financial services gets access to those services, or they can put regulations in place that make sure the services are made available to those who need them.

Any type of government intervention is of course only as good as the government making that intervention; while the private sector has its limitations, the track record of governments in providing the appropriate interventions has not always been very good. The challenge in providing all those who need them with financial services is to work out what type of intervention will help, rather than hinder, in the goal of providing services both efficiently and equitably.

There are also important ways in which private financial service providers can adapt the way they provide services and so reduce the problems of information asymmetries and high transaction costs. Increasingly, innovative financial services providers are learning from, and building on, the traditional systems of financial intermediation that exist in poor communities. This allows them to reduce information asymmetries, so as to provide financial services to people previously not reached by formal providers.
Section 1 Self Assessment Questions

Question 1

True or false?

When we talk about access to financial services we mean access to loans.

Question 2

Fill in the missing word/phrase.

An important reason for market failures is when people who could undertake transactions with each other do not have access to all the _______ they need about each other.
2.0 **FINANCE FOR THE POOR**

**Section Overview**
In this section we will home in on the financial service needs of the poor. We will discuss the characteristics of the livelihoods of the poor, and consider the ways in which they need to manage their money to survive. We will begin to think about the systems that poor people already make use of, and their strengths and weaknesses. Finally, in light of these considerations, we will define ‘rural finance’ as we will examine it in the remainder of the module.

**Section Learning Outcome**
By the end of this section, students should be able to:

- explain the ways in which poor people manage their finances, using the concepts of saving up and saving down, and to outline how these concepts can be used to understand the livelihoods and financial management needs of the rural poor

2.1 **Understanding the livelihoods of the poor**
We will now apply the same exercise that we did in Section 1.2, thinking about our own finances, to a poor household, so that we can be clear about the particular challenges that poor people face.

Think of a typical poor household in a country with which you are familiar; as best you can, try to go through the same exercise for its livelihood strategies. Choose either a rural or an urban household. Our focus in this module is rural poverty, but if you are more familiar with urban poverty then use an urban example for now; you will have many more opportunities in later units to think about rural livelihoods. There are more similarities than differences between rural and urban poverty, and the function of this exercise is to enable you to understand aspects of poverty that affect all poor people, wherever they live.
Make a list of the income sources of your selected household; you can add as many as you like. Then guess what the amounts are likely to be for the household you have chosen, and make a note of the total and of the amounts from each significant source. The total value will undoubtedly be smaller than for your own household, even if the poorer one has more members, but how many different sources are there?

Think also about the vulnerability or security of each source of income; how vulnerable is it to floods, droughts, pests, disease, selling price or input cost changes, and so on? Roughly work out the likelihoods of those sources being lost as you did when you were doing it for your own livelihood. (A completed example is shown below.)

<table>
<thead>
<tr>
<th>Income source</th>
<th>Approximate annual income</th>
<th>Vulnerability</th>
<th>Probability percent of reduction/loss</th>
<th>Net value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Daily wage labour earnings</td>
<td>$4000</td>
<td>High</td>
<td>50%</td>
<td>$2000</td>
</tr>
<tr>
<td>Sale of milk and crops not consumed by household</td>
<td>$500</td>
<td>High</td>
<td>40%</td>
<td>$300</td>
</tr>
<tr>
<td>Remittance from city</td>
<td>$2000</td>
<td>Medium</td>
<td>20%</td>
<td>$1600</td>
</tr>
<tr>
<td>Total</td>
<td>$6500</td>
<td></td>
<td></td>
<td>$3900</td>
</tr>
</tbody>
</table>

Now consider what sources of ‘fallback’ funds such a family might have, such as selling livestock, or mortgaging or leasing out land, or getting or extending the duration of credit from the local shopkeeper or moneylender, or getting an advance from a buyer of crops or from the landowner for a sharecropper, or even ‘selling’ a family member’s labour in advance.
Use the table below to enter the main sources of fallback funds, approximate estimates of their ‘true’ value, and an estimate of their realisable value if they had to be used at short notice. Remember that when you have to sell something quickly, for example, you are often unable to get the best price for it. Add up the total fallback available.

<table>
<thead>
<tr>
<th>‘Back-up’ source</th>
<th>‘True’ value</th>
<th>Rapid realisable value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sell gold</td>
<td>$120</td>
<td>$100</td>
</tr>
<tr>
<td>Sell cow</td>
<td>$500</td>
<td>$300</td>
</tr>
<tr>
<td>Mortgage land</td>
<td>$10000</td>
<td>$5000</td>
</tr>
<tr>
<td>Total</td>
<td>$10620</td>
<td>$5600</td>
</tr>
</tbody>
</table>

(A completed example is shown below).

Compare the figures for your own situation from Section 1 and those you have produced for a typical poor household. What are your main conclusions?

(a) Which household has the highest earnings?
(b) Which household has the most sources of income (i.e. the number of different sources each contributing 10%+ of total household income)?
(c) Which household loses the highest proportion of the value of its assets if they have to be realised at short notice?
(d) Which household’s realised value from its assets is the highest multiple of its annual income?

