

4 Central Bank Support for Microfinance Initiatives

4.1 Background

Most commentators agree that the provision of financial services to the poor requires active policy support. Rural credit markets in developing countries, especially insofar as they encompass the poor, are subject to market failure. For instance, Besley (1994) identifies three distinctive features of rural credit markets, namely, scarce collateral, the underdevelopment of complementary institutions, and covariant risks. These factors contribute to various market failures, in particular, those related to adverse selection and moral hazard. One result is lower than optimal provision of financial services, in rural areas and to poor households. Hence, government intervention may be appropriate to encourage the provision of an optimal level of financial services. Government intervention may also be justified on distributive grounds, especially where financial services are an effective tool for poverty reduction.⁶

It is also clear that, in practice, microfinance has relied heavily on support from governments and donor agencies, and central banks to a lesser extent. While MFIs should aim to become self-sufficient, this takes considerable time. McGuire et al. (1998) found that few if any financial institutions reaching significant numbers of poor clients in Asia have been established without external support. Had it not been for such support, it is unlikely that microfinance could exist on anything like its current scale.

Nevertheless, it is clear that much support for microfinance has been ineffective. With limited resources, it is important to ensure that support for microfinance is as effective as possible in fostering outreach and sustainability. Moreover, the suggestion that microfinance requires active support does not necessarily imply that central banks themselves should be involved in providing this support. As noted, in most cases such support has been provided by other government agencies and/or donor agencies, rather than by central banks. In considering any role for central banks, it is necessary to consider their comparative advantage in providing such support, relative to other mechanisms and institutions.

4.2 Perceptions of Central Banks Regarding Microfinance

The extent to which central banks are involved in microfinance depends in part on how central banks themselves perceive their broader financial sector role. In turn, this depends largely on what central banks see as their objectives. Central bankers who see their objectives as relating essentially to monetary policy and prudential regulation and supervision of the banking system are less likely to consider that they should support the microfinance sector. By contrast, central bankers who see their mandate as extending to developmental and promotional activities for broader financial sector development are more likely to undertake initiatives intended to support microfinance.

Active policy support is required to provide financial services to the poor

Central banks may not be the best agencies to provide support

Depending on their objectives and perceptions, central banks may or may not accept a role

⁶ However, we should note Besley's comment that, given the current state of empirical evidence on many relevant questions, it is impossible to conclude categorically that an intervention has been justified.

Some central banks accept responsibility for microfinance

In four countries, central bankers perceive they have an explicit role in supporting microfinance. In India, the central bank has traditionally had a role in the development of financial markets and financial infrastructure, and in recent years has extended increasing recognition to microfinance. Since its inception, the central bank in Nepal has seen the delivery of credit to the rural poor as an important objective and has introduced some innovative measures to that end. In Sri Lanka there appears to be informed support for microfinance at the highest level of the central bank. For instance, its recent annual reports map out the full extent of institutional microfinance activity, including activities that are not under its jurisdiction. And the central bank in Viet Nam sees itself as an instrument for achieving the national government's objective of poverty alleviation, through measures which include microfinance. In these four countries the central bank has undertaken a range of developmental and promotional activities to support microfinance, as discussed below.

In Indonesia, central bank support for microfinance has been concerned with financial sector development, not specifically with poverty alleviation. A former governor of the central bank has acknowledged that its policies with respect to the financial system may impact on poverty. However, he argued that poverty alleviation itself is a government function, which the central bank can only address within the scope of its role as a central bank.

In most countries central banks do not claim a major role

In most other countries, central bankers do not perceive that they have any major role with respect to microfinance. Generally speaking, this reflects resource constraints and a desire to concentrate on what are conceived as "core" functions. In some cases, central banks may even have concerns about the emergence of microfinance to the extent that this appears to involve decentralized and spontaneous activity which may be difficult to control. In the case of PRC, for instance, the central bank is opposed to the emergence of unregulated financial institutions at the local level because of various irregularities that have occurred, and it is reluctant to see NGOs or community organizations play any role in financial intermediation.

4.3 Directed Credit Requirements

Under directed credit schemes, commercial banks are required to lend a certain proportion of their loan portfolios in particular sectors. These schemes are generally administered through the central bank. Four countries — India, Nepal, Pakistan, and Philippines — continue to impose directed credit requirements. In the Philippines these are of relatively minor significance, but in India, Nepal, and Pakistan, banks are still required to channel significant proportions of their loan portfolios to agriculture and disadvantaged groups in the community.

