Financial Sector Liberalisation

Should the Poor Applaud?

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1 Introduction

As micro-finance began to be overtly championed for its antipoverty properties, and as donor and government interest grew rapidly, the killjoys emerged. Some sceptics refused to view micro-finance as being all that different from the older, much criticised approaches to finance for small farmers (Adams and von Pischke 1992). It was argued that micro-finance should be brought under the same principles applied to the development of other segments of financial sectors. Promotion of micro-finance supposedly indicated that governments and donors were still insufficiently trusting of market forces in the supply and demand of financial services to the poor.

One area of strength in recent thinking, however, lies in its convincing identification of weaknesses in past approaches. Well-meaning policies were often benignly unhelpful in serving the poor; often they served the rich better. Interventionist policies often generated economic rents, inefficiencies, and financially unsustainable situations (e.g. pressure on government budgets from bad debts in public-sector credit programmes and public banks, losses in private banks due to directed credit, financial instability, etc.). In many countries financial development has been severely repressed. For example, financial deepening in sub-Saharan Africa in 1980 was the same as in East Asia 20 years earlier, as indicated by estimates of M2/GDP (Cole and Duesenberry 1994). Thus, there remains a strong case for less meddling in financial sectors, especially to eliminate crude macro-economic instruments like interest-rate ceilings.

The purpose of the article is to examine how the poor might best be served when current approaches to financial sector development are applied to micro-finance. The article concludes that in spite of predictions by financial liberalisation theory, the poor are likely to remain underserved by the financial markets.

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The argument is organised as follows. The second section describes some influential ideas within micro-finance. It is less a description of consensus and more an outline of the dominant strand.

The third section sketches the core elements of the financial sector liberalisation theory on which much of the leading ideas on micro-finance are predicated. Studies of financial sector liberalisation experiences reveal an inconsistent and confusing picture. This muddy picture contrasts with the overbearing confidence underlying the current thinking on finance, as exemplified by Vogel and Adams (1997). It is not clear whether the latter is based on a systematic empirical evaluation of competing plausible theories.

The fourth section highlights some shortcomings of the liberalisation theory in terms of the main process by which presumably it could help the poor, namely greater market competition between service providers. Based on this, the concluding section argues that policymakers should resist a shift in focus away from poverty elimination, even if it means continued subsidisation of micro-finance.

2 Leading Ideas on Pro-Poor Finance

Pro-market viewpoints very much influence current thinking on finance for the poor. Financial liberalisation 'remains the only game in town' (McKinnon 1989: 53, quoted in Gibson and Tsakalotos 1994: 578). This view states that the determining of interest rates and allocation of credit between sectors and groups of people, should be left to market forces. Governments should withdraw from direct involvement in financial institutions and specialised programmes should target financial services to specific groups. Sneaky taxation, such as excessive reserve requirements, should be cancelled, along with the financial sector subsidies that they pay for. Public policy should concentrate on effective legal and regulatory systems, and market competition between service providers (Vittas 1991). Liberalising financial markets would create an 'enabling environment' in which intermediaries would opt to supply better financial services to the poor. It is assumed that the poor will be able to obtain the services they require within a market-driven enabling environment. 'Competition forces survivors to be innovative in producing attractive financial products and services and also in lowering transaction costs ... Self interest, rather than altruism, dominates decisions.' (Vogel and Adams 1997: 375–76.)

For the most part, (unfettered) informal financial markets are seen as the best place for the poor to obtain financial services, and the fact that the poor do in fact resort to such markets seems to justify this view. Programmes with an explicit pro-poor emphasis are conditionally tolerated. Within micro-finance, therefore, the poor should no longer be regarded as 'beneficiaries', but instead as 'micro-capitalists' (von Pischke 1996: 229). The suppliers of micro-finance should no longer be viewed as poverty-oriented, but rather business-oriented. If they are not subsidy-free, they should head towards it (Yaron 1992). The bottom line is that micro-capitalists, even poor ones, should pay for the services they receive to cover all costs at market rates. It is anticipated that liberal financial markets would supply services to all types of people, including the poor.