Answer
(a) almost certainly your own household
(b) probably the poor household
(c) the poor household
(d) your own household’s
What are the implications of these conclusions for any attempts to improve poor households’ livelihoods?

Answer

– Poor households have more diverse sources of incomes or livelihood strategies.

– Poor households NEED more diverse sources of income, because each source is more vulnerable than better-off people’s incomes.

– Having to juggle a range of income sources probably means not being able to specialise in any one of them, so missing out on a chance to achieve higher returns to labour over time.

– Poor people need more protection from reductions in income, but generally have less protection, in that they lose more if they have to sell assets to finance consumption.

We saw when we applied this exercise to our own lives that all people need access to financial services at different times in their lives, and that even those of us with relatively secure sources of income cannot be sure that we will always be able to depend on those income sources. None of us know what the future holds, and unexpected expenses can happen to anyone. Poor households, whose sources of income are less secure than ours, not only lose more if they have to sell assets to finance consumption, but also have less access to financial services when they need them. Lack of access to financial services thus reinforces the importance of diversification as a livelihood strategy for poor households. The lack of social safety nets in poor countries compounds the vulnerability of poor people.

How could access to financial services help the poor rural household that you used in your example to protect themselves better from the risk of reductions in their income? What sort of financial services would help them?

Answer

– savings: to build up savings over time to make use of in case of emergency

– credit: to take a loan when the need for cash arises, rather than having to sell a valuable asset

– insurance: to set up an insurance policy to cover, for example, health expenses in case of illness
2.2 How do the poor manage their money?

All people, regardless of where they live, their wealth or their livelihood, can benefit from a range of financial services to enable them to manage their household finances in the most efficient way. Obviously the types of financial services that will be most useful will vary from situation to situation, but generally speaking poor people can benefit from being able to access funds to invest in productive or income-earning activities, and to help them through times when their income is inadequate to meet their expenses, be those daily expenses or larger one-off expenses.

According to Collins et al (2009), there are three different types of financial management that all people need to take care of:

- **Managing basics**: cash-flow management to transform irregular income flows into a dependable resource to meet daily needs. In economics terminology this is known as ‘consumption smoothing’; ensuring that you are able to buy what you need to consume on a daily basis even if your income is inadequate or irregular.

- **Coping with risk**: dealing with the emergencies that can derail families with little in reserve. These types of emergencies are often described as ‘shocks’ to household economies.

- **Raising lump sums**: seizing opportunities and paying for big-ticket expenses by accumulating usefully large sums of money.

(Collins et al 2009 p. 18)

Although the details differ from place to place – for example, one study found that only 11% of the rural poor in East Timor were in debt, compared with 96% in Pakistan (Bannerjee and Duflo 2007) – generally speaking, the poor make use of a myriad of informal financial services, and even occasionally formal financial services.

At the individual or household level, there are numerous ways in which poor people manage their finances, planning so that they can meet their daily needs, be able to cope with any larger expenses, unexpected or otherwise, and, hopefully, to invest in better livelihood options in the future, for their children if not for themselves (for example, through education). Poor people save money at home, save in kind, or purchase assets such as livestock or jewellery that can be sold in times of need. We often imagine that poor people are simply too poor to save but, in fact, poor people have been found to save larger percentages of their incomes than rich people. They save because they have to; their lives often depend upon it.

There are also numerous informal financial systems in place through which poor people co-operate to help each other manage their finances better; in ways that fit the more standard definition of financial intermediation. Relatives, friends and neighbours frequently help each other out, sharing each other’s financial resources – lending a little today on the understanding that they will be helped out when they need something extra. Sometimes they spread the risk among a group. Informal savings and loans groups of various kinds are commonly found in rural areas, groups that pool their funds and allocate them to different members at different times, depending on how the system works.

We discussed above how efficient financial intermediation is limited by information asymmetries; the fact that the people providing the service and the potential users of those services often do not know enough about each other to risk entering into
financial transactions with each other (lenders might not trust clients to repay their loans, savers might not trust those taking deposits to keep their money safely).

The informal systems described here overcome the problems of information asymmetries and transactions costs extremely effectively, as the transactions are between people who live close to each other, who know each other well, and who know very well the nature of each other’s livelihood activities.

These communal methods of mutual support have been described as a ‘moral economy’, referring to the responsibility people feel for and take for each other, even if it has a negative impact on their own economic status. Helping a neighbour or relative out may, of course, also be seen as a self-interested strategy, if that person will then help you in time of need.

Poor people also make use of individual informal financial service providers. These can range from friends, relatives or neighbours who provide each other with fairly informal loans, with or without interest, depending on the nature of the relationship. There are also people who specialise in providing loans, be they specialised moneylenders, or shopkeepers, traders or landlords. These people are usually able to provide larger loans than those available from friends or relatives, or through group-based systems. There are also individuals who provide savings services, collecting regular deposits from clients and keeping them safe until the client wants to access them. There is often a small charge for this service.