In India, detailed instructions apply to bank lending to agriculture and "weaker" elements in the economy

An example of how these schemes operate can be seen from the situation in India. All commercial banks and regional rural banks are required to lend 40 percent of net bank credit to "priority" sectors. In broad terms, at least 18 percent of lending must be to agriculture. A further 10 percent must be to "weaker" sections, such as small and marginal farmers, rural artisans, and agricultural laborers. Allocation of the remaining 12 percent is discretionary, and can be for either of the above categories or for small-scale industry. Of the lending to small-scale industry, 40 percent must be for "tiny" industry. Schemes in other countries operate along broadly similar lines.

The three economies in transition, PRC, Kyrgyz Republic, and Viet Nam, do not have directed credit requirements as such, but have similar programs. In PRC, for instance, the allocation of credit was traditionally set by a centrally determined credit

plan, itself linked to the overall state plan for physical production. Under this credit plan, the central bank fixed both aggregate and sectoral allocations of bank credit, and lending institutions met their obligations by adhering to lending ceilings. In 1998 the final abolition of the centrally directed credit plan was announced, and banks are now supposed to allocate credit based on commercial judgments rather than on central bank and government directives. However, the influence of various levels of government on lending is still pervasive, with the term “policy-oriented commercialized loan” conveying something of the flavor. Similar arrangements have existed in Viet Nam. In the Kyrgyz Republic, the government has also used government-owned banks to provide subsidized credit to agriculture, although these allocations are declining.

Five countries, namely, Bangladesh, Indonesia, PNG, Sri Lanka, and Vanuatu, do not have or have by now abolished directed credit schemes.

Use of Directed Credit

- Some countries, particularly in South Asia, still have directed credit.
- In transitional economies, state banks still make “policy” loans.
- However, a number of countries have abandoned directed lending, because of its low repayment rates, ineffective targeting, and the imposition of costs on the banks.

Directed credit is an instrument of financial repression that militates against the development of sustainable financial systems. Such lending generally suffers from low repayment rates, with McGuire et al. (1998) finding that repayment rates in India, Nepal, and Pakistan ranged from less than 50 percent to around 75 percent in the early 1990s. There is evidence that repayment rates for comparable programs in PRC are also around 50 percent. Directed credit is frequently subject to interest rate ceilings, with interest rates too low to cover operating and financing costs. Hence, such loans generally impose losses on the commercial banks. Directed credit can also adversely affect the balance sheets of central banks. In India, for instance, most lending to priority sectors is eligible for refinancing from the National Bank for Agriculture and Rural Development (NABARD) at concessional interest rates. NABARD was established in 1982 as an apex body for rural credit, with the central bank detaching its agricultural credit department for the purpose. While the central bank still has significant influence, NABARD now has considerable scope for independent action.

There is also considerable evidence that directed credit schemes are an ineffective and inefficient means of reaching the poor.⁷ They tend to be poorly targeted, with evidence from a number of countries that non-poor households often obtain most of the benefits from programs ostensibly targeted to the poor. There do not appear to be any examples of directed credit programs that have successfully reached poor borrowers on a sustainable basis. It would seem appropriate for those countries that still impose directed credit requirements to replace them with more effective policies for supporting microfinance.

Remaining directed credit programs should be replaced by more effective means of supporting rural- and microfinance

7 For example, see World Bank. (1989).

4.4 Other Developmental Activities to Support Microfinance

Developmental activities may, as previously described, include credit guarantees and insurance, participation in the capital and management of development institutions, priority sector lending, differential interest rates, preferential rediscount rates and facilities, and target credit/deposit ratios for rural bank branches. They are undertaken to affect the allocation of resources directly, often involve long-term programs, and generally require significant financing by the central bank with implications for aggregate money supply.

There are a number of ways in which governments, donor agencies, and central banks have provided developmental support for microfinance. These include supporting individual MFIs, supporting second tier microfinance institutions which provide loans to retail MFIs, channeling support through the banking system, and establishing government retail microfinance operations. Within this framework, central banks have also provided support in a number of ways. They have provided loans and grants from their own resources, and have refinanced or guaranteed loans made by MFIs and banks. And they have acted as conduits for programs funded by governments or donor agencies, on-lending these funds to MFIs or banks.

Supporting Individual Nonbank Microfinance Institutions

As noted, MFIs in most countries have received considerable external support. In the past, most of this has been in the form of financial assistance direct to individual MFIs. Such support has been critical in enabling them to establish and to increase their outreach and financial self-sufficiency.⁸ Nevertheless, a great deal of the support that has been provided has been ad hoc in character and ineffective. It is now generally accepted that support should only be provided to institutions that demonstrate a commitment and a capacity to reach poor clients on a sustainable basis.

