

FINANCING POVERTY ERADICATION: TOWARDS NEW FRONTIERS

Geof Wood

The Macro Context

Despite recent records of favourable economic growth rates compared to many other countries, the current economic growth rate in Bangladesh is in decline: at just over 5%, a long way short of the double digit figure assumed necessary by many to lift the country out of poverty. This is significantly attributed to a decline in the investment ratio. Part of the problem has been the assumption among many economists, especially within the international agencies, that such growth can only be led by those already established in purportedly dynamic sectors of the market, stimulated by various forms of public sector investment such as infrastructure. However the widespread rent-seeking in these sectors of the economy is consistent with investment strike, thus removing the intended trickle-down effects envisaged by conventional economics.

The alternative argument suggests that the poor themselves can positively contribute to economic growth rather than relying on trickle down from others. It is argued that the poor, still largely confined to the (broadly conceived) agricultural sector, can themselves lead this dynamic sector with appropriate financial support through both larger scale trading and services activities, as well as through investment in higher return technologies in production, processing, transportation and marketing activities. There are also related prospects for the poor in leading the development of rural infrastructure and gaining much value-added from it. However to facilitate this approach to economic growth (equity for growth rather than growth with equity?), it is essential to remove the distortions in rural and urban financial markets which at present encourage both rent-seeking and other forms of allocative inefficiency, while functioning to exclude the enormous unmet demand from poorer classes for capital widening and deepening.

Within this broader context of the connection between economic growth and poverty elimination, this workshop focused upon the role of microfinance in the financial sector to support the graduation of the poor, especially in facilitating their entry into wider markets either via higher productivity enterprises or through earnings from deposit accounts. We need, then, to be alert to the relationship between the graduation of the poor via financial services, and the graduation of the institutions serving them. This latter graduation may involve MFIs and NGOs with MFS in a scaling up from 'micro'-financial services to 'meso'- and 'macro'- ones; it may also involve them in performing wider banking functions. Both options would enable such institutions to retain their most trustworthy and profitable clients, to spread their portfolios across different products, and thereby through internal activity contribute to the minimisation of risk incurred through both widening and deepening activity, as described below. A further corollary, or pre-condition, has to be the creation of a level playing field with other financial service actors in the formal banking sector, where informal subsidies distort allocative efficiency and undermine the economic efforts of the poor and their financial service providers.

Financial Services as a Human Right

It has often been argued, not least by Md. Yunus of the Grameen Bank in Bangladesh, that credit is a human right. We would wish to extend that remark to assert that access to financial services is a fundamental right for any citizen. Why should this remark not be dismissed as simply utopian and fanciful? The answer lies in the significance of financial services as a key ingredient in the individual or household's management of livelihood strategies. To be denied access to financial services is tantamount to a form of social exclusion (Davis 1999, Room 1998, Silver 1995, Gore et al 1995), since most successful families (in terms of livelihood strategies) rely extensively upon financial services for the normal management of personal liquidity and consumption smoothing. In this sense, access to financial services in terms of savings and borrowing has become a fundamental feature of market inclusion, with positive interlocked effects to other labour and commodity markets. For example, being able to borrow and save enables the individual to cope with flexible labour markets and periods of structural, temporal unemployment. It enables individuals and families to access otherwise prohibited consumption. It enables them to invest in human capital as a precondition for labour market re-entry. It enables people to postpone present consumption in order to provide for old age welfare. It enables them to perform expected social duties, thereby avoiding social closure and instead contributing to the creation and maintenance of social capital. In short, it enables people to perform as Rawlsian citizens (Rawls 1972), thereby ensuring the maintenance and flow of key satisfiers to human need (Doyall and Gough 1991).

Of course the fundamental problem with any idea of a 'human right' is the performance of correlative duties (Whitehouse 1996). In this case, that means that institutions have to be available and willing to perform these financial services, thereby giving effect to the right. It also means that other sets of conditions in the political economy have to be favourable: political order to underpin trust in monetary transactions; the participation of a tiered range of institutional stakeholders willing to get involved as long as risk is spread and offset; therefore a functioning state with the attributes of governance and transparency; and prevailing conditions of economic growth and productivity which permit real value added to monetary assets. Obviously the problem addressed by microcredit interventions is that the normal, commercial banking sector in most societies with mass poverty has not been available and willing to perform these correlative duties for poor, often rural, clients. They have been regarded as too expensive and too difficult to reach, and risky also with little collateral to offer.

These arguments thereby place financial services in a necessary and prominent position in the architecture of livelihood maintenance. In any developed economy, their presence is taken for granted in the form of loans (e.g. house loans), overdrafts, savings facilities, insurance, instant access, current accounts, standing orders, bank drafts, money orders, re-financing, information and monitoring of client performance. They appear as a normal, intrinsic part of personal and household level livelihoods management. Thus for many citizens in developed economies, the existence of financial services as a right only becomes apparent when their presence is threatened (i.e. through default, labour market exclusion, and trading losses), with absence and withdrawal (enforced exit) thereby representing a form of social exclusion. This withdrawal can quickly translate into forms of destitution such as loss of address (i.e. homelessness) with all the attendant withdrawal of entitlements and access, constituting a further round of constraints to market and societal re-entry.

Thus we have to see financial services as a routine feature of livelihoods maintenance in any society rather than as a special set of institutions justified by low overall development status, low savings and investment ratios, particular barriers to market entry and quality of presence within them, and high incidence of poverty. In this sense, financial services become a human right across the board, not just an anti-poverty instrument. However, financial markets have been segmented by the idea that significant sub-sections of the population are, and for the foreseeable future will be, unable to access 'normal' financial services. These sub-sections therefore require 'micro' finance or credit, characterised by subsidised targeting and low equilibrium economic activity, yielding low net returns on activity, which effectively precludes richer clients from seeking access to such subsidies (see Wood on 'finance ghettos' 1997). As part of a 'rights' argument, we wish to see an end to market segmentation of this kind, and greater integration between the small and large scale ends of the financial market. In this way, poverty eradication becomes a mainstreamed activity of the economy rather than a residual haven for do-gooders with limited sustainability. In this sense, the ultimate goal is to remove the 'micro' from microfinance, although it will take several steps to get there. This book is all about taking those steps.

Poverty and Financial Services

Two decades of development practice in Bangladesh have established that microcredit, savings and other financial services are important tools with which to fight poverty. Although on-going research has yet to establish whether financial services to the poor actually eliminate poverty, it is clear that access to financial services does indeed alleviate poverty. On-going efforts to at least contain poverty are thus crucial alongside specific poverty eliminating strategies. There is an argument to be made therefore, that financial services should be made accessible to all kinds of poor in Bangladesh. These efforts should aim not only to address the needs of today's poor and the poorest, but also to address the needs of tomorrow's poor as well.