Financial sustainability (or the promise of such) distinguishes programmes and institutions currently identified as being successful in providing financial services to the poor. In other words, to join the ranks of the successful, a micro-finance programme must be *at least* financially self-sustaining, with success in other areas providing additional bonuses. So the most exciting situation is when micro-finance programmes relaunch themselves as formally established banks, as has occurred in a handful of well cited cases. So, while previous interventions in financial markets, such as small-farmer credit, might have had significant beneficial effects,[2] the argument is that those benefits could have been achieved at a far less cost within a liberalised financial system.

3 Liberalisation: What is it Meant to Do?

Rather than stimulating investment, cheap credit is argued to have quite the opposite effect. Low lending rates mean intermediaries have to set low

[2] See for example Binswanger, Khandker and Rosenzweig (1993), or Lipton and Toye (1990).

interest rates on deposits, and if the rate of inflation exceeds the interest rate, deposit rates become negative in real terms. This depresses savings in financial instruments by lowering the financial return to saving.[3] The effect of lower savings will be to depress the quantity of investment, and hence growth. Financial sector liberalisation suggests that intermediaries can set interest rates and raise the quantity of investment, due to the consequent increase in savings. The key assumption here is that in developing countries total investment is constrained by the level of savings. Therefore, there is a virtuous circle of greater saving–investment–growth (McKinnon 1973; Shaw 1973; Gibson and Tsakalotos 1994).

It is further argued that fixing interest rates decreases the quality of investment. Applying a conventional supply–demand framework, fixing interest rates below the rate where the market clears generates a demand for credit in excess of the supply of savings. With the cost of borrowing low (due to low interest rates), the returns to projects proposed for finance can also be lower. Unable to ration credit by charging higher lending rates, intermediaries tend to select a larger proportion of these low return projects for financing, since lower project returns also imply lower risk. Thus the quality of investment is lowered. Directed credit (forcing banks to lend to certain sectors, specialised credit programmes, preferential terms to certain sectors) also reduce investment quality and allocative efficiency, because the financial sector is unable to allocate resources to the most productive sectors. Interest rate liberalisation, combined with the elimination of sectoral quotas, would ensure that the loan portfolio quality of banks would improve.

How might the poor fit into this kind of a model? Positively, if the poor are able to access better financial savings instruments, which allow them to save in small amounts, whilst ensuring them non-negative real interest rates. This is especially so since low-income groups tend to hold a larger proportion of their assets as cash, and are therefore subject to greater 'inflation tax'. Also positively, if the poor are able to gain better access to credit. If savings increase due to higher real interest rates, institutions might innovate on their lending (because idle funds cost money), and some of this innovation might include lending to the poor. Furthermore, as the market for capital begins to clear on the basis of price, without the distortions of credit quotas, financial institutions would be willing to lend to projects which offer better returns, even if they are riskier. So long as the poor wish to invest in such projects, they would be financed.

Many econometric studies have tested this thesis.[4] Review articles indicate that the empirical debate is far from conclusive (Gibson and Tsakalotos 1994: 594). For example, while the model predicts that savings are supposed to increase with real interest rates, empirically some studies show the predicted interest elasticity of savings, and others do not. 'Despite a hot debate, no convincing general evidence either way has been produced which leads one to the provisional view that the saving rate is largely independent of the interest rate.' (Modigliani 1986: 304.) 'Decisions to save are determined by several factors and the relationship between savings and real interest rates is at best ambiguous.' (Cho & Khatkhate 1990.) It is difficult to reconcile the conflicting evidence partly because of poor data. Similarly inconsistent evidence is found for the impact of savings on investment, and for the supposed virtuous circle of growth (Gibson and Tsakalotos 1994: 595–6). In conclusion, Gibson and Tsakalotos point out that 'links between variables of interest remain obscure, ... equations are misspecified, particularly with regard to omitted variables, and thus the estimates presented are unreliable for policy analysis ... Thus we have to conclude here that the econometric evidence does

[3] In fact the effect of a change in interest rates on savings is much less clear in theory. This is because two countervailing tendencies may result. An increase in the returns to savings raises the stream of future income and wealth, and thus may reduce savings by raising current consumption based on the greater wealth. At the same time, the higher returns from higher interest rates should encourage savings, because postponing current consumption would imply larger future consumption out of current income.