Central banks have generally not provided direct financial support to MFIs that are not licensed financial institutions. However, there are a number of exceptions:

- (i) In Bangladesh, the central bank provided support to Grameen Bank from as early as 1979, before it was established as a specialized development bank in 1983. The central bank has also supported Grameen Bank with lines of credit; in 1993–94 it provided a line of credit of Tk6 billion (\$122 million), though less than half of this was drawn down.
- (ii) In India, NABARD (which, as previously noted, was established by the central bank as an apex body for rural credit) has provided a small amount of revolving fund assistance to nonbank MFIs undertaking experiments in the direct implementation of microfinance. This program has been financed from a special fund contributed by the Swiss Agency for Development and Cooperation.
- (iii) In PRC, the central bank is required to offer support to rural credit cooperatives (RCCs) in a number of ways, including “policy lending.” Central bank loans have been directed to RCCs in poverty-stricken areas that have been unable to mobilize savings sufficient to meet the local need for agricultural credit. RCCs are regulated by the central bank, and can be regarded as “near banks.”

External support has been crucial to the success of MFIs, but such support should be reserved for those with the potential to reach the poor sustainably

There are some instances of direct central bank support for MFIs

8 Financial self-sufficiency requires microfinance programs to cover all administrative costs, loan losses, and financing costs from operating income, after adjusting for inflation and subsidies and treating all funding as if it had a commercial cost (CGAP, 1997 and *The MicroBanking Bulletin*, 2000).

Supporting Second Tier MFIs

A number of countries have some form of “second tier” microfinance institution which channels funds to individual MFIs. The largest and most successful second tier institution is the Palli Karma Sahayak Foundation in Bangladesh. Second tier institutions of varying degrees of effectiveness are also important parts of the microfinance sector in India, Pakistan, Philippines, Nepal, and Sri Lanka.

There is considerable debate as to the effectiveness of second tier MFIs. McGuire (1998) has argued that they can be an effective means of supporting MFIs. He argues it is more efficient for one institution to analyze and monitor the performance of individual MFIs than for different government and donor agencies to do their own appraisals and evaluations. Second tier institutions can also play an important role in establishing and enforcing performance and reporting standards for MFIs. On the other hand, Gonzalez-Vega (1998) has taken a more pessimistic view. It is generally agreed that second tier institutions can only play an effective role where there is already a group of strong retail MFIs. Other problems with second tier institutions may include their being subject to pressure to meet unrealistic disbursement targets, causing institutions to lower their standards, and lack of political independence. Most second tier institutions have not been in operation long enough to enable firm conclusions concerning the effectiveness of this approach.

Should Second Tier Institutions Receive Support?

As apex institutions, “second tier” institutions are well placed to monitor MFIs and to establish and enforce operational and reporting standards. However, it should be noted that:

- the existence of a strong set of MFIs may be a precondition for their effective operation
- they may be created by donors or governments simply to “shovel” money at MFIs.

In principle, central banks could provide funds to second tier institutions for on-lending to retail MFIs, or could refinance loans by second tier institutions to retail MFIs. In practice, there do not appear to be any current examples of central banks’ providing funds through second tier institutions.

Alternatively, central banks could operate as second tier institutions in their own right. As noted already, NABARD in India has done this to a minor extent (albeit in an agency role for the central bank). Another example is in Nepal, where the central bank administers the Rural Self-Reliance Fund, which provides wholesale funds to MFIs for on-lending to final borrowers.

Channeling Support Through the Banking System

In a number of countries, the national government operates specific microfinance programs in which funds are channeled through the banks. Such programs, along with directed credit requirements, are the most common developmental activity in which central banks are involved. There is also considerable overlap between such programs and directed credit requirements. For instance, lending to priority sectors under directed credit requirements is often refinanced by the central bank, or provided by government-owned banks with explicit or implicit central bank support.

Central banks could work with second tier institutions, but this has not happened. Some have acted as second tier institutions themselves

Governments have required central banks to channel loan funds through banking systems but, in general, little of this money has reached the poor

The largest of these programs is the Integrated Rural Development Programme (IRDP) in India. The scheme involves the provision of credit by banks, with a cash subsidy provided to borrowers by the government. The central bank is also involved, as lending by banks under IRDP is eligible for refinancing from NABARD. Numerous evaluations have shown that IRDP has not met its objectives. For instance, an expert committee constituted by the central bank (Reserve Bank of India 1995) found that loans were often captured by better-off households, and repayment rates were only around 30 percent. The central bank is also involved in other programs channeling support through the banking system, including the NABARD program for linking banks with self-help groups.

