W A Wijewardena: Microfinance – a potent instrument of poverty alleviation

Valedictory address by Mr W A Wijewardena, Deputy Governor of the Central Bank of Sri Lanka, at the Third Training Program on Microfinance Delivery System, College of Agricultural Banking, Reserve Bank of India, Pune, 16 March 2007.

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It is indeed an honor for me to deliver the Valedictory Address on the occasion of the conclusion of the Third Training Program on Microfinance Delivery System in Pune. The Central Bank of Sri Lanka made a request to the College of Agricultural Banking, a renowned training institute on microfinance, to prepare a tailor-made training program for its staff and microfinance practitioners engaged in its poverty alleviation projects. The College, popularly known as CAB, very kindly agreed to this. After the exchange of several correspondences between the two institutions, the training program was finally arranged. Two batches of trainees have already followed the program and enjoyed the hospitality which CAB had offered them. Back at home, those trainees have spoken very high of the quality of the training imparted to them by CAB. I am sure that those who pass out today in this third program too will return to Sri Lanka with the same high opinion on CAB's professional standards.

Microfinance is a very potent instrument of poverty alleviation. It fills the gaps which normally arise in macro-type poverty reduction policies pursued by governments. The usual strategy adopted by governments to attack poverty has been the attainment of a high economic growth continuously over the long run. With that growth, it is expected that the benefits of economic uplifting would trickle down to lower levels of the society. As a result, the overall economic conditions of all segments of the population would elevate to a higher level. It will kill the absolute poverty levels. Some good examples are countries like **Malaysia** and **South Korea**. Both these countries were able to reduce absolute poverty from a very high level of over 50 percent to a very low level below 6 percent within about four decades.

If macroeconomic growth can tackle poverty, the n why should one be bothered about microfinance? The reason is very clear. When macro-policies are adopted, there are certain gaps that are created in the alleviation of poverty. As a result, some segments of the society would experience a worsening of their situation. This is because all the people in a society are not capable of moving along with the market at the same speed. Some move faster than the market. They are the super-performers and stand to gain more. Some move at the same rate as the market. They attain a gain more or less equivalent to the market performance. There is no problem about both these categories. That is because they have the capacity to look after themselves. The problem arises in the case of people who are unable to move forward at the speed of the market. They become laggards and are left out. Hence, there should be a special strategy to bring them to the mainstream of economic life.

The normal strategy that had been adopted to address this issue has been the introduction of **safety nets** to capture them before they make a free fall to the ground. The safety nets so introduced have taken different forms depending on the era or the country. About five decades ago, the safety nets took the form of providing outright grants to the poor people. The objective of the grants was to provide some relief to them, so that they could at least meet their food requirements. The weaknesses in this type of strategies are well known. It encourages poor people to remain in the safety net forever. They have no incentive to move out of the net, because moving out would mean their having to work hard for a living. If at least the basic requirement of food is provided free of charge, then why would anyone want to work for the same? Economists have long named this problem "moral hazard" problem. This problem simply says that, when one helps another, the person being helped does not have the incentive to adopt even the minimum safety measures. As a result, he increases the chance of the occurrence of the event which the helper desires to prevent. The consequence is that it imposes an additional burden on the helper. As a result, neither the helper nor the helped would be able to get out of the vicious circle in which the both parties would get trapped.

The moral hazard behavior by people who get free goods is not a new phenomenon. It had been known for many centuries. **The Buddha** has preached in one of the discourses titled ***Chakka Vatti Seehanaada Sutta*** how the king of a country was duped by the people who were given free capital to commence self-employment projects. According to this ***Sutta***, the people of a certain country had resorted, in large numbers, to theft and robbery. The king had consulted his wise advisors to find how to eliminate it. The advice given was that people had resorted to theft and robbery, because they had

no a way of earning a livelihood. Hence, to enable them to start self-employment projects, the king opened his treasury and allowed them to take whatever the money they needed for use as capital. After some time, the people realized that if they resorted to more theft and robbery, they could get more money from the king. As a result, instead of such felonies declining, they indeed started to rise in the kingdom.

A similar example has been attributed to the Chinese philosopher, **Confucius**, who lived in the 5th century BC. One day, when he was returning from the river after a fishing expedition, a beggar, sitting by the side of the road, was reported to have asked him for a fish. "I'll not give you a fish. Instead, I'll tell you how you could catch a fish" Confucius is reported to have told the beggar. The moral of the story was that if the beggar was given a fish, he would get used to the free fish and beg for it everyday. Then, it would have been a severe burden on Confucius. So, he advised the beggar to depend on himself rather than begging from others.

The experience in poverty alleviation throughout the globe has shown that safety nets in the form of outright grants do not work in the long run. Hence, the safety nets that were introduced earlier were converted to "**safety ropes"**. Those safety ropes were expected to provide a means for the poor to hang onto and then climb upward with the support given to them. Thus came the era of microfinance which indeed was a safety rope through which the poor could cross the poverty line. Such microfinance would help them to attain the goal of getting out of poverty, provided certain conditions are met.

The training program conducted by CAB teaches us these conditions which are needed for the sustenance of microfinance schemes. The experience throughout the world tells us that microfinance alone is not sufficient to eliminate poverty. This is because microfinance satisfies only the funding requirements of micro-enterprises. But, funding is only one aspect of a micro-business. Prior to as well as subsequent to funding, there are a large number of other requirements that have to be satisfied.

First and foremost, anyone desirous of starting a micro-business should have a good knowledge of the market in which he would sell his products. A feature of the market is that it is driven by the consumer who is considered the sovereign. If the consumer does not need a product, no one could force him to buy it, even when it is supplied free of charge. Hence, the goods and services that are produced by micro-businesses should always meet the requirements of the consumers.

