

Do governments in Asia have a role in development of sustainable microfinance services? Some views

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As Joseph Stiglitz (1993, p.19) noted “the role of the government in financial market development is one of the long-standing, and unresolved debates that has engaged economists around the world.” However, until recently much of the literature on this subject did not discuss issues relating to financial services for the poor. The poor and the enormity of their demand for a variety of financial services and also the significance of meeting this demand through sustainable financial institutions is a relatively new area of concern in the literature. It is in this context that the role of the government in the development of microfinance has received some attention in recent years. It is important to pay more attention to this subject because views about the role of the government “influence actual policies and programs, and in the end, social welfare.”(Gonzalez Vega, 1997) and inappropriate interventions by the government can retard sustainable development of microfinance as they did in the case of agricultural finance during the 1960s-1980s in most developing countries (World Bank, 1989; Meyer and Nagarajan, 2001). Conversely, appropriate interventions can lay the foundations for a sound microfinancial system and make a positive contribution to the industry growth.

Many who write on the role of the government in microfinance development generally provide a standard list of measures that governments should do to promote microfinance. These recommendations, among other things, include improving the enabling policy environment; developing a legal, regulatory and supervisory framework (commonly branded as financial infrastructure development); and eliminating provision of directed credit at subsidized interest rates. The problem with such standard lists is that they are not tailored to specific country conditions, and as a result, less useful to both policy makers and practitioners. Most of these recommendations are based primarily on the negative experiences of agricultural finance and new paradigms on formal financial sector development. They are good in theory. This brief paper identifies different schools of thought on the subject and discusses the role of the government taking particular country conditions into account. The latter is important because the government’s role needs to be adapted to the conditions prevailing in the microfinance market and the environment within which the existing markets operate.

Some clarifications

This paper is an attempt to discuss the role of the government in the development of sustainable microfinance services to reach a majority of the un-served and under-served poor and low-income households and their microenterprises. Two aspects are thus emphasized: one is sustainable services, and the other is to serve a majority with such services. For the purpose of the discussion, the government is defined to include the central bank. However, this does not imply that central bank should not be independent.

There is a good reason to emphasize sustainability and mass outreach at the outset. If one is just discussing microfinance development without reference to these two aspects, then one is likely to come up with an entirely different set of views on the role of the government. Often

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policy makers who are concerned about providing the services to the poor tend to ignore the issues relating to permanency of services. Such immediate concerns lead to neglect of basic pillars necessary for building permanent services and reaching the mass market.

Three different schools of thought

A review of literature on microfinance development enables one to identify at least three different schools of thought on the role of the government:

- **Laissez-faire school:** the government should maintain macroeconomic stability and leave sustainable microfinance development to nongovernment organizations (NGOs) and the private sector. The more it will try to help, the less it will contribute to sustainable development. Those who hold this view – that benign neglect is the most appropriate role for the government - often cite Bangladesh and Bolivia to support their view. For example, Rhyne (2001, p.206) noted that “ Bolivia shows that microfinance evolves happily with little direct government support. Government’s main contribution to the industry was to stay out of the way by closing state banks and avoiding directives.” Many microfinance leaders in Bangladesh express somewhat similar views.
- **Interventionist school:** markets have failed and as a result a majority of the poor are out of the frontier of formal finance. Traditional commercial banks are not interested in this market for various reasons. Private risk capital is unlikely to come because of high risks. Hence, the governments have a major role to play in expanding the frontier including provision of services by different type of government-owned organizations. While those who can be grouped under this school admit the possibilities for “government failure”, they seem to have faith in potential positive contributions by the government. This school is dominant in South Asia in particular.
- **Moderate interventionist school:** the government should not only maintain macroeconomic stability but provide the enabling policy environment and essential financial infrastructure. However, this school does not support direct interventions by the government in the provision of services.

In general, there appears to be a consensus among the three schools that there is a role for the government in microfinance development. However, there is no such consensus on what exactly that role should be. This is understandable partly because financial development is a highly complex issue in theory and in practice and formal microfinance is still not a mature industry. Also, more importantly, the most appropriate role for the government varies depending on a variety of country-specific conditions.

What factors and how do they define the role of the government?

