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FINANCIAL SECTOR REFORM POLICIES AND POVERTY REDUCTION

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1. Introduction

Africa is a richly endowed continent and yet is engulfed in poverty of immense proportions. Sub-Saharan Africa, as a region, ranks lowest in terms of human development, with its 612 million inhabitants sharing gross domestic product of only \$326 billion in 1997, less than that of Holland, a country with only about 15 million inhabitants. Life expectancy at birth in Sub-Saharan is the lowest in the world and fewer people in Africa have access to safe drinking water. With population growing at about the same rate as output, per capita income in Africa has remained stagnantly low over the years. The majority of Africans live on less than \$1 a day. In addition to severe geographical constraints, natural disasters, civil wars, poor governance and economic mismanagement have contributed to the general impoverishment of the continent. More people are now under the poverty line than was the case twenty years ago. With all its agricultural potential, Africa is now a net importer of food. Threat of famine and starvation has made some parts of the continent dependent on international aid for survival.

Finance is the oil for growth. It is indeed the life-blood of the economic system. The financial system is the vessel that carries this life-blood through the economic system. It is the system of institutions and operations that canalises the financial resources into productive use. In most developing countries, the economies are characterized by dual systems running parallel – monetized and non-monetized; formal and informal systems. On the one hand is the money economy where transactions predominantly take place with money as a medium of exchange and on the other is the non-monetized rudimentary economy where the subsistence economy and barter dominate. The other kind of dualism refers to the formal financial system with the banks and other formal financial intermediaries as distinct from the informal system made up mostly of various shades of rotating credit systems and moneylenders. The poor usually operate in the non-monetized system and/or the informal financial system.

In the 1980s, when most African countries adopted an IMF/World Bank supported Structural Adjustment Programme (SAP), financial sector reforms formed a major part. The financial sector reform involved institutional restructuring, enhancement of the legal and regulatory framework for banking operations, and liberalizing interest rates. Clearly, The financial sector reform has more to do with the formal system than with the informal sector activity. In particular, policy reform by way of interest rate liberalization affected the formal sector directly and any impact on the informal financial activity was only secondary. Arguably, a credible transmission channel for the reforms to reach the poor will be through institutional and regulatory reforms via quasi-informal market.

This essay investigates the impact of financial sector reforms on poverty reduction. The main aim here is to assemble and crystallise thoughts and research in this area with the aim of informing policy-making. It will also attempt to point out policy-relevant issues that may require further research.

The rest of the paper is organised as follows: the next section looks at what the financial sector reforms entail. We will pick on example of the reform in Ghana to illustrate the elements involved. Section 3 looks at the poor and their need for financial services. Section 4 investigates whether the financial reforms have had any impact on poverty reduction. We conclude in Section 5 with some recommendations.

2. The Financial Sector Reform

For most African countries, the financial system was virtually underdeveloped in the period up till independence. After the introduction of money in the colonies principally for the reason of taxation, not much was done to develop the financial system of the colonies. There only a few expatriate banks, which catered for the needs of the expatriate merchants. These banks failed to advance loans to local peasants and entrepreneurs primarily because they lacked collateral securities. Credit thus circulated only among the big expatriate commercial houses, which could afford to provide 'good' collateral. The collateral demanded included life assurance policies,

stocks, shares, bills and other financial instruments, which could not be found in the portfolio holding of the natives. Thus, after independence, most African governments initiated plans to indigenise their banking sectors so as to make credit easily accessible to the indigenes.

After independence, the pressure to develop economically led to fiscal pressures, which put severe strain on the financial sector. With interest rates fixed at ridiculously low levels most governments borrowed cheap from the financial system and thereby crowded out the private sector. As the economies of African countries run into more macroeconomic problems, the financial sector became more and more distressed. For instance, the high inflation rates experienced in some countries together with the devaluations that were introduced to correct the imbalances left most banks with negative net worth. There was therefore a need to reform the financial system. The rest of this section describes the financial reform in Ghana, which is the epitome of financial reforms elsewhere in Africa.

