

## AGRI-FINANCE AND SUSTAINABLE PRODUCE: BRIDGING THE GAP BETWEEN FARMERS AND FINANCIAL SYSTEMS

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### **Abstract**

*The global food and agribusiness industry is in the midst of major changes, and the pace of change seems to be increasing. Evidence suggests that productivity in the agricultural sector can benefit from better access to financial instruments tailored to the needs of farmers and agribusinesses. Policy makers can take a series of steps to make this happen. Changes suggest three fundamental critical financial issues for the sector: Firstly, investing in rural financial infrastructure can overcome the information asymmetries that discourage financial providers from serving agricultural firms. The availability of public databases on agricultural and weather statistics would allow lenders and insurers to distinguish good clients from bad ones more precisely and monitor their actions. Governments have a comparative advantage in providing information to help lenders or insurers identify their risks and price them accordingly. Secondly, strengthening property rights and contract enforcement can open up access to important financial products to farmers and agribusinesses. Thirdly, governments should abstain from paternalistic policies that discourage financial providers from entering the market and that distort the incentives for farmers and firms. Public subsidies directed at agriculture should be carefully considered because they provide inappropriate incentives for farmers to invest in unprofitable farming activities. While certain subsidized insurance products could be justified on the basis of achieving the higher take-up of these products and allowing users to understand their value, subsidies that do not involve proper assessments of the quality or feasibility of projects should be avoided. The focus of this paper is the synopsis and application of conceptual/theoretical frameworks that can be used in financial decision making and analyzing the implications and consequences of future agribusiness with special reference to India.*

**Keywords:** *Subsidies, agricultural finance, micro credit*

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### **Introduction**

Worldwide, agriculture is the main source of income among the rural poor. Relative to other sectors, agricultural growth can reduce rural poverty rates faster and more effectively, one relevant vehicle to achieve growth in the sector may be finance.

Farmers' decisions to invest and to produce are closely influenced by access to financial instruments. If appropriate risk mitigation products are lacking, or if available financial instruments do not match farmers' needs, farmers may be discouraged to adopt better technologies, to purchase agricultural inputs, or to make other decisions that can improve the efficiency of their businesses. Improving access to finance can increase farmers' investment choices and provide them with more effective tools to manage risks.

One major reason is geographical. Low population density and large geographical dispersion of clients in rural areas make it difficult for banks to operate at a profitable scale. The lack of financial institutions branches has translated in a limited provision of saving, insurance and credit products to farmers and agribusinesses.

A second factor inhibiting financial institutions from serving the sector has to do with the systemic risk characterizing agricultural activities. When natural hazards or adverse weather conditions take place, they typically affect a large number of farmers and firms simultaneously, making it more challenging for financial providers to diversify their portfolio of clients, since when one client fails to pay, many others will be in the same situation. This problem is aggravated by the paternalistic behaviour or political motives that governments may have. Policies ranging from bailouts to relieve households from their debt obligations to political loans to the sector may distort firms and farmers incentives and discourage financial providers to enter the market. India's largest bailout program did not alleviate problems of debt overhang of its beneficiaries. Instead, program recipients increased their reliance on informal credit and reduced their productive investment.

Another challenge that banks face when serving the agriculture sector is that financial infrastructure in rural areas is in general very poor. Tracking identity of clients or monitoring production outcomes becomes extremely difficult in rural areas. If financial providers cannot track their clients back, then the punishment of default or underperform for a farmer is low, especially if contract enforcement is low. Hence, potential lenders or insurers may well decide not to engage with the sector in the first place, or to respond by excessive credit rationing or over-reliance on traditional forms of collateral, which many farmers lack.

In the last two decades, new approaches attempting to reduce these challenges have been developing in agricultural finance. One with great potential in agricultural settings is the use of technology to facilitate financial transactions. Credit and movable collateral registries, mobile banking and correspondent banking are examples of ways in which

technology can help ease market failures in the agriculture setting. While rigorous impact evaluations on many of these new developments are pending, there are some studies that provide some insights. The use of fingerprints to identify clients makes the threat of future credit denial credible. As a result, the incentives for clients to pay back the loan increases, while simultaneously incentivizing lenders to engage in more transactions. Even though projects of this type are in piloting stages, these initiatives show great potential in reducing information costs of lenders or insurers.

### **Subsidies as an instrument in agriculture finance**

Providing sustainable financial services for rural areas and agriculture in developing countries has proven to be difficult in spite of recent reforms and billions of money spent in subsidizing programs.