In Indonesia, a major activity of the central bank under successive governments has been to refinance a wide variety of credit schemes for small-scale economic activities. Most have not reached the poor to any significant extent. However, there are some exceptions. For instance, under the Microcredit Project, which commenced in 1995 with support from ADB, the central bank disburses funds to the provincial government commercial banks (BPD) and rural banks (BPR) for on-lending to small financial institutions and microentrepreneurs. The interest rates charged by BPD and BPR are not regulated, and they lend at their normal rates of around 2 to 4 percent per month. This program has been considerably more successful than most other programs where central banks channel funds through licensed banks. This is because interest rate controls are absent, and because these small banks, unlike licensed banks in most countries, have developed appropriate products and processes for reaching microentrepreneurs. Despite the removal from the central bank's operational control of all "liquidity credit" refinancing schemes since the new central banking legislation of 1999, it will continue to implement this scheme, which is externally funded and has the nature of a pilot project.

In Viet Nam and elsewhere, subsidized credit schemes for the poor undercut genuine microfinance activities

In Viet Nam, the central bank provides funds to the government-owned Viet Nam Bank for the Poor (VBP) and the Viet Nam Bank for Agriculture and Rural Development, which both lend directly to targeted poor households. VBP has been created for the specific purpose of providing subsidized credit to the poor. A government ministry issues criteria and guidelines for the selection of poor households, and even provides an official list of poor households which are the targeted clients of the national government's poverty alleviation programs. The central bank provides subsidized funding for lending to these households. Such activities undermine sustainable microfinance, since independent MFIs are unable to compete with the state subsidies.

A number of other countries also channel support through their banking systems, often with central bank involvement. In Nepal, the central bank is the major shareholder in the Credit Guarantee Corporation, which operates schemes to guarantee livestock loans and priority sector credit. In both Nepal and Sri Lanka, the central bank has been the executing agency for microfinance projects funded by external agencies and channeled through the banking system. Programs operating through the banking system with varying degrees of central bank involvement have also been features of the microfinance landscape in PRC, Kyrgyz Republic, and Pakistan.

Commercial banks are reluctant partners in government-mandated credit programs

Experience with such programs indicates that they are generally unsuccessful and commercial banks are generally reluctant partners. Goodwin-Groen (1998) found that over 95 percent of commercial banks she studied in the Asia-Pacific region undertake microfinance lending only because it is required of them by government. In many cases such programs are operated through government-owned banks. In most cases portfolio quality is low, the scale is very small, and/or lending does not reach the poor, although Indonesia, as mentioned previously, provides an exception.

Establishing Government Retail Microfinance Operations

The other main category of microfinance programs is those operated directly by government agencies. In general, such programs have not been successful. For instance, an analysis of government microfinance programs in the Philippines found that they were inefficient, highly politicized, uncoordinated, and unsustainable (Llanto et al. 1996). These criticisms could equally be leveled at direct government microfinance programs in other countries. McGuire et al. (1998) concluded that, in general, governments should abolish direct state microfinance programs and support microfinance through other means.

In most countries central banks have not played a role in such direct government microfinance programs. However, in at least two countries the central bank has shareholdings in retail MFIs. In Nepal, the central bank holds a majority shareholding in the five regional rural development banks (RRDBs) and appoints their chief executive officers. In 1998 it extended a line of credit of NRs100 million to the largest of the RRDBs to overcome a severe fund shortage resulting from the rapid expansion of its program. In practice, the central bank's substantial participation in the management of the RRDBs implies effective control, though political interference in the operations of the RRDBs is also reported to be pervasive. The central bank also has small shareholdings in the two major development banks in the country. Similarly, in Sri Lanka the central bank maintains a 72 percent shareholding in, and nominates some board members to, the new regional development banks. This in fact represents a dilution of the central bank's high degree of involvement with the predecessor institutions of these new regional development banks.

Central banks own and control retail financial MFIs in Nepal and Sri Lanka

Role of Central Banks

In most of the countries considered in this study, central banks have been active in developmental activities to support microfinance. In most cases this has involved administering directed credit requirements and/or channeling funds through licensed banks for microfinance activities. To a lesser extent, central banks have provided support to individual nonbank MFIs and in some countries have even maintained shareholdings in retail microfinance operations.

In the majority of cases these activities have not been successful. It would appear that most such programs have not been effective in targeting the poor, have had low repayment rates, and have not been sustainable. In some cases they may have even been counter-productive, by making it more difficult for MFIs striving for sustainability to operate. There appear to be some exceptions to this conclusion, however, such as central bank support for the Grameen Bank in Bangladesh and for the rural banks in Indonesia. Support has been most successful where it has been directed to institutions with appropriate products and processes for reaching poor households and microentrepreneurs, and where the central bank has not imposed interest rate controls.

