Crossfire: Microfinance has upstaged enterprise development, and finance is now in danger of doing the same to value chain interventions

JEANNE DOWNING and MALCOLM HARPER

In our regular debate between two experts, Crossfire invites Jeanne Downing and Malcolm Harper to argue the case surrounding: 'Microfinance has upstaged enterprise development, and finance is now in danger of doing the same to value chain interventions'

Dear Malcolm,

We cannot pretend that one solution, be it finance or value chains, is a silver bullet

I do not believe that microfinance has upstaged enterprise development or value chain development. We need to remember what we are trying to achieve, i.e. poverty reduction. Yet poverty cannot be effectively reduced without economic growth, which in turn requires more than finance. It requires the ability to compete in increasingly globalized markets, be they global or local. Finance is a critical input to value chains and their enterprises trying to compete, but it is far from the only thing that is important. In fact, finance advocates would do well to see how this input fits into the larger framework needed to understand how best to promote growth that reduces poverty. You cannot just focus on those who are poor and you cannot just focus on finance. Markets, the business-enabling environment, inter-firm relationships, inputs, market information, skills and know-how are all important depending on the context.

If we are to serve the poor effectively, we cannot pretend that one solution, be it finance or value chains, is a silver bullet. Have we not learned over the years that development and poverty are complex, messy and often political?

Rather than competing over who has the best solution, let us look at how to use these approaches – microfinance, SME finance, enterprise development and value chains – to address the problems of poverty effectively.

For example, value chains represent an approach to link the poor to growth opportunities. However, to be able to take advantage of end-market opportunities, small firms and farmers need to upgrade. This requires investment, which requires financial services. I would challenge those focused on finance to help move the frontier of value chain finance that will allow the poor to upgrade and

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to transition into higher-return activities from the low-return activities where the poor are mostly concentrated. Value chain finance could include microfinance as well as other instruments. Too few organizations engaged in microfinance are focused on this important need for value chain finance.

While the path-breaking work on finding new and effective ways of reaching the poor is laudable, one path that has not been well trodden is finance provided by actors in a value chain. These actors are sometimes in the best position to assist the small firm in upgrading and are more effective than direct project interventions. Moreover, effective upgrading may require more than finance, and lead firms can sometimes offer small firms markets, inputs, credit, and the knowledge and skills needed to compete.

Not enough has been done to support finance provided by actors in a value chain

So, Malcolm, can you really say that microfinance is upstaging value chains?

Best wishes
Jeanne

Dear Jeanne,

Thank you, but in spite of your arguments I do feel, quite strongly, that value chains, and micro-enterprises are subsets of the general case that microfinance has 'crowded out' other approaches to the alleviation of poverty.

Thomas Dichter wrote eloquently of 'the hype and the hope' of microfinance, and the over-arching theme of the book we edited together was the danger of exaggerated expectations (Dichter and Harper, 1997). Microfinance is so dangerously attractive; it is not very difficult to sell formal financial services of fair quality at (usually) quite reasonable prices to people who have previously had no access to such services at all; it's rather like selling dirty water to desperately thirsty people. We can do good and do well at the same time, and in today's turbulent times it is even more attractive. The microfinance market is remarkably insensitive to price, and the debts tend to get repaid; very different from the assets which are bringing down so many giant institutions round the world.

You say, so rightly, that finance is not the only input that value chains need, but when microfinance institutions get involved in value chain development they tend to behave like any specialist; they believe that their product will do the job. We would laugh at a cardiologist who performed by-pass operations to fix broken legs, but that is very similar to the behaviour of many microfinance institutions (MFIs) when they try to promote value chains: 'what they need is what I have got – finance'.

When MFIs get involved they believe that their product will do the job

And MFIs tend to be strong, ambitious and professional, and they can ride on the mistaken belief in many countries that all

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that is needed to start or develop a business, or a farm or any other enterprise, is credit. The sustainable livelihoods framework includes five types of capital: human, social, natural, physical and financial. Financial capital is the easiest to understand, and to supply; that is what banks have always done for better off people, and it is what MFIs now do for poorer people. We don't quite know where to go to get the other four types, and as a result MFIs have upstaged them.

The sustainable livelihoods framework includes not one but five types of capital: human, social, natural, physical and financial

I have just completed a book about successful and inclusive value chains in India. The 14 examples which are described in the book were chosen because they included very small producers and they appeared to be sustainable, not because they focused on any particular type of input or because they were promoted by any particular type of institution. Eight of them were promoted by large for-profit companies, as a means of securing more reliable better-quality supplies for retail chains or export markets. Some of these companies had cleverly reduced their costs by tapping into government or other assistance programmes which were providing skills, or extension, or finance or other inputs, but these services were ancillary to the major goal, which was to build the supply chain. The other six were promoted by local community groups, or by development agencies with donor assistance. Only one was promoted by an MFI, and this was one of the least successful.

In all six of these latter cases, there had been or shortly will be an 'exit' problem; the promoting agency was not itself an active participant in the value chain, but was 'facilitating' its development. The eight companies did not have this problem, because they were themselves integral and vital links in the chain. If finance, or training, or raw material supplies, are needed, the company which is promoting the chain will either provide them or arrange for their supply by other institutions, but the emphasis of the value chain will remain focused on its main function. The large companies are focused on making money, not on the supply of finance or any other particular input for the small producer, and their management realize that they will only continue to profit if the small producers and every other player in the value chain makes money too. This, not finance, is the basis of sustainable and inclusive value chains.

