

The role of the financial sector in supporting agricultural SMEs and rural economies

POLICY NOTE

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This policy note underscores the critical role of financial institutions in supporting Uganda's rural economy and outlines targeted policy pathways to expand credit access, strengthen agricultural SMEs, and build resilience in the face of climate and economic shocks.

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The recently launched Fourth National Development Plan and the government's 10-fold growth strategy place rural transformation, agro-industrialisation, and inclusive wealth creation at the centre of Uganda's development agenda. The Parish Development Model complements this ambition by taking financial inclusion closer to communities, anchoring household production in the money economy. Within this policy landscape, the financial sector - commercial banks, savings and credit co-operative societies (SACCOs), microfinance institutions, and fintech providers - has a pivotal role to expand rural credit, mitigate climate-related risks, and unlock the potential of agricultural small and medium-sized enterprises (SMEs). Strengthening rural finance will not only safeguard livelihoods but also drive structural transformation, create jobs, and secure Uganda's long-term growth.

Against this backdrop, the Ministry of Finance, Planning and Economic Development, in partnership with the International Growth Centre (IGC), convened the third annual Climate Change Workshop in June 2025 under the theme "Making Growth in Uganda Sustainable: Insights from Frontier Research." The forum brought together policymakers, researchers, and practitioners to reflect on how Uganda can safeguard its sustainable growth trajectory in the face of floods, droughts, and an evolving global climate landscape. During the discussions, two researchers, Dennis Egger (University of Oxford) and Mohamed Abouaziza (London School of Economics), highlighted the critical role of rural credit in supporting agricultural SMEs and strengthening resilience in rural economies.

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Under-utilisation of resources in the Uganda's rural economy

Uganda's rural economy, like that of many developing countries, is endowed with abundant natural and human resources – fertile land, labour, and agricultural potential – that remain largely underutilised. Limited access to finance, low adoption of modern inputs and technologies, and fragmented value chains prevent farmers and small agribusinesses from achieving their full productivity potential. This under-use constrains income growth, employment creation, and overall rural development.

Dennis Egger highlighted that Uganda's rural economy may be demand-constrained, suggesting that policies aimed at stimulating demand could be more effective than those solely focused on increasing productivity. He noted that targeted cash transfers, broader economic inclusion, and improved market access can generate a demand shock that raises household consumption, supports local production, and does so with minimal increases in factor input prices or quantities. He further demonstrated that when resources are under-utilised, such as during periods of high unemployment in low agricultural demand seasons, supply tends to be highly elastic, which can lead to large multiplier effects and minimal inflationary pressures from cash transfers.

Egger argued that financial institutions have a pivotal role to play in designing and delivering credit products that not only relax liquidity constraints for rural households but also crowd in private investment, amplify demand-driven growth, and build resilience against seasonal and climate-related shocks. Over the long term, these gains can be reinforced through complementary investments in health, education, and local public infrastructure, which together create a stronger foundation for inclusive and sustainable rural development.

Barriers to financing agricultural SMEs in Uganda

Agricultural SMEs (Agri-SMEs) are often considered difficult to finance because the sector is seen as high risk.

- Agriculture is highly exposed to weather variability, pests, diseases, and price fluctuations, all of which can undermine the ability of borrowers to repay loans.
- Agri-SMEs typically have seasonal and irregular cash flows that do not align well with standard loan repayment schedules.
- Many of these enterprises lack titled land or formal assets to use as collateral, making it harder to secure credit.

- Their operations are often informal, with weak financial records and limited credit histories, which reduces the ability of lenders to assess their creditworthiness.
- Serving rural borrowers involves high transaction and monitoring costs, while the relatively small loan sizes requested by Agri-SMEs make lending less attractive to banks.
- Agri-SMEs face unstable markets and fluctuating commodity prices that erode revenue predictability, and most financial institutions do not offer products tailored to agricultural realities, such as long production cycles or the need for grace periods.

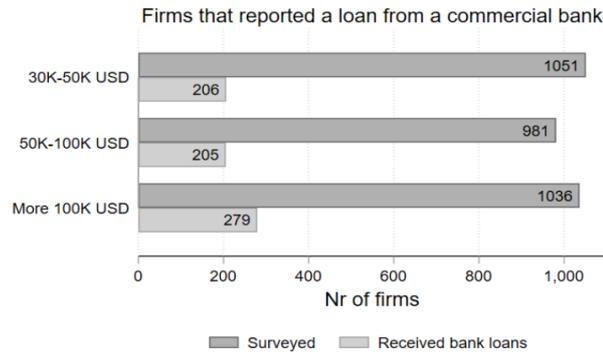
These challenges are compounded by policy and institutional gaps, including weak agricultural insurance markets, limited risk-sharing schemes, and inconsistent government interventions, all of which reduce incentives for financial institutions to lend to the sector.

Mohamed Abouaziza presented findings from a survey conducted in Uganda to assess the constraints facing Agri-SMEs in accessing finance. The survey also evaluated the effectiveness of the Aceli Africa initiative, which is a catalytic market facility established in 2020 to expand financing for agricultural SMEs by reducing the risks and costs that discourage banks from lending.