Developmental support of microfinance by central banks has generally not been successful, though there are exceptions

There appear to be three primary reasons why developmental activities by central banks have, in the main, been unsuccessful:

- (i) Most of these activities have been in the form of directed credit schemes and programs channeled through licensed banks. These activities are generally not the most effective means of encouraging sustainable microfinance. While no arrangements for support are without their drawbacks, support for individual MFIs committed to sustainability and for effective second tier institutions is likely to be more effective.
- (ii) Central banks may not have comparative advantage in providing financial support for microfinance, relative to other institutional arrangements. Central bankers

often have limited understanding of the microfinance sector. Moreover, such developmental activities may be inconsistent with other objectives of the central bank such as maintaining price stability.

- (iii) Reflecting the above, developmental activities conducted by central banks have rarely embodied microfinance best practice. For example, they have generally involved subsidized interest rates and have not made use of new technologies for increasing repayment rates.

Reasons for the Limited Success of Central Bank Developmental Support

- Much support has been by way of directed credit or channeling via commercial banks. These are both inherently unsatisfactory procedures.
- Central banks have often lacked comparative advantage in the activities selected.
- Best practice microfinance principles have often been ignored.

Bangladesh and the Philippines are world microfinance leaders, despite central bank inactivity

In no country has the central bank completely avoided developmental activities. However, in four countries, namely Bangladesh, PNG, Philippines, and Vanuatu, developmental activities by the central bank in respect of microfinance have been relatively minor, especially in recent years. Interestingly, Bangladesh is the world leader in the field of microfinance, and the Philippines has one of the more vibrant microfinance sectors. Clearly, developmental activities by the central bank are not necessary for the development of sustainable microfinance; they may even be a hindrance. In general, it would appear more appropriate for support for microfinance to be provided through other channels, such as other government agencies or donor agencies.

This is not to say that central banks should never undertake developmental activities to support microfinance. However, whether or not they should undertake this role depends on a number of factors, including:

- (i) their comparative advantage relative to other potential institutions or mechanisms for supporting microfinance, such as second tier institutions or direct support from donor agencies to individual MFIs;
- (ii) the mandate of the central bank, and the extent to which the central bank sees its role as including the development of the financial system, including in rural areas and for poor households; and
- (iii) the institutional arrangements for ensuring that such activities do not impact adversely on the central bank's balance sheet.

Central banks should not create money for microfinance lending

In general, there does not appear to be a case for central banks to use their own resources for lending to or refinancing retail MFIs or licensed banks for microfinance activities. Any such activities have the potential to affect the balance sheet of the central bank negatively, and hence to compromise its ability to meet its key objectives.

In limited cases, there may be a role for central banks in managing funds from the government and/or donor agencies and on-lending them to retail MFIs and licensed banks. This is especially likely to be the case in small countries where there is limited financial infrastructure and where it would not be feasible or appropriate to establish a separate second tier institution or any other institution responsible for microfinance. PNG and Vanuatu, for example, are countries likely to fall into this category.

Where the central bank does manage funds from government or donor programs, it would also appear appropriate for a number of specific conditions to be satisfied:

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- (i) The central bank would need to have clear comparative advantage in managing such funds. There would need to be compelling reasons why channeling funds through the central bank is more appropriate than other options such as supporting individual MFIs directly or channeling support through a second tier MFI.
 - (ii) The decision whether to undertake such a role should rest with the board of the central bank, based on the objectives of the bank and a realistic assessment of the costs and benefits.
 - (iii) There should be a clear contractual arrangement between the government and the central bank, and the central bank should receive a management fee sufficient to cover all costs it incurs in managing the program. There should also be transparent arrangements for managing any foreign exchange risk.
 - (iv) It may be necessary to establish a separate unit within the central bank responsible for microfinance activities. The responsible central bank staff would need to develop a different mindset to operate as effective microfinance “wholesalers.” Monitoring nonbank MFIs gives rise to issues very different from those associated with monitoring licensed banks.
 - (v) The central bank would need to adopt clear funding criteria, designed to maximize outreach and sustainability.

Central Bank Management of Government or Donor Funds — the Issues

Central banks may manage government or donor money for microfinance programs, but only where they:

- have clear comparative advantage in doing so
- are able to maintain independence in the process
- are not financially committed
- can acquire and deploy the necessary expertise and are prepared to adopt objective and transparent procedures.

4.5 Promotional Activities to Support Microfinance

General Discussion

As previously mentioned, promotional activities to support microfinance may include support for pilot projects using innovative approaches to microfinance, the conduct of research, the collection and publication of data, and the undertaking of advocacy

Promotional Activities of Central Banks

Promotional activities of a central bank are designed to:

- generate positive externalities
- reduce the transaction and information costs associated with an enterprise, such as the provision of microfinance services.