The period 1983-1988 was an era of crisis in the financial system in Ghana. High default rates had rendered most bank assets non-performing, the high rates of inflation had wiped out the capital base of most banks, and the weakened confidence in the financial system had adversely affected bank deposits. These affected the ability of the banks to perform their intermediation function properly. This also affected the recovery effort initiated under the ERP. Thus, in 1988, a comprehensive Financial Sector Adjustment Programme (FINSAP) was launched. The FINSAP was financed with an adjustment credit from the World Bank, with co-financing from Japan and Switzerland. The Government of Ghana also contributed by converting its loans to the banks into equity and by paying government guaranteed loans to the state-owned-enterprises.

The financial reform involve institutional restructuring, enhancement of the legal and regulatory framework for banking operations, and liberalizing interest rates. These

were carried out in phases. FINSAP-1 covered the period 1988-1991; FINSAP-2 is from 1992-1995; and FINSAP-3 started in 1995.

The major objectives of FINSAP-1 were: (1) to review the legal and regulatory environment and amend the existing Banking Acts and Laws; (2) restructuring the banking sector to make the banks viable and efficient; and (3) revitalize the financial sector by creating new institutions. FINSAP-2 and 3 were to continue with the restructuring of the financial sector.

(i) Regulatory and Legal Reforms

The Banking Law (PNDCL 225) was revised in 1989. The innovations in the new law included (i) the tightening of risk exposure limits, (ii) establishment of tighter capital adequacy ratios, (iii) strengthening of accounting standards and making them uniform for all banks, (iv) broadening the scope for audits of the banks, (v) imposition of stringent reporting requirements, and (vi) improvement of on-site and off-site supervision of banks by the Bank of Ghana. A revised Bank of Ghana Law (PNDCL 291) was also enacted in 1992 to give more supervisory powers to the central bank. These two laws together provide the legal and regulatory framework for the banking business in Ghana.

In order to bring more financial institutions under the purview of the Bank of Ghana a Financial Institutions (Non-Banking) Law (PNDCL 328) was also enacted in 1993. This law covered the activities of discount houses, finance houses, acceptance houses, building societies, leasing and hire-purchase companies, venture capital funding companies, mortgage financing companies, savings and loans companies, and credit unions.

(ii) Financial Restructuring

The reforms also involved management and financial restructuring of the banks. New boards were created for most of the banks and there were shake-ups in the top management positions as well. Financial restructuring involved in the main the

recapitalization of the banks with equity injection where liquidity was low, and the cleaning up of their balance sheet of non-performing assets.

(iii) Institutional Restructuring

There was also institutional restructuring of the financial system involving the establishment of new institutions, mergers and liquidation of banks and divestiture of public sector shareholding in some of the banks. Under the FINSAP, five new banks and twenty non-bank institutions were established. This was to encourage competition in the financial sector. In 1995, the Social Security Bank merged with the National Savings and Credit Bank. Under the institutional restructuring, the money market was formalized in the creation in 1991 of a second discount house, the Security Discount Company (SDC) to compete with the Consolidated Discount House (CDH), which was created in 1987. Both were wholly owned by the banks in Ghana and charged with carrying out interbank operations. These institutions help optimise the allocation of resources within the banking sector and facilitate proper mobilization of resources to the needy sector; thus, reducing structural imbalances in the system.

Although the first rural bank in Ghana was established in 1976, the period of the financial sector reform saw a lot more of them coming up. This was to make up for the inability of the commercial banks to reach the rural areas and also to support agriculture. The rural banks were established as small unit-banking operations, which are owned and managed by the rural communities. The central bank also owns shares in the rural banks and also acts as their supervisor. The prime aim was to mobilize savings from the rural folk and also to help cottage industries.

