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Donors' Support for Microcredit as Social Enterprise

A Critical Reappraisal

Machiko Nissanke *

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Abstract

The donor community has enthusiastically embraced the concept of microfinance as a promising mechanism to attain the objectives of poverty alleviation and microenterprise development. Amid the high expectation, a myth has been inadvertently created that they could be the *ultimate* solution to poverty reduction. The objective of the paper is to examine the nature of support rendered by the donor community to microfinance programmes and the effectiveness of this particular outlet of official aid for microenterprise development and poverty alleviation. To this end, the paper first examines economics of microfinance as an instrument of microenterprise development and poverty reduction as well as its delivery mechanisms. The paper then assesses empirical evidence of the performance of microfinance institutions and their impacts on poverty alleviation and microenterprise development. Given this background, the paper discusses main features and trends in donor support and policy implication of the analysis for the donor community. …/

Keywords: microfinance, microcredit, poverty, microenterprises, donor assistance, aid effectiveness

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* School of Oriental and African Studies, University of London

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Given donors' desire for creating and sustaining microfinance institutions as *social enterprises,* performance-based support is provided by donors to microfinance institutions with strong financial incentives to reach the twin targets of financial *sustainability* and the *outreach* of the poor. The paper argues that this might have produced unintended negative effects on the very objectives of poverty reduction and microenterprise development. There is an inherent tension in the two operational targets set out. Microfinance institutions are expected to be 'subsidy-independent' in an unrealistically short time framework and able to generate substantial surpluses over time to fulfil their social mission on an ever-expanding scale. The tension between the two targets at the conceptual level is directly translated into incredible pressures and stresses on both microfinance institutions and their clients in the fields.

We also suggest there is a need to improve the design of microfinance programmes on the deeper understanding of the *symbiotic* relationships that have been evolving between financial and real sector development. The performance of microfinance and microcredit programmes always reflects, as well as impacts upon, the development of real economies. Rather than recommending the standardized best practice through financial engineering, there is a room for a substantial diversification of financial products and loan portfolio in offer to meet the need of the wide variety of microenterprise activities.

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UNU World Institute for Development Economics Research (UNU/WIDER)
Katajanokanlaituri 6 B, 00160 Helsinki, Finland

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1 Introduction

Over the last decade or so, we have observed a proliferation of microfinance institutions (MFIs) in developing and transitional economies as well as in some developed countries such as USA and Canada. Modelled on infamously 'successful' institutions such as the Grameen Bank of Bangladesh, the Badan Kredit Kecamatan (BKK) of Indonesia or BancoSol of Bolivia, new strands of 'innovative' microfinance institutions have been established specifically for reaching 'the poor', in the field of 'micro-enterprise finance' and 'poverty lending'. Drawing lessons from the widely acknowledged failure of the earlier experiments with credit interventions such as the targeted rural credit programmes based on subsidized interest rates, new microcredit programmes lean heavily towards 'market-based solutions', with use of concepts such as group lending and joint liability contracts.

At the Microcredit Summit in November 2002 organized by Consultative Group to Assist the Poorest (CGAP), it is reported that the number of 'microfinance' clients has risen to 54.9 million at the end of 2001, from 30.7 million a year earlier, and 13.5 million in December 1997. They included 26.8 million of the world's poorest, defined as those people living in the bottom half below their country's poverty line. The number of the poorest served has showed a more than triple increase in four years from 7.6 million in 1998. *Microcredit Summit Report* proclaimed that this annual increase of 37 per cent achieved is just one point below the rate required to meet the Summit Campaign's goal of providing microcredit to 100 million of the poor household by 2005 (Microcredit Summit 2002).

Indeed, the international donor community as well as northern and southern NGOs have enthusiastically embraced the concept of microcredit and microfinance as one of the most promising mechanisms to poverty alleviation and eventual eradication. Reflecting their preference of providing financial and technical assistance on a 'wholesale' rather than a direct 'retail' basis by working through intermediaries, many donor agencies view MFIs and microcredit programmes as the key component of their lending towards microenterprise development (DAC/OECD 1994). Microenterprise development is, in turn, recognized as a central part of the private sector development agenda, microenterprises being referred to as a unique channel for achieving the donors' targets of 'poverty reduction through private sector development', while attending the growth and equity objectives of economic development. For example, the Development Assistance Committee (DAC) of OECD identifies the role of microenterprises not only in creating jobs and incomes with a more equitable diffusion of the benefits of growth, but also in having 'direct impact on poverty reduction and on the integration of women and other marginalized segments of society into economic life' (DAC/OECD 1994: 4).

As found in many of documents that have spelled out donors' strategy towards poverty reduction, a very high hope is placed on the success of MFIs to serve hitherto credit constrained poor households. Indeed, amid the high expectation raised towards MFIs' ability to carry out the ascribed mission, a myth has been generated that MFIs could have a significant impact on the livelihoods of millions of poor people around the world. High-profile speeches and documents have been delivered and issued with many impressive 'performance' indicators and achievements, producing inadvertently an unfounded claim that MFIs could be the *ultimate* solution to poverty reduction.

This rhetoric has sometimes prevented the donor community from tackling real challenges and issues confronting MFIs on the ground. It has obscured the need for understanding the scope and reality of microfinance in different local conditions, and hence, the required care for the diversity of approaches towards incentive and delivery mechanisms. While acknowledging the potential for economic development and poverty alleviation embedded in the microfinance concept, we feel it is important to evaluate underlying economic theories and empirical evidences concerning the premise of MFIs and microcredit programmes, so that we could have a more realistic picture of the likely impact of microcredit programmes on the poverty profile and enterprise development as well as of their limitations.

The objective of this paper is to examine critically the nature of support rendered by the donor community to MFIs and microcredit programmes and the effectiveness of this particular outlet of official aid for microenterprise development and poverty alleviation. The paper is structured as follows. The next section (section 2) provides a brief review of economic theories of microfinance. It examines main analytical rationales for the role of MFIs in microenterprise development and poverty reduction as well as the delivery mechanisms adopted by microcredit programmes. Section 3 discusses features and trends in bilateral and multilateral donor support for microfinance and microenterprises. Section 4 critically assesses empirical evidence on the performance of microfinance institutions and the impact of microcredit programmes on poverty alleviation. The final section (section 5) discusses policy implications of our analysis for donors' support towards microfinance and microcredit programmes.

2 Economics of microfinance institutions

2.1 The poor and financial services

The central premise of the microfinance credit approach is that the lack of access by the poor to credit constitutes one of most critical impediment to poverty reduction and broad-based economic development. The poor are conventionally viewed as 'unbankable'. To start with, *borrower net worth* of the poor is too low to get access to financial services provided by formal financial institutions such as banks.[1] Second, the poor cannot easily overcome the informational and enforcement problems that normally exist as frictions in the borrower-lender relationships.[2] Third, the poor usually cannot offer collaterals to overcome the agency problems characteristic to a principal-agent relationship.[3]

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[1] The borrower net worth is defined by Gertler and Rose (1994) as the sum of a borrower's net liquid assets and the collateral value of his illiquid assets, including not only tangible physical assets, but any prospective future earnings that the borrower could offer as collateral.

[2] In a principal-agent relationship that characterizes lender-borrower interactions for dealing with idiosyncratic risks, lenders are preoccupied with the question of whether they will be repaid, and the cost of acquiring information and contract enforcement becomes a critical element in realization of a proposed credit transaction.

[3] When credit relationships are extended beyond the 'exclusive' borrower-lender relationship and repeated personalized transactions within the close-knit community, collateral is typically used to sustain transactions. In general, collateral pledged in exchange for loans serves the three important functions: i) of directly reducing cost to the lender of a loan default; ii) of adding an incentive for the

Indeed, in information-constrained economies such as low-income countries or transitional economies, where endowments of information capital is very low, banks are burdened with the problems caused by costly and imperfect information - adverse selection, moral hazard and contract enforcement- in dealing with idiosyncratic risks of private borrowers (Stiglitz and Weiss 1981). In particular, banks are constrained to serve the poor, as transaction costs for obtaining information on them for screening and monitoring are too high. Banks usually resort to collateral requirements as a credit rationing device, though the foreclosure of collateral property is known to be difficult in view of inefficient judiciary systems and the ambiguities surrounding property rights. Banks do not also posses a comparative advantage in offering financial products and services required by the poor, i.e., small-scale and short-term liquidity and saving facilities.