We usually think of the various financial services that can be made available as discrete products and used for specific purposes, for example, taking a loan to invest in a business, saving up money for a child’s wedding, or buying health insurance in case a family member falls ill. In practice, however, poor people do not separate the way that they use financial services into neat categories. They may have forms of insurance, but at the same time rely on loans or savings to help in times of need, and they may borrow and save at the same time in order to come up with the money they need when they want it. Again, these practices are not unique to poor people; most of us combine our use of financial services to meet our needs; saving for one purpose (education perhaps) while taking a loan for another (buying a house), or combining insurance payouts and savings to make up for losses (buying a new car).

? Reflecting on your own knowledge and experience, what are some of the financial management methods and informal services that the poor use?

Answer

You might have included the following in your list, and you may have thought of others that are not included here. The point to take away from this is that the poor already have use of a myriad of financial management methods and informal services even if they do not have access to formal service providers:

– saving money in the home
– purchasing assets such as livestock or jewellery
– saving and borrowing through informal mutual financial mechanisms such as savings clubs
– saving with individual savings collectors who come around and take deposits
- taking loans from family, from friends or neighbours, from local shopkeepers or moneylenders or other people with whom they have some sort of relationship
- giving loans to friends or relatives; helping someone out but also a form of savings in itself, provided the money is returned at some point. Giving loans to friends or relatives is a form of insurance; it may mean that they can fall back on those people for help should the need arise
- investing accumulated savings with the local shopkeeper

Saving up and saving down

We tend to think of different forms of financial management as quite different from each other (savings versus loans for example), but it is possible to think of most forms of financial management in terms of savings. One of the benefits of doing this is that it emphasises the common, overarching goal of protecting basic consumption needs whilst responding to requirements for irregular sums of money, whether planned (investments) or unplanned (shocks).

- Loans – a lump sum to be enjoyed now in exchange for a series of savings to be made in the future in the form of repayment instalments. We can think of this as ‘saving down’.
- Savings – creating a lump sum to be enjoyed at some point in the future, when the need arises, by making a series of savings deposits now. We can think of this as ‘saving up’.
- Insurance – creating the possibility for a lump sum to be received at some unspecified time(s) in the future, if needed as a result of a particular shock. This is done by making a series of savings deposits regularly, both now and in the future. We can think of this as ‘saving through’, as the deposits continue both before and after any claims.
- Pensions – creating a lump sum to be enjoyed in the distant future by making a series of savings deposits now.
- Remittance transfer – enabling migrants to save money and send that money home, to be saved there either in the form of cash or assets or to meet ongoing or emergency household expenses.

Limits to informal financial management systems

Although the informal financial services that poor people use are an essential component of their livelihoods, they do have serious limits. They are limited in the amount of funds they have available and they are usually only helpful for relatively small, short-term financial needs. The resources available from family and friends are often not enough to cope with the many serious financial crises that poor people find themselves in. However, the larger sums of money that may be available from moneylenders are usually very expensive.

While poor people are able to save much more than is commonly thought, the fact that they are poor means that they only have access to limited resources. It also means that there is only so much they can do to help each other out, even when they are affected by shocks at different times. Mutual support systems thus tend to
benefit the better off proportionately more; poorer people are likely to have less reliable support networks and thus tend to be hit harder when problems strike.

Access to financial services that enable the poor to manage their finances without having to rely on insecure or expensive forms of saving, asset sales, and unreliable loans can enable poor people to maintain a more stable and secure flow of income, and build up assets in the future.

2.3 Livelihoods and finance in rural areas

Think about a ‘typical’ rural poor person. What sort of person are you thinking of? When you think of how the rural poor make a living, what first comes to your mind?

Answer

The first thought that might have come to your mind was of a farmer, someone who lives off the land. Or, depending on where you live or where you have worked, you might have thought of a poor landless person, working as a wage labourer on someone else’s land. Or you might have thought of a pastoralist, someone who raises livestock for a living. None of these are wrong, but at the same time none of them are exactly right. It is true that the livelihoods of the rural poor vary widely depending on where they live, but one thing that is common to most of the rural poor is that they, and their families, do not engage in a single activity, but rather a whole range of different activities to make a living.

Farming lies at the core of the economy of most rural areas in developing countries, but many, many people, particularly the poorest, are not farmers because they are landless. Even where the rural poor own land, they often own so little land, or such unproductive land, that they cannot produce enough food to sustain themselves through the year, and so supplement their farming with other activities. When we talk about rural economies, we are not talking simply about farming.

Farming is important because many of the poor work on other people’s farms, have some land of their own, work in activities related to farming, or find ways to earn money in the off-farm sector which is affected by the productivity of and wealth created by farming. But many, if not most, of the rural poor will not benefit directly from interventions that aim to increase incomes from farming. It is important to keep this in mind when we consider what types of financial services will help the rural poor. Also, many rural households survive through income from migration to urban areas, which is important to keep in mind when designing financial services.

Regardless of their livelihoods, rural populations need financial services just like any other people anywhere else.

Consider the three different types of financial management: managing basics, coping with risk and raising lump sums. Suggest examples of each of these requirements for the ‘typical’ rural poor person whom you thought of just now.
Answer.

- **Managing basics**: cash-flow management to transform irregular income flows into a dependable resource to meet daily needs. The incomes of many rural people are highly irregular, due to the seasonality of agricultural production and hence also the demand for other goods and services that is derived from agricultural incomes. Cash flow management tools are required so that incomes received predominantly in the month or two after harvest can be converted into basic consumption flows throughout the year.