[4] These include Gupta (1987), Giovannini (1983), Cho & Khatkhate (1990), Nissanke (1990), Arrieta (1988), de Melo and Tybout (1985), Mwega *et al.* (1988), Oshikoya (1992), Aryeetey and Gockel (1991), Lipumba *et al.* (1990), Nyong and Ekpenyong (1994), and Fischer (1993), collectively covering a wide number of Asian, African and Latin American countries. This is only indicative, and by no means a comprehensive list.

not provide much help in finding for or against the McKinnon–Shaw hypothesis [liberalisation theory].' This view is consistent with several other review papers (Hadjimichael 1995 *et al.*; King and Levine 1993; Arrieta 1988).

4 Servicing the Poor

If empirical studies do not provide conclusive evidence on financial liberalisation theory, they do at least suggest the complex way in which financial markets work in different countries. The main lesson is a need for closer scrutiny of the micro-economic foundations of much of the leading thinking on finance, as it relates to the poor. Two areas are especially relevant for understanding how liberalised financial markets react to the opportunities offered by the poor. The first relates to the assumption that liberal interest rates would be sufficient to address some fundamental information difficulties in financial markets which tend to ration the poor out of formal markets. The second relates to the fact that the poor source many financial services within the informal market. Consideration of these two areas, as discussed below, indicates an important gap in financial markets increasingly being filled by micro-finance, and which is unlikely to be filled simply by market liberalisation.

The problem with the poor is that they bank in small transactions, and often can be more costly to service, for example because of rural residence. This means that the cost of collecting information to assess risk is high, especially in relation to the money to be made on small loans. Though in practice interest rates may be determined by a number of macro-economic factors (Moretti 1992), it is argued that liberalisation allows intermediaries freedom to set interest rates to cover extra costs. This would encourage formal lenders to increase services to the poor. Thus interest rates would rise to clear the market and, as long as the poor were willing to pay the going rate, they would not be rationed out of the market by any other means. Indeed the literature now takes the view that credit demand by the poor is quite inelastic to the interest rate, and so the poor would be willing to pay higher rates. This is in contrast to the previous assumption that the poor could only afford cheap credit. Both, of course, may be true.

Exactly how far interest rates would need to rise depends on a number of factors, such as the location of the poor, infrastructure, population density, etc., as these affect the costs of service provision. A study of BRAC's micro-finance programme in Bangladesh estimates that a lending interest rate of 75 per cent would be required for subsidy elimination (Khandker and Khalily 1995: 58–69). It is easy to speculate that banks may require even higher rates to reach the poor than an explicitly pro-poor NGO such as BRAC, especially since much of the formal financial sector remains inexperienced in serving the poor. However, lenders may be reluctant to raise interest rates too high. Overly high interest rates may be perceived to increase project failures (by increasing the burden on borrowers), drive out good projects ('adverse incentives'), and attract risk-seeking investors ('adverse selection'). Such information failures in financial markets have been well analysed (e.g. Stiglitz and Weiss 1981; Hoff and Stiglitz 1993). The situation is worsened by weak legal systems hampering foreclosures and debt recovery.

Indeed, the evidence is that in a number of countries banks have been slow to innovate in lending and have found themselves with excess liquidity.[5] Rather than thrusting into new markets to serve the poor, banks have tended to be passive after liberalisation. Studies in Bangladesh and the Philippines suggest that commercial banks retreated from providing financial services to the poor after liberalisation, being content to leave that part of the market to informal agents and NGOs (McGregor 1994; Agabin 1988). Moreover the spreads between deposit and lending rates have tended not to be competed down, or invested in raising service quality, or meet the higher transaction costs of servicing the poor. Instead wide spreads seem to cover the costs of inefficiency and past bad debt (World Bank 1995; Fischer 1993). Much of the problem has to do with oligopolistic banking sectors in many countries (Hadjimichael *et al.* 1995). Thus:

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[5] This is the experience in Malawi (Lindauer and Roemer 1994), Gambia (Lindauer and Roemer 1994), Bangladesh (World Bank 1995), Bolivia (Moretti 1992), Ghana (Aryeetey 1993; World Bank 1994), Southern American Cone (Fischer 1993), Indonesia and the Philippines (Sikorski 1994).