In these low-income country environments, informal financial market segments[4] have developed devices mechanisms in coping with the agency problems resulting from imperfect information.[5] These mechanisms operate within geographically and socially confined community settings, and are firmly rooted in indigenous social codes and norms. In this set of circumstances, as found in many rural credit markets and most group arrangements, the relationship between borrower and lender is often exclusive and repeat transaction is critical. Then the promise of repeat borrowing and social sanctions serve as effective incentives for borrowers not to default. Clearly, borrowers repay loans for fear of losing access to future loans upon default (particularly in schemes involving groups). In addition, defaulters are subject to effective and severe sanctions by the whole community. Social sanctions could include exclusion from other financial transactions (such as informal insurance) or other economic or social penalties. Social sanctions are available only in reasonably cohesive social groups, providing yet another reason for the propensity to transact credit within the confined community settings.

Similarly, informal commercial lenders could also rely less on collateral assets than on social pressure, reputation and personal knowledge of borrowers or interlinked credit contracts for screening, monitoring and contract enforcement. In short, all informal agents and groups effectively use a relatively accurate communalized information-base in order to reduce the risk of dealing with small borrowers, who remain high-risk for formal lending institutions. However, in many parts of the world, informal financial services are used mainly for cash flow and liquidity management for consumption smoothing at a low-income equilibrium. The effective lending rates charged by commercial informal lenders are often too high for these funds to be used by micro- and small-scale enterprises or rural small farmers as a regular source of working capital, let alone for financing fixed capital

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borrower to repay, thereby reducing the moral hazard; and iii) of mitigating the problem of adverse selection by enabling the lender to screen out borrowers most likely to default (Udry 1990). See Nissanke and Aryeetey (2000) for more detailed discussion on institutional arrangements for credit risk management in low-income countries.

4 As Sindzingre and Stein (2002) note, distinctions of institutions based on the degree of formality are conceptually ad hoc. While recognizing the ambiguous nature of the dichotomy of formal/informal institutions, we have adopted here this conventional terms purely for sake of an easy reference to existing literature in this field of financial economics.

5 'Informal' segments comprise of heterogeneous agents/associations. In general, 'informal' financial transactions can be grouped into those that are non-commercial, such as transactions between relatives and friends or small-scale group arrangements, and those that are commercially-based, conducted by single collectors, estate-owners, landlords, traders or money-lenders.

investment. Most informal insurance mechanisms are weak with regard to frequent external shocks that can be highly covariant across households. They hardly provide adequate protection (Morduch 1999b).

Now, in the face of shrinking formal employment opportunities, micro- and small-scale enterprises/firms are increasingly viewed as an important vehicle in reducing poverty and meeting simultaneously the growth and equity objectives of developing and transitional economies. Yet, it is not uncommon for these enterprises to have insufficient working capital even for day-to-day operations. Indeed, most surveys conducted in these economies report that *financial constraints*, i.e. the lack of access to and cost of finance, remain the binding constraint on operation and expansion for small-scale establishments. Of course, these shortages and constraints may be symptomatic of supply and marketing problems or of managerial inefficiencies, which could be the real cause of their liquidity problems and lack of creditworthiness. Nevertheless, for many enterprises the potential for growth takes the demand for capital beyond the limits of self-finance, and such needs are not easily met from either banks or informal lenders. Thus, there is a sizeable shortfall in the provision of financial services for microenterprises.[6]

At the same time, while poverty is increasingly recognized as a multi-dimensional condition (Sen 1984 and 1993; Chambers 1997) rather than merely a shortfall in income and consumption, the microfinance concept has become regarded as one of powerful mechanisms for poverty reduction, by providing the poor with the means for risk management mechanisms. In the face of frequent income shocks with meagre asset endowments, the poor have to engage in different risk coping as well as risk reduction and mitigation strategies.

Risk reduction and mitigation are methods of *ex ante* risk management, which could involve various decisions ranging from migration to crop and income diversification (Holzmann and Jorgensen 1999). Risk coping refers to *ex post* risk management, in which the poor seek to cushion against the imminent consumption risk and choose to smooth consumption across time and space. While inter-temporal consumption smoothing is effected by saving-borrowing and self-insurance at individual/household levels, spatial consumption smoothing amounts to pooling idiosyncratic risks of individuals/households and co-insuring against risks (Alderman and Paxson 1992, Besley 1995, Nissanke and Aryeetey 2000). It is claimed that MFIs could provide the poor with these vital financial services for risk management, known as *poverty lending*.

Thus, microenterprise finance and poverty lending have become twin-pillars of MFIs' activities. While microenterprise finance centres on poor people with enterprises of their own, poverty lending aims at concentrating on lending toward income-generating activities of the very poor with a view of mitigating poverty rather than enterprise development.[7] However, this distinction has been increasingly blurred in recent years, since microenterprises are viewed by the donor community as 'a key ingredient for helping families and communities out of poverty' (Eversole 2000: 45).

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6 For more detailed discussion on financing enterprise development in low-income countries, see Nissanke (2001).

7 There is a large number of literature on microfinancial institutions established earlier (Levitsky 1993; Otero and Rhyne 1994; Yaron 1994, and Hulme and Mosley 1996). Morduch (1999a) contains a useful and updated literature survey on microfinance.

2.2 Credit delivery mechanisms of microfinance institutions

With considerable perceived gaps in credit service delivery to the poor and microenterprise, the mission of microfinance institutions (MFIs) is set to address this market failure by serving the 'unbankable' segments of the population in the name of poverty reduction. For this purpose, MFIs have adopted a set of delivery mechanisms with 'innovative' contracts and incentives with the view of minimizing the risks in dealing with the poor. MFI's risk-minimization approaches are adopted from those practised by 'informal' finance in solving the information and enforcement problems.

One of most prominent features of new innovation is the use of the mechanism of group lending in creating *joint liability*, so that social pressure, collateral substitutes and other group dynamics to motivate repayment.[8] In particular, peer pressure or group dynamics is used as a way of reducing the transaction costs of microfinance in lending to the poor by solving information problems such as adverse selection, moral hazards, auditing and enforcement (Hulme and Mosley 1996). Like 'informal' lenders, the joint liability lending institutions are supposed to utilize the local information and 'social capital' that exist among borrowers in close-knit social environments for peer selection, peer auditing, and peer monitoring (Stiglitz 1990; Ghatak 1999 and 2000; Ghatak and Guinnane 1999).[9] Hence, a creation of joint liability is viewed to act as a mutual guarantee mechanism with a particular structure of incentives to ensure high repayment without demanding physical collateral assets to back up loans. It is seen effective in mitigating the problem of strategic default in particular.

MFIs also adopt mechanisms such as progressive lending, frequent repayment schedules and compulsory savings to generate dynamic incentives for repayment. Progressive lending refers to the system by which borrowers obtain increasingly larger loans if repayment is made promptly. As long as the system is credible and alternative sources of finance are less attractive, this type of incentive can enhance repayments (Morduch 1999a). Frequent repayment schedules are also seen to act as an added mechanism to secure repayment. As most microfinance organizations collect repayments before investments bear fruit, they are, in fact, lending against the borrower's steady income stream (not just the investment) and, hence, securing part of the loan repayment even if projects fail. Compulsory savings, along with emergency funds and other group funds, play a role of collateral substitutes, used as insurance against loan defaults.

MFIs are also recommended to levy relatively high 'market-based' interest rates to cover operational costs. As discussed below, this certainly reflects a clear apathy to subsidized cheap interest rates, which are blamed to be a chief culprit in the failure of many donor support programmes towards SMEs as well as the targeted rural credit schemes in the 1960s and 1970s (Adams *et al.* 1984).

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[8] Not all MFIs adopt a group lending methodology. See Mordoch (1999a) for discussion of individual based micro finance contract.

[9] As Marr (2002) notes, Stiglitz's model of per monitoring is based on four assumptions: (i) that group members have perfect and costless information about one another; (ii) that all individuals are identical in their risk types; (iii) that peer monitoring is costless; and (iv) that borrowers do not have alternative sources of credit. Assumptions are one by one relaxed in the subsequently developed theoretical models of joint liability. For a critical literature review of these models, see Marr (2002).

It has been claimed that by effectively overcoming key constraints for credit delivery to the poor through these innovative financial engineering, the MFIs enjoy high repayment rates so as to ensure their financial viability and sustainability in the long-run. At the same time, it is contended that the MFIs could make significant contribution towards poverty reduction through a reduction in the vulnerability of the poor to shocks as well as to enhanced gender and community empowerment.