- **Coping with risk**: dealing with the emergencies that can derail families with little in reserve. Rural households are subject to numerous ‘shocks’, from weather, illness and disease (human or livestock), theft, conflict and even market fluctuations.

- **Raising lump sums**: seizing opportunities and paying for big-ticket expenses by accumulating usefully large sums of money. Whilst free education is returning in many countries, school fees (uniforms, books, other contributions) remain a big expense for many poor households. Weddings (including dowries) and funerals are also major expenses. New couples aspire to have and furnish their own house; existing households to upgrade theirs. Then, of course, rural households aim to invest in their productive capacities. A bag of fertiliser can account for a significant share of annual household income for a poor household. Others aspire to acquire livestock, ploughing equipment or a means of transport. Smoothing consumption to ‘manage the basics’ is vital, but, without investment, many poor households do not generate enough income each year to provide even the very basics. Hence, they go hungry for several months or get trapped in a cycle of debt.

As you will have realised, there are some important characteristics of rural economies that present particular financial management challenges to poor people living in rural areas. The biggest of these is the fact that farming is a seasonal and highly risky economic activity. Even where the rural poor are not farmers, all rural populations are affected by what is going on in the farming economy.

### 2.4 Defining ‘rural finance’

Given the importance of investment finance (loans) to strategies for raise the productivity and profitability of smallholder agriculture, some people in governments and development agencies might in practice (if not in theory) define rural finance as:

‘Credit to poor rural people for farming’.

? Do you think this definition is a good one or a bad one? Make a note of what you like about it and what you don’t like about it. Is it too broad, or too narrow? Why?

**Answer**

We shall argue that:

- Finance means financial services of all sorts; savings, insurance, transfers as well as loans. Because we are interested in how to provide services to people, we will focus on activities that take place between two or more people.

- Rural means affecting rural people, whether or not the financial transaction takes place in a rural area or is carried out by a rural institution.
The livelihood to which the finance relates need not be farming, or livestock. It can be for any activity which affects rural people, such as a shop or a factory or an internet café, and it can take place in a non-rural place, or in another country; what matters is that it affects rural people.

The institution which provides a financial service need not be a registered financial institution; it can be an input supplier, or a processing or marketing business, and it can be informal, a money lender or money guard, a local shop or a friend or relative.

Our main concern is with poor people, because they need to improve their welfare, but the people who are directly involved in a financial transaction need not be poor; what matters is that the transaction affects poorer people.

It follows from this that ‘credit to poor rural people for farming’ is not a useful definition of rural finance.

CGAP (The Consultative Group to Assist the Poor) offers the following more useful and broader definition

‘The provision of financial services for rural farming and non-farming populations at all income levels.’

Source: Microfinance Gateway (2013)

This specifically includes non-farm activities, and both rich and poor people, and, because it uses the broad term ‘financial services’ rather than ‘credit’ and does not mention any particular types of institutions, we can probably accept it.

In this module, when we talk about ‘finance’ or ‘financial services’ we will usually be referring to transactions between two or more people. As discussed above, the ways people manage their finances by themselves are crucial and must be understood. When we talk about financial services, however, we are talking about services that can be offered to enable people to manage their finances better through transacting with someone else.

Finally, in this module, we shall be ‘institution neutral’; what matters is the suitability of the service for its intended task, and we recognise that village money lenders and money guards, family members, local fertiliser dealers, and other less familiar and more informal sources of financial services may be the optimum suppliers of certain financial services in some circumstances.
Section 2 Self Assessment Questions

Question 3

True or false?

A poor person can count up the current value of any assets they have that they would be able to sell in case of emergency, but this will not tell them exactly how much they can expect to raise should the need arise.

Question 4

True or false?

Poor people are likely to need financial services even more than relatively well-off people because:

(a) they are poor so need more money
(b) their income sources are less reliable so they need to manage the money they have to cover times when they have no income
(c) they are uneducated and don’t know how to manage their money properly

Question 5

Which of the following can usefully be considered examples of rural finance? Put Y if it can, N if it cannot.

(a) a loan to a small farmer to finance his maize crop
(b) a village market stallholder’s savings account
(c) a loan from the World Bank to refinance an insolvent rural bank
(d) a sale of pesticide on credit by a village shopkeeper to a farmer
(e) a car loan to a rich farmer
(f) a village school-teacher’s pension fund
(g) a village policeman’s health insurance policy
(h) a city worker sends money home to his village with a local bus-driver
(i) a village co-operative’s wage payments to its staff
Question 6

True or false?

Indicate which of the following statements is true (T), or false (F).

(a) Rural financial services should only be provided by formally registered financial institutions.

(b) The main function of rural financial institutions is to provide farm credit.

(c) Rural finance is only about financial services for poor rural people.

(d) Rural people’s livelihoods often include non-farm businesses; they need and should get financial services for these as well as for farming.