While the poverty alleviation campaigns of NGOs and the Grameen Bank for the last two decades started with providing micro-loans, it has been increasingly evident that deposit services and other financial services may have a more significant role in helping the poor, especially the poorest of the poor. One strong argument for the significance of savings and other financial services has to do with the income risk faced by the poorest of the poor in the rural areas of Bangladesh. The adverse effects of income risk on poor people's welfare prevent them from moving beyond the poverty line, and can even push people living on the margins of poverty into deeper pockets of poverty. (These comments are consistent with the increasingly significant distinction made between chronic poverty and transitory poverty. The prevalence of the latter over the former, establishes the case for income smoothing. See McCulloch and Baulch 1999 for a parallel analysis of Pakistan.) Access to diversified financial services mitigates liquidity problems that the poor face (especially the transitory poor) given the risky environments in which they live. Yet, only less than 25% of poor households in Bangladesh have access to financial services provided by NGOs and the Grameen Bank. Therefore, there is a need for further widening of these services to meet the vast, as yet unmet, demand.

Studies have established that different groups of the poor need variegated financial services. For example, a strong case can be made for providing savings services to the poorest of the poor to include them in the financial system. It has been documented that the poorest of the

poor may not have the debt capacity to be regular borrowers on microcredit programs; that they self-select themselves out of these programs; that they are 'screened out' by potentially stronger repayment performers in joint liability/social collateral arrangements; or that they are intentionally excluded by the credit-providing institutions themselves (see various chapters in Wood and Sharif (eds.) 1997). Massive savings mobilisation therefore, is an important mechanism to reach the poorest of the poor. On the other hand, poor producers or marginal farmers may be in a position to use loans effectively to raise their income levels, and eventually arrive at a position to afford other financial services such as crop insurance, health insurance, consumer credit, housing improvement loans, mortgages, and educational loans. There is a case therefore, for developing a financial system that will offer diversified and flexible financial services to the poor.

Graduation, Prevention and Social Protection: Heterogeneity of Needs and Capacities

In these discussions, it is important to remember that the poor do have special financial needs beyond the normal case for financial services which applies to everyone, as noted above. The experience of poverty is the experience of vulnerability and insecurity with respect both to income flow and therefore to a bundle of entitlements. For those in subsistence production there is the familiar risk of low technology, climate dependent production. For those in petty commodity trading, there are two persistent risks: that customers themselves lose entitlements and drop out of the petty trader's market; and that too many local competitors will saturate the local market and drive down margins (see Wood 1997 in Wood and Sharif 1997). For those in employment, agricultural work is seasonal with a labour market deeply socially embedded and characterised by imperfect information; urban manufacturing and services work is precarious at the lower, unskilled end partly because of substitutability and partly because it can be highly sensitive to other market forces (price shifts, demand volatility, re-located sources of supply, especially under increasingly globalised market integration).

These uncertainties restrict the opportunities for personal planning, especially longer range planning. By definition, the poor have to give priority to immediate, practical needs thereby discounting the strategic future more highly than other groups. Thus the role of financial services to the poor has to be so designed as to engage with this discounting reality. Much contemporary microcredit operates to this effect with small loans, rapid repayment schedules and repeat loans with limited prospects for long term graduation. When interventions are extended to savings and deposits, there remains a strong presumption (e.g. by those arguing correctly for open access) that for the poor they function primarily as short term liquidity management, even if stretched over life cycle events such as initiations, weddings and funerals. In this sense, the ghetto problem remains by restricting the function of financial services to welfare and short term consumption rather than to the longer term prospects of graduation.

Thus the link between financial services and poverty eradication (in contrast to alleviation) has to consist of an ambition to link the poor to the more normal range of financial services available to others in order to perform development and strategic objectives, as well as welfare and practical/immediate ones. For example, this ambition would convert consumption smoothing from short term, seasonal liquidity management to lifetime planning. Sickness insurance would be another example. In this way, financial services contribute to the removal of insecurity and uncertainty, thereby performing a more developmental function, albeit indirectly.

At the same time, heterogeneity among the poor has to be noted. For a financial services discourse, a major conceptual distinction should be drawn between those with a prospect of graduation through sustained production, trading and employment activity; and those whose destitution, or ‘highly dependent poverty’ (see Wood 1999b) entails a moral right to social protection, albeit implemented through a sub-sector of the financial services industry, operating at the grassroots level. In another language, ‘welfare to work to well-being’ does not work for all, though there should be disincentives for the ‘able’ to jump over the middle part of the equation. Despite this conceptual distinction, the poverty reduction issue is partly one of preventing a pervasive and chronic life cycle pattern of movement from the first to second category, i.e. from poverty to destitution, or highly dependent poverty. Thus the challenge for financial services is whether they can achieve the dual objectives of assisting graduation as well as prevention, thereby keeping the major proportion of the social protection function outside of any state-led tax and benefit system.

It may be objected that such a state avoidance strategy is not redistributive and does not call upon a sense of moral responsibility for poverty reduction by the richer elements in the society. The counter-argument is that the agenda of poverty reduction cannot wait for states to become sufficiently legitimated within their societies to perform a widespread net, or ‘zero-sum’ redistribution function, hence the attraction of the financial services option which is essentially premised on a Pareto optimum principle. At the same time, if the classification between poverty and destitution, or highly dependent poverty, is accepted, then states may more easily reach legitimation on more limited zero-sum redistribution to the destitute, orchestrated either by the state itself, or arguably by franchising the administration of such welfare commitments also to the grassroots, retailing end of the micro financial services sector via both screening and benefit delivery.

It has been necessary to make these observations as the basis of acknowledging the complex interrelation between a poverty reduction oriented microfinance sector and the state both in terms of mobilising resources but also in determining how such resources are distributed and how they are managed. Given the differentiated products which should characterise the microfinance sector, we are arguing that they should be calibrated closely to different types of poverty. But we are also saying that the state has different types of participation in the microfinance sector which are partly determined by these different types of poverty and needs:

- as direct contributor of resources to MFIs to support graduation objectives;
- a guarantor role which functions to lever other resources to the poor;
- use of the retailing grassroots end of the MF sector under franchise to perform targeted social protection services on behalf of the state, using public revenue sources (accounting for them separately to avoid distorting cross subsidisation);
- and maintaining a supportive economic and legal environment within which differentiated MF activity, calibrated to the heterogeneity of poverty, can occur.