3 Donors' support for microfinancial institutions

Based on these up-beating premises of microfinance, most of bilateral and multilateral donor agencies have established a specialized microenterprise and microcredit unit within their lending programme for private sector development, though the budget for these units typically accounts for a rather insignificant share in their overall PSD programme[10]. The donor community's involvement has been particularly strong in the movement to advance the microfinance concept worldwide as a viable, self-sustaining vehicle for poverty reduction.[11] Towards this objective, the donor community formed a consortium—Consultative Group to Assist the Poorest (CGAP)—in 1995 with a team of microfinance specialists housed in the World Bank. CGAP's main mission is identified as promoting 'best practice' in microcredit especially in the way donors would like MFIs to evolve. CGAP is also to act as the central funding channel for microfinance initiatives with the provision of small grants, often 'performance based' linked to the attainment of the 'financial sustainability' as discussed below.[12]

At its inception in 1995, CGAP had 9 donor members. At the Microcredit Summit of 1997,[13] a global campaign was launched to promote microfinance with the explicit aim of raising US$ 22 billion to reach 100 million poor people by the year 2005. In 1997, 618 NGOs and related organizations became associated to the global microfinance campaign; by Dec 2000, the number grew to 1,567 organizations which operate worldwide in many corners of developing and transitional economies, while 20 more bilateral and multilateral donors became CGAP members. In the first three years since the establishment, CGAP provided around US$ 32 million in grants to MFIs and its networks, while CGAP participating donors committed over US$ 400 million to microfinance activities (Micro Credit Summit Report 1998).

On the eve of the MicroCredit Summit (Summit Plus Five) in November 2002, 29 bilateral and multilateral donors are registered as members of CGAP. At least 1,580

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[10] As Gibbon and Schulpen (2002) note, it is hard to establish precise levels of donors' financial support to microcredit and enterprise programmes, since most of donors do not publish systematically the size of their microcredit programmes. The on-line Global Donor Portfolio Database, on which CGAP has been working in the past two years, may allow us to examine global donor flows in near future.

[11] Currently, the microfinance gateway posts nearly 100 websites of multilateral and bilateral donor agencies or private foundations, which cover microcredit and microfinance programmes as one of their important development-related activities (www. Microfinancegateway.org).

[12] One of CGAP's first grants was its co-investment of US$ 2 million with another US$ 1 million provided from a private banker in Comparatamos, which works with very poor women in Mexico's most destitute regions (World Bank 2002, Box 8: 40-1).

[13] The 1997 Microcredit summit was organized by civil society in response to the UN summits of the 1990s.

NGOs and other related self-help organizations, which are members of the Microcredit Summit Campaign, are delivering microfinance services as a central strategy for attacking poverty worldwide, and a large number of national governments currently endorse their political commitment to microfinance through this campaign (CGAP 2002). With these unified donor support, MFIs worldwide as the end of 2001 serve 54.8 million of the poor, of whom 26.8 million identified as the poorest.[14] The poorest clients include 21.2 million women, an increase of 7 million on the previous year.[15] However, it should not be forgotten that there is a huge regional variation. The number of microfinance clients in Asia jumped from 23.6 million to 47.9 million in the end of 2001, which includes 23.3 million of Asia's poorest. Eighty-seven per cent of microfinance clients in the categories of the poor and the poorest reside in Asia.

While providing about US$ 5 million per annum in grants, CGAP' main function is to offer services to microfinance industry, donors and MFIs mainly in the form of policy development, institution- and capacity-building such as technical tools and services; training and capacity-building; and technical advice and exchange. This may or may not require the provision of credit to firms or intermediaries (World Bank 2002).

On the whole, donors' support for this movement is firmly based on the strategic positions drawn from the evaluation of the past experiences with their support for SMEs development. For example, citing in-house research papers such as Batra and Mahmood (2001) and Caprio and Demirgüç-Kunt (1998), the World Bank (2002: 39) concludes:

> … the financial support to larger private firms, SMEs, microfinance schemes and rural borrowers has typically resulted in mediocre outcomes, when based on credit with subsidized interest rates. Incentives to divert such subsidized credit to powerful parties or to support substandard projects have reduced effectiveness. […] Subsidized credit does not lead to superior firm-level performance and the provision of finance in weak investment climates is ineffective.

Hence, their policy conclusions resulted from these evaluations are: First, 'Credit operations for private firms should be *un-subsidized*. This requires sufficient flexibility in interest rate policy, in particular the revision of usury laws that hamper the development of microfinance operations'. Second, it is best to shift to 'wholesale' SME support through financial intermediaries, since 'direct financing of SMEs is costly and ineffective in meeting the needs of the clients, as evidenced in the case of IFC' (World Bank 2002: 40).[16]

A distinct feature of CGAP's use of its grant fund is an investment-style approach that ties tranched funding to MFIs' institutional performance in two critical performance indicators: financial *sustainability* and poverty *outreach.* Outreach measures performance by the number of poor people who gained access to superior financial

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[14] 'Poorest' means that the family was in the bottom 50 per cent of the population living below their country's poverty line (Microcredit Summit Report).

[15] The World Bank estimates that 1.2 billion people are living in absolute poverty globally, on less than one dollar a day.

[16] Webster *et al.* (1996) on IFC's experience is cited as findings supporting this position.

services as a result of the programme, while financial sustainability refers to the programme's independence from concessional funding.

It is contended that performance-based grants provide MFIs with strong financial incentives to reach the twin targets of sustainability of financial intermediaries and the outreach of the poor for the poverty reduction objective. Hence, CGAP takes a 'hand-off' position towards the use of this equity-like funding, leaving it to the discretion of the MFI's own management. It is argued that the performance contract accompanying its funding ensures that 'reporting, monitoring, and continuation of disbursements are tied to the MFI's fulfilment of performance thresholds at the institutional level'. MFIs are expected to achieve 'full financial sustainability' to cover the commercial cost of funds as well. This implies that MFIs are expected to be 'subsidy-independent' in a relatively short timeframe and able to generate substantial surpluses over time to fulfil their social mission on an ever-expanding scale.[17]

While there has been an intensive debate within the Campaign group whether financial sustainability and social mission of poverty reduction could be reconcilable without causing organizational tension in MFIs, CGAP has been pushing hard on the twin goals of achieving sustainability and deepening poverty outreach in recent years.[18] It cites, as examples, several MFIs such as Comparatamos in Mexico, who serves the very poor with an average outstanding loan balance of US$ 66, but stayed on track to financial sustainability with the very high repayment rate and attracting commercial funds.

Within this broad framework set out by CGAP, multilateral financial institutions, numerous UN agencies, and many donor agencies have microcredit support programmes. It is very interesting to note that a remarkably high degree of donor coordination has been achieved, under the leadership of CGAP, in donors' approach to microfinance and microcredit programmes, which is not quite prevalent in other aid programmes. They all provide both financial and non-financial technical support with specifically agreed objectives within the CGAP forum. Non-financial components are emphasized in all programmes on the recognition that MFIs require considerable technical assistance for capacity building in reaching out to the poorest of the poor.

Among multinational financial institutions, the World Bank is a key player in the donor community under CGAP in advancing the Microcredit Summit's pledge in building a robust microfinance industry. It provided over US$ 900 million in grants and concessional loans to MFIs worldwide in the 1990s. At the end of 2001, the World Bank managed over 100 and about 150 active projects with a microfinance component and with a rural finance component, respectively. Both Asian Development Bank and Inter-American Development Bank have accumulated very rich experiences in supporting microfinance institutions over many years and plan to expand their technical and financial support with a specially drafted microfinance development strategy as well as through different operational windows. In contrast, European Bank for

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[17] In 2000, CGAP launched the Pro-Poor Innovation Challenge, which was established to encourage MFIs to undertake innovative work in reaching the poorest with each programme entitled awards up to US$ 50,000.

[18] The Microcredit Summit Campaign states four core themes of: (i) reaching the poorest families; (ii) reaching and empowering women; (iii) building financial self-sufficient institutions; and (iv) ensuring impact on the lives of clients and their families (Microcredit Summit Report).

Reconstructions and Development (EBRD) and the African Development Bank are relative new into the field, but both have rapidly built up active microfinance portfolios.

In addition, many UN agencies have been actively supporting microcredit and microfinance programmes. These include UNDP, which established a special initiative called Microstart in 1997, as well as specialized agencies such as the FAO, IFAD and ILO. Among bilateral donor agencies, USAID has been historically very active in supporting MFIs. It has long committed to enterprise development and building market-based financial institutions. On the other hand, both CIDA and DFID place their microfinance and microdevelopment programmes as a central component of the overall poverty reduction strategy, The two agencies run a substantial programmes of microfinance and microcredit worldwide. Other donors such as European Union, GTZ of Germany as well as Nordic and Scandinavian aid agencies are all known to provide technical and financial support to microenterprise and microfinance programmes. The scope and other features of these main donor programmes are presented in appendix.