(e) Poor rural people are too poor to save; they do not need savings accounts.
3.0 SUSTAINABLE LIVELIHOODS – THE LIMITS TO FINANCIAL CAPITAL

Section Overview
This module is about rural finance, but it is important to be clear from the outset that financial services alone are not enough to enable poor rural people to make a sufficient and sustainable improvement to their livelihoods. Other things are required, some of which are much more important than financial services and more difficult to provide. In this section, we shall use the sustainable livelihoods framework to identify and classify the things that poor households need, and consider how to assist them to get it. Rural finance must be understood in the context of the wider range of problems that poor rural populations face.

Section Learning Outcome
By the end of this section, students should be able to:

- use the sustainable livelihoods framework to identify the missing or deficient capitals in a given household’s livelihood

3.1 The sustainable livelihoods framework
The sustainable livelihoods framework in 3.1.1 is an effort to conceptualise livelihoods in a holistic way, capturing the many complexities of livelihoods, and the constraints and opportunities that they are subjected to.

3.1.1 Sustainable livelihoods framework

These constraints and opportunities are shaped by numerous factors, ranging from global or national level trends and structures over which individuals have no control,
and may not even be aware of, to more local norms and institutions and, finally, the assets to which the households or individual has direct access. For now, we will use the household as a unit of analysis, but as we will discuss in later units, it is important to recognise that not all individuals within a household have equal decision-making power, or benefit equally from household assets or income.

The vulnerability context in 3.1.1 refers to the external environment in which people live. This includes trends (such as national or international economic trends, changes in available technology, political systems), shocks (such as illness or death, conflict, weather), and seasonality (of prices, production cycles and so on). The vulnerability context is important because the three factors have a direct impact on the possibilities that poor people have to earn a living now and in the future. Wider economic conditions can create more or fewer opportunities; an illness in the family can deprive a family of an important source of income and can force them to sell important assets that they have built up. Seasonal shifts in prices, production and employment opportunities are one of the most enduring sources of hardship for poor people all over the world.

The ‘transforming structures and processes’ box refers to the institutions and policies that affect poor peoples’ lives, from public and private entities to national policies and local culture. All of these can change both the vulnerability context and the assets to which poor people have access.

The idea of assets is central to the sustainable livelihoods approach. Rather than understanding poverty as simply a lack of income, the sustainable livelihoods approach considers the assets that poor people need in order to sustain an adequate income to live.

Based on those assets, and shaped by the vulnerability context and the transforming structures and processes, poor people are able to undertake a range of livelihood strategies – activities and choices – that ultimately determine their livelihood outcomes. As we discussed earlier, poor people are usually obliged to combine a range of strategies in order simply to survive; individuals may engage in multiple activities, and the different members of a household may live and work in different places. The outcomes that they may achieve, all being well, could include more income, increased well-being, reduced vulnerability and greater food security. Sometimes one outcome can negatively affect another; for example, when poor people engage in less risky, and hence lower income activities, in order to be less vulnerable to shocks.

Five types of assets, or capital as they are described in the literature, have been identified that we all, not just poor people, need in order to make a living. These are the following:

- **Human capital:** skills, knowledge, the ability to work and good health. Good health is not simply a means to earning a livelihood; it is of course an end in itself.

- **Social capital:** the social resources that people draw on to make a living, such as relationships with either more powerful people (vertical connections) or with others like themselves (horizontal connections), or membership of groups or organisations. Generally relationships of trust, reciprocity and exchange that the poor can draw on in times of need, and that lower the costs of working productively together. Like human capital, social capital has an intrinsic value;
good social relationships are not simply a means, they are an end in themselves.

- **Natural capital**: the natural resource stocks that people can draw on for their livelihoods, including land, forests, water, air and so on.

- **Physical capital**: the basic infrastructure that people need to make a living, as well as the tools and equipment that they use. For example, transport and communication systems, shelter, water and sanitation systems, and energy.

- **Financial capital**: savings, in whichever form, access to financial services, and regular inflows of money.

The more assets any household has access to, the less vulnerable they will be to negative effects of the trends and shocks as described above, or to seasonality, and the more secure their livelihood will be. Often increasing one type of capital will lead to an increase in other amounts of capital, for example, as people become educated (increase in human capital) they may get a better job which earns more money (increase in financial capital) which in turn means that they are able to upgrade their home and facilities (increase in physical capital). Sometimes, however, one form of capital decreases as another increases. This could be true, for example, where a person or household sells their land to migrate to a city.

The sustainable livelihoods approach is no more than an attempt to provide a tool which is ‘useful to think with’. You might, therefore, find it helpful to ‘test’ the livelihoods framework by trying to assess your own personal situation. The very fact that you are studying this programme suggests that you are more fortunate than most people in your country, or in the world as a whole, or at least that you are not poor. What do you ‘have’, that has enabled you to get to your present status, and that will most likely enable you to progress further, by whatever measures you assess progress?

What shocks have you suffered along the way? Are there trends that you have benefited from? Are there structures and processes that have helped or hindered your progress so far?