Social and Economic Development

These arguments about graduation, prevention and social protection have to be pursued and disaggregated further. There are some hard questions to pose in terms of the linkage between development and poverty **eradication**. It could be argued that in the past the objectives of

development and growth on the one hand, and poverty alleviation on the other were more loosely linked conceptually. This is reflected in a bundle of assumptions about market segmentation for income-generating activity: skill levels; risk aversion; uncertainty; appropriate technology; small scale economic projects; rapid, high turnover but low financial returns; imperfect markets characterised by imperfect information; virtues of the informal sector (ease and price of entry). This combination of assumptions has functioned to limit the 'financially serviced' economic ambitions of the poor to the more traditional and perhaps non-dynamic sectors of the economy. This is the ghetto point, entailing restricted prospects for serious graduation. It also fails to acknowledge the potential role of the poor in contributing more dynamically to the overall development of the economy through higher productivity, higher capitalised economic activity, thereby adding to the quantum of effective demand in the economy.

Thus a key premise for some of the discussion in this book is that there is considerable under-utilised potential for growth in economies like Bangladesh, but that past and present microfinance activities make only a limited contribution to that potential for three reasons. First, by setting a ceiling, in effect, on the scale of income-generating projects run by and for the poor. Secondly, by confining them, in effect, to the lower productivity sectors of the market. And thirdly, as a result of the first two reasons, by restricting, in effect, the scale of their effective demand (another growth driver). The purpose behind this argument in this book should not be misinterpreted as a dismissal of the enormous value contributed by the microfinance sector to date. We are very respectful of that history (see below). Indeed it is that history which convinces us that microfinance can make a bigger contribution to overall economic development by releasing still further the skills, energies and entrepreneurial inclinations of those hitherto excluded from major and expanding market opportunities. It is clear that the major NGOs in Bangladesh with MFS have interacted through capital and skills training with a widespread, latent business sense among landless men and women. It is also clear that these NGOs have opted to behave conservatively with respect to risk, preferring to support many traditional rural activities (such as cattle fattening, handicraft production, petty trading in paddy and rice, rickshaw pulling, and so on) which rely heavily upon known techniques and established local demand. The problem with such a strategy is the tendency to over-saturate these local markets, driving down suppliers' margins. This constrains capital accumulation based on such activities for use at the next level of more capital intensive activity. It also provides little experience of operating in new, innovative markets thus maintaining the principle of market segmentation. It retains the principle of risk aversion via the over-exploitation of the cheapest factor of production: labour. Thus we have institutions themselves imitating poor peasants' risk aversion, which is hardly developmental.

If these arguments ring true, then, despite the best intentions and undoubted achievements of the past, as we look to the future, we might conclude that by only continuing MFI activities (especially the credit dimension) in their present form (i.e. low technological content, micro scale of financial support, petty trading entry levels in the market) poverty alleviation rather than more ambitious development/eradication objectives will dominate. In contrast to this, can we envisage an alternative scenario?

Several, more innovative possibilities arise:

- separating capital owning from capital use;
- recognising the worth of the entrepreneurial poor;

- relaxing principles of group solidarity and equality to enable economic talents and leadership to flourish;
- encouraging the formation of local shareholding and stockholding companies among the poor;
- enabling poor savers to invest in equity markets remote from their own economic activity, when the rate of return is higher in the former;
- investing in more capital intensive activity, making greater use of enhanced infrastructure to reach wider markets;
- encouraging strategies of vertically integrated production via partnerships with other economic actors to make best use of comparative advantage (e.g. outwork, out-sourcing, rural industrialisation using 'just-in-time' production management techniques);
- and recognising the production and service opportunities created by administrative decentralisation and associated processes of rurbanisation.

This list (not exhaustive) of direct linkages between the poor and economic development implies high social content, which is where the distinctive mobilising role of NGOs enters. Just as we now recognise that all markets are socially embedded and therefore operate through different types of relationships and moral or cultural presumptions, so the social development activity of NGOs constitutes a key underpinning of these wider economic ambitions. In other words, the proposed **economic** innovations to be undertaken by the poor require corresponding **social** innovation, for example:

- in the formation of local shareholding and stockholding companies;
- in the establishment of critical level production units;
- in accessing and sharing market information;
- in organising more complex management functions and specialist tasks among such 'companies of the poor';
- in developing capacities to operate in depersonalised, commodity markets.

It is in this sense that social and economic development have to go hand in hand. But unlike the atomised, individualised middle classes, the organised poor have some institutional advantages via connections with NGOs and MFIs to enter markets at a higher level of performance.

A crucial aspect of these institutional innovations can be that poverty focused microfinancial services might not always lend to the poor directly, but sometimes to their employers. This is obviously a much more controversial proposition. But to what extent could poverty-focused MFIs and NGOs switch the criterion for justifying aspects of their financial services (i.e. larger scale credit for higher technology, longer gestation projects) from the **poor** as direct recipients towards **activity** which contributes towards poverty eradication? For example, lending to the small-scale, bottom end of the garments industry under a series of conditions regarding labour rights and standards might better secure stable, quality employment for the poor so employed than lending the same amount directly to those poor in other ways. We accept that larger garments operators would have no need of such loans and would screen themselves out. Given the social and economic development opportunity cost of scarce funds, the primary objective of these funds should be poverty eradication rather than their direct utilisation by the poor. If the two go together—great! But do they always? It must not be forgotten that the main rationale for lending to the poor directly as the method of poverty eradication is pervasive hostility of the political economy through which we cannot otherwise

expect redistribution. This is the critique of trickle down approaches. But where **socially conditional** lending can achieve more poverty eradication, more efficiently (because of other knowledge and market linkages by small scale garment entrepreneurs, let us say), then an aspect of the hostile political economy has been bucked and made more poor friendly.

Prevention and Social Protection

These observations on the past limits of microfinance to contribute to graduation objectives and thereby wider processes of economic development and growth clearly imply that the major outcomes of microfinance interventions to date have been prevention and social protection. Such a judgement may come as a surprise to all those who might counter with masses of evidence of credit-supported economic and income generating activity among landless men and women. It might also be surprising to those who can offer evidence (e.g. from Grameen Bank and ASA) of the progressive scaling up of loan sizes as previous ones get repaid (i.e. in response to assessed client performance behaviour). It may therefore be true that some graduation for some microcredit clients has occurred. But how widespread and how complete in terms of autonomous client relations with the formal banking sector using newly accumulated collateral as the entry qualification? Against that harder question, the evidence is at best anecdotal. We might cite the many landless operated shallow tube well irrigation projects among Proshika groups and other agencies as an example of greater financial autonomy from agency Revolving Loan Funds (RLFs), but how far has graduation spread to all group members in such schemes? Some other groups have successfully invested in mechanised transportation, and still others in larger scale wholesaling of rural produce and urban manufactured goods.

