# Finance and Guarantees in Rural Development

**By Zvi Galor**
**www.coopgalor.com**

## 1. Introduction.

In this brief article, I will try to examine the needs existing in rural development organizations to finance their activities, and to look beyond the simple provision of credit to the poor as part of poverty alleviation projects, and examine what is the triangular linkage credit has with the producer, as well as with the supply of inputs and marketing. According to this approach, small business of production or services requires credit to purchase the necessary inputs, and once this production is completed in an efficient manner, the production is marketed so the producer can repay the credit borrowed. Therefore, the Essential Triangle of Production (ETP) is composed of credit, supply of inputs, and marketing, all around the producers. This article describes briefly the relationship between these three factors, and investigates how each can be targeted and used complementary to achieve successful developmental objectives.

Another important issue that would be discussed here is the credit allocation, necessary for production, and the guarantee needed in order to obtain credit, and the limited ability of the Poor to provide satisfactory ones.

The story of the Grameen Bank of Bangladesh is quite known and of interest as an approach of giving credit to the poor, and is known for the fact that this credit has been repaid to the credit supplier. This credit was used to enhance income-generating projects, initially in farming. The secret to the Grameen Bank's success is the way credit was secured. One of the problems with credit allocation is securing its

reimbursement. The Grameen Bank introduced a mutual guarantee among small groups of producers who mutually guaranteed the repayment of the credit allocation, without almost any default.
We start our discussion with the issue of guarantee to credit.

# 2. The Guarantee.

Allocating loans is an activity which involves selling of money, from an individual or an institution, utilizing, generally, others' money, where the money is in surplus, to where money is in shortage. Those who get the money, in a form of credit, are ready to pay for it a price, called in most cases interest. The problem of those who allocate credit is as how to guarantee that the credit would be reimbursed by the borrowers, including its own price. Many commercial financial institutions apply a policy where borrowers supply guarantees of various sorts to the credit suppliers, in order to assure them that their money would be returned.

## 2.1. The Mutual Guarantee

Poor people have difficulties, when applying for credit, to provide sufficient and appropriate guarantees, and as a result, they have almost no access to formal forms of commercial credit. They also have difficulties providing an appropriate (in the eyes of the commercial finance suppliers) destination for utilization of this money, namely a business plan, a production project, a farm planning program, or any other income-generating projects, capable of generating enough income to sustain themselves and to be able to reimburse the credit.

One solution for this problem is the mutual guarantee created among the poor. The Grameen Bank is famous for this policy.
The Moshav in Israel, based it's economic activities on the mutual guarantee created among all its members, to enable the availability of long and short term credit allocation deriving from external financial

sources, since its foundation in 1920s. I still remember, many years ago, when serving as a treasurer of a young Moshav, going to the bank, holding in my hand a long sheet containing all names of the 80 members of the Moshav and their signatures, the mutual guarantee of the members, to serve as part of the guarantees needed by the bank.

Mutual guarantee is, in some circumstances, a very useful means through which poor may obtain credit, especially for productive purposes. Mutual guarantee alone is however, in some cases, a short-sighted policy. A mutual guarantee should be part of a more comprehensive policy, which can be described as part of the Essential Triangle of Production (ETP).

## 3. Guarantees to ensure production.

The way it has been developed was a quite long one. The following paragraph will describe how it has been evolved, and its contribution to obtain the needed credit .

#### a. First of all.

One more important point is that at the time of the introduction of the mutual guarantee method to the members of the Moshav, during the 1920s and 1930s, they were highly poor. The cooperative way is a very good one for poor people. The mutual guarantee enabled development in these poor communities. The development of the mutual guarantee method went through several stages. In the beginning, sixty to eighty years ago, farmers, who were the members of the Moshav, were very poor. Their productive activities were financed, not by banks, hardly existing and very small, and in their initial stage at that time, but by organizations, which, in a colonized country at that time, were non-governmental ones. At that time, the cooperative, very simple in its compositions and its functions, functioned mainly in the channeling needed credit to the producers.