### Critiques of the sustainable livelihoods framework

In recent years the prominence of the five capitals has been criticised by development practitioners for focusing too much on the micro-level and neglecting the ‘higher’ levels of governance, the policy environment, national and global economic growth and so on. This has led, for example, to a limited understanding of how markets work; how processes far from the lives of poor people nonetheless have an enormous impact on the possibilities that exist for them to earn a secure income. These issues are of course captured in the wider sustainable livelihoods framework, within the transforming structures and processes and the ‘vulnerability context’ but, in practice, many people have used the idea of the five capitals more than they have the linkages between those and the wider environment in which people live. It is very important to keep in mind that the wider environment affects not only the assets to which people have access, but also what can be achieved with those assets.
The sustainable livelihoods framework has also been criticised for failing to take power dynamics into consideration, as it relates to gender, for example. Again, while such dynamics are included in the framework, in practice, they have been neglected. In particular, social capital has often been seen as simply 'a good thing' whereas, in reality, social networks can be both inclusive and exclusive, with often the weakest and most vulnerable excluded. They also often involve hierarchical and coercive relationships that limit options for those at the lower levels, and even when relationships are more horizontal than vertical, the obligations that reciprocal relationships involve can be onerous.

All of the criticisms and limitations of the sustainable livelihoods approach outlined above are certainly valid. The approach attempts to summarise in a single set of diagrams and connected terms the extremely complex and diverse reasons for poverty and the possibilities for addressing it. Inevitably, when used in practice it is unwieldy and certain elements will be highlighted more than others depending on the interests of the users. Nonetheless, it remains very useful for our purposes in this module, both for considering the very micro-level details of poor people's livelihoods and for considering the wider context in which those livelihoods operate.

### 3.2 Identifying missing livelihood capitals

We shall now apply the sustainable livelihoods approach to some real cases that explore what types of inputs, or 'capitals', are needed to enable poor rural people to escape poverty. These cases cannot in any sense be considered typical or 'representative'. However, they do make the point that addressing poverty and vulnerability requires much more than simply the provision of financial services.

Read the case studies in 3.2.1 about Jakla Punama and Fatima Begum, two women from Andhra Pradesh in India whose husbands committed suicide. As you read the cases, think about their misfortunes from the point of view of their households' asset or capital endowments; to which of the five types of capitals do they have or not have access?
### 3.2.1 Two rural Indian agrarian tales

![A water well, India. Source: Navaneeth (2011)](image)

**Jakla Punama's story, Anna Sagar Village, Andhra Pradesh**

Jakla Punama’s late husband was a paddy farmer. In the year 2000 or thereabouts he had taken a loan from a local moneylender to dig a bore well. He dug his well, purchased pipes, and bought a motor, but the yield of his well was quite low. So, he leased his land out to raise some money to help pay his debt. According to Jakla, her husband’s total debt was around 50,000 rupees, or around US$1000. There may have been other debts of which she is unaware. In 2002, Jakla’s husband had collected together enough money and was able to repay what he owed. Unfortunately, the moneylender did not give her husband a receipt and denied that he had been repaid. He seized her husband’s land in lieu of repayment and harvested the standing crops for himself. According to Jakla, when this happened her husband walked out to his field and committed suicide by drinking a bottle of pesticide.

In 2004, after the introduction of a government scheme to assist the families of suicide victims, Jakla Punama was given 150,000 rupees in compensation. She used 50,000 rupees to repay the loan and recover the land, and she put the balance into an account with the State Bank of India, under her daughters’ names. She also receives 200 rupees a month as widow’s pension. She told us that her late husband’s family are trying their best to lay a claim to the children’s accounts.

Though Jakla Punama should have inherited her husband’s land, her mother-in-law will not let her cultivate it. She has to keep herself and her daughters by doing casual labour on other people’s farms, for around fifty rupees or a dollar a day. Her mother-in-law has informally leased out the land to someone else. Because Jakla is illiterate, she would find it very difficult to find out who has legal title to the land and how much belongs to her.

**Fatima Begum’s story, Tatipathy village, Andhra Pradesh**

Fatima Begum’s husband Mohammed hanged himself in 2002. Fatima is illiterate, and she probably was unaware of the exact amount of her husband’s debt, but she told the story as follows. In 1998 or thereabouts, Mohammed got a loan from the local primary agricultural co-operative society, or PACS, which is part of India’s massive network of over 100,000 such institutions; they (all or most) are only co-operatives in name, and are usually dominated by the richer farmers in the local community. Although the loan was distributed between all his family members, because their ancestral land had been divided between them, somehow the repayment burden fell only on Mohammed.

The money was used to dig bore wells for irrigation, but the wells failed. Mohammed then took another loan, this time from a local moneylender, for around 6000 rupees or US$120. The PACS had issued Mohammed three notices telling him to repay his loans. The money lender also pressured Mohammed to repay his loans. Although Mohammed prayed regularly at the nearby Masjid, Fatima said that he never discussed his problems
within the community. Fatima thinks that it was the third notice he received from the PACS as well as increasing pressure from the moneylender that prompted Mohammed to take the drastic step and end his life.

In 2004 the government started a program to provide compensation for families of farmers who had committed suicide. So, in 2005, Fatima received 150 000 rupees. 50 000 rupees was used to pay off the PACS loan her husband had taken and the other 100 000 rupees went for the marriage dowry of her eldest daughter. The priority placed on a marriage dowry is extreme and Fatima described her current burden; her second daughter was ready for marriage but they did not have enough money for a dowry to get her married, a fact that would of course be a blow to their social status.