Best wishes
Malcolm

Dear Malcolm,

It is true that microfinance is a tried and true intervention, and that new work in financial services has spawned lots of new and innovative financial products. These are all good for the poor. At the same time, we

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Addressing the food crisis requires promoting value chains in which large numbers of local producers participate

Global markets also offer producers in developing countries opportunities for learning about distant markets

Finance is key to developing value chains, but by themselves financial services do not generate income

see such problems as the food crisis. Addressing the food crisis will require promoting value chains in which large numbers of local producers participate and from which they earn their living. Donors are investing lots of money in staple crop value chains, with the aim of improving food security. To be successful, they need to take a value chain approach. They need to focus on end markets and competitiveness. Can Africa staple crops compete with imports? What upgrading is needed to improve their competitiveness? How can fair benefits to producers be fostered? Without fair benefits, competitiveness will be difficult to achieve.

Another key issue of our time relates to how to generate growth in developing countries. The Center for Global Development held a meeting to discuss this topic. Below is a quote from the transcript:

> The third point has to do with leveraging the global economy to speed, catch up, and to drive growth for decade upon decade. It is virtually impossible to do this without leveraging the global economy. So globalization is not an option, it is a necessity. The question is, how do you link to it? And what do you need to do to benefit from the system?

Value chains are a tool for leveraging the global economy. Donors can help small entrepreneurs and farmers upgrade, as they have in many places. With the bargaining power garnered from upgrading, small entrepreneurs and farmers can more easily participate in global value chains on terms that are fair and profitable. Global markets also offer producers in developing countries opportunities for learning about distant markets and how to compete in them. The Chinese are masters at this and using the learning to develop and brand their own value chains. In other words, the global economy – at least in more sanguine times – can help accelerate growth.

My point is that value chains offer solutions to some of the huge problems of our day. Again finance is key to developing value chains, but by themselves financial services do not generate income. Rather they facilitate firms in generating income. In other words, finance is a supporting market.

It is true that microfinance can do ‘good’ and well at the same time, during these turbulent times. But the power of microfinance to address poverty is limited. Why? Because finance is an input, the poor need access to lucrative activities to put credit to good use.

Best wishes
Jeanne

Dear Jeanne,

I am sure that we agree on many issues, such as the variety of

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inputs that may be needed to enable poorer people to be included in 'modern' value chains. I do not agree, however, with your statement that 'finance is key to developing value chains'. Accessible primary health care and education, decent government, improved skills or methods, one or many of these and many others may be lacking and may need to be provided, and may be the 'key' to a particular situation, but none of them is always necessary, and none of them is the universal 'key'.

Of course every member of a value chain needs assets, which have to be financed from somewhere, but the danger lies in assuming that finance is any more necessary than any of the other things that are needed. And, following from that, the assumption that microfinance and hence microfinance institutions have a special role to play.

Very often the most appropriate source of finance is not an MFI but an 'upstream' or 'downstream' business in the value chain

Fortunately for small producers, value chains involve businesses, not donors

Sometimes, there is no need for additional finance at all. It can be that knowledge, or access to raw materials, or an ability to break through traditional social barriers, is what is needed. And, very often, the most appropriate source of finance, if it is needed, is not a microfinance institution but is an 'upstream' or 'downstream' business in the value chain, which needs large amounts of credit in order to finance the small producers or retailers which are also members of the value chain. A microfinance institution may be a redundant 'middleman' (or woman) in such a situation.

If the small producers are farmers, the interest rates charged by many microfinance institutions are in any case too high to leave any margin for the borrower. It is good business to borrow at 36 per cent a year in order to finance petty trade which can earn 10 per cent or more in a day or a week, but few on-farm operations yield anything like that rate of return. Large-scale buyers of farm products understand this, and their transaction costs are low because they are part of the procurement process; they can afford to provide finance at rates which are economic for small farmers.

'We', you and I, and many of the readers of this journal, are donors, or we work for donors. Sometimes local donors, such as governments or private national foundations, more often foreign donors, whether official or otherwise. And the word 'donor', with all that it implies, provides a clue which explains the all-too-common overemphasis on finance. When all is said and done, donors donate, and donations are money. Money is all we have, whether we give it or we lend it.

Fortunately, for the small producers or others which are part of them, value chains involve businesses, not donors. Businesses are in business to make money, not to spend it, and their success depends

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on their having the particular inputs which are needed to produce, process and market the goods in which they specialize. Donors may or may not have a peripheral role in 'lubricating' business activities when some temporary subsidy is needed to overcome their initial reluctance to involve small producers or other marginal players in a value chain.

Value chains are nothing new, however. Businesses have always known that they cannot themselves perform every function, and that they must develop mutually dependent and sustainable relationships with other enterprises, large and small, in order to maximize their own profitability. When finance, or perhaps microfinance, is necessary, donors may need to facilitate its availability, but successful value chain development depends on working with an open mind, without assuming that any one input is the key.

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