The factors with potential bearing on the most appropriate role for the government include, but are not limited to: level of macroeconomic stability; stage of development of the banking system; stage of development of the microfinance sector; size of the potential microfinance market; geographical diversity of the country; and population density.

Macroeconomic instability

It is widely recognized that ensuring macroeconomic stability is one of the most important tasks for the government in countries where this is a major issue. The implications of macroeconomic stability for sustainable microfinance are not much different from those for the rest of the financial sector. Macroeconomic instability adversely affects overall economic growth and thus limits productive economic opportunities and potential for sustainable microfinance. High inflation in particular erodes the capital of financial institutions and makes it difficult to mobilize resources to expand services. In general macroeconomic instability increases the volatility of interest rates, exchange rates, and relative prices and impose additional costs and risks on the financial institutions and their existing and potential clients. This could be particularly damaging to the microfinance industry if it is heavily dependent on funds borrowed in foreign exchange. In fact, those who discuss the microfinance industry in Bangladesh do not often fully recognize the important contribution that price stability made to the rapid development of the industry. On the other hand, many transitional economies like Laos and Uzbekistan have found it difficult to make rapid progress partly because of the problems created by high inflation. Brazil, despite having a large potential market with high poverty rates, the largest concentration of microenterprises in Latin America, and scant outreach by the banking sector, had virtually no microfinance industry until recently “because of its inability to shake off inflation” (Rhyne, 2002, p.205). In high inflation countries, it is difficult to harness the full benefits of supportive measures and hence the government must focus their attention on controlling inflation.

Weak banking system

The stage of development of the banking system also conditions the role of the government in many ways. In general, in countries with a less developed banking system, the government should focus its attention on supporting the development of a sound banking system to provide traditional banking services prior to the establishment of a formal microfinance industry. Basic banking services are essential for the development of sustainable microfinance although traditional banking institutions may not often provide microfinance services directly. For example, in some Central Asian transitional economies such as Tajikistan, even NGOs and other non-bank microfinance institutions experience difficulties in selecting a safe place to park their deposits which they want to use for lending to the poor. They are not sure of the safety of deposits in poorly managed and performing banks. They also have to incur high transaction costs in withdrawing deposits from such banks. A less developed banking system also makes it difficult and more costly for MFIs to access funds from the banking system, while a more developed banking system can be a significant source of support. In a number of Latin American countries, commercial banks have entered the microfinance market through equity investments in microfinance institutions. At the same time, some MFIs in Asia have lost their deposits because the banks in which they deposited poor people’s money have been unable to return the deposits due to poor performance or liquidation.

Stage of development and structure of the microfinance sector

The appropriate role for the government also varies with the stage of development and structure of the microfinance sector. For example, in countries such as Bangladesh where the industry has a relatively long history and reached a certain level of maturity in terms of competition, it appears that the government should support development of a credit bureau. Yet in a country such as Laos where microfinance is still at a very early stage of development, a credit bureau cannot be considered a priority. Similarly, in such countries as Bangladesh where NGO-MFIs dominate the microfinance industry, the priorities for the government also include facilitating

transformation of matured NGO-MFIs into formal financial institutions. This is essential if such countries are to ensure permanent services. While a few Bangladeshi NGO-MFIs are the largest and perhaps the most efficient microfinance entities in the world (Association for Social Advancement is a good example for such a MFI), they continue to suffer from some of the typical problems of NGO-MFIs. They lack real owners and their long-term future is questionable. More importantly, they do not have a legal charter to provide certain types of financial services such as voluntary deposit taking. Given this industry structure, the government can play an important role by introducing an environment – both policy and legal – to transform matured NGO-MFIs into formal financial institutions. This could be done through creating “a distinct legal tier for nonbank MFIs, with regulation and supervision either by a distinct unit within the central bank or by a third party having delegated supervisory authority” (Charitonenko and Rahman, 2002, p.42).