The central bank plays the role of innovator and catalyst, encouraging “supply-leading” initiatives which serve to fill gaps in the financial structure.

While the case for promotional activities is stronger, it still depends on whether the central bank has both mandate and comparative advantage

and training. While the dividing line between developmental and promotional activities is blurred, promotional activities generally involve short-term programs, are intended to catalyze unsubsidized and voluntary activity by the private sector, and involve negligible commitments of financial resources by the central bank.

The case for central banks to undertake promotional activities is generally stronger than the case for their undertaking developmental activities. As mentioned previously, because of central banks' positions as the apex bodies for the financial system, they are well placed to play a role in leadership and coordination. Nevertheless, as with developmental activities, whether or not a particular central bank should undertake promotional activities depends on how the central bank perceives its role, and on the comparative advantage of the central bank in respect of those activities.

Central banks may wish to support pilot projects to research and publicize innovative approaches to microfinance. McGuire and Conroy (forthcoming) argue that funding agencies should take explicit account of the need for innovation when deciding which institutions to support. An institution using innovative approaches will generally incur higher costs than an institution replicating an existing model, reflecting the higher costs of developing new systems and the greater degree of risk involved. At the same time, more innovative institutions may generate positive externalities, such as new or improved institutional forms, processes, and products that are then adopted by other institutions. Hence, there is an important role in providing small amounts of "seed capital" to support innovation, and this may possibly be a suitable activity for central banks to pursue.

Central banks may be well placed to support innovation in microfinance, but not beyond the "promotional" level

At the same time, the dividing line between developmental and promotional activities can be particularly blurred when supporting pilot projects. The pilot projects for supporting linkages between banks and MFIs in India and Indonesia, discussed in more detail later in this section, provide an interesting contrast. When supporting such initiatives it is appropriate for the central bank to have a clear exit strategy, with clear limits on the quantum and time period of such support. In Indonesia, the central bank phased out refinancing for its bank/NGO/self-help group linkage program so that it did not become a major developmental commitment when the project moved beyond the pilot stage. By contrast, India has continued refinancing even though the project is now operating on a substantially larger scale. What was originally a small and targeted promotional activity has now evolved into a developmental activity absorbing significant resources. It is not appropriate for central banks to engage in developmental activities on the pretext of supporting innovation.

There are a number of other ways in which central bank may wish to facilitate the development of the microfinance sector.

- (i) They can conduct research into rural financial markets, microfinance, and informal finance, in order to increase understanding among policymakers of the characteristics of these financial markets and to ensure that any policy initiatives are grounded in empirical evidence. For instance, this could include research into issues affecting access to capital by low income households, such as land tenure, chattel mortgaging, foreclosure, and small claims procedures.
- (ii) They can collect and publish data on the microfinance activities of licensed banks. They can also collect data on nonbank MFIs, in collaboration with networks of MFIs and other institutions. This would include monitoring the outreach and sustainability of the microfinance sector.
- (iii) They can be advocates for sustainable microfinance, by preparing and disseminating publications on microfinance best practice, conducting and/or participating in workshops, and similar activities.
- (iv) They can conduct or initiate training programs for officials from government agencies, banks, MFIs, second tier institutions, and other bodies. Such training programs would generally focus on issues where the central bank may be

Legitimate Promotional Activities for Central Banks

Legitimate promotional activities for central banks appear to include:

- research and data collection
- advocacy and dissemination of information on best practice principles
- conduct and/or support of training programs
- provision of technical expertise in appropriate fields
- provision of economic intelligence for the microfinance sector.

presumed to have particular expertise or an obvious leadership position, such as policy issues and performance and reporting standards, rather than on operational issues. Alternatively, in some cases there may be a role for central banks to facilitate or coordinate training on operational issues, in the absence of initiatives from any other source.

- (v) They can provide technical expertise in areas where they may have comparative advantage, such as helping second tier institutions, networks of MFIs, and credit rating agencies to establish performance and reporting standards for MFIs.
- (vi) They can disseminate broader economic information to the microfinance sector, such as macroeconomic data, information on the performance of particular economic sectors, and information on sources and cost of capital.

Most central banks have undertaken promotional activities to support microfinance. The most active central banks in this regard are possibly those of India and Indonesia.

India

In India, the central bank and NABARD have undertaken a variety of promotional activities to support microfinance. For instance, in 1992 NABARD launched a pilot project for linking self-help groups (SHGs) to banks, with bank loans to SHGs refinanced by NABARD. This project has received increasing emphasis during the past few years and is now being encouraged as a regular program of the banking sector. By March 1999, the program is reported to have linked some 33,000 SHGs to banks, with coverage of around 560,000 families. While this program could originally have been seen as a promotional activity to research an innovative approach to microfinance, it has now taken on the character of a developmental activity. It should also be noted that the program is not sustainable in its current form. There are ceilings on the interest rates that banks can charge NGOs and SHGs, and these do not provide a sufficient margin for NGOs to recover the costs of forming and motivating SHGs.