4 Performance microfinance institutions and impact of microcredit

4.1 Performance

Several 'high-profile', well-established micro-finance institutions such as the Grameen Bank of Bangladesh, the Badan Kredit Kecamatan (BKK) of Indonesia or Bancosol of Bolivia have captured the imagination of the donor community who have been searching for an effective conduit of channelling official aid for poverty lending. While the public has often been dazzled by the claim that MFIs are an unqualified success in achieving the twin targets of financial sustainability and poverty outreach, this is far removed the reality. First of all, these 'successful' institutions themselves have followed quite a different path of institutional evolution. Dunford (2000) classifies them, for example, in a continuum from *traditional business* (a purely financial bottom line) at one end to *traditional social service* (a purely social bottom line) at the other end. Second, newer MFIs that have replicated innovative practices in different parts of the world have produced highly varied results in their financial performance as well as in the poverty impact (Hulme and Mosley 1996; Morduch 1999a; Marr 1999).

The Grameen Bank, the most celebrated microfinance institution in the world, has expanded fast its 'poverty lending' operations, with 2.4 million members, 95 per cent of whom are women with an average loan size of US$ 134 as in 2002. It rigidly follows the original 'innovative' delivery mechanisms (and hence known as the Grammen formula) with group lending methodology-joint liability incentives, weekly repayment schedules and meetings, 10 per cent compulsory savings and progressive loans.

However, despite consistently producing a very high loan repayment rate as well as charging an interest rate of 20 per cent, it has remained subsidy-dependent on the donor funds. Morduch (1999a) estimates that the effective subsidies to the Grameen Bank amounted to about US$ 176 million between 1985 and 1996. In order to wean from this dependence, the Grameen Bank has tied to shift the major source of funding over time from donor agencies to the central bank and money markets and most recently, it has sought financing through bond sales.

Bolivia's BancoSol is one of exceptional cases in not being subsidy-dependent. However, it specializes in lending to the relatively well-off and charges a high interest rate, 45-48 per cent at an annualized base rate plus 2-3 per cent of commission fees in 1998. It was converted into a full-fledged bank in 1992 from Prodem, a NGO, affiliated to the US-funded Accion International, which has been firmly in support of striving for financial sustainability. While promoting the group-lending methodology in 20 developing countries and 30 US cities with half a million members worldwide as of 2002, Accion places less an emphasis on social issues than business viability. BancoSol itself has moved away from group lending to individual lending.

At the other end of spectrum, village or communal banking programmes, which have been operating under the Foundation for International Community (FINCA), continue to target the poor and make an explicit commitment to building community-based networks that could serve as financial and social self-help organizations (Marr 1999). FINCA serves, as in 2002, nearly 165,000 members in 20 countries, 95 per cent of whom are women with an average of loan size of US$ 191. The concept of village Banking has been replicated in over 5,000 places in 32 countries by NGOs including CARE, Catholic Relief Services, Freedom from Hunger, Project Hope, Save the Children, and World Relief. However, many of these programmes have found difficult it to attain financial self-sufficiency.

Generally, unlike the credit cooperatives in Germany and other European countries in the nineteenth century, which relied on local funds, the contemporary microfinance schemes obtain most of their lending funds from donors (Ghatak and Guinnane 1999). It is not surprising to find that although subsidization is supposed to cover start-up costs only, many programmes remain heavily subsidy-dependent, requiring constant injections of donor funds, against aims and aspirations of MFIs and donors like. Morduch (1999a) offers several estimates of programme sustainability. One estimate suggests that no more than 1 per cent of NGO programmes worldwide are financially sustainable at the close of the 1990s, and perhaps only a further 5 per cent of NGO programmes will ever cross the hurdle. Even using a less strict measure of sustainability, i.e. *operational* sustainability that measures the ability of institutions to cover operational costs only but not the full cost of capital, the emerging picture is not encouraging: the microfinance programmes that target the poorest borrowers generate revenues sufficient to cover just 70 per cent of their full operation cost. Eversole (2000) provides another estimate, suggesting that typically MFIs require seven years of subsidies before they can become sustainable, and then success is not guaranteed.

This is not surprising, since the innovative microcredit mechanisms tend to incur high administrative costs if they are adopted and initiated by NGOs and banks. As outsiders to the community, rather than insiders as in the case of informal associations and lenders, they have to engage in intensive monitoring of groups and are obliged to rely heavily on the promise of repeat and progressive loans in successive periods as incentives for high repayment. Yet, the agency problem characterizing the principal-agent relationship in borrower-lender interactions often remains unsolved between programme officers and groups. Such problems are compounded, when groups are large or put together by programme officers, since group cohesion cannot be guaranteed.

The start-up and administration costs of microfinance programmes tend to be higher in areas of low population density such as are found in Sub-Saharan Africa.[19] It is not surprising that microfinance is most successful in densely populated regions of Asia, which accounts for 87 per cent of microfinance clients. If administrative costs were to increase significantly, many NGOs and banks, in the short run, find it difficult to make the necessary adjustments to accommodate new approaches, without cross-subsidizing internally or externally-funded subsidies. The high loan repayment rates of 95 per cent or above, often reported by MFIs in the initial loan cycles to assure donors of low default risk, can easily mask overall high transaction costs on account of high operation costs. This can prevent them from graduating from subsidy-dependence for a considerable period.

4.2 Impact

A large number of studies have been conducted to evaluate the impact of microcredit programmes on poverty reduction, driven partly by the donor community's needs to establish whether these programmes have been successful for meeting the poverty reduction targets. Hulme and Mosley (1996) examine the impacts of microfinance programmes on income poverty through the effects on productivity, technology and employment. Khandker (1998) expands the analysis to include effects on seasonality of consumption and labour, children's nutrition and schooling, and fertility and contraception. Zeller *et al.* (1997) analyses the impacts that microfinance programmes might have on food security. Cohen and Sebstad (2000) examine the effects of the programmes on the risk management strategies of poor households, which affect the degree of their deprivation and vulnerability.

Many other studies have extended the scope of analysis to include intra-household dynamics and their impacts on individual wellbeing (in particular, that of women and children), the relationship between household and enterprise development, and the potential impacts on the wider community. In view of the multi-dimensional aspects of poverty, effects have been studied not only in terms of changes in income and consumption levels, but also in terms of variations in vulnerability to risk, skill development, gender empowerment and participation in community networks.[20]

These studies by and large support the claim with some cautious notes that 'microfinance can have the potential to help many poor people improve their lives' (Hulme 2000: 26). Khandker (1998) provides an estimate that: (i) about 21 per cent of the Grameen Bank borrowers managed to lift their families out of poverty within about four years of participation; (ii) extreme poverty declined from 33 per cent to 10 per cent among its participants. In the case of the Bank Rakyat Indonesia (BRI), there was a report out in 1990, claiming that net household incomes of borrowers increased by

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[19] Programmes operating in Sub-Saharan Africa are known to have incurred very high costs, in particular. Bagachwa (1995) discusses the difficulties of one of such programmes initiated in Tanzania, the Presidential Trust Fund for Self Reliance (PTFSR), which has adopted the Grameen Bank model. In 1991, the PTFSR extended TSh 4.3 million in loans against a cost of TSh 5.6 million. As of June 1992, it had made TSh 9.6 million in loans, yielding interest income of TSh 0.99 million against an operating cost of TSh 7.7 million. Savings are reported to have been only TSh 1.01 million.

[20] For the detailed critical survey of the recent impact studies, see Marr (2002).

about 76 per cent and employment increased by 84 per cent within three years of programme participation (ADB 2000).[21]

However, the potential of microfinance and the success of established MFIs appear to be somewhat exaggerated by practitioners and donors. As Hulme (2000) argues, there is a need for a much careful monitoring of these programmes by MFIs and the donors, with an acute awareness that microcredit could have both positive and negative impacts on loan recipients.

First, as Hulme aptly reminds us, the other side of the 'microcredit' is 'microdebt'. This means, while microdebt can lead to improved incomes and reduced vulnerability for the poor, it could lead to such a scale of indebtedness that the poor find it hard to get out. There is a greater need for better understanding of real economic environments in which the poor conduct their income-generating activities and microbusinesses. The targeted borrowers 'work in low-return activities in saturated markets' and they are subject to various shocks beyond their control. It has been reported that many indebted borrowers, who fail to generate returns sufficient to make a prompt repayment regularly, turn to money-lenders for buying time. As Rahman (1999) and Goez and Gupta (1996) report, borrowers from the Grameen Bank have had to sell household assets or their own food supplies, or have had to leave their homes in search for wage labour in an urban area to repay their loan. There are plenty of stories around, as found in Montgomery (1996), that delinquent borrowers of MFIs are ostracized by joint-liability groups and communities, and they become destitute in their community. Or worse, they commit suicides out of desperation, burdened with cumulative 'unbearable' indebtedness far beyond their repayment capacity.