(iv) The Capital Market

Under the FINSAP, Ghana's capital market was established in 1989. The Ghana Stock Exchange (GSE) began full operations in November 1990 with 12 listed companies and one Government bond. Market capitalization within the first two years of operation increased from 30 billion cedis in 1991 to 43 billion cedis in 1992 while

the listed companies to increased to 15. In 1993, the total market capitalization went up by about 120 percent to 95 billion cedis. Thus, the GSE established itself as a profitable investment venture for the Ghanaian economy with total capital gains amounting to 123 percent at the end of 1993.

There is no doubt that the Ghana Stock Exchange has the potential to attract long-term financing of investment in Ghana. During the seven years of its existence, the market has raised about 140 billion cedis and US\$ 4.8 million through equities and bonds and the number of listed companies has risen to 21.

(v) Interest Rate Liberalization

Under the financial reform interest rates have been deregulated. This move was in part to encourage competition among the banks. But, the deregulation of the interest rate was also to conform to the new form of financial programming Ghana was following under the Structural Adjustment Programme (SAP). Under the SAP, Ghana was using the money supply as the nominal anchor. This implied that the price of money (the rate of interest) should be determined by market forces.

The move towards interest rate liberalization was a gradual process. The first distinctive move was the abolition, in September 1987, of the maximum and minimum deposits, except the minimum saving deposit rate, which was temporarily maintained at 12%. In February, 1988 minimum lending rates for commercial banks were also abolished and by March of 1989 commercial banks were given the right to determine their own rates and display them in their banking halls. In November 1990, there was further liberalization of the financial sector by the abolition of 20% mandatory lending to agriculture. Thus by the beginning of 1991 the financial sector was almost liberalized. Since the liberalization, both real lending and real Treasury bill rates have been positive. Saving rates have been struggling to stay positive. This is reflective of the weak mobilization efforts by the banks since most savers would rather hold their idle balances in the form of the relatively risk-free but high yielding government bills.

3. Financial Habits of the Poor

Poverty is sometimes difficult to define. Some times using an absolute standard of welfare (e.g. amount of income, consumption, life expectancy, housing conditions), one can be described as poor. As against this absolute measure of poverty, there is also the “relative” measure, which identifies the poor by relating their position to another individual or an international average. Sometimes we identify the poor by certain characteristics. Usually, the extreme poor (also sometimes referred to as the "hard-core poor") are more likely to be underweight, susceptible to illness, and have higher mortality rates; they are the least likely to own assets (e.g. land) and have severe fluctuations in their employment status. Their immediate challenge is to obtain adequate food/nutrition in order to survive. If their income increased, they would spend proportionately more on food than anything else.

Although qualitative indices are very relevant for understanding the poor, they can also give rise to speculative conjectures. Thus in most cases poverty analysis is based on quantitative expressions using income expenditures. Apart from the more conventional approach based on income expenditures, the amount of calorie in-take and even social indicators such as security, freedom from harassment and dignity can all indicate poverty levels [Chambers, 1988]. Salmen (1992) defines as absolute poor those with income-per-person too low to afford 2,250 calories per day and thus at risk of poverty-induced under-nutrition.

If we use the generally accepted income definition and characterized the poor as those with little or no money, one then wonders what kind of financial services the poor will demand. Can those with little or no money save or invest? The poor in the villages of Africa have since time immemorial been engaging in non-monetary saving. Thus most from rural households in Northern Ghana would save the cattle and use it as dowry when their sons get married. But do the poor do financial saving?

Zellar and Sharma (1998) pointed out that “the myth that poor households in developing countries, who often earn less than a dollar a day, are not credit worthy or

able to save has been firmly put to rest in recent years". This view is supported by other writers like Rutherford (1999). In their opinion, poor households place special value on reliable and continued access to different types of financial services, which are available at reasonable cost and cater for their specific needs. The authors noted that the availability of credit and savings facilities could help poor rural households manage and often augment their meager resources and acquire adequate food and other basic necessities for their families. In addition, short-term borrowing or savings are often used to maintain consumption of basic necessities when household incomes decline temporarily — after a bad harvest or between agricultural seasons, for example.