NABARD has also made bulk loans to retail MFIs undertaking experimental action in microfinance, and provided microfinance training, exposure, and capacity building to both bank and MFI staff. In February 2000, the minister for finance announced the creation of a Rs1 billion (\$23 million) fund within NABARD for the promotion of microfinance. This was in line with recommendations by a task force on microfinance initiated by the central bank and headed by NABARD. It is proposed that the fund be used to support capacity building of MFIs and the provision of equity and start-up grants. Again, this appears to incorporate a mixture of developmental and promotional activities.

NABARD has played a strong promotional role in India at the behest of the central bank

Other promotional activities by the central bank include:

- (i) The establishment in 1998 of a task force on microfinance within NABARD, already referred to. The task force was charged with developing a policy framework for sustainable growth of microfinance, encompassing issues in policy, regulation, financing, and capacity building. It reported in July 1999.

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- (ii) The establishment in 1999 of a microcredit special cell within the central bank. The objective of the cell is to identify and suggest practical measures for making microfinance a sustainable and marketable product for the financial system.

Indonesia

Bank Indonesia, the central bank, has actively promoted microfinance

The central bank in Indonesia has also engaged in a wide variety of promotional activities. Indeed, the greatest contribution of the central bank is arguably promotional rather than developmental, in terms of its leadership for innovation in microfinance. The central bank has played an active role in the project for linking banks and self-help groups (PHBK), first established in 1989 in conjunction with the German government technical assistance agency (GTZ). This project went beyond the pilot stage in 1992. In 1995 the central bank stopped providing refinancing, and the program now operates on a sustainable, if still limited, basis with participating banks charging market interest rates.

The central bank has been involved in a number of other promotional activities, involving both MFIs and rural banks:

- (i) Since 1994 it has associated itself with attempts to create an umbrella group for MFIs, and was actively involved in the inauguration in March 2000 of the United Movement for the Development of Indonesian Microfinance (GBPKMI).
- (ii) It is currently working with GTZ to provide technical assistance to BPR and other small financial institutions.
- (iii) It has supported efforts to strengthen the Association of Indonesian Rural Banks (PERBARINDO), the umbrella organization for BPR.
- (iv) It has provided some loan funds for capacity building of BPR and staff training, as well as conducting a feasibility study of a deposit guarantee scheme for the rural banks and actively preparing for its introduction.

Other Countries

Promotional initiatives have been more limited elsewhere

Central banks in most other countries have also undertaken promotional activities, although these have been more limited than in India and Indonesia.

The central bank in Bangladesh has issued circulars encouraging the commercial banks to lend to MFIs, and conducted a seminar on this issue in 1994. Unfortunately, the impact of these measures has been limited, with banks lending to MFIs in only a small number of instances. More recently, the central bank was provided with resources under a World Bank project to undertake two studies. One explored the appropriate regulatory framework and institutions for regulating and monitoring deposit taking by MFIs, and the other considered regulatory reforms and proactive measures to enhance linkages between MFIs and the formal financial sector. These studies were undertaken as one exercise and completed in January 1999.

In the Kyrgyz Republic, the central bank has undertaken a number of measures that have promotional characteristics. The Financial Company for the Support and Development of Credit Unions (FCSCU), wholly owned by the central bank, was established in April 1997 to develop and supervise the ADB credit union project. FCSCU conducts training in management, general accounting, credit analysis, and other operational functions for credit unions. The central bank also has a pledge registration office for tracking collateral that has been pledged to guarantee loans. Information from this office can be accessed directly by MFIs. Several other promotional ideas have been suggested to the central bank, but these are of relatively low priority given other challenges it is currently facing.

The central bank in Nepal has also been involved in some promotional activities. The introduction of limited banking licenses for MFIs and the formulation of the Financial Intermediary Societies Act, while dealing specifically with regulation of MFIs, were also designed to promote the microfinance sector. The provisions of the Act are not entirely appropriate, however, for the long-term promotion of microfinance and will require amendment for this purpose.

In PNG, the major promotional activity by the central bank is its renewed support from 1992 for the savings and loans movement, intended to compensate for the decline in outreach of the banking system. By 1998 the central bank had overseen the creation of five new societies. It also intends to develop the capacity of the Federation of Savings and Loan Societies to provide technical, management, and other support services to individual societies. Other promotional activities include negotiating a financial institutions license for Village Finance Limited to help fill the gap in financial services for low income clients.