This finance was used to establish farms, the necessary fixed assets, as well as the initial finance of the operation of the farming activities. The finance for the establishment of the cooperative was given by the Jewish Agency on a long-term credit basis, and was calculated within its nominal value, so the reimbursement, on the long run, became insignificant. No guarantees were needed.

The credit for the operation of the cooperative and especially the one which finances the productive activities of the farmers is of a short term credit nature. The nature of this credit depends very much in its duration on the length of the production length period. When a farmer launch a field crop, the needed credit is for the period of time starting from the preparation of the land to the harvest and marketing of the crop. It varies from crop to crop, and is between 3-6 months on average basis. When we examine animal husbandry the situation is a bit different, since there is a time difference between the birth of a milking cow to the time it gives milk to be marketed, and this time, generally two years, should be financed. There is a time span from the time the chicken is hatching out of the egg to the time the chicken starts to lay eggs, usually 6-8 months.

The finance needed to the production activities is sometimes important in size, even though it is for short time. The solution found at the Moshav system, so long time ago, is the Mixed Farm Approach. The Mixed Farm Approach proposed the farmer to have several production activities to enabling him to have a whole calendar year of employment, to avoid the underemployment characterizing the traditional rural areas, as well, as much as possible, a whole year balanced cash-flow.

The idea was that during the 12 months of a year there are overlapping time of, on one hand, months of production and the need for finance, and on the other hand, months of marketing when the cash-flow is positive. Since we are speaking of a cooperative with one hundred members-producers, the overlapping between need to finance and positive cash-flow exists in most of the year, including the fact that the Mixed Farm Approach presenting possible income through out the year. This is the Saving and Credit function of the Moshav, where the members in need of finance pay to the members who have positive cash-flow a Competitive Rate of Interest (CRI), through the Moshav. This overlapping enables to reduce the need for external finance from external financial sources, generally rare and costly, and to respond to the financial needs of the members.

**b. The second characteristic.**

The second phase happened sixty to forty years ago. Slightly faster development took place in the country, so more credit sources were needed and available. Those credit sources were mainly from banks. Then, the guarantee for credit allocation became indispensable. The cooperative, the Moshav, became more and more a multi-purpose cooperative, and the mutual guarantee among all the members of the Moshav was the practice. A Moshav is generally composed of 50-100 members and they are guarantors to each other. This was, at that time, a very comfortable system for the individual member, but this was not enough. Another element to guarantee credit was added, the cooperative marketing. All the produce of the Moshav members was marketed by the Moshav, and the payments for this produce, part of it, was used to repay allocated credit. In this phase we see the constitution of the Essential Triangle of Production, where the Moshav serves the member-producer as the source of credit, supplier of inputs, and marketer. Another element is savings, mentioned already, and now was empowered. The Moshav supplies credit, which is composed out of external sources and of the members' savings. A way to encourage members to leave their money within the cooperative was to offer them a Competitive Rate of Interest (CRI) as compared to other available outlets for savings.

**c. The changes.**

The third phase, forty to twenties years ago, was a period of very rapid development in the country. This period saw another method of credit, mainly from government sources, the "Guided Credit". This credit was allocated after a business plan was prepared by the cooperative, a plan that shows the profitability that will enable the reimbursement of the credit. To this were added the existing methods of Mutual Guarantee and Cooperative Marketing.

After this phase other changes came, but I will not get into those in this paper. I would like to emphasize here that a micro-finance project should include, among other elements, the providing of credit at a Competitive Rate of Interest (CRI), as well as the possibility for borrowers to save their financial resources at a rate that will safeguard the real value of their money, the money of the poor producers. At the same time, this money should be directed, as credit, towards income generating projects. The production, and the services provided, should benefit from the supply of the cheapest possible inputs, the ability to market the produce at the highest possible return and the transferring of this money (minus the total operating expenses) to the producers. I am not sure if this is the practice in Self-Help projects where ever they are implemented.

**d. Understanding the model.**

The Essential Triangle of Production is a must in any environment of production. It exists everywhere production is. What is it about?