However the vast majority of the income generating activity supported through microcredit has been of the low return, high turnover kind noted above. It is important to be clear what judgement is being made here. The evidence is strong from numerous evaluations, reviews, regular monitoring data and so on that micro-lending, increasingly linked to hypothecated savings (rather than the social collateral of group liability), has maintained coping livelihoods where they would otherwise have declined: i.e. the welfare and social protection function (or 'prevention'). In this sense, such microfinance interventions are reproducing the capacity of many poor families to cope and, in many cases, modestly improve through scaled up loans to support house acquisition or invest in children's education. Such micro-lending is predicated upon assumptions of limited absorptive capacity among poor clients, significantly women. Some of the papers in this volume will point out that the unmet demand for this category of micro-lending is substantial, thus making the case that such micro-lending should be significantly expanded. When we add the broader interpretation of financial services (i.e. open access savings, money orders and other 'insurance' type products) which contribute significantly to liquidity management, consumption smoothing and remittance transfers between members of dispersed families, then the contribution of microfinance institutions to poverty **alleviation** is assured, significantly through the self or collective construction of safety nets. The issue then is:

- how to extend coverage of the poor population with such services;
- how to expand the resource base to meet this wider demand;
- how to protect the integrity of poor people's money when it is deployed as a key contribution to that resource base;

- and how to add value to the funds from other non-poor sources, investing in this expansion of microfinancial services?

Widening and Deepening Financial Services

These arguments lead us to the rationale for both widening and deepening financial services to the poor. In understanding the rationale for both of these objectives, we should return to the distinction between the two terms: poverty alleviation; and poverty elimination or eradication. After the failure of earlier revolutions around the world seeking to achieve poverty eradication and equality, agencies, some governments and most activists have been settling for the important, but less ambitious, objective of poverty alleviation containing high welfare functions, paying less attention to the structural causes of poverty and long term graduation of the poor into sustainable positions in the economy. It has been helpful globally that the recent UK-DFID White Paper on International Development has put those more ambitious objectives back on the agenda, replacing the language of poverty alleviation with the language of poverty elimination.

We might therefore consider the following matrix:

Financial Services/ Poverty Objectives	
Widening for Alleviation	<25% of poor households in BD presently receive microcredit services from NGOs with MFS, or from MFIs; the micro-scale of this credit can only support liquidity management and micro-activity (high turnover, overcrowded petty commodity and product markets, low returns at or near prevailing wage rates, sustaining low level equilibrium traps, with limited prospects for graduation even under graduated lending schemes); such microcredit might be regarded as performing essential welfare functions (though liquidity management might be achieved better through savings) consistent with alleviation objectives. Wider support for these essential welfare or ‘livelihood maintenance’ functions by extending the coverage of poor households to around 10 million can therefore be seen as a necessary condition of poverty alleviation but not a sufficient condition for poverty elimination.
Deepening for Elimination	This entails the principle of graduation for poor households into sustained positions above the poverty line, implying a restructuring of economic relations and opportunities. For poor households, such graduation entails two principles of deepening: larger loan sizes to groups, other institutional forms such as companies, and even to individuals to enable investment in activity with higher rates of return (often this will occur via technological investment); and secondly the investment of poor people’s saved capital in other remote markets, yielding high productivity returns.

These complementary options of widening and deepening, of alleviation and elimination can be further illustrated in the following two diagrams, contrasting poverty alleviation and elimination objectives but both leading to a case for expanding the resource base for offering flexible and diversified financial services to the poor.