Promotion by Central Banks

While the central banks in India and Indonesia have most actively promoted microfinance, there are other instances in the region.

For example:

- In Kyrgyz, the central bank has set up a company to develop and support credit unions, while the PNG bank has committed to revitalizing the savings and loan movement.
- The central bank in Nepal has made legislative and licensing innovations, and in Bangladesh the central bank has researched the feasibility of doing so.
- In PRC, the central bank has tested the potential of rural credit cooperatives to adapt to microfinance, while the Philippines bank has actively supported financial reforms relevant to microfinance.

In PRC too, the central bank has undertaken a number of promotional activities. Most importantly, the governor has defined tasks for the central bank in supporting and guiding the development of rural credit cooperatives (RCCs). He has urged RCCs to increase lending to individuals and households, deliver loans to the doorstep, simplify the loan procedure, and trial group guarantees. The central bank has also been sympathetic to microfinance experiments in regulated institutions and has conducted one of its own, with RCCs as the intermediaries, in Hebei Province. It is also a member of the Poverty Alleviation Advisory Board, convened by UNDP, which discusses policy for microfinance in the broader context of poverty alleviation.

The central bank in the Philippines has also undertaken a range of promotional activities. One example is its active participation in the activities of the National Credit Council with the central bank using that forum to promote a market-oriented approach to microfinance led by the private sector. The central bank has also put its considerable influence behind the National Credit Council's effort to rationalize directed credit programs and to get government agencies which are not financial institutions out of the business of lending. It is also a member of the Coalition for Microfinance Standards, which has developed performance standards for self-regulation by MFIs.

In Vanuatu as well, the central bank has undertaken a number of activities that could be described as promotional. It is represented on the board of trustees of the Vanuatu Women's Development Scheme (VANWODS), the only significant MFI in Vanuatu. It has conducted some research into informal financial systems, and it

The central bank in Vanuatu sits on the board of the country's only MFI

undertakes some broad monitoring of developments with respect to credit unions, cooperatives, and similar financial arrangements. Nevertheless, the central bank stresses that with the exception of its membership on the board of VANWODS, it does not see these activities as supporting microfinance. Rather, it monitors the nonregulated financial system to ensure that such activities do not contravene the banking legislation.

Comment

In most countries, central banks have undertaken promotional activities to support microfinance. There has been a wide variety of such activities. Some of the more common ones have included supporting pilot projects testing innovative approaches to microfinance, supporting capacity building and training for MFIs and banks, supporting networks of MFIs and banks, and helping to develop an appropriate policy framework for microfinance.

Many of these initiatives appear to have made a significant and positive contribution to the microfinance sector. Moreover, in many cases the central bank appears to have some comparative advantage in comparison with other institutions in pursuing such promotional activities because:

- (i) It has a role at the apex of the financial system and generally has greater independence than other government agencies, which may give additional credibility and prestige to such activities when conducted by it.
- (ii) The central bank is likely to take a more market-oriented approach than other government agencies, and its involvement in policy initiatives may result in greater emphasis on sustainability.
- (iii) In some countries, especially smaller countries, the central bank may be the only agency with expertise in issues relating to banking and finance, and may be the only feasible agency to support capacity building and training for MFIs. At the same time, promotional activities in such countries will necessarily be limited by the resource constraints facing central banks.

In many countries there will likely be some expectation on the part of both government and community that the central bank should support the development of financial systems for poor households. As discussed already, it may be appropriate for central banks to undertake developmental activities in some limited circumstances. However, it has been argued here that promotional activities will generally make a more positive contribution and are in any case less likely to be in conflict with central bank "core business." At the same time, it should be acknowledged that the distinction between developmental and promotional activities is somewhat blurred. For instance, the case for central banks to support innovation should not be used as a pretext for central banks to engage in developmental activities.

Neither is it appropriate for all central banks to undertake a wide range of promotional activities. In some countries, other agencies may have comparative

What Comparative Advantage Do Central Banks Have in Promotional Activities?

- Central banks generally have clout, because they sit at the apex of their financial systems and are (to a greater or less degree) independent.
- They employ considerable human resources.
- Particularly in a small country they may be the preeminent source of financial sector expertise.

advantage in some or most of the promotional activities already discussed. Also, and necessarily, promotional activities will be limited by the resources of central banks and the need to strengthen core responsibilities such as monetary policy and prudential regulation and supervision of licensed banks. Nevertheless, in most countries, central banks have found it useful to undertake some promotional activities to support microfinance, and these activities have made a positive contribution. In all countries the central bank should be a major stakeholder involved in developing an appropriate policy framework for microfinance, even if it does not undertake any other promotional activities.