In countries such as Sri Lanka and the Philippines where cooperatives play a significant role in providing financial services for low-income households, the government role needs to be adapted to address their major problems. These include poor accounting practices and governance, lack of transparency of operations, and lack of effective regulation and supervision of the cooperatives. The need to focus government attention on cooperatives stems not only from their current weak financial and operational status but from the fact that most cooperatives mobilize a substantial amount of deposits from non-members even if they do not have a legal charter to do so. However, the cooperatives in most developing countries are neither regulated nor supervised effectively, and hence safety of the clients' deposits is questionable. Often the government agencies responsible for cooperative development and or regulation and supervision do not even fulfill their basic function of maintaining an up-to-date registry of cooperatives. The cooperatives are a potentially significant type of institution to provide microfinance services on a sustainable basis if the governments can promote the financial infrastructure for cooperatives and provide adequate incentives, support and effective regulation to improve their performance and outreach.

While effective regulation and supervision of financial cooperatives is of paramount importance to ensure sustainable microfinance, this does not mean that central banks in such countries should be assigned this task. Since central banks in many developing countries have a difficult time keeping pace with developments in the traditional commercial banking sector and regulating and supervising commercial banks effectively, it is unrealistic to assume that central banks will be interested in taking over this additional responsibility. Multilateral financial institutions such as the International Monetary Fund are making a concerted effort in many developing countries to have central banks focus on their core central banking functions and do not support expansion of the central banking operations into other areas. Thus, the governments may need to consider alternative mechanisms. Depending on the relative size of the cooperative sector, such mechanisms may include, establishment of new institutions for regulation and supervision of cooperatives. Whatever the mechanism, it should ensure that the cooperatives have strong governance structures with “fit and proper” board members, effective internal control and risk management systems, and proper accounting practices with special emphasis on classification of loans, loan loss provisions and accounting for non-performing loans.

Regulation and supervision of microfinance in general has received much attention in recent years in the literature. Some organizations have warned about the rush to regulate because premature and inappropriate regulation can have significant adverse impact on the growth of the industry (Christen and Rosenberg, 2000). Rhyne (2001, p.206) notes that “ banking authorities in many countries seek to define regulations for microfinance institutions in advance of their

development, thus risking choking off potentially crucial innovations and adaptations.” In countries where the industry has reached a reasonable level of maturity and formal institutions have a significant presence, governments need to consider how they can be brought under effective prudential regulation. In other countries, the governments may better serve the industry by focusing on measures that increase the information available to both potential clients and service providers, non-prudential regulation and improving transparency and governance of semi-formal microfinance institutions. In transitional economies where there are restrictions on mobilizing deposits by financial cooperatives from even their members and operations of NGOs in microfinance, governments need to focus on easing those constraints rather than regulation of the industry.

There are many countries where the microfinance sector is characterized by small and medium-size NGO-MFIs none of which have yet reached a sufficient level of maturity to seriously consider transformation into formal banking or non-banking financial institutions. They lack basic accountability mechanisms of business and incentives for efficiency. Often their performance and operations are shrouded behind a veil of secrecy. In such cases the government can play a useful role by promoting transparency of operations of NGO-MFIs through measures that require disclosure and dissemination of information on operations of these institutions. The government can also consider providing one-time performance-based grant support for capacity building to a limited number of potentially viable retail institutions. Restricting such support to a few is important rather than thinly distributing available limited grant support among a large number of institutions. First, it will enable better monitoring and relatively more comprehensive support. Second, and more importantly, it is argued that creating one excellent institution is far more important than creating several moderately successful institutions because of the spontaneous spread effect a great institution will have on the industry (see Rhyne, 2001, p.207). In many countries, the industry growth has been speeded up substantially by a highly successful institution or two. The examples include BancoSol in Bolivia, BRAC and ASA in Bangladesh, CARD Bank in the Philippines, ACLEDA Bank in Cambodia and BRI-Unit Desas in Indonesia. Some may object to this kind of a strategy as one of supporting a monopolist. But since success attracts other investors into the industry, the strategy is likely to promote competition in the medium- to long-term.