Diagram 1

Poverty Alleviation and Widening

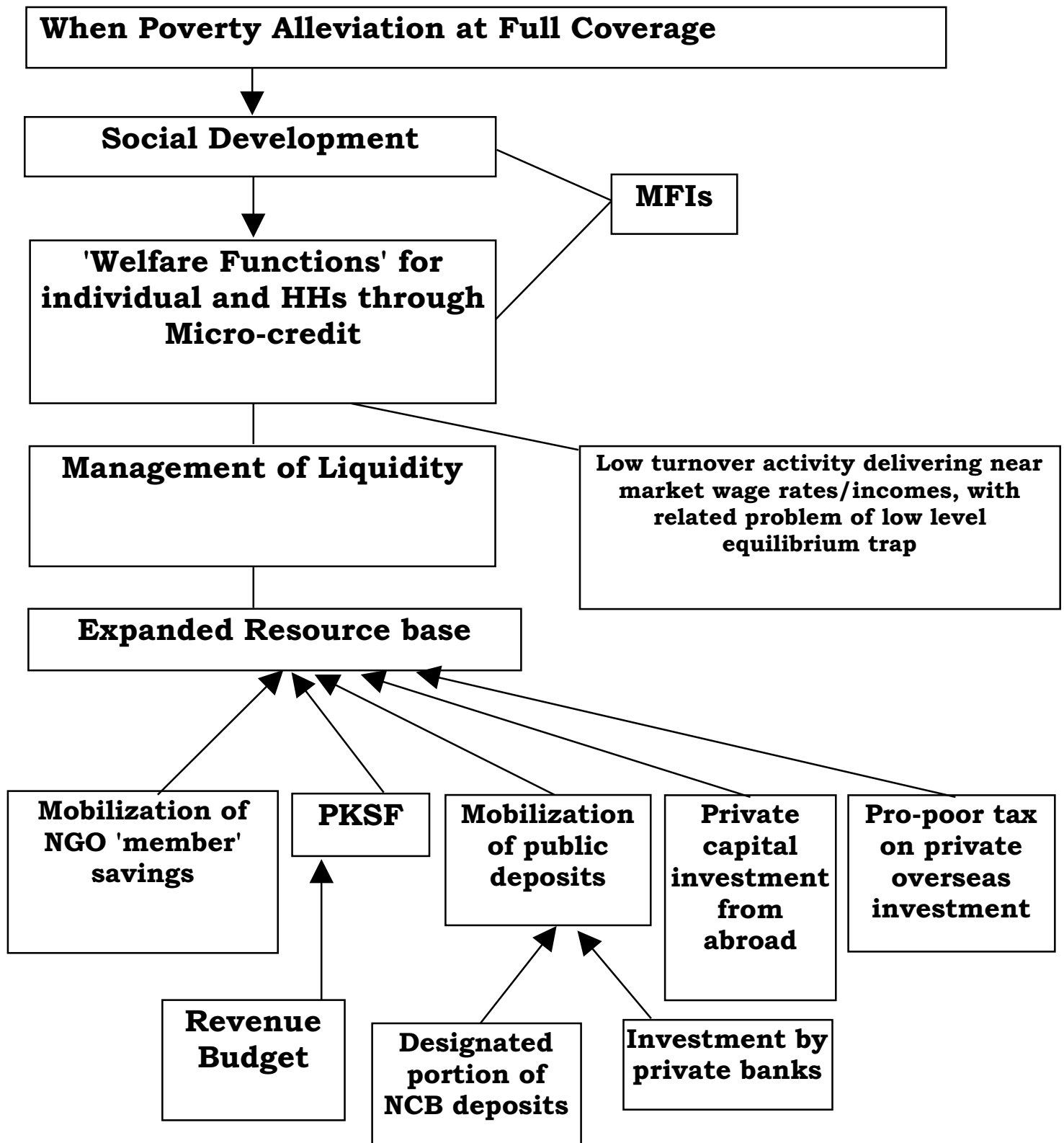
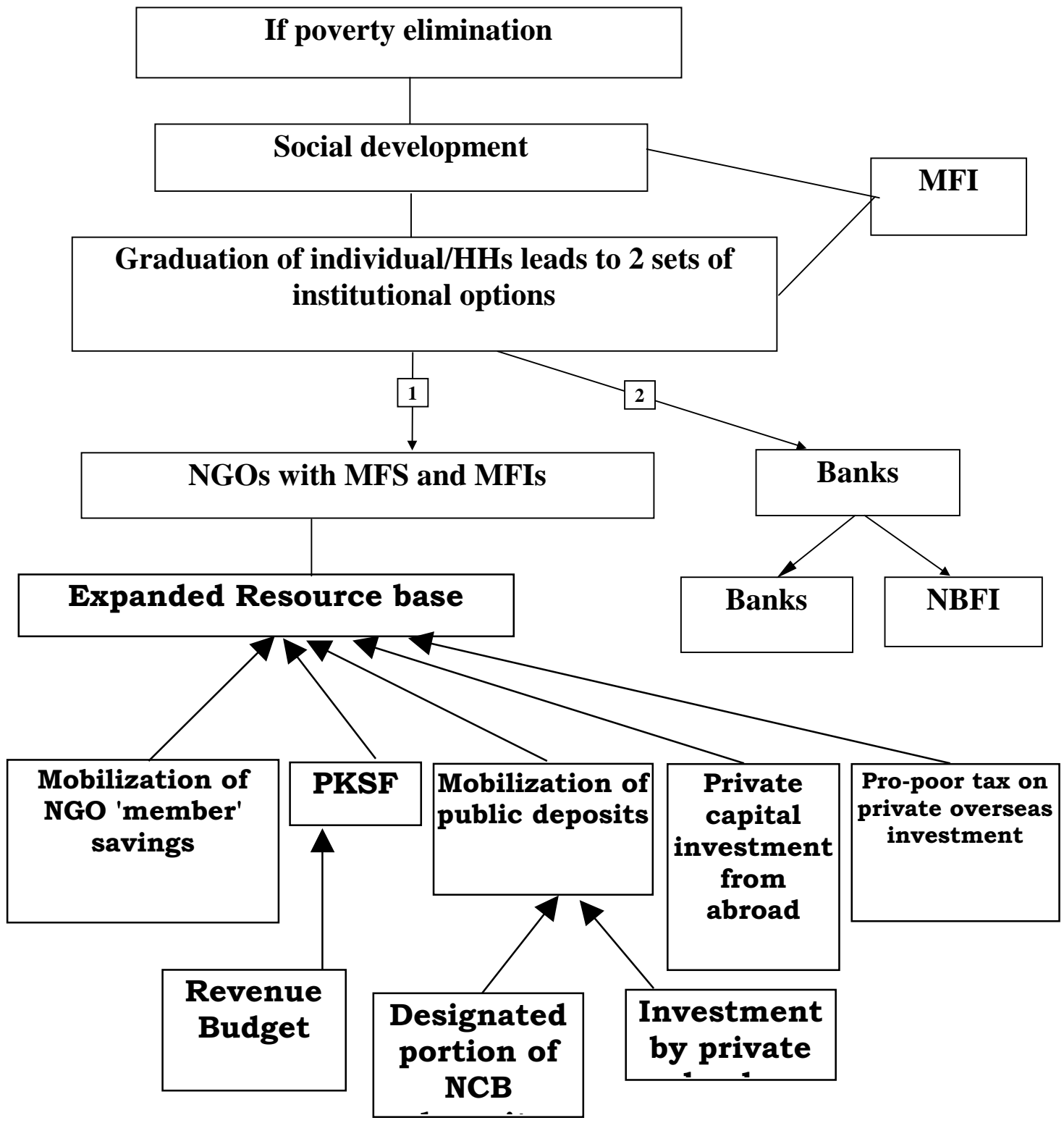


Diagram 2

Poverty Elimination and Deepening



These ambitions of widening/alleviation and deepening/elimination through flexible and diversified financial services to the poor and/or other economic actors contributing to poverty eradication are therefore justified in terms of:

- Meeting unmet demand through expanding the coverage of poor clients with microfinancial services (i.e. extending the ‘micro’ principle);
- Stimulating a process of graduation for those poor with higher absorptive capacity by increasing the scale of services and range of products to selected clients (i.e. removing the ‘micro’ principle);
- Acting as a growth lever for the economy as a whole, through tapping the potential for greater productivity and investment from among the poor, and from other economic actors who can contribute to poverty eradication through employment generation. The ‘employment generators’ remain dependent upon this sub-sector of the financial market for access to investment funds and are therefore prepared to accept ‘social responsibility’ conditionality as the price for access, given the lack of alternatives.

Thus the availability of financial resources targeted on the poor and related economic actors has to be dramatically expanded, and the fortunes of the poor linked more systemically to the rest of the economy through financial integration. This ambition represents a significant ‘gearing-up’ of poverty-focused thinking towards new frontiers of finance and institutional performance.

Expanding the Resource Base for Poverty-Focused Financial Intervention through Integrating Financial Markets

Given the inability of donors to fund this widening and deepening agenda, and given the experience of Grameen Bank in mobilising savings for lending and accessing other capital markets (as it is legally entitled to do, as a Bank), other MFIs and NGOs with MFS have to look to other sources to capitalise their financial activities. There is a further imperative for this search, also linked to donor fund constraints. At present, the PKSf (sourced significantly by the World Bank at heavily subsidised rates) represents a major source of subsidy to MFIs and NGOs with MFS to which it on-lends. But this is not an infinite source of cheap funds. As the PKSf is increasingly compelled to raise funds in private capital markets, so the interest rate margins to its MFI, and NGO with MFS, clients will decline dramatically, thus removing this source of income in the sustainability calculations of these client institutions.

What are the options, without donors?