Second, as Hulme (2000) observes, it is hard even for 'poverty-focused' MFIs to provide credit facilities to the 'hard core' of the poor. The poorer segments of the poor are usually excluded from group lending, because not many want to share joint liability with them. Even when they join MFIs at the inception as targeted clients, they are often the first to drop out through loan cycles. Marr (2002) documents the case of communal banking programmes in Peru, where group dynamics engendered by the joint-liability microcredit programme have had significant negative impacts on the well-being of participants. In her case study, tension between financial and organizational sustainability has been built up to such a scale that it has produced a fundamental instability of the system, leading to the fracturing of groups and greater exclusion of the poor.

Very high pressures to attain simultaneously the target of financial sustainability and outreach in terms of loan repayment and disbursement in a very short period, and the accompanying internal incentive structures could easily work against organizational sustainability and stability. Typically, as Marr observes, programme 'officers' performance is measured by their achievements in relation to loan repayments and lending portfolios, rather than to stable and sustainable organizations'. They tend to immediately classify delinquent borrowers as strategic defaulters. Furthermore, those with delinquent loans are under pressure to engage in similar trading activities as all other participants for loan repayment purposes, leading to over-indebtedness as well as local market saturation. Thus, Marr suggests, 'high repayment rates of loans to

[21] This statistics come originally from BRI (1990).

programme officers are often being achieved at the cost of an erosion of organizational sustainability, which in the longer term leads to instability of finances and the eventual meltdown of the system'.

The consequences of these 'wrong' incentive structures for the communities in her case study are:

i) A tendency to abandon the joint-liability system, with individually-based collateral increasingly gaining importance in relation to that of collective sanctions and social collateral;

ii) The poorest and most vulnerable members of any given group leave microfinance schemes prematurely or are actively excluded, resulting in serious negative impact effects on their wellbeing;

iii) Benefits are unequally distributed within the group and often favour the better-established households, and tend to empower people already powerful to begin with;

iv) An inclination on the part of the programme officers to move away from targeting the poor segments of the population in favour of the less poor sectors, and consequently poorer people are rationed out from microfinance markets;

v) A fundamental instability and a tendency to lose cohesiveness dominate the group, which implies that not only organizational sustainability is compromised but also financial sustainability is affected in the medium and longer term, leading to negative impacts for all parties concerned.

These are sombre warnings to enthusiasts of microfinance, who tend to perceive MFIs as 'a cure for poverty'. Many structural, sociopolitical and historical factors specific to the local environments in Peru as well as institutional factors characterizing the communal banking programmes concerned, such as inappropriate programme design and implementation, did play some parts in producing these results. However, similar circumstances, if not more difficult, are often present in other locations worldwide, where the microfinance concept is uncritically embraced. The proper lesson to be drawn from this experience is that the MFIs should adjust the design and implementation of microcredit programmes to the local conditions in which they operate, so that these programmes nurture the trust existing already in the communities. Unfortunately, as Marr (2002) notes, microcredit programmes established and organized in haste, tend to exploit, instead, existing social, often hierarchical, structures in order to achieve their own financial sustainability. This often results in an erosion of social fabric of the communities they serve.

Furthermore, financial products offered by MFIs are not necessarily those demanded by borrowers in the communities they are supposed to serve. The fungibility becomes an issue. In order to get access to finance their immediate consumption requirements such as school fees or medical expenses, women 'have to pretend they need 'microenterprise' loans' (Holmes 2000: 27). In this regard, one of weakness of many of MFIs is that they focus on credit delivery, forgetting the fact that their targeted clients may also require appropriate savings mechanisms to smooth consumption. Most MFIs' compulsory savings facilities are established as collateral substitutes and insurance funds for loan

defaults to sustain MFIs' credit programme operation. These facilities do not offer members flexible savings services at the time of their needs. The empirical evidence worldwide suggests poor households and microenterprises have a large demand for safe and convenient savings services as well as for insurance services (Nissanke and Aryeetey 1998).[22]

The mismatch of financial products between what is demanded and what is supplied by MFIs is an issue in relation not only to poverty lending, but also to microenterprise finance. To address the high administrative cost and to increase financial viability, many new microfinance programmes have adopted a *minimalist* credit approach, as opposed to a more *integrated* approach, including technical assistance and other forms of training. The minimalist approach, however, could claim adequacy if programmes are to deal with a specific phase of enterprise development, when enterprises' needs are concentrated in repetitive financing of working capital. Many existing 'successful programmes are, in fact, effective mainly in providing working capital in small doses (Levitsky 1993).

Yet, the diversity of microenterprise activities is overwhelming in terms of size, market, sector, assets, experience and many other characteristics (Eversole (2000)). Further, in terms of enterprise dynamics, microenterprises in both the formation and transformation phases often require more integrated assistance to overcome other obstacles and constraints. Furthermore, for development, enterprises require assistance to overcome financial obstacles other than lack of working capital (Boomgard 1989, Nissanke 2001). As production technology and marketing strategy change as enterprises expand, the need for financial services also undergoes substantial changes. To meet the need of different phases of enterprise development as well as the wide variety of microenterprise activities, there is a need for a diversification of the loan portfolio of the microfinance programmes.

Seen from this perspective, the donor community tends to place too much emphasis on the standardization of products and services, i.e. the standardization of 'successful' operating procedures or the replication of 'best practices', all in the form of simple 'financial engineering'. However, in providing microfinance services, it has to be recognized that 'enterprise finance' differs qualitatively from 'poverty lending' for income-generating activities at the lower end. The former requires a deeper understanding of evolving dynamics of credit demand on the part of entrepreneurs in terms of enterprise development (Nissanke 2001). Indeed, as Eversole (2000) notes, microloans replicated on the Grameen or BancoSol model are designed to serve well only one sub-set of a very diverse microenterprise market. For example, regular provisions for working capital in small quantities may be appropriate for meeting the financial needs of stable, high-turnover businesses, such as trading activities, but not for other diverse categories of microenterprises.

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22 The high demand for flexible savings services by the poor has been recognized by the donor communities for some time (e.g. DAC-OECD 1994, World Bank 1999 and Asian Development Bank 2000). The microfinance programmes supported by the Asian Development Bank now have savings facilities as a central feature of their activities, as discussed in Appendix. However, many new MFIs still tend to focus more on credit delivery. Recognizing this drawback prevalent in Africa, MicroSave-Africa was established in 2000 to conduct pilot projects in 11 countries in East and southern Africa.

5 Policy implications for donors

Our discussion above suggests the urgent needs to address and re-examine the fundamental question facing the donor community: is there tension in the two goals set out to achieve by microfinance and microcredit schemes; attaining the financial sustainability while carrying out social mission of poverty reduction?

Some established MFIs have resolved this tension, opting consciously to be institutions operating as traditional businesses rather than *social enterprises* (Dunford 2000). BancoSol of Bolivia (mentioned above) is an example of such an institution. For these institutions, social objectives, i.e. serving the poor, are only a by-product. In this sense, they abandoned to measure their progress primarily against social objectives. While they still address significant market failure to the borrowing needs of small and even micro enterprises in the location they serve, they do so only incidentally. At the other end of the microfinance spectrum, they are traditional social service organizations, which serve the very poorest such as refuges and disaster victims as emergency operations. They should not and cannot make financial sustainability the prime objective. As Dunford suggests, their functions may lie in developing a strategy to graduate their clients into more sustainable institutions.

However, donors' involvement in the microfinance movement in the past decade or so is explained mostly by their desire for creating and sustaining MFIs as social enterprises through their financial and technical support. These MFIs are supposed to have 'a double bottom line' with both financial/institutional and social objectives. As Dunford (2000) aptly describes, this is the 'Holy Grail of Microfinance': i.e., they are supposed to aim at reaching very poor people but, at the same time, aim at financial sustainability, as discussed in section 3 above. The donor community has been rigorously and constantly re-defining and advocating the frontier of 'best practices' of combined impact and sustainability.

We argue here, however, that donors should be much more aware of the trade-off between the two goals in their microcredit campaign, when microfinance mechanisms are instituted in different local conditions. The tension between the two objectives at the conceptual level is in fact directly translated into incredible pressures and stresses on both the microfinance institutions and their clients in the fields in many parts of the world, as we discussed in section 4. There are microfinance institutions which are reported to be successful in attaining the two objectives, such as Compartamous in Mexico or CRECER in Bolivia operating as village banking programme under an international NGO, Freedom from Hunger. They are, however, the exceptions rather than the rule, when global experiences are fully taken into account. The Grameen Bank in Bangladesh is also rather an exception, by reaching over 2.4 million people and accumulating experiences over a considerably longer period. What is required is a very careful analysis of the conditions that have engendered these successful operations, not only in relation to their service delivery mechanisms, but also in relation to specific local factors and conditions that have led to their success. Mere replication of their 'best practice' would not produce the same results in other locations in the absence of these 'facilitating' factors and conditions.