### **Developing agricultural and rural credit markets**

Credit markets diverge from an idealized market because information is imperfect and loan contracts are difficult to enforce. Market failure is said to occur when the market fails to allocate resources efficiently. The complicated environmental, material, and production features of agriculture inhibit the demand for and supply of credit and insurance, making it especially difficult to create sustainable financial institutions to serve the sector. Not surprisingly, therefore, efforts to increase formal credit supplies have had a spotty record, and quick fixes have not worked. Most successes have been the result of careful long-term institutional development. In the period 1960–80, old-paradigm, subsidized, directed agricultural credit programs were common in top-down government and donor policies and programs. In the 1980s, a new financial systems paradigm emerged that shifted the emphasis from dispersing cheap credit to creating sustainable institutions, treating borrowers and savers as clients rather than beneficiaries, developing products that clients demand, and pricing products and services to cover costs and risks. Donor agencies reduced the use of credit lines in favour of grants, loans, and technical assistance to help in the design of appropriate products, institutions, and policies. Microfinance also thrived by following this market-oriented approach. Microfinance institutions (MFIs) have made inroads into agriculture and rural areas, but more efforts are needed to design products and methodologies to fit the seasonal cash flow patterns of farm households. Managing the costs and risks of agricultural lending has been challenging. There is a need to better understand the demand for and use of agricultural credit to develop effective products, institutions, projects, and policies. The rapid growth of microfinance suggests that there may be large unmet demand for agricultural loans, but two issues need consideration. First, there may be a tendency to overestimate demand, as has occurred with microfinance. Second, an empirical question concerns borrower sensitivity to interest rates relative to other factors affecting demand. Farmers' demand for loans may be limited if the interest rates charged are as high as MFIs require to provide small microenterprise loans sustainably.

### **Scaling up access to finance for agricultural SMEs**

Around the world, agriculture is and will continue to be a major building block in the achievement of the development goals of our country. Recent statistics show that agricultural production needs to increase by 70 percent by 2050 in order to feed the world, while demographic growth, climate change, and urbanization put pressure on available cultivable land. Three-quarters of the world's poor live in rural areas and more than 80 percent of them either directly or indirectly depend on agriculture for their livelihoods. Hence, in low income countries, the agriculture sector is vital for economic growth. Increased agricultural productivity can enhance food security, poverty reduction, job creation, and economic growth. Therefore, this brings new attention to the issue of agricultural finance. After more than a decade of low recognition, international donors, politicians, and specifically the G-20 are putting a renewed focus on this topic. Within the financial systems development expert community, the debate on effective solutions to sustainably support agricultural development has been renewed. The issue of agricultural finance is frequently on top of the international development agenda. Now, with the triple shocks of the recent years — food, fuel, and finance the urgency of food security has increased greatly and created political pressure to act immediately. There is now broad support for more and better investments to increase agricultural production, to improve marketing of commodities, and to combat poverty. However, there are no quick political fixes and the provision of sustainable financial services for agriculture has proven to be difficult. The past years have demonstrated that neither commercial banks nor the emerging micro-finance industry are willing or able to sufficiently meet the financial needs along agricultural value chains, leaving farmers and agricultural SMEs unserved in the so-called “missing middle.” There is a broad consensus that existing mechanisms for agricultural finance are not adequate and that we need to move to innovative and market-based approaches that are scalable and can reach a large number of beneficiaries.

### **Microcredit and Agriculture**

Providing sustainable financial services for agriculture continues to be a challenge in spite of billions of rupees having been spent in subsidies to strengthen financial institutions to serve the sector. Critics have argued that the market-oriented reforms implemented after the collapse of the directed credit paradigm have failed because agriculture still receives a small share of total formal credit. Some advocate a rollback of reforms and a return to active governmental intervention including the resurrection of state-owned agricultural development banks and the reintroduction of interest rate ceilings on agricultural loans. Considerable success has been achieved by some micro finance institutions (MFIs) in providing sustainable microfinance services that contribute to resolving the agriculture credit problem by serving some

of the rural poor. Most limit their operations to areas with high population densities and farm loans usually represent a small share of their loan portfolios. Others, however, are successfully innovating to adapt to rural populations and seasonal agricultural producers. These innovations address the challenges of high costs and risks encountered in serving this market. Expectations are rising that the mobile phone banking will make rural areas even more attractive for market-oriented financial institutions.

### Conclusion

Finance in agriculture has played an important role in Indian agriculture since 1960s. The so-called second green revolution or farm diversity is essential not only for promotion of agribusiness but also for eradication of poverty and unemployment in the country. In the light of diversities, financial challenges in agriculture, there is a need for reform in agricultural education – a management education – for rural labourers and entrepreneurs: education that gives knowledge and not just disseminating information or providing data. The impact of real and managerial education will be on cost (reduction and control), quality (enhancement) and knowledge (sharing). Knowledge and expertise in the green revolution days of the 60s were highly concentrated and/or costly. Today it is diluted and cheap, and many a times, localised. That makes agriculture less dependent too.

To conclude, from a “backward agriculture” to “value added agriculture”, Indian Agriculture has come a long way. But there are miles to go. And Indian farmers, beyond doubt have the required amount of patience needed to undergo a metamorphosis for bringing about the healthy transition from inhibitive farming to innovation farming. That is agribusiness after all.

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