1. Expanding the savings base from the clients of MFIs and NGOs with MFS, and mobilising such savings as a capital base for expanded, flexible and diversified financial services;

2. Accessing a portion of the national revenue budget as grant or subsidised loan via PKSF for onward lending to institutional clients, thus maintaining a public subsidy element through differentiated 'PKSF to MFI/NGO to end client' interest rate/service charge margins (with the related objective of binding the nation's middle classes into public commitment to pro-poor policies);
3. Accessing a portion of deposits held by the national commercial banks (e.g. 10%) for poverty-focused lending not by those banks, since they do not have the experience or appropriate financial technologies, but by proven institutional actors (i.e. MFIs and NGOs with MFS) (NB the prospect of an experiment to this effect with the Sonali Bank and the NGO sector, with an initial injection of Tk. 100 million);
4. With the prospect of financial liberalisation and privatisation of the banking sector, persuading such banks to go down-market, not initially through replicating direct service provision, but through investing in MFIs and NGOs with MFS, on the grounds of the 'bankability of the poor' and the quality and transparency of such institutional providers;
5. Attracting private capital investment from abroad, on the same principles as above;
6. A pro-poor tax (not discussed in the workshop) levied on the repatriated profits of overseas private investment at rates which would enable such investors to claim ethical status without constituting a disincentive to invest.

Fulfilling these objectives of both widening and deepening financial services will depend on the institutional capacity of MFIs and their viability in financial markets in the long term. Such a strategy is absolutely essential to ensure both quantity and quality of microfinancial services. To ensure and promote the institutional capacity of MFIs and NGOs with MFS to carry out this job of widening and deepening effectively, it will be important to delineate appropriate conditions and performance standards. This is especially true in the case of deepening as it involves a change in the nature of risks faced by these institutions. The following discussion explores further the implications of these options, together with some of the institutional conditions required to make them work. The more precise proposal is then offered in the concluding chapter to this volume.

The Case for Savings and Deposits from the Poor

It has already been established, above, that the poor have a strong interest in saving under open access conditions which enables them to manage liquidity over both short and longer term cycles, as well as functioning as insurance against shocks and disasters. However, the purpose of this discussion is to link this propensity to save to the objectives of widening and deepening poverty-focused financial services. The savings and deposits of the poor can function as part of the required expanded resource base, especially during 'transition' periods when other classes remain to be convinced of the efficacy of

investing in these objectives. However to attract such expanded savings from the poor and translate them into longer term deposits in a more remote, abstract financial system, with corresponding restrictions on access and instant withdrawal, entails a proliferation of financial products.

Any restrictions on access, as we have shown, are particularly difficult for the poor. The general conditions of uncertainty and insecurity affecting their livelihoods require highly flexible forms of risk management, in which instant access to savings plays a major part. It is precisely the conditions of poverty, which contradict longer-term deposit making. For the poor, the future has to be valued less highly than the present (i.e. discounted at a higher rate than by the non-poor). With high discount rates, the poor trade off long-term strategic investment in all forms of capital in order to secure essential, urgent flows in the short term (Wood 1999a). Thus there must be adequate and substantial compensation for the loss of liquidity in the form of higher interest rates, dividends and bonus accumulations. In effect, the effort is to persuade the poor to discount the future at a lower rate in order to attract their deposits. This cannot be achieved via financial market instruments alone. This is why the social policy and social development agendas of intervening agencies are so important in trying to reduce uncertainty and insecurity (e.g. securing more stable and adequate incomes in labour markets or through petty commodity trading), alongside social sector interventions in health and education. All such interventions contribute towards greater predictability over time, thus altering the discounting behaviour of the poor. In another language, there has to be a positive interaction between the decommodified behaviour of external agency support and the commodified opportunities in labour, product and trading markets (Esping-Andersen 1990, Room 2000).

One of the implications of the preceding argument about overcoming the reluctance of the poor to invest long term, is that deposit making becomes a symptom of achieving graduation from poverty rather than a vehicle for that graduation. Thus the case for deposit making cannot only be made in terms of expanding the resource base for poverty-focused microfinancial services. It must be made in terms of earnings to the poor themselves. This refers to the opportunity cost of poor people's scarce money in generating positive net returns. As observed before in this chapter, and in our previous book (Wood and Sharif 1997), the poor experience a ceiling in their value-added earning possibilities by borrowing 'micro' credit and investing in high turnover, low return activity. This activity is typically in locally overcrowded, saturated petty trading and commodity markets in which every operators' margins are driven down. When all costs are calculated, including significantly the unvalued labour of women (e.g. as in household level rice processing), these activities can be highly self-exploitative (i.e. often below prevailing labour market rates). This raises the prospect that poor people's own savings may earn higher returns by being invested in other people's higher productivity, more efficient, activities than by investing in one's own activities directly. Thus saving and making deposits in other financial markets might yield a higher return than the classic 'micro' combination of open access, low interest, savings (now more common) and micro-borrowing. This notion of a ceiling on potential earnings derives from a combination of: small money limiting the scale and/or point of market entry; poor

people's own human capital limitations (especially in relation to more advanced, risky, but 'high return potential' technologies); and poor people's lack of effective access to richer people's markets (as sellers of goods or services).

We can add a further dimension to this notion of poor people investing via deposits and even shareholding in other people's higher return economic activity. The value of investing in this way in one's own poor country will depend upon overall economic circumstances and expectations about co-variant risk. We might assert a world of difference between encouraging the poor of Uganda (or more obviously the republic of Congo) to invest in their own financial markets and, say, the poor in India. The latter enjoys more stability and growth potential than the former. This prompts the notion of mechanisms which enable the poor of some countries to invest in economies other than their own: i.e. on the global market. Could we, for example, imagine the Pakistani peasant investing via intermediaries in the Indian electronics industry or US telecommunications?

The Case for Investing in the Poor

The arguments for investing in the poor can be made along a number of dimensions, so long as their risk is managed at a level which encourages their entry into product and trading markets. Part of this risk management relies upon their relationship to external facilitating agencies for information, training and appropriate support if contracts are not honoured. This continues to be the role of NGOs, but crucially needs to include those elements of solidarity which determine the fairness of economic transactions when the stronger party seeks unfair advantage, through interlocking and embeddedness.

However despite these social and political economy constraints for the poor, they still warrant 'investment', justified by other than charitable instincts, because:

1. They have good track records of repayment.
2. They have a higher incentive than the rich to make their loans 'work'.
3. Their risk aversion can also be an advantage in constraining risky ventures and reducing moral hazard.
4. The inevitable deployment of family labour at below imputed shadow prices for that labour offers some cushion during periods of financial stress, provided that the period is not so long as to become self-exploitation.
5. The successful economic activity of poor removes the need for other grants and subsidies to support their welfare.
6. Higher returns, either in the form of wages or profits, reduce their discount rate thus encouraging non-essential (in the sense of life saving) current expenditure and thereby boosting effective demand across the economy.
7. In this sense, in societies of mass poverty, the non-subsistence economic behaviour of the poor contributes to the overall growth of the economy.
8. Rather obviously, as a result of all the above points, the poor have the opportunity to graduate.