These successful cases should not be used as excuse for turning away from the reality that many other institutions have been facing so far. Even for CRECER, Dunford (2000) could not give an unqualified answer to the question as to whether they have achieved

both objectives. He concludes that as social enterprises that can last long enough to bring about a major improvement in the lives of many poor people, it is not necessary for CRECER to be totally subsidy-free. He asks the critical question why should not social enterprises tap financial sources available for 'social subsidy' and 'social investment', since there is a developing market for subsidy to social enterprises—for start-up capital, for technical assistance and for loans at concessional rates.

It appears that donors' apathy to subsidy has gone too far. There are solid economic theories to provide an analytical rationale why social investment with use of tax-cum-subsidy should be made in the presence of externalities, public goods and the prevalence of market failure. The issue here is not that temporary or practical subsidies cannot be justified socially or analytically. Rather, the real challenge facing economists and the donor community is to design a microfinance programme so that the subsidy element would not be used as a mere justification for permanent inefficiency so as to perpetuate aid dependency culture, as sadly observed in many other official aid programmes.

Donors should not try to preach for the attainment of the full financial sustainability for all microcredit programmes in an unrealistically short period, standardized across the board. Instead, they should pay much more attention to projecting a realistic timeframe for attaining different categories of financial sustainability for each of their sponsored MFIs in the light of local conditions, and to helping each draw a strategic plan of measures and policies to attain intermediate targets in *sequence*.

In this regards, Gibbons and Meehan (2002: 12) argue that donors should understand that MFIs have different funding requirements at different stages of development. According to their information gathered from MFIs worldwide, 'quasi-equity (concessional loans) is critical in the years prior to break-even to cover (operational) deficits not financed by grants and to provide early on-lending funds that cannot yet to be borrowed from banks'. They estimate that quasi-equity may be required throughout MFIs operational cycles. They also warn the cost implications of rapid scaling up and outreach on sustainability, as scaling-up may increase substantially operational costs so that MFIs, which had once reached a breakeven point, could start experiencing substantial deficits. They urge the donor community to accept that there is a major funding problem affecting the microfinance industry, as microfinance institutions have been experiencing the dearth of equity and quasi-equity financing at any stage of maturity. In order to address this particular funding gap which is expected remain so for the foreseeable future, Gibbons and Meehan (2002) recommend CGAP to lead its way to build the institutional capacity of national and regional-level micro credit funds by encouraging its members to finance them with grants, and by monitoring and evaluating the performance of the funds.

Donors should also take a much more *system-wide* approach to the development of financial markets in developing and transition economies. Currently, many NGO- and donor-driven programmes are operating largely in isolation from the rest of the financial system, often even without adequate coordination with similar microcredit programmes operating nearby.[23] This has generated *premature* market saturation in certain segments

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23 In this respect, there is again a huge regional variation in the degree of financial market integration, involving MFIs. While coordination and linkages among institutions have gathered a pace over the last two decades and quite advanced in Asia, financial services are typically very fragmented in Sub-Saharan Africa (Nissanke and Aryeetey 1998, Asian Development Bank 2000).

of credit demand, while leaving other segments largely under serviced. On one hand, it is not uncommon to observe a rapid increase in very similar vending and trading activities in a small locality where many microcredit programmes compete by offering standardized microloans. This sort of situation is unsustainable, often resulting in a collapse of demand for products marketed by microcredit recipients, and hence, in a difficulty for microfinancial institutions to sustain high loan repayment levels beyond short loan cycles. On the other hand, a wide variety of financial services demanded by microentrepreneurs other than small working capital remains grossly under-supplied.

Consequently, the impact of microfinance programmes on financial landscapes and real sector developments has been rather disappointing. In order to make a greater contribution to the enhancement of financial market landscapes, potential roles of microfinance programmes have to be evaluated in an integrated approach to market development, wherein the types of financial products demanded locally have to be carefully analysed and the real gaps in financial services to be filled by new programmes should be identified. Options for future microfinance programmes would include linking them into local institutions (both formal and informal), or transforming these programmes into sustainable institutions anchored in local set-ups, and capable of providing a comprehensive set of financial services to different categories of the poor and microenterprises.

In this context, some valuable experiences with *microequity* programmes should be carefully evaluated. As Pretes (2002) and Eversole (2000) discuss, microequity schemes are conceived on the recognition that microcredit seldom reaches the poorest, and the very poor are too vulnerable to business risk to be indebted (see section 4 above). The transaction costs of participating in microcredit programmes may also be too high in relation to expected returns on their income-generating activities. In contrast, microequity provided as start-up capital to the very poor can lead to reduced risk of start-up businesses and lower transaction costs, compared to microcredit provision. It can also create credit worthiness for the entrepreneur who has benefited from equity financing and has accumulated some business experiences prior to receiving microcredit. As Pretes (2002: 1345) argues, 'equity-based grants are not handouts and a welfare mentality in the recipient can be avoided by making grants to small groups, where peer pressure acts to insure that the grants are used appropriately, and where misuse may impinge upon the ability to receive future grants'.

At the same time, grants as opposed to loans to microenterprises can be justifiable on the same grounds, as for grants or concessional loans given to microfinance institutions at the start-up stage. Thus, Eversole (2000: 50) raises a legitimate question: 'if it is worthwhile to provide grants to institutions, as a kind of seed capital to get good ideas off the ground, then could it also be acceptable to provide seed capital to businesses?' Indeed, from a perspective of microequity providers, as equity financier, microequity can lead to an increase in social equity of the local community and its sustainability and independence from continued overseas aid, as equity finance could lead to the sustainability of the businesses, in which equity investment is made (Pretes 2002).

It can be suggested that equity grants could complement microcredit programmes in meeting the financial needs of those, for whom microcredit is not necessarily the most appropriate instrument. For example, as Eversole (2000) and Pretes (2002) describe, the 'trickle up' conditional grant programme experimented in Africa, Asia and Latin America has adopted the concept of microequity for start-up businesses, which is run

alongside, not in competition with, microcredit programmes which cater for the needs of more experienced business people. By capitalizing businesses, the Trickle Up Programmes target those 'who are too poor to be good credit clients, but who have the desire to invest their time and abilities in creating a business (Eversole 2000: 51). With this objective, the Programme provides equity-grants to the fragile poor as part of a larger integrated development package. This example points to the donor community the possibility of exploring a system, wherein grant- and loan-based microfinance programme will work in tandem to offer a more complete spectrum of financial services.

All in all, it should be more explicitly recognized by donors who render support to microfinance, that microcredit schemes are not necessarily the best instrument to tackle the poverty problem of those who are at the bottom of poverty pyramid. The poorest are as a rule risk- averse to take a loan with little fall-back position. Furthermore, as Hulme argues, 'providing effective microfinance services to poor people is a part of poverty reduction strategy—but only a part' (Hulme 2000: 28). It is understandable that donors are increasingly impatient, as they realise that they could miss the 'Millennium Goals' of reducing the number of the poor by half by the year 2015. They are often dismayed by the statistics such as 'only one per cent of the world's poor households have access to financial services from MFIs (*Microcredit Summit Report* 2000).

However, donors' policies should not be driven exclusively by political or moral imperatives or emotions. Instead, their poverty reduction strategy should be formulated on a firm basis of the deeper understanding of the *symbiotic* relationships that have been evolving between financial and real sector development. While the potential contribution microfinance and microcredit programmes to poverty reduction is promising indeed, it is not possible to change the world easily by just applying instruments of financial engineering. The performance of microfinance and microcredit programmes always reflects, as well as impact upon, the development of real economies.

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Appendix: Main features of selective donor microfinance and microcredit programmes

Main features of financial and nonfinancial support provided by major multilateral and bilateral donor institutions and agencies for microfinance and microcredit programmes are summarized as well as presented in Table 1A. Unless otherwise specified, these summary descriptions and data draw on information provided at the websites of CGAP, Microcredit Summit Campaign, multilateral financial institutions, UN agencies as well as bilateral donor agencies.

A1 Multilateral institutions

A1.1 World Bank[24]

The World Bank is a key player in the donor community under CGAP in advancing the Microcredit Summit's pledge in building a robust microfinance industry, in particular with a view of its own two overriding objectives: poverty reduction and financial sector development. During period FY1991-FY96, the World Bank supported 55 microfinance projects with a total investment of US$ 713 million. Its support has accelerated over time. In 1996 alone, it provided loans of about US$ 88 million worldwide. It is reported that the World Bank Group provided US$ 200 million in concessional loans and grants for two years since the launch of the Microcredit Summit Campaign in 1997.