> far from suffering the credit gap predicted under the theory of financial repression, many African financial systems are marked by a clubby conservatism and persistent excess liquidity. This implies the holding of deposit liabilities over and above statutory requirements. It also implies a lack of motivation to attract new deposits and an unwillingness by financial institutions to mop up liquidity by committing new loans... High financial liquidity co-exists with unfunded development needs.
> (Wagacha, 1991: 119–20.)

There is now a substantial literature showing that the formal financial sector is not the only possible source of financial services for the poor. Financial markets consist of a range of informal service providers such as traders, landlords, moneylenders, friends and relatives, who operate outside the legal system governing the financial sector. Structuralist analyses of financial sector development attempt to incorporate this fact. Though the macroeconomic conclusions from such analyses are debated (see, for example, Buffie 1984; Kapur 1992; Cho 1990), the view that the activities of different segments of financial markets are linked is most certainly true. The key question here is whether, overall, considering both formal and informal agents, the poor are able to gain better services following liberalisation of financial markets.

Recently the opinion over informal lenders has been revised. Whereas previously the informal market was seen as exploitative of a captured market composed of vulnerable customers, now it is seen as a competitive market for financial services. Much of the revision has come from a growing awareness of the huge variety in informal finance (Adams and Fitchett 1992), and some is based on a number of studies suggesting the high interest rates charged by some informal lenders are due to the high costs of lending to the poor (Aleem 1990; Chowdhury 1992; Rahman 1992). Studies show that the poor benefit from informal finance, though less so from the moneylender variety (Buckley 1997). It is therefore important to assess the impact of liberalisation in general on informal financial services for the poor, and the pressure on micro-finance institutions in particular to attain financial sustainability.

Despite the recent warming in development thinking towards informal lenders, there are a number of reasons why intensifying competition in the traditional markets of some informal lenders remains important for antipoverty. It is doubtful whether the informal sector actually intermediates in the sense of mobilising capital from informal savers to informal borrowers. Christensen (1993) shows that informal financial arrangements tend to be either for savings or for lending, and are less engaged in intermediation (excepting some mutual assistance groups and savings and credit associations). Many informal arrangements simply provide safe-keeping for savers. So in terms of savings facilities, the poor may be a source of cheap working capital for people like traders, sometimes at zero or negative real interest rates (Bouman 1984).

A large part of informal lending activities are financed either from formal credit (Rahman 1992; Germidis *et al.* 1991), or from the lenders' own resources ('equity lenders'). Formal real interest rate hikes might result in not only increased formal funds, but also higher informal rates when those funds are on-lent. Arguably some of those funds are on-lent in the informal sector only because they are cheapened in the formal sector through subsidisation, and so interest rate liberalisation and credit quota removal may wipe out some of these informal funds. In other words, some informal on-lenders may feel a squeeze in their funds. This might result in reduced rather than increased competition between informal lenders, giving an advantage to equity lenders, such as professional moneylenders.

Iqbal (1988) shows that moneylenders do drop their interest rates in response to increased formal interventions, and also discriminate between borrowers. Studies have shown that there can be many types of informal contracts, specifying a variety of financial terms and conditions, apart from variations in interest rates, and also perhaps linking them to vital services in inputs and products markets (Sinha and Matin 1998; Binswanger and Rosenzweig 1986). Arguably these suggest scope for competitive pressure in informal markets since it is clearly far from being a 'uniform commodity' market. Informal lenders have 'a broad range of discretion' which they can use to their advantage (Yotopoulos and Floro 1991: 162).