One of her two sons attends a madrassa in the nearest town, where he gets room and board. The older son works at a restaurant stall in town. Fatima wants him to stay there, as there is no work for him in the village. Fatima herself does daily labour work wherever she can find it—intensive work that pays only 50 rupees or around one dollar a day. A new government program, the National Rural Employment Guarantee Act (NREGA) guarantees 100 days work at 80 rupees a day for one person in every household that wants it; both women and men are eligible. Fatima explained why she wasn’t working under this scheme; she knew about it, but that others in the village told her that it wasn’t for women.

Fatima is part of the minority Muslim community in a predominately Hindu village. Now that she is a widow, she is also ostracised for that. This could explain why she cannot get the information she needs to take advantage of the NREGA scheme. When we asked whether she was part of a women’s self-help group, she said that she was but admitted it was a newly formed group and she still hadn’t really opened up to the group. In the five years since her husband had killed himself, Fatima said she had not really shared the story with anybody. Her in-laws were also of no support to her.

Source: adapted by unit author from an unpublished paper by Rozina Kanchwalla

Now think about which of the five capitals of the asset pentagon these women’s households had access to and which they had more or less of.

_draw an asset pentagon (as per the sustainable livelihoods framework in 3.1.1) for each woman. These should be irregular pentagons, with a longer distance from the centre to a point indicating that the woman in question had relatively more of that particular type of capital._

Then compare your pentagons to the ones below.

![Asset Pentagons](https://via.placeholder.com/150)

**Jakla Punama**  
**Fatima Begum**
Both households had land, that is natural capital, and there was also water, although it was not easy to obtain the needed financial capital in order to reach it. Both farmers, however, were able to access credit, and the co-operative society from which Fatima Begum’s husband took a loan was a formal government supported institution.

There is no evidence that they suffered from problems related to lack of physical capital; they had reasonable dwelling houses and roads and other communications appear to have been available.

They were physically able to work, and they appear to have known what to do; they had bad luck with their irrigation bore wells, or perhaps they were badly advised as to the locations, but they appear to have been fairly skilled farmers who knew what they needed. Being literate may have helped Jakla access her land. Overall, both had reasonable, though not high, human capital.

In both cases, the men who had committed suicide appeared not to have discussed their problems with their wives, or with their acquaintances or those who were part of the same community. Their widows, in their turn, suffered from the traditional problems of women’s marginalisation both within their families and in the community. They lacked family support, and information about their entitlements; they seriously lacked social capital.

Both farmers were able to access capital, in the form of loans for their wells. One from formal sources and the other from informal sources, but both could have been repaid had the investments been a success, and if the lender had not cheated Jakla’s husband. They did have financial capital.

The main problem, in both cases, was their lack of social capital. This applied to the husbands, who seem not to have been able to talk through their problems to anyone, particularly their wives, and there was no debt counselling service which might have helped them to sort out their financial problems. Social capital of this kind is often the most important capital, and is the hardest and slowest to provide.

As you work through the module, reflect on the conditions under which improved access to financial capital (through improved financial services) is likely to assist rural households to escape from poverty.
Section 3 Self-Assessment Questions

Question 7

Which of the following is clearly not true?

(a) The rural poor need multiple sources of income because they cannot rely on any single one of those sources, either to provide enough income to survive, or to last forever.

(b) Access to appropriate financial services is all that most of the rural poor need to pull themselves out of poverty.

(c) Social capital is often the most important form of capital, so important that without social capital a person might not have a viable livelihood, even if they have access to all the other forms of capital listed in the sustainable livelihoods framework.

(d) Small farms may eventually become unviable, even if farmers have access to all five of the forms of capital listed in the sustainable livelihoods framework.

Question 8

True or false?

A comprehensive rural poverty alleviation strategy will focus closely on building up at the village level the access of poor people to the five assets described in the asset pentagon.
UNIT SUMMARY

This unit has introduced you to the subject of financial access and why it matters for economic development generally, and to rural development specifically, including a discussion of some of the major challenges faced in providing rural finance. We have also introduced the sustainable livelihoods approach, and have used the asset pentagon to think about what assets poor households need to sustain their livelihoods. We looked at examples that stressed the importance of social capital, and also examples that drew our attention to the limits of working to strengthen assets at the local level, when wider level processes can overrule whatever assets the rural poor might have.

Section 1

In this section we outlined the importance of financial access in economic development, both at the macro-level and at the level of individual livelihoods. We discussed the ways in which financial access can be incomplete, due to information asymmetries and resulting market failures.

Section 2

In this section we narrowed our focus down to the finances of the poor, and discussed the ways in which poor people manage their finances, and the strengths and weaknesses of those mechanisms. We argued that all financial management can be conceived in terms of savings. We also had a closer look at what rural finance means in practice for poor rural people. We established that rural finance is much more than simply the provision of credit to poor people, and we concluded that the best definition of rural finances for our purposes is the following: ‘The provision of financial services for rural farming and non-farming populations at all income levels’.