Rutherford (1999) gave three reasons why the poor need to save to accumulate large sums:

- Life-cycle needs – dowry, funeral expenses, childbirth, education, home building, widowhood, bequest.
- Emergencies – *personal emergencies* such as sickness or injury, loss of employment, or the death of a bread winner; *impersonal emergencies* such as war, floods, fires, drought, or the displacement of slum dwellers by the authorities.
- Opportunities – investing in existing or new business, buy land or other productive assets.

Rutherford (1999) argues that there are three ways in which the poor raise the large sums they need:

1. by selling assets they already hold (or expect to hold).
2. by taking loan by mortgaging those assets
3. by finding ways of turning their small savings into large sums.

The first method does not usually require 'financial service' but the second and third usually require the use of a financial institution. But the formal banks usually shun the poor.

Research by Musinguzi and Smith (2000) examining savings and borrowing behaviour by rural households in Uganda concluded that

- Lack of savings was due to low income and lack of access to financial institutions due to poor confidence in them. Households savings were not directed at productive ventures but rather future consumption on needs such as school fees and medical expenses
- Borrowing was less prominent in the rural areas as compared to those at the urban areas or trading centers. Reasons for not borrowing ranged from lack of collateral, lack of access, risk of non-repayment or refusal by the lender. Those who borrowed obtained accessed them mainly from informal sources such as friends, relatives and sometimes in the form of assets rather than finance. The use of loans was however not directed at productive ventures such as farming inputs but for medical expenses, rent and food.

Another survey by Zellar and Sharma (1998) in nine countries including 5 from Africa, found that

- A large number of poor households in developing countries experience real constraints in the financial market due to unfavourable prevailing transaction terms
- Because the cost of failure can be high at extremely low incomes, poor households are likely to be risk averse and sensitive about the projects they choose to finance. Access to credit may enhance their capacity to bear risks and therefore indirectly foster technology adopted and asset accumulation.
- Poor households in Africa and Asia face complex, multiple constraints on earning opportunities. They lack education, markets, and other essential services. Thus the impact of financial services on welfare is likely to vary with accessibility to complementary inputs such as irrigation, education, and market services.

Because of the rejection by the formal sector, the poor seek their financial services from the informal sector.

Institutions in the informal financial sector include deposit collectors, money lenders, Rotating Savings and Credit Associations (ROSCAs). These informal mechanisms vary from country to country but their basic operation is to provide a means for accumulating large sums by the poor. Deposit collectors will accept people's savings and return a lump sum to them, moneylenders will provide the lump sum up front and then collect 'savings' in repayment, and ROSCAs allow people to get together and make savings from which each in turn takes a lump sum.

But do these mechanisms cater for the financial needs of the poor? Rutherford (1999) argues that these mechanisms are time-bound, while the needs of the poor for basic financial services are never ending. In addition the poor lose interest by saving through these mechanisms. Further more these mechanisms do not have the flexibility of the formal system in terms of savings and withdrawals. Besides, these mechanisms for satisfying basic financial needs are built on trust and carry too much risk.

Wright and Mutesasira (2001), compared risks associated with savings of poor people in Uganda and found that those who were lucky to have access to the formal sector were less likely to lose any savings and in terms of relative loss they were better off than those who saved in the informal sector. Those with no option but to save in the informal sector were almost bound to lose probably about one quarter of what they save there.

4. Impact of the Reforms on Poverty Reduction

There are two ways in which the financial sector reforms can be expected to lead to poverty reduction. First, viewed within the general context of macroeconomic reforms, financial sector reforms can lead to poverty reduction if growth is engendered in the economy. Second, the financial sector reform can directly lead to poverty reduction, if it causes restructuring of the financial system in a way that makes credit available to the poor and therefore improves their welfare. These issues are examined in this section.