The World Bank provides both lending and nonlending supports to microfinance operations. The latter includes: (i) technical assistance; (ii) policy dialogue; (iii) grant for pilot operations; and (iv) economic and sector work. In 1997, the World Bank created the Small Enterprise Development Unit in the Private Sector Development as a centre of expertise in small- and medium-enterprise development, microenterprise development, and microfinance. The World Bank also provides International Finance Corporation's (IFC) loans and equity to mature microfinance institutions.

On the whole, the World Bank uses several institutional channels for microfinance support: (i) training services by the Economic Development Institute (EDI) and country departments; (ii) grants through CGAP; (iii) concessionally priced IDA credits; (iv) market-based IBRD loans; (v) International Finance Corporation (IFC) equity investments.

In Asia, the World Bank approved in 1997 a loan of US$ 105 million for Bangladesh to support an apex of microfinance institution, which would administer the funds to MFIs. In 1998, a loan of US$ 90 million was approved for Pakistan. In addition, the World Bank was involved in operations in Sri Lanka, India, Vietnam, Indonesia, northwest China. In Africa, the World Bank provided loans to MFIs in Benin, Eriteria, Madagascar and Mali, among others. It provides support through social funds to smaller NGOs for initiating microfinance and credit programmes. IFC provided equity investments of US$ 1 million in Kenya Rural Enterprise Programme.

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24 World Bank (1999, 2002).

In Latin America and the Caribbean, it has microfinance projects in Jamaica and Mexico to leverage private commercial banks to reach greater number of microenterprises, while IFC is involved in equity investment in Peru. The World Bank also established social funds in many countries such as Guatemala and Honduras in providing support to village banks. In the Middle East and North Africa, the World Bank started projects in Lebanon, Tunisia, Morocco and the West Bank/Gaza. Jordan, many of which involve equity and quasi-equity investment by IFC. The World Bank is active in several post-conflict countries and transition economies, including Bosnia, Tajikistan, Armenia, Moldova and Albania.

As the end of 2001, the World Bank managed over 100 and about 150 active WB projects with a microfinance component and with a rural finance component, respectively. Several of microfinance programmes are stand-alone projects, while the rural finance projects are spread over several sectoral families. Both programmes are seen as one of most critical WB lending programmes. In addition, the World Bank is very active in capacity building and technical assistance with four pillar action plans: (i) promoting supportive financial sector policy and regulatory environments; (ii) supporting capacity building through training courses; (iii) disseminating best practice information; and (iv) facilitating donor coordination as chair of CGAP.

A1.2 Asian Development Bank

Asian Development Bank (2000) reports that during 1988-98, ADB approved 15 microfinance projects totalling about US$ 350 million, 6 projects with microfinance components of about US$ 53 million, and 34 technical assistance activities for about US$ 18 million. Asian Development Bank covers the region where many larger and established MFIs operate. However, its assistance during this period was very much concentrated in two countries, Bangladesh and Indonesia, which received 62 per cent of the total loan amount for microfinance projects. The rest was divided among Philippines and Nepal, accounting for 33 per cent; Kyrgyz 4 per cent and Mongolia 1 per cent.

ADB's microfinance projects are generally more advanced, providing more integrated services, including savings facilities.

Drawing lessons from its past experience of the fragmented nature of its support for microfinance, Asian Development Bank formulated in 2000 a special 'microfinance development strategy' as a central component of its overall poverty reduction strategy in the region. Microfinance policy issues are also incorporated into broader financial sector reform programmes supported by ADB. It aims, among other objectives, at: (i) promoting a common approach to microfinance operation and encouraging pro-poor products; (ii) contributing to better coordination with other funding agencies. With rich experiences with the microfinance concept in the region behind, it adopts the financial system development approach for improved financial infrastructure and apex microfinance organizations, and recognizes the need to provide a variety of financial services, including savings services, to the poor. The Asian Development Bank has provided a support to two national-level apex microcredit funds in the Philippines and Nepal.

A1.3 African Development Bank

African Development Bank established a special programme on microfinance, 'Micro Finance Initiative for Africa (AMINA)' in September 1997 as an initiative specifically

for poverty reduction with the aim of promoting capacity-building, information dissemination, policy dialogue and donor coordination. It made US$ 20 million available for 10 countries for the pilot phase, including funds for on-lending by MFIs. These funds are offered on subsidized terms for loan financing schemes. The ten countries included in the pilot phase are Burkina Faso, Cameroon, Cape Verde, Chad, Ethiopia, Ghana, Malawi, Mauritania, Mozambique and Tanzania.

A1.4 Inter-American Development Bank

Inter-American Development Bank (IADB) started providing support for microfinance with the 'small projects programme' in the late 1970s. So it is regarded as a pioneer with rich experiences wit a growing microfinance portfolio. Between 1990 and 1996, it approved 471 microfinance operations totalling US$ 452 million with its estimated over 600,000 microentrepreneurs as beneficiaries.

Based on this experience, it drew a new microenterprise development strategy in 1997, and launched a five- year programme, MICRO2001, in 2001 with focus on promoting policy and regulatory reform. During this phase, IADB plans to increase its investment in microenterprise development to about US$ 500 million, including equity investment, loans and TA from the Multilateral Investment Fund. The Microenterprise Unit at Department of Social Programmes and Sustainable Development is responsible for coordinating and monitoring the MICRO 2001. IADB disburses soft loans and grants of up to US$ 1 million plus technical cooperation grants through its social entrepreneurship programme (SEP). It also provides equity investments, loans and technical assistant grants of up to US$ 2 million to well-established, mature programmes through the Multilateral Investment Fund (MIF) for financial and nonfinancial service programmes. MIF was established in 1993 to encourage private sector development in the region with funding of US$ 1.3 billion. It provides technical assistance grants and investment programmes with over 400 projects in operation.

The Global Microenterprise Development Programme is fledging microcredit programmes by providing technical assistance and a line of credit.

In 1998, IADB approved US$ 107 million in microenterprise development programmes, divided among the SEP (US$ 10 million), MIF for (US$ 31 million), technical cooperation programmes (US$ 41million) and global microenterprise loans (US$ 65 million). In 1998, IADB also received grant assistance from the government of Norway and established the Norway Fund for Microenterprise Development for strengthening the implementation of the microenterprise development strategy of IADB.

A1.5 European Bank for Reconstruction and Development (EBRD)

The EBRD's main focus is on the private sector development, with 70 per cent of all Bank operations (by volume) devoted to private sector activities. Its central component is to build a financial sector that serves the needs of the business community, in particular, small- and medium-sized enterprises (SMEs) and microenterprises. Its financial sector operations represent almost a third of the total value of EBRD operations, the largest sector operation. It renders support financial institutions by investing in them, developing skills and by promoting sound business practices.

As of 30 December 2001, the EBRD invested over € 3.03 million in bank lending (112 projects), € 1.02 million in bank equity (80 projects); € 1.22 million into equity funds

(63 projects); € 403 million through micro and small business programmes (19 projects) and € 236 million in nonbank financial institutions.

It posted, at its website, net cumulative business volume in micro- and small business programmes as June 2002, amounting to € 332 million in total.

A2 UN Agencies

Several UN agencies are actively supporting microcredit and microfinance programmes. These include UNDP, UNCTAD, UNICEFF, UNHCR, UNWFP, UNESCO, FAO, IFAD and UNCDF.

A2.1 UNDP (United Nations Development Programme)

UNDP's programme, Microstart, established in 1997, is the best-known pilot initiative, initially with 36 projects in 25 countries for capacity-building in microfinance. It is designed to build the capacity of five to 10 new or small local microfinance organization such as NGOs and banks. In short, in terms of specialization among donors, Microstart opted for the lower end by supporting very small institutions and investments. It provides a grant of up to US$ 150,000 to local NGOs or community organizations to receive technical support from established MFIs such as Grameen, Accion, SEWA and BRAC. UNDP also established, with UNCDF (United Nations Capital Development Fund), the Special Unit for Microfinance (SUM) in 1997. SUM supports UNDP's microfinance portfolio by providing advisory support services. At the beginning of 2002, SUM supported the UNDP and UNCDF portfolio of microfinance operation in 42 countries through technical advisory services and financial support. Many of SUM's microfinance interventions are in the rural regions of Africa.

A2.2 FAO (Food and Agriculture Organization of the United Nations)

FAO provides, through its Rural Finance Group, several technical assistance programmes such as provision of key information (Agri-Bank Stat) or software for automating banking operations (the FAO Microbanking System.). The latter is a collaborative venture with the German Agency for Technical Cooperation (GTZ), and is used in over 25 countries throughout Asia, Africa and East Europe. FAO also supports regional agricultural credit associations (RACAs), which organize and coordinate training programmes on rural finance.