In order to produce, a producer needs credit. The same applies to a person wishing to create an income generating project selling services. With this credit he is able to purchase the necessary inputs. He produces, utilizing the various factors of production, including the necessary know-how to enable him to produce in the most efficient way. The produce is marketed, and enables the producer to repay the credit borrowed. The ETP is composed of credit, supply of inputs, and marketing. The triangle should always be closed, to enable the project to succeed, and for better performance for the producers it is recommended that it would belongs to the producers.

In the traditional set-up, the production is financed by credit allocated by the money-lender, who lends the money at the highest possible rate of interest. The supply of inputs is done by the private trader who sells these inputs at the highest possible price. The produce, when production is done, is marketed by the middleman. The middleman pays to the producer, generally, the lowest possible price. In many countries, the three functions are done by the same person, and in most cases, not at all to the advantage of the producer. This enables the person who supplies the credit to guarantee its reimbursement.

Many developmental projects have failed since these projects neglected the existing of the ETP. They tended to provide credit, but neglected the other functions of the triangle, namely the production, the inputs and the marketing. The success of the Moshav for many years was due to the fact that it closed the triangle at the link of the angle between marketing and credit allocation. In the Moshav, the triangle was closed, but more than this, it belonged to the members of the Moshav.

The success of the triangle depends greatly to the fact that it belongs to its members. A possible way to create this success is the cooperative way. The credit would be supplied through a savings and credit cooperative belonging to the members, the producers. The inputs would be supplied by a supply of inputs cooperative belonging to the members, the producers. The marketing would be done by a marketing cooperative belonging to the members, the producers. The producers are the owners of the three single purpose cooperatives, making practically one multipurpose cooperative.

I have already mentioned that mutual guarantee was not enough to obtain credit, especially short term credit. The complementary part of the guarantees came from the linkage between the marketing of the production and the credit allocated to producer.

# 4. Another possibility

I would like to describe another model of Micro-Finance.
The poor person needs finance when approaching any economic activity. Poor people are out of accessibility when requesting finance. Projects based on Micro-Finance are important when offering finance to poor people. In many cases, worldwide, these projects are not reaching their target of providing the poor with the opportunity to get out from poverty.

I would like to propose a different angle to look at the Micro-Finance projects and their achievements.

1. The Micro-Finance enterprise belongs to its members, and provides them the best possible service at the lowest possible cost.

2. The Micro-Finance enterprise allows its members-owners to save their money at a Competitive Rate of Interest (CRI), the highest possible one. A rate of interest which takes into consideration the rate of annual inflation in the given country where this enterprise exists, as well as to be higher than that offered by any other financial institution for fixed deposits. It allows them to obtain credit when necessary, at a Competitive Rate of Interest (CRI), the lowest possible one.

3. The Micro-Finance enterprise exists to serve its members at the best possible way. This means, no profit, no surplus. The enterprise would function on the basis that its total income would cover its operational expenses plus the interest paid to members on their deposits.

4. The Micro-Finance enterprise is aimed at the provision of credit to income generating projects (not exclusively, but mainly). This credit is part of the Essential Triangle of Production (EPT), where the production process is inside a triangle. The triangle is composed of the Savings and Credit side, the Supply of Inputs side and the

Marketing side. The connection existing on the angle between the Marketing side and the Credit Supply side determines the rate of success of the Income Generating Project.

## 5. Summing-up

The Micro-Finance enterprise aims at giving credit as its main activity. Attention should be paid to the ability of the beneficiary to utilize the money in order to create income generating projects of any nature. The projects would generate the necessary income to pay back the credit. The activity of the supply of inputs is integrated as well. In that way marketing is integrated into its action, at least to increase the level of reimbursement of loans.

Micro-Finance enterprise should be considered in the broad aspects of its possible activities, and its potentiality to bring development to the poor.

I feel that many governments, NGOs, and other credit organizations, including those supported by WOCCU, are dealing only with credit, and are not taking into consideration the other components of the triangle. EPT is essential to the success, but as well to the sustainable development of the poor.