(i) Poverty Impact of Macro Reform

The debate on the poverty impact of adjustment programmes has become quite intense recently, leading to the disruption of global economic meetings in Seattle, Prague and Washington D.C. There are those who doubt that SAP engenders growth at all. They believe that structural adjustment policies focus unduly on macro stabilization to the neglect of growth issues. Policies like financial liberalization, which invariably leads to hikes in interest rates in developing countries as well as the call for fiscal prudence, which withholds subsidies for vital services, are inimical to growth and poverty reduction.

The celebrated success of structural adjustment in Ghana in the 1980s, for example, has more to do with stabilization than with growth. Because the economy of Ghana had hit its nadir in 1983, the turn around appeared very dramatic. Growth rates, which had been negative in the years before the adjustment suddenly, turned positive. However, the average growth rate of 5 percent was not enough to lead to significant reduction in poverty. With the population growing at 3.2 percent, impliedly per capita output was growing at a meagre 1.8 percent at the most. Considering the extent of poverty in the country before the SAP was initiated, such a growth rate is unlikely to take a lot of people out of poverty. In deed, the World Bank estimated that at such a low rate of growth it would take 50 years for the average man to cross the poverty line.¹

Earlier studies, particularly by the World Bank, have tried to demonstrate the positive growth prospects of countries under Structural Adjustment Programmes. Recently, however, it has been shown that most of those studies have serious econometric shortcomings, particularly with the treatment of cross-country data. Easterly (2001) reported that twenty years of structural adjustment in developing countries produced lower per capita income growth compared to twenty years before SAP. In changing

¹ The World Bank (1992) "Ghana 2000 and Beyond: Setting the Stage for Accelerated Growth and Poverty Reduction." Western Africa Department, Washington, D.C.

over from the Enhanced Structural Adjustment Facility (ESAF) to the new Poverty Reduction and Growth Facility, the IMF observes that “The change involved not just a new label, but also important changes in the Fund's operations designed to ensure that the IMF would deliver on its new commitment to fight poverty.” “... The core aim of the PRGF is to arrive at policies that are more clearly focused on economic growth and poverty reduction and, as a result of better national ownership, more consistently implemented.” In a sense, this is an admission that the SAP failed to promote growth and poverty reduction, and hence the change of policy to the PRGF. The liberalization of interest rates under the financial sector reform acts as the interface to macroeconomic stabilization and growth. This relationship hinges, on the one hand, on the importance of saving and investment in the determination of a nation's output; and on the other, in the role of financial intermediaries in the saving-investment process. A collapse in the confidence of either borrowers or lenders can break the link between saving and investment and may lead to decline in economic activity. Thus in a situation where the opportunity cost of financial services – the interest rate – is held constant over a long period of time, savers and investors fail to get the right signals from the market. Thus, interest rate liberalization calls for optimum performance from the financial institutions.

Unfortunately, interest rate movements since the liberalization have not produced the advantages envisaged. For example, the essential argument in favour of abandoning direct controls was that, where the controls are enforced and are effective, they force banks and other financial institutions to adopt portfolio positions (patterns of lending and borrowing), which are different from those that the banks would choose if they were left entirely to their own devices. In particular, the risk-return configuration of bank lending was distorted by the administrative direct controls of interest rates. Thus through interest rate liberalization, the banks were expected to optimise their portfolio management.

However in Ghana as in other African countries, since the liberalization, as if by collusion, the banks display similar rates with an ever-widening gap between lending

rates and deposit rates. The lending rates closely follow the hikes in the discount rates, as government borrows more from the bank and non-bank public, while the saving rates remain either the same or even fall. In Ghana, since 1990, saving rates have hovered between 9 and 24 percent while lending rates have been in the range 17 to 39 percent. This gives a spread of over 10 percent between the lending and the saving rates. Such wide spreads coupled with safe investments provided to the banks through the sale of securities lead to a weakening in the intermediation function of the banks.