The microfinance industry in some Asian countries with a relatively large potential market is also characterized by too many small-scale suppliers. For example, more than 700 NGO-MFIs operate in Bangladesh while in the Philippines there are over 500 NGO-MFIs in the market together with some 800 rural banks with a branch network of over 1,500. A survey in 1997 in the Philippines showed that only three of the 223 responding NGO-MFIs were operating programs of nationwide scope. The total outreach of 131 microfinance NGOs was only 67,000 clients while only six NGO-MFIs had more than 3,000 clients each (Dingcong and Joyas, 1998). More recent information indicated that about 20% of the NGO-MFIs account for 80% of their total outreach. In Sri Lanka, a country with a total population of only 19 million, there are 306 multipurpose cooperatives societies with a cooperative rural bank branch network of 1,507, some 8,500 thrift and credit cooperatives, 970 village banks (Samudhi Banking Societies), in addition to an unknown number of NGO-MFIs (see Charitonenko and Silva, 2002). Although institutional diversity is generally an important characteristic of a robust microfinance industry, institutional proliferation cannot necessarily be considered good for the industry. A majority of the small-scale service providers are unable to diversify their risks adequately across space and activities that they finance. They also run greater risks of being subject to liquidity problems that in turn affect their service quality and reliability (Fernando, 2001). Most of these small operators have neither adequate capital nor human resources to use new information and communication technologies to expand their operations to realize economies of scale. In such countries, the

government should provide incentives for consolidation of the small-scale institutions while preserving the institutional diversity. Such incentives may include, for example, more attractive time-bound tax exemptions for the consolidated institutions.

Size of the potential market

The size of the potential market also matters in defining the appropriate role for the government. However, as Millard Long (1999, p.5) pointed out at the Third Annual Seminar on New Development Finance in Frankfurt in 1999 “ we have paid little attention to the scale of financial systems....and we need to pay more attention to size in thinking and advising on financial structure.” It is often forgotten by many that what is suitable for a country with a large potential market is not necessarily suitable for a country with a small potential market. This is so because countries with small potential markets cannot support excessive costs associated with financial infrastructure. Nor can they afford to have too many institutions operating in a thin market. In countries with small potential markets such as Western Samoa, Vanuatu and Fiji, it makes sense to limit the number of service providers.

Geographical aspects and the population density also influence the size of the potential market and therefore have a significant bearing on the role of the government. In countries such as Nepal and Laos part of the population is in remote highland areas. Population density in most of these areas is low. This, coupled with difficult terrain, makes sustainable microfinance a complex proposition in such areas. The prospects for commercial operations are questionable with the available financial technology. Governments can promote either community based operations for such areas through NGOs or even offer smart-subsidies (on auctioned basis or on the basis of the number of clients reached, for example) to commercially oriented suppliers to operate in those areas.

Rural infrastructure

Perhaps the least emphasized aspect in the microfinance literature and discussions concerning Asian countries is the importance of rural infrastructure and the considerable negative impact that poor infrastructure exerts on development of a sustainable microfinance industry in many countries. In most countries the industry will grow better quantitatively and qualitatively if their governments address basic rural infrastructure deficiencies. This is, for example, the case in Laos, Nepal and some states in India, particularly Bihar, Orissa, and Assam. Better rural roads, bridges, irrigation facilities, market facilities, primary health care and education facilities on the whole increase economic opportunities for the rural population, and thus enable productive use of basic financial services. Such infrastructure also reduces potential risks and transaction costs for financial institutions and provide incentives for innovations and to diversify and expand their operations. The outreach of the microfinance industry of Bangladesh grew faster than that of Nepal, for example, during the 1980s and 1990s partly because of the country’s relatively good rural road network. However, it is also true that its growth is constrained by the high risks associated with frequent floods.

Four other tasks for the government

- **Curtail the emerging trend for re-introduction of directed credit programs**

While it is generally assumed that the old directed credit paradigm is out and the new paradigm of financial system development is dominant and widely accepted, some Asian countries continue to have significant directed credit programs or have re-introduced them recently to channel credit toward the sectors that are considered important for growth and poverty reduction. Such programs have become popular in Indonesia after the Asian financial crisis. The Philippines has also introduced some new directed credit programs. For example, the Department of Trade and Industry in the Philippines announced in early January 2003 that some P10 billion in financing will be made available to SMEs throughout the country in the next six months. Budgetary funds are used for these programs. They are different from the old programs at least in two major aspects: first they tend to rely on financial institutions; second, they do not in general compel participating financial institutions to lend at subsidized interest rates. However, these programs are in practice not serious about loan recoveries and thus weaken the financial institutions. They also damage the potential for sustainable development of the microfinance market primarily through weakening of the financial discipline among borrowers and reducing incentives for operations by commercially oriented service providers. Therefore, it is essential for the governments to phase out such programs where they exist and stay away from those in future as a policy. The rush to substitute short-cuts for building sustainable microfinance systems are most likely to reduce social welfare of the poor in the long-term.