How can a micro-entrepreneur identify the **market requirements**? What proxies can he use for that, if he does not have direct information on the same? A problem which he would face in this respect is that he has to produce for the future. Hence, any information relating to the past may be a poor guide for that. This is not a problem unique only to micro-businesses. It is equally relevant to big producers as well. But the advantage for such big business firms is that they have the benefit of the results of consumer preference surveys conducted by various institutions. Such survey results are expensive and beyond the financial capacity of micro-businesses. Yet, without the benefit of such results, it would be a pure gambling for a micro-business to get into the production of these goods and services. In a world where information is costly, this would be a serious blow to the potential micro-entrepreneurs.

What this means is that if correct information is not available, micro-businesses are doomed to fail. Hence, in the delivery of microfinance, it is equally important to arm the micro-entrepreneurs with accurate market information regarding the consumer preferences. Though such information may be costly to a single user, it may not be so if all micro-entrepreneurs get together and acquire the necessary information wholesale. Such information could be kept in an information bank maintained at microfinance institutions. Since it is not advisable to provide such information free of charge, due to the potential moral hazard problem, a fee should be charged from the users. In addition, microfinance institutions too could conduct such market research and disseminate the required information among their customers. That should also be provided at a price.

Another important requirement of micro-businesses is the need for preparing **micro-business plans**. The necessary technical know-how for this is not available with the ordinary micro-entrepreneurs. It requires them to prepare the estimates of cash flows, market sales, funding requirements, legal and marketing aspects and business disaster management techniques etc. Once they are put into a generally accepted format, then only they would be acceptable to the lending banks. It is necessary that all the potential micro-entrepreneurs should be knowledgeable of preparing such business plans. If they cannot do that, they could engage specifically trained business plan consultants for the preparation of those plans at a fee.

This was experimented in one of the development projects implemented by the Central Bank of Sri Lanka. In this particular project, bank financing was available for both micro and small businesses. One of the requirements of banks was the submission of a comprehensive business plan, acceptable to the banker, by the prospective micro-borrowers. But, none of the borrowers had the capacity to prepare them. As a result, the utilization of the moneys in the project became a problem. As a solution, it was decided to outsource the function to some business development consultants at a cost to the borrowers. Accordingly, a number of youth who had studied economics, business studies and accounting for the GCE Advanced Level were selected for training as business consultants. Then, they were appointed to provide consultancy services to potential entrepreneurs for a fee. The lending banks also paid a certain commission to them for services such as loan recovery and follow up work. The program worked well and a new generation of fee-based business consultants was developed by the project. At the end of the project, most of these consultants, having used their own expertise, started their own businesses.

Another pertinent issue involved in microfinance delivery is how to reduce the **transaction costs** and make available the loans at the time they are needed by the borrowers. The transaction cost is simply the additional resources which a person has to spend, other than what is paid to the supplier, in order to complete a transaction. In the case of borrowing, transaction costs include any payment which the borrower has to make other than the payment of interest to the lender. Such costs, therefore, comprise legal fees, application fees, loan processing fees, any bribes or commissions payable, stamp duties and other taxes and, finally the opportunity cost of the time spent for pushing the application through bureaucracy and the waiting time. This can be compared with a **village money lender** who is alleged to be charging an exorbitantly high interest rate. Yet, the transaction costs involved in borrowing from a money lender is practically zero. Hence, from an efficiency point of view, a village money lender is preferable to a microfinance institution with a high transaction costs.

In Sri Lanka, in late 1980s, the Central Bank ran an agricultural credit scheme of which the interest rate payable by the farmer had been fixed at 9 percent when the market interest rates amounted to about 20 per cent. The subsidy was intended to reduce the farmers' cost of production and promote agriculture. A study conducted by ADB revealed that the effective interest rate paid by farmers, after taking into account all the costs, amounted to 30 percent, much higher than even the free market rates. The difference between the actual cost incurred by the farmer and the rate paid by him to the lending bank was wastage of resources. It had not been the income of anyone. Hence, such costs are known as **deadweight losses.** Microfinance institutions should, therefore, strive to keep the transaction costs at a minimum and eliminate the possibility of incurring deadweight losses.

The **on-time delivery** of microfinance loans is also a very important requirement. Most of the microfinance projects are agriculture based businesses. Hence, there is a necessity for meeting crucial expenses on-time. For instance, if a farmer has to apply fertilizer to his field, he has to do it on the due date. For him to buy fertilizer, he needs money also on the due date. This requires the microfinance institutions to release their loans on the due dates. Any undue delay would be immensely costly.

A final word should also be said about the subsidization of the interest rates under microfinance credit schemes. Such **subsidized credit** is demanded, not by the microfinance borrowers, but by urban based social workers and politicians. The problem with subsidized credit is that it flows not into the microfinance projects but elsewhere. What microfinance borrowers need is not **cheap credit**. They need credit on simple terms in time at zero transaction costs. When the credit is subsidized, it not only leads to wastage, but also goes into the hands of undeserving individuals. Most probably, middle class and lower middle class people would flock to appropriate such credit which they plan to use for other types of non-productive purposes. In this context, informal money lenders would definitely provide a role model for microfinance institutions. Instead of trying to fight the money lenders, microfinance institutions should learn good management practices adopted by them.

All in all, microfinance delivery is a very subtle subject which should be handled very carefully. The best practices of microfinance lending are common to all countries. But, there may be a necessity for such countries to vary the actual implementation based on the specific country requirements. This arises from the famous dictum that one shoe will not fit all the feet. For the size and the variance of each and every foot, a different variety of a shoe has to be made. I hope that the participants of this training program have acquired this wisdom and would return to Sri Lanka armed with that wisdom.

Thank you.