In the new liberalized attitude under the banking reforms, banks have introduced all kinds of charges, which are clearly against the poor. Most banks have minimum deposit requirements, which are above the average monthly income levels. Depositors who fail to meet these minimum requirements are made to pay some penalties. Further, some of the banks have taken advantage of the liberalized era to introduce charges such as monthly “processing fees” irrespective of transaction, which are designed to drive small depositors away to the informal market. Meanwhile, the small deposits, which are pooled together by the banks, are invested in Treasury bills at high rates, which are not shared with the depositors. These actions are not in favour of poverty reduction.

In recent times a large number of researchers now echo the concluding remark of Musinguzi and Smith (2000) “...that policies to promote economic development and alleviate poverty have often focused on macroeconomic stability, liberalization of trade and deregulation of domestic markets. However, these measures, though necessary preconditions, may not be sufficient. This is because the impact of such policies may lead to the isolation of a section of the population from national markets and hence their inability to share in national economic progress.”

(ii) Poverty Reduction Through Financial Reform

Long before the introduction of reforms in the financial sector, African governments have been interested in making credit available to poor households. These ranged

from state-run Development Financial Institutions such as Agricultural Development Banks, which provided subsidized credits to farmers to donor-funded programs, targeted at the poor. There were also government support to some rural banks, co-operatives and credit unions, which were mandated to provide loans at subsidized interest rates to poor small farmers. But these efforts failed to reach the poor due to

- over-dependence on government funding,
- pervasive political patronage
- political influence in disbursing donor-funds
- difficulties in ensuring repayments from subsidy recipients, and
- failure of interest rate subsidies to reach the poor.²

The failure of these policies prompted the decline of state-sponsored development banks and led to the need for financial market reforms. However, the financial market reforms have concentrated on the formal financial systems without inclusion of services to the rural poor. Market liberalization resulted in the withdrawal of such organizations from direct service provision to smallholders. These reforms led to the reluctance of most commercially oriented banks to engage in business involving smallholders. This brings to the fore the need to create new means of channeling seasonal inputs to smallholder producers on credit against the background of high administrative costs and defaults among small borrowers. To cater for small borrowers a number of Microfinance institutions were set up. These Microfinance institutions existed before the reforms, but their activities were formalized under the institutional and legal reforms of the financial sector restructuring. These institutions come in all shapes sizes ranging from Non-Bank Financial Intermediaries (NBFIs) to donor agencies and NGOs.

Bearing in mind repayment characteristics of smallholder producers, new initiatives have developed after economic reforms for seasonal lending. These include:

- *Group liability* – This is practiced mainly by donor agencies and NGO programmes. This approach has been characterized by risk of group

default especially in bad agricultural years. To avoid default, regular monitoring of borrowers activities by the lender may be conducted or regular repayments as a substitute for monitoring of loan use may be used.

- *Contract farming and Out-grower Schemes* – this is a lending approach similar to pre-liberalization marketing boards where processing logistics or effective legal sanctions provide a localized output marketing monopsony. Some contract farming schemes have collapsed as a result of opportunistic traders who promise the farmers higher output prices than those available within the scheme.

Mosley (2001) adds that more than filling a market failure across the developing world by offering loans to the rural poor, the new generation of Microfinance institutions also offers innovative products including insurance, which promises to overcome moral hazards. It is important to note that the World Development Report for 2000/01 places major emphasis on risk and vulnerability as a detriment for well-being and thus relies on strategies such as insurance to reduce vulnerability. These new range of insurance schemes either cover or intend to cover agricultural risk, health, funeral expenses, enterprise equipment, business fraud and other crime. The Centenary Rural Development Bank (CERUDEB) in Uganda and other micro insurance initiatives in Morocco, Nicaragua, Tunisia and Ethiopia insure poor farmers against poor weather. Once data arrives which indicate that rainfall has been below a specific threshold level, the insurance fund pays out immediately to any insured client.