Section 3

We finished the unit by elaborating the sustainable livelihoods approach to understand the rural poor and their constraints more deeply. We used this approach – and, in particular, the five types of assets or capital that are identified within it – to analyse two real life case studies, identifying which capitals poor households might lack. This made the point that often financial capital is not primarily what is lacking. While the sustainable livelihoods approach is extremely useful, we also identified some areas in which it is lacking.
UNIT SELF ASSESSMENT QUESTIONS

Question 1

It has been argued that financial markets should be left alone in order to have the most efficient allocation of resources in the economy. Why is it that if it is left to itself, the financial market will not necessarily result in the most efficient allocation of resources – that is, with everyone who wants to save able to transfer their surplus so that all those who want to invest are able to do so?

Question 2

Fill in the missing words/phrases.

Through either financial management in their homes, or externally offered financial services, people generally need to save in different ways. They can:

(a) save up, which means _________________________________.
   The financial service to enable them to do this would be some sort of ______.

(b) save down, which means _________________________________.
   The financial service to enable them to do this would be some sort of ______.

(c) save through, which means _________________________________.
   The financial service to enable them to do this would be some sort of ______.

Question 3

Fill in the missing word/phrase.

Rural finance can be most usefully defined as ________.

Question 4

You have used the sustainable livelihoods approach to assess your own and others’ situations. Outline the ways in which the approach has helped you to analyse the situations, and suggest some of the limits of the approach.
**KEY TERMS AND CONCEPTS**

**adverse selection** refers to the fact that it is often people whose activities are particularly risky who take high interest loans, or buy insurance, which means that financial service providers may end up with a set of particularly risky clients.

**coping with risk** dealing with emergencies that arise through life. These types of emergencies are often described as ‘shocks’ to household economies.

**credit rationing** refers to situations when banks do not meet the demand that exists for loans. Some argue that this occurs only when interest rates are set by the government and the market is unable to balance itself. Credit rationing can, however, also occur due to information asymmetries and transaction costs.

**finance** the ways that people manage their money, and the systems that exist to enable them to do that effectively.

**financial capital** savings, in whichever form, access to financial services, and regular inflows of money.

**financial intermediaries** 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.

**financial intermediation** the process through which resources are channelled 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.

**human capital** skills, knowledge, the ability to work, and good health. Good health is not simply a means to earning a livelihood; it is also an end in itself.

**information asymmetries** refer to the fact that, in the real world, information does not flow smoothly. Some people have access to information that others do not. In the case of financial services, this means that those providing the financial service do not always know as much as they would like to know about the person to whom they are providing the service, and may therefore not provide the service, even if they have the funds available. Moral hazard and adverse selection arise because of information asymmetries.

**managing basics** household cash-flow management to transform irregular income flows into a dependable resource to meet daily needs. In economics terminology this is known as ‘consumption smoothing’; ensuring that you are able to buy what you need to consume on a daily basis even if your income is inadequate or irregular.
market failures situations when the market alone does not produce the most efficient outcome. Then some sort of government regulation or direct intervention may be necessary to produce that outcome, rather than just leaving it to the market.

moral hazard is when someone’s behaviour changes based on their access to financial services which makes them more of a risky client. For example, a business person may make a riskier investment after taking a loan with a high interest rate (to try to get a higher rate of profit and so repay the loan more easily), or a person who has taken insurance against their car being damaged may drive less carefully because they know they will not have to pay for it in case of an accident.

natural capital the natural resource stocks that people can draw on for their livelihoods, including land, forests, water, air and so on.

physical capital the basic infrastructure that people need to make a living, as well as the tools and equipment that they use. For example, transport and communication systems, shelter, water and sanitation systems, and energy.

raising lump sums seizing opportunities and paying for big-ticket expenses by accumulating usefully large sums of money.

rural finance ‘the provision of financial services for rural farming and non-farming populations at all income levels’ (Fernando 2007).

saving down saving later after taking a lump sum now, for example, taking a loan and repaying it over time.

saving through saving consistently to have a lump sum when the need arises, for example, paying regular insurance premiums.

saving up saving now to have a lump sum later.

social capital the social resources that people draw on to make a living, such as relationships with either more powerful people (vertical connections) or with others like themselves (horizontal connections), or membership of groups or organisations. Generally relationships of trust, reciprocity, and exchange that the poor can draw on in times of need, and that lower the costs of working productively together. Like human capital, social capital has an intrinsic value; good social relationships are not simply a means, they are an end in themselves.
sustainable livelihood  
’a livelihood comprises the capabilities, assets (stores, resources, claims and access) and activities required for a means of living; a livelihood is sustainable which can cope with and recover from stress and shocks, maintain or enhance its capabilities and assets, and provide sustainable livelihoods opportunities for the next generation; and which contributes net benefits to other livelihoods at the local and global levels and in the short and long term’ (Chambers and Conway 1991 p. 6)

transaction costs  
the costs associated with providing a service. The transactions costs of providing financial services to the rural poor are very high because the poor need services on a very small scale, which pushes up relative administrative costs. It is also expensive to reach the rural poor and to find out information about them, given poor transport and communications infrastructure in rural areas, and their lack of documentation