- **Support ICT development in rural areas**

Government interventions are needed to support use of new information and communication technology in rural areas because these can not only expand the size of the potential markets but also reduce transaction costs and risks for both clients and service providers. As Meyer and Nagarajan (Vol. 3, p. 53) noted this is not only an “appropriate government intervention” but also “a more promising way to encourage sustainable rural finance than the old paradigm policies to induce more lending in rural areas.” Meyer and Nagarajan argue that supportive policies by governments are required to deal with the emerging “digital divide” between urban and rural areas and particularly help rural financial institutions to take advantage of the new information and communication technologies.

- **Allow more room for foreign equity participation**

The governments can also make a significant contribution to the microfinance industry by liberalizing foreign investments in the industry. In general, most MFIs still do not have a capacity to bear foreign exchange risk associated with borrowing in foreign currency. On the other hand many social investors in the North are interested in investing their funds in the microfinance industry but are unable to make equity investments in MFIs because of the restrictions imposed by governments. For example, foreign equity participation is not permitted in rural banks in the Philippines although these banks suffer from inadequate capital for expansion and have the potential to become dominant players in the microfinance market. If governments can initially allow and facilitate equity investments by foreign social investors, more dynamism can be injected into this market. The experience of equity investments of such social investors may be used to determine whether microfinance market liberalization should be deepened to include commercial investors.

- **Reform state-owned rural financial institutions**

Some Asian governments have taken effective measures to reform state-owned rural financial institutions and contributed significantly to the sustainable development of their microfinance industry. A notable and well-known example is the Unit Desa system of the Bank Rakyat Indonesia (Robinson, 2002). Pakistan has also taken bold initiatives recently, supported by the Asian Development Bank, to substantially reform its ailing Agricultural Development Bank, now known as Zarai Taraqati Bank Limited. (The Agricultural Development Bank of Pakistan, established in 1961, had a network of 343 branches, and total assets equivalent to \$1.3 billion and served about 420,000 borrowers in 2001. It suffered from severe governance, operational, and financial problems and relied heavily on state subsidies to continue its operations). Sri Lanka has also taken some initiatives to introduce incremental reforms into its regional development banks that cater to the rural population, although it has a long way to go in transforming these into sustainable rural financial institutions with a significant outreach to the poor households. Notwithstanding these, a number of other Asian countries continue to rely on state-owned rural financial institutions that adopt the old paradigm of subsidized credit and continue to undermine potential for sustainable microfinance. Such countries include the People's Republic of China, Laos, Nepal, India and many Central Asian countries. In these and other Asian countries where state-owned rural financial institutions are important in the landscape of rural finance and do not perform well, the governments need to take a fresh look at these institutions with a view to either reforming or liquidating them. Emerging evidence appears to suggest that their physical infrastructure can be effectively used to provide financial services for the rural population including the poor, provided that governments are willing and committed to introduce and implement essential reforms. The governments can mobilize financial and technical support for such reforms from multilateral financial institutions such as the Asian Development Bank, if a strong willingness and firm commitment can be demonstrated for the reforms.

Conclusions

The status of the microfinance market in the Asian region clearly shows that the governments have an important role to play in developing a sustainable microfinance industry. However, what precisely is the role of the government in a given country depends on the country-specific conditions, given the high degree of heterogeneity of the industry across countries. Even in a given country, the role varies over time depending on how the industry evolves. The precise role for the government, therefore, needs to be defined on the basis of thorough analysis of the macroeconomic aspects, the overall financial system and its performance, structure and performance of the microfinance industry, the stage at which the industry operates at a given time and the environment within which it operates. Essentially, the appropriate role is largely an empirical issue. General principles can only be used as a guide to address this issue.

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