Operating in Tanzania, Uganda, Rwanda, Kenya, and Zambia, the initiative works with 45 partner lenders. It provides a mix of supply-side incentives, including origination support to cover administrative costs, first-loss coverage to absorb potential defaults, and additional bonuses for loans directed toward women- and youth-led enterprises as well as climate-related projects. By aligning financial returns with development objectives, Aceli Africa aims to unlock greater private sector investment in rural economies and strengthen the role of Agri-SMEs in driving inclusive growth.

The study found that only 20% of the 3,069 firms surveyed reported having obtained a loan from commercial banks, as shown in Figure 1. However, among those firms that did access bank credit, 71% indicated that they would be willing to borrow more under the same terms. This finding points to the existence of credit frictions: while firms can access loans, the volume of credit extended appears insufficient to meet their financing needs. Such frictions may reflect conservative lending practices by banks, inadequate loan sizes relative to business requirements, or structural barriers such as high collateral demands and risk perceptions in agricultural lending.

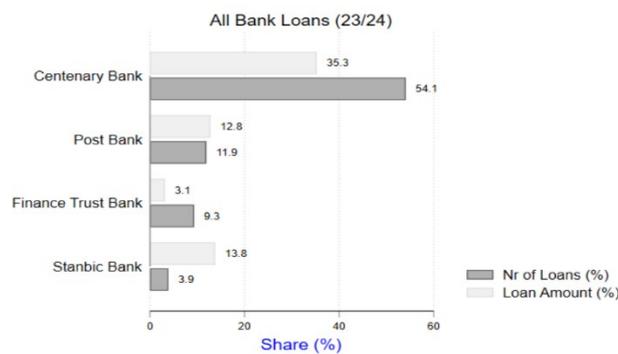
Figure 1: Few firms borrow from banks



Source: Abouaziza et al. (2025)

Aside from firm-specific barriers, Mohamed documented that concentration of lending banks to just a few banks could be a binding constraint, as it limits competition and choice in the financial market. With few lenders, interest rates tend to remain high, loan terms are often rigid, and banks have little incentive to design products tailored to the needs of specific sectors such as agriculture. The limited number of willing banks also means that credit is concentrated among a small set of clients, leaving many firms – especially riskier or smaller ones – excluded.

Figure 1: Bank lending is concentrated



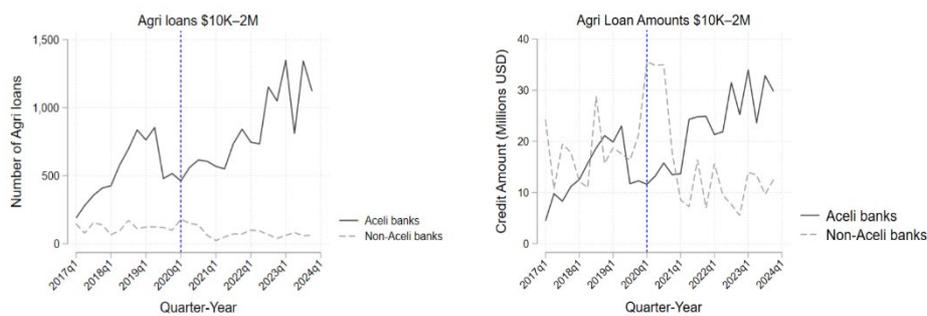
Source: Abouaziza et al. (2025)

The survey results showed that although the rejection rate for bank loans is very low – 97% of firms that apply are approved – most firms still rely on retained earnings or profits to finance investments and input purchases. Firms reported several reasons for not applying for bank loans, including no perceived

need for external financing (50%), high interest rates (20%), and an aversion to debt (10%).

As illustrated in Figure 3 below, addressing supply-side constraints led to a significant increase in credit supplied by Aceli partner banks to agricultural SMEs in Uganda. This improvement is evident not only in the greater number of loans extended to Agri-SMEs but also in the larger average loan sizes, indicating that firms were able to access financing more aligned with their investment and operational needs. The findings suggest that targeted incentives for banks effectively reduce the barriers that typically limit lending to the sector. Consequently, these measures enhance the ability of Agri-SMEs to invest in productivity-enhancing inputs, adopt climate-smart practices, and expand their operations, thereby strengthening the broader rural economy.

Figure 3: Trends in credit supply from banks to Agri-SMEs



Source: Abouaziza et al. (2025)

Policy implications

Expanding rural credit is crucial to unlocking the productivity potential of agricultural SMEs and promoting inclusive growth in Uganda's rural economy. Financial institutions should offer tailored credit products that account for seasonal cash flows, climate-related risks, and the specific needs of smallholders and Agri-SMEs.

Initiatives like Aceli Africa show that supply-side incentives – such as origination support, first-loss coverage, and bonuses for women, youth, and climate-focused projects – can significantly increase access to finance for underserved firms. At the same time, broader participation by banks in agricultural lending is needed to boost competition, reduce borrowing costs, and expand financing opportunities for smaller or higher-risk enterprises.

Complementing these financial interventions with demand-side measures, such as cash transfers or programmes that stimulate household consumption, can further support local production and enhance the effectiveness of credit. Finally, investments in infrastructure, health, education, and market access are essential to amplify the impact of rural finance and sustain long-term, inclusive, and climate-resilient development.