But questions have been raised as to whether Microfinance institutions (MFI) can effectively engage in insurance of the poor. Warren (2001) believes that insurance may be a good way to overcome risk of vulnerability facing the poor, but wonders whether the Microfinance institutions have the capability to support such insurance scheme. He suggests that a better mechanism would have been for the MFI to enter into partnership with an insurer in the formal sector, in which the MFI acts as the

2 See Zellar and Sharma (1998), Marr (1999) and Dorward et al (1998)

agent (marketing and selling the product to its clientele) whilst the Insurance provider acts as the partner (actuarial, financial and claims processing as well as meeting capital and reserves required by law). MFI experience in countries, which have undertaken a form of insurance, suggests that a very limited product, developed and managed in partnership with an established insurer is the best way to start. Over time, the experience gained from the partnership in handling insurance products and information collection and utilization can be internalized by the MFI as they take the product in-house.

The foregoing examples point to financial services provided by Microfinance institutions, which can help reduce poverty. Owusansah's study on Ghana attests to the fact that micro finance can indeed be used as a strategy for reducing poverty. Using an impact analysis studies on clientele of two micro finance institutions operating in Ghana—Sinapi Aba Trust (SAT) and BRI-UD—the paper pointed out that by providing micro credits to SAT's clientele, household incomes increased on the average by 157% for the period August 1994 to July 1997. In the case of BRI-UD, clientele enjoyed 25 percent growth in real profits, 21% in household income and 18% growth in employment per enterprise.

However, Zellar and Sharma (2000) found evidence that suggests that in spite of the vibrant informal financial markets in many developing countries, financial services to the poor still remain inadequate. Access to credit in Bangladesh, Ghana, Madagascar, Malawi and Pakistan was found to be severely limited for small farmers, tenants and entrepreneurs and in particular women. Other factors such as low risk-bearing capacity and inadequate access to know-how, markets and infrastructure also affect borrowing for poor households.

A study of micro finance institutions selected from Bangladesh, Bolivia, Philippines and Uganda by Cohen and Sebstad (2000) concluded that

1. Micro finance programs have been more successful in reaching clients from moderate poor and vulnerable non-poor households than extreme

poor households. Majority of clients cluster just above and below the poverty line.

2. The limited participation of clients from extreme poor households suggests that programs may have more impact on reducing the incidence of poverty than the severity of poverty.
3. Micro finance clients at all poverty levels are vulnerable to frequent and wide ranging risks—such as seasonality, inflation, weather, unexpected emergencies (sickness, death, loss of employment), life cycle events such as funerals, marriages, education etc. Risks associated with taking a loan include stress of repayment in case of default, price fluctuations, loss of employment, theft, limited market access etc.
4. To protect against risk ahead of time, clients need to (1) diversify household income sources to smooth income and consumption (2) build a solid and mixed base of assets that can be drawn on in times of need and (3) manage money wisely by saving, minimizing expenditures and maintaining access to multiple sources of credit if possible.
5. To cope with shock after they occur, clients need to (1) reduce consumption by cutting back on expenditures for food, clothing and education and (2) draw on social assets by receiving in-kind assistance in the form of food childcare or housing.
6. Clients use program loans for a wide range of purposes—invest in existing or new businesses, build assets that can be drawn on in times of need—which, improve their ability to protect against risks ahead of time. Maintaining access to credit is an important risk management strategy for the poor. WDR evidence shows that clients go to great lengths to repay their loans, even when they are hit with a shock or economic crisis or both.