The Constraints for Expanded Resource Mobilisation

As indicated above, these ambitions for finance against poverty required a substantially expanded resource base for this sector. However, there are various constraints, some familiar, on this resource expansion. **First**, in the context of aid-dependent societies like Bangladesh, the past donor subsidies to the microfinance sector cannot be assumed to continue, and certainly not at a significantly expanded level. Donors, including international organisations like the World Bank and the Asian Development Bank, are committed to establishing a commercial basis for this sector in the quest for sustainability. Part of the evidence for this stance lies in their encouragement for donor-funded NGOs to move further into market viable financial services, becoming more completely MFIs. The diagrams above thus deliberately envisage a rapidly approaching finite limit to donor funding. This has serious implications for the PKSf dependent NGOs with MFS in Bangladesh which are presently planning their routes to sustainability on the margins earned from on-lending heavily subsidised capital injections from the PKSf. Indeed most of the sector, including the Grameen Bank, has yet to be tested against the efficiencies of deploying commercially borrowed money.

Second, despite the optimistic assumptions of the bankability of the poor, based on repayment performance to date, deepening if not widening enlarges the risk of lending in the sector. Present microfinancial activity incurs little risk to the lender, especially where subsidies enable highly favourable staff-loan ratios to insure against failures of social collateral and joint liability mechanisms for reducing transactions costs. The willingness of commercial interests to enter this sector are therefore constrained by this enlarged risk associated with larger-scale lending and the efficiency requirements of driving down transactions costs. Thus market uncertainty and incapacity to police repayment avoidance intrude in the calculation. This is why the use of savings and deposits from the poor in an expanded resource base is such an important indicator to convince other, external actors to enter this sector. Such savings and deposits represent, in effect, a collective or macro social collateral. If the poor have faith in their own enlarged borrowing and are prepared to put their scarce and highly valued savings at risk, then others should be more convinced to do likewise.

Third, the opportunity cost of commercial capital inevitably directs it to entrepreneurial opportunities which are less risky based on predictions of competence, capacity and market information shown by bidders for capital. In other words, where does the comparative advantage for poor business persons lie? Given the high default rates experienced among other richer classes of borrower in Bangladesh (an experience widely shared in other countries—e.g. Pakistan), the need among the poor to remain creditworthy is higher, thus reducing the moral hazard explanations of non-repayment/compliance. Also, given the propensity of the poor to increase consumption under conditions of steady, if slow, economic growth, the demand for low-cost goods with modest quality represents an opportunity for the expansion of ‘quasi-informal sector’ manufacturing and services, where the literate and entrepreneurial poor (i.e. the

better-off poor) can excel over other classes of entrepreneur seeking to enter higher quality, more expensive market niches.

Fourth, the attraction to the poor of formal credit with tight conditions over other sources of funding has to be considered. The prevailing arguments about financially and ethically appropriate interest rates on loans to the poor are partly influenced by the presumption that the informal, private alternatives are so inferior as to offer much room for manoeuvre to institutional providers. Informal, local money-lending has the advantages of availability (if a favoured client) without elaborate documentation. On the downside, real interest rates are very high, reflecting a combination of power and risk management by the moneylender with relentless pursuit of property or labour value (i.e. bonded arrangements) collateral within the local political economy. The prospects of any 'return' on borrowing are very remote under such conditions. Such inferiority of the informal product increases the demand for the formal product and some willingness to accept the high end of the commercial interest rates continuum, along with repayment regimes. These demand conditions should function to attract suppliers into this part of the financial market, thereby relaxing the constraints to resource expansion.

Fifth, potential lenders to the poor, or for poverty eradication, have to consider co-variant risk among their clients. The poor are, by definition, vulnerable.¹ They are therefore more exposed to higher risk on their economic activities than others. They live in countries whose macro-economic conditions are unstable (witness the recent East Asia crisis). Financial institutions have yet to convey sufficient security and autonomy from local financial fluctuations to offset speculation and panic withdrawals. These institutions are also vulnerable to the volatility of global financial markets, having less cushioning via widely spread portfolios across those markets. In addition, poor countries can quickly lose comparative advantage on raw materials and finished products to international competitors. Such countries have often been historically dependent on a narrow range of export products (e.g. jute for Bangladesh) which are being replaced by synthetics, and/or on a dominant single commodity (e.g. Zambia and copper) making the whole economy vulnerable to both competition and global market downturns. Such countries quickly lose the multipliers within the domestic economy associated with those commodities, including the overall level of demand for unrelated consumption items. Finally such countries also more frequently suffer war and other disasters (floods, droughts) which can affect the ability of their populations (not just the poor) to meet their financial obligations. Clearly such co-variant risk makes potential lenders cautious, and can set limits to expansion of the resource base for mobilising finance against poverty. This is why external financial actors, certainly, will seek as much security as possible, assuming they are attracted by the positive aspects to expanding their portfolio to include poverty eradicating financial services. One security constitutes the J.D. Von Pischke proposal to include risk reducing insurance from outside the country to offset internal co-variant risk. Another security constitutes some domestic process of regulation, supervision, monitoring which legally or market clears potential free-riders on both the demand and the supply side.

¹ These terms are not synonymous, since the non-poor can be vulnerable too (see Wood 1999b, and Loughhead, Mittal and Wood 2000).

Need for Innovative Institutional Linkages between Sectors of the Financial Market

These five constraining elements to expanded resource mobilisation for the ‘finance against poverty’ sector all occur within a context of high potential at both the micro-income level as well as overall macro-economic growth. However it is clear that these prospects rely heavily upon hitherto unrealised linkages between different sectors of the financial market. With projected limits to donor funding of a significantly enlarged sector, along with the donor search for policy and institutional initiatives which secure long term sustainability, access to commercial capital becomes axiomatic. But how to establish attractive linkages to the banking sector: a sector which has traditionally ignored financing poverty eradication, especially the poor themselves, on the grounds of high transactions costs for little return at high risk. It has, after all, been this traditional reluctance which prompted the semi-formal microcredit interventions in the first place.