A2.3 IFAD (International Fund for Agricultural Development)

As an agency specializing in rural development with focus on rural poor, IFAD regards microcredit as an empowerment tool and as a means of bringing income-generating activities to poor farmers as well as the landless. It tries to combine credit with access to extension and better technologies and ready access to markets. Over 20 years to the close of the 1990s, it provided about US$ 2 billion for microfinance activities. At the end of 1990s, it planned to commit about US$ 130 annually specifically for microfinance through IFAD financed projects or NGO/ECP (extended cooperation) grant facility.

A2.4 ILO (International Labour Office)

ILO contributes to microfinance through capacity building programme and research.

In 1999, it provided grants of about US$ 42.5 million to poverty-oriented MFIs and US$ 48 million for training, capacity-building and research through the social finance programmes (the trust funds).

A3 Bilateral donor agencies

A3.1 USAID

USAID has long held a perspective that enterprise development is one of most critical conduits for economic development and growth, and has engaged in building market-based financial institutions and best-practice for serving the financial need of small and microenterprises over the last two decades in developing countries. With that strong tradition, USAID instituted in 1994 the Micro Enterprise Project (MIP), an initiative to support technical and financial assistance, research and training on microenterprise development and finance. It is an agency-wide initiative designed to integrate microenterprise more fully into its programming. It was developed in consultation with the US Congress and a policy group of microenterprise practitioners under microenterprise coalition. Indeed, the Clinton Administration advocated microcredit lending programmes internationally as well as through domestic agencies. USAID has acted to strengthen the link between the domestic and international microenterprise movements. MIP has several sub-projects, including the Microenterprise Best Practice Project (MBP) and Assessing the Impact of Microenterprise Services (AIMs) to assess the outreach and sustainability.

In FY 1996, USAID worked in about 40 countries worldwide with US$ 138 million devoted to microenterprise programmes. It is a major funder of village banking and supported 68 village banking programmes run by US NGOs in 1996.

USAID was active in 17 countries in Africa, in 11 countries of Asia and Near East, in 10 European (former socialist) countries, 10 Latin and Central American countries.

A3.3 CIDA (Canadian International Development Agency)

CIDA places its microfinance and microdevelopment programmes as a central component of the overall poverty reduction strategy with its own credit union movement tradition. On the basis of its history and experiences, it produced 'microfinance and microcredit development institutional action plan' (MFD/MED) for 1998-2000. It has been very active in providing both financial and technical supports in MFD/MED through Canadian NGOs such as Calmeadow, MREDA (Mennonite Economic Development Association) and NGOs.

Over the 10 years (1990-99) cumulatively, CIDA spent about US$ 1.8 billion on 540 projects in 92 countries, while in the late 1980s and early 1990s it had a larger budget. In 1998, CIDA supported microfinance and microcredit programmes in 42 countries and planned to expand to 8 additional countries in 1998-99. In FY 1997-98, CIDA spent US$ 70 million on MFD/MED related programmes. It also supported Canadian NGOs working in the field through the partnership programme on a multi-year basis.

A3.4 DFID (Department for International Development)

DFID also placed its microfinance programme as a central component of the poverty reduction strategy embedded in its White Paper on International Development.

DFID supports strongly MFIs which provide voluntary savings facilities as well as credit. DFID gives grants to MFIs towards institutional capacity-building, operational costs, loan funds, as well as technical assistance for training and systems development

In 1998 it funded microfinance programmes in 36 countries worldwide with a focus on some 20 countries in Sub-Saharan Africa and South Asia. It is reported that the commitments to microfinance programmes total approximately US$ 80 million annually as in 1999. DFID provides these funds to established MFIs through its bilateral country programmes, while it set up a 'joint funding scheme' (JFS) to assist fledging institutions which are required to link up with an experienced UK-based NGOs.

A4 Other donors

European Union provides technical assistance and credit lines to micro-enterprises and microfinance institutions through Rural Development Programme and European Development Funds. Local, medium, small and microenterprises are singled out as the focus of European Commission (EC), European Investment Bank (EIB) and Centre for the Development of Industry/Enterprise as well as other decentralized cooperation programmes in EU's strategy paper for private sector development in ACP countries issued in 1998. GTZ (German Agency for Technical Cooperation) is also very active in offering technical support to microfinance development and network programmes for self-help groups as part of its financial system development programme. SIDA (Sweden), Norway and the Netherlands are also known to provide technical and financial support to microenterprise and microfinance programmes.

Appendix Table
Main features of donors support for microcredit and microfinance programmes

Years	Programmes	Objectives	Projects	Scale of support	Scope	Features of support	Financial characteristics
World Bank Group							
1991-96	Through EDI, IDA, IBRD, IFC	Poverty reduction, financial and private sector development	55 microfinance projects	$713 million cumulative	Worldwide	Financial and technical support	Concessional loans and grants
1997-99				$200 million			
currently			100 microfinance projects and 150 rural finance projects				
Asian Development Bank							
1988-98		Poverty reduction, financial sector development	15 microfinance projects	$350 million	Bangladesh and Indonesia (62% of the total loan amount), Philippines and Nepal (33%), Kyrgyz (4%), Mongolia (1%)	Financial and technical support	Concessional loans and grants
			6 projects with microfinance components	$53 million			
			34 technical assistance projects	$18 million			
2000 to date	Microfinance development strategy	Poverty reduction					
African Development Bank							
Pilot phase started in 1997	Microfinance Initiative for Africa (AMINA)	Poverty reduction with capacity building, information dissemination and policy dialogue		$20 million	Burkina Faso, Cameroon, Cape Verde, Chad, Ethiopia, Ghana, Malawi, Mauritania, Mozambique, Tanzania	Financial and technical support	Concessional loans and grants

Appendix Table continues

Appendix Table con't
Main features of donors support for microcredit and microfinance programmes

Years	Programmes	Objectives	Projects	Scale of support	Scope	Features of support	Financial characteristics
Inter-American Development Bank							
1990-96	Small project programmes		471 microfinance operations	$452 million cumulative			
1993 to date	Social entrepreneurship programme (SEP)			$10 million in 1998		Financial and technical support	Concessional loans and grants
	Multilateral Investment Fund (MIF)	Encouraging private sector development, directed to well-established, mature programmes	400 projects in operation	$1.3 billion cumulative ($31 million in 1998)		Financial and technical support	Equity investments, loans and grants for technical assistance
	Global microenterprise development programmes			$65 million in 1998		Financial and technical support	
2001-05	MICRO2001	Promoting policy and regulatory reforms		$500 million planned			Concessional loans and grants
EBRD							
2001	Micro and small business programmes		19 projects	403 million			Concessional loans
UNDP							
1997 to date	Microstart	Pilot initiative for capacity building in microfinance, directed to very small institutions and investments	36 projects		25 countries	Technical support	Grants
	Special Unit for Microfinance (SUM)				42 countries, especially African rural regions	Financial and technical support	Grants

Appendix Table continues

Appendix Table con't
Main features of donors support for microcredit and microfinance programmes

Years	Programmes	Objectives	Projects	Scale of support	Scope	Features of support	Financial characteristics
FAO							
	Agri-Bank Stat	Provision of key information					
	FAO microbanking system	Software for automating banking operations			25 countries in Asia, Africa and East Europe		
	Regional agricultural credit associations	Training programmes on rural finance					
IFAD							
1979-99	IFAD funded programme and NGO/ECP grant facility	Focus on rural poor, bringing income generating activities to poor farmers and landless		$20 million cumulative			
1999 to date				$130 million annually			
ILO							
1999		Poverty reduction		$42.5 million			Grants
1999	Social finance programmes	Training, capacity building and research		$48 million			Grants
			Selected bilateral donors				
USAID							
1994 to date	Microenterprise project (MIP), of which micro-enterprise best	Enterprise development		$138 million in 1996	17 countries in Africa, 11 countries in Asia and Near East, 10 European (former socialist) countries, 10 Latin	Financial and technical support, research and training	

Appendix Table continues

Appendix Table con't
Main features of donors support for microcredit and microfinance programmes

Years	Programmes	Objectives	Projects	Scale of support	Scope	Features of support	Financial characteristics
USAID (con't)							
	practice project (MBP) and assessing the impact of microenterprise services (AIMs)				and Central American countries		
	Village banking		68 village banking programmes				
CIDA							
1997-2000	Microfinance and microcredit development institutional action plan (MFD/MED)	Poverty reduction		$70 million in 1997-98	50 countries	Financial and technical support	
1990-99			540 projects	$1.8 billion cumulative	92 countries		
DFID							
1998	DFID funded programmes and joint funding scheme (JFS) with UK-based NGOs	Poverty reduction		$80 million in 1999	36 countries, with focus on 20 countries in Sub-Saharan Africa and South Asia	Financial and technical support	Grants

Source: Websites of respective donor agencies.