5. Summary and Policy Recommendations

Studies on poverty have revealed new insights and meaning to the term. The definition of who the poor are has gone through a series of changes—from 1950s to 1970s, the poor were the small or marginal male farmers whose poverty could be

overcome by credit-induced productivity, from 1980 to 1995 the poor were seen as micro-entrepreneurs (mostly women) with no assets to pledge for credit but available micro-credit could transform their lives. Currently however, the poor are referred to as vulnerable households with complex livelihoods and varied needs. [Martin et al, 1999].

Contrary to the general misconception, the poor do in fact save. They need large lump sums to meet certain life-cycle needs, emergencies and certain opportunities that may come their way. The formal financial sector is usually reluctant to deal with the poor.

Financial sector reforms involved restructuring the sector through market liberalization, institutional and legal reforms. The liberalization of the market, particularly, the lifting of controls on the rates on interest affected mostly the formal sector. Any poverty reducing effect that may have come about by this policy may have been an indirect one resulting from growth in the general economy through a better performance of the formal financial sector. Through the institutional and legal reforms a lot more Microfinance institutions became operative. This is the channel by which some gains may have been made as far as poverty reduction is concerned.

The impact of finance on poverty reduction has many pathways according to Martin, Hulme and Rutherford (1999). These are through

- Income Generation — this decreases the cost of income smoothening by allowing households to engage in more risky but also profitable activities.
- More Cost Efficient Assets and Liabilities — improved access to credit may make it possible for the household to smooth consumption at lower costs compared to traditional strategies. Improved financial services induce changes in the household composition of assets and liabilities.
- Direct Use for Immediate Consumption Needs—households attempt to smooth their consumption by adjusting their disposable income through savings, self-help and insurance as well as high-cost lending.

Micro enterprise finance has generated enthusiasm among donors and NGOs as an instrument for reducing poverty in a manner that is financially sustainable. Nevertheless, the debate on micro finance and poverty has continued to rage on among providers, promoters and others involved in the micro finance field. It is now accepted in the literature that the relationship between micro finance and poverty reduction is not straightforward. Poverty reduction is multifaceted and micro finance is just one of the many factors that can contribute to poverty alleviation. However, evidence from various studies show that micro finance has positive impacts in the ability of individuals and households to deal with risk and reduce their vulnerability.

In conclusion, it is recommended that to enable finance to impact positively on poverty reduction

- The poor need financial services to help them maintain and improve livelihoods. Innovations that address the constraints faced by the poor due to an imperfect financial market can allow them to take up direct income generation, increase productivity of existing enterprises, and help smoothen consumption and cope with life cycle needs.
- Both informal (including self-provision) and formal providers can help meet these needs.
- Understanding the existing financial service behaviour and preferences of the poor can be a good guide to product design and development by other agencies.
- Financial service innovations for the poor need to be dynamic, context-specific and adapt to the changing needs.
- Providing poor people with effective financial services helps them deal with vulnerability and can thereby help reduce poverty. However, the relationship is driven by complex livelihood imperatives and is not simple. Therefore, it is not a panacea that converts the poor into the non-poor.
- Policies and programs, which target the poorest of the poor under micro finance institutions, must market financial products suitable for this category of people and reduce entry barriers faced by them.

- Credit alone may not help in poverty reduction other financial (insurance, pension) and non-financial (technological inputs, extension, etc.) services may be needed to reduce poverty.
- Encourage microfinance institutions to provide other financial services such as insurance and pension schemes for the poor. But such services must be provided in partnership with formal sector operators.
- Government must create a favourable legal framework for the operation of the informal insurers.

With the World resolved to halve poverty by 2015, time is of essence to fashion out policies to reach this goal. There is need for more research to understand client perspectives (includes economic goals of poor households, management of resources and activities in the household economic portfolios and dealing with risk in day-to-day lives of poor households) in improving the outreach, impact and sustainability of micro finance programs. There should be more research also on the critical relationship between risks facing borrowers and risks to MFI portfolios. Research should also find schemes to enable formal sector financial services to reach the poor.

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