1. A principal-agent relation has to be established where capital owning is differentiated from the entrepreneurial capacity to deploy that capital in profitable financial services to the poor. In Bangladesh, a range of financial service institutions have demonstrated their ability to intermediate between capital and client.
2. Therefore, their track record can be accepted as some guarantee of efficacy, probity and return on capital. They constitute in themselves the critical dimensions of trust and risk minimisation as a precondition of their sustainability as financial intermediaries—inverted moral hazard, in effect. Nevertheless, even these intermediary institutions will have to move into new areas of financial risk (i.e. the large-scale mobilisation of deposits for on-lending) if poverty eradication via ‘deepening’ is sought.
3. Thus, if the banking sector is to act as holder of these liabilities through its trust of the grassroots intermediaries, it is bound to seek some guarantees of good practice and risk avoidance through supervisory and regulatory arrangements governing their financial interdependence. Given the overall problems of governance in Bangladesh, and societies like it, there has to be some reluctance in relying upon the state to perform these regulatory functions to the satisfaction of potential commercial entrants to this part of the financial market. The current performance is disastrous with excessive defaulting across the Bangladeshi business sector to the Nationalised Commercial Banks (NCBs).
4. The ‘finance against poverty’ sector has to find convincing ways of self-regulation, or at least supervision. These options are debated heavily in different parts of this volume, especially given the centrality of the PKSf role in any likely concerted search for commercial capital sources to on-lend.
5. To what extent should PKSf adopt this supervisory role, as it partially currently does in its screening of NGO-client performance? Is PKSf too vulnerable to capture by government nominees to be credible in this role?
6. If so, at least in the perception of the major grassroots players in Bangladesh, then will the commercial capital sector accept the formation of some self-policing institutions among the grassroots providers themselves? Such an institution would, in

effect, perform the dual function of providing surety to both capital suppliers on the one hand and to borrowers and small-scale depositors on the other.

7. After moving through these various regulatory and market-based risk management options, this volume reaches the conclusion that the only feasible solution in Bangladesh is some element of self-policing amongst grassroots providers through establishing well monitored codes of conduct: the formation of a club, in effect, with high costs to those institutions which decline to sign up to its conditions, as customers (i.e. small depositors and large-scale corporate financial investors alike) switch their business towards members of the accredited club.

Conclusion

In this chapter, we have been arguing for a significantly enlarged vision of possibilities in linking financial services to the removal of poverty. While respectful of the record so far, the microcredit sector represents, almost by definition, a limit to ambition both in the sense of addressing alleviation and welfare, and in the inter-linked sense of envisaging small-scale economic activity (often trading rather than production) in locally overcrowded markets. Across the ‘finance against poverty’ sector, the argument for a wider conception of financial services has now been established. Both credit and savings are now familiarly linked to liquidity management and consumption smoothing objectives over individual and household cycles of varying length, as well as in relation to more sudden shocks. These might all be regarded as initiatives under the ‘widening’ heading where the demand is clearly strong and only partially met.

Less obvious in the literature are the stronger ‘scale’ ambitions under the ‘deepening’ heading. These ambitions include not only lending larger amounts over long gestation periods to larger-scale projects run by the poor either as individuals or in some kind of corporate entity. They also include, more heretically, lending for poverty eradication objectives to the non-poor, willing to accept elements of social conditionality in return for the opportunity to generate new employment opportunities among the poor. This is the agenda of removing the ‘micro’ from microfinancial services. Obviously larger projects and more skilled employment, with implicit assumptions about higher returns on capital and effort (i.e. higher productivity), require corresponding human resource investment in skills and business planning (including market assessment). This is where grassroots intermediaries such as NGOs with plural agendas have comparative advantage over the traditional banking sector, so long as they themselves can reach institutional sustainability based upon this expanded management of money.

These ‘deepening’ ambitions presume a significant expansion in the availability of capital to the sector under conditions where concessionary donor funds are predicted to be inadequate to the task. Therefore the key to realising these expanded ambitions in a sustainable manner lies in accessing non-subsidised, commercial funds in wider financial markets. Thus the linkages between different sets of actors, hitherto operating in highly segmented financial arenas, becomes crucial. These commercially sound linkages can only be established if sufficient trust exists between the different stakeholders in such

extended financial markets, where contractual intimacy (i.e. as between borrowers and lenders in the existing landscape of Grameen Bank, BRAC, Proshika, ASA and so on) has to be replaced by a more generalised market morality where more universal principles of contract, legal redress, governance and stable macro-economic management prevail. But how to establish these latter principles in a society where the argument for contractual intimacy and 'hands-on' compliance precisely arose from the absence of these principles? The poor in Bangladesh cannot wait for such improvements in overall social capital², so other, more deliberate mechanisms are required for financial markets to operate for poverty eradication.

These conditions link the fortunes of the poor, grassroots intermediaries and a wider set of financial institutions together, with the sustainability of the first two sets of actors connected firmly to access to the third set. Given the uncertainties, imperfections and embeddedness of markets and financial markets in countries like Bangladesh, predictions of mutual profitability between these three sets of actors are necessary but insufficient bonding agents. This brings the argument and this volume to address the problem of what is sufficient to bring about this desirable partnership with market-based risk spreading, supervision, statutory regulation and self-policed clubs offered and debated as institutional options. Central to most of these options is the problem of overcoming moral hazard, with incentives for any single sub-set of actors to free-ride at the expense of others by passing on risk and becoming insensitive to inefficiency and prospects of incurring losses.

In particular, in Bangladesh, the grassroots intermediaries (i.e. NGOs with Microfinancial Services as well as Microfinance Institutions) have good reason to avoid entering a regulatory framework, managed by government. The track record of government regulation over other parts of the financial sector has been dismal with high defaulting and over-protected NCBs encouraging over-speculative lending. But the NGOs are additionally wary of giving government any further powers to determine their policies, strategies and practice. Although, formally, regulation in the financial sector is distinct from more generic regulation of NGOs, in Bangladesh the boundary between the two will inevitably blur. However the context-specific caution shown by the Bangladesh grassroots intermediaries coincides with the caution of other commentators (i.e. in this volume) who base their arguments more clearly on the analysis of financial behaviour involving moral hazard and incentives. Avoiding the rush to regulate is therefore the overall message of this volume.

However, moving to the other extreme of the continuum, involving the neo-liberal propositions of market self-regulation through an interlaced mechanism of guarantees, capital-to-lending ratios and insurance, does not seem quite convincing in the imperfect markets of Bangladesh where information is at such a premium. Both rich investors (definitely including international ones) and small-scale micro-savers need more surety than this to enter such inter-linked and extended financial markets.

² See North 1990 for the discussion of social capital that links distant strangers; see Wood 2000 forthcoming for the 'long haul' analysis of prospects for such social capital at the national level in Bangladesh.

Thus we return to some principle of contractual intimacy: operating at realistic levels of trust in the society connected to present institutional practices. Hence the preference for self-policing clubs of financial intermediaries (i.e. grassroots and their immediate backers) involving codes, labelling, monitoring, membership hurdles and exclusion for non-compliance. Institutionally, therefore, we are favouring the civil society option over market or state options, because it coincides with where efficacy and probity currently reside most strongly. However, this option should not itself encourage complacency. It has to be market-tested on one dimension, otherwise the option is futile. That is: self-policing clubs must be attractive to investors external to them, including internationally, if poverty eradication ambitions via financial services are to be realised. At the same time, even clubs have to establish rules and elements of enforcement (e.g. under conditions when the excluded operators dispute either denial of membership or their expulsion). Thus there remains a case for a facilitating legal framework - but very hands-off.