Some claim interventions via micro-finance are possibly changing the social landscape facing the poor. Rahman and Wahid (1992: 303) claim that '...the Grameen Bank brought a silent revolution in the century old patron–client relationship in rural Bangladesh.' Based on interviews with patrons, they argue that Grameen Bank intervention decreased sharecropping, increased agricultural wages, decreased patron–debtor links, and reduced patrons' quasi-judiciary powers (under *salish*). Ray (1985), Hossain (1984), Yaqub (1995) and Rahman (1986) suggest similar effects. Micro-finance may improve the poor's bargaining position with informal lenders by altering rural power balances and increasing competition amongst service providers, and also may make the poor more attractive to informal lenders through pre-screening, increasing debt capacity, facilitating savings, and reducing risk (Sinha and Matin 1998).

Thus micro-finance may be a valuable alternative savings and credit service for the poor and also a means to stimulate market competition. Service provision by semi-formal institutions such as NGO micro-finance also has the benefit for the poor that they can be brought under a certain amount of financial supervision and prudential regulation, as compared to the informal agents. Subsidies to such semi-formal institutions may be tolerable if they provide a competitive advantage in service quality and terms, so as to cut into informal markets and stimulate competition. Yet the indiscriminate pressure is for subsidy removal in micro-finance, reducing competition precisely in segments of the financial market most relevant to the poor. Especially since by escaping formal rules (some of which, like reserve requirements, serve economic functions), informal service providers are helped in undercutting formal providers in terms of 'effective interest rates' (i.e. rates which account for all explicit and implicit costs and inconveniences) (Herath 1994, Table 1; Ahmed 1989; Castello, Stearns and Christen 1991). Subsidies to semi-formal institutions may allow competition against the advantages of informality. In this case the focus should be to work out ways of providing the least subsidy, with least adverse impacts on incentives for the borrowers and the semi-formal institution. Nevertheless total subsidy removal may be premature for antipoverty.

5 Conclusions

Strong reliance on market forces is good where it eliminates anti-poor incentives and biases arising from excessive financial sector interventions. Much of the pro-market emphasis in micro-finance policymaking is in line with a neoclassical account of financial markets, which calls for laissez faire financial-sector policies. Empirically this account is found to be lacking. The theory seems to oversimplify the workings of financial sectors in developing countries. This suggests caution regarding current thinking on pro-poor finance. This article argues in particular for restraint in assuming that market liberalisation and financial sustainability of micro-finance programmes are certain pro-poor strategies. The reality appears to be more complex, and less certain. 'Undermining rural development with cheap credit' (Adams *et al.* 1984) may be true, but also, undermining the poor with overly simplified ideas is likely.

If liberalised financial markets do not behave as predicted, and the poor continue to be under-served, then an important role exists for micro-finance to provide poverty-focused finance. In some situations there may be valuable antipoverty rewards for providing certain kinds of subsidies to micro-finance. Not all situations, methods and objectives of providing subsidy would be successful, but the specific ones that are should become increasingly better defined as more detailed research unfolds. For example, Jain (1996) dispels some earlier naive assumptions about group-based micro-finance, highlighting instead the importance of investing in managerial and organisational strength. Lipton (1996) argues that subsidising transaction costs and administration, not interest rates, would be appropriate. Given the major financial innovations already made by some micro-finance programmes, the strong lesson of micro-finance must surely be that careful intervention – rather than *laissez faire* – is the way to produce new services useful to the poor. Micro-finance is hardly a triumph of market reforms. It should be emphasised that not all interventions are financially repressive, especially those that deepen the financial sector by including the poor more, and it is important to distinguish them from those that are.

The tendency to incorporate micro-finance into the market paradigm misses a major contribution of

group-based micro-finance, namely, that it is a proven example of selfish motives channelled into co-operative behaviour. Such behaviour helped to ameliorate some information problems, making collateral-free credit possible (de Aghion 1994; Besley and Coate 1991). Finding the right institutional design and incentives system has been a matter of costly experimentation. The poor were previously thought unbankable by some, and micro-finance innovation proved this wrong. The concern here is whether the pressure to innovate is being replaced by the pressure to achieve financial sustainability and adhere to simple pro-market ideas. Such a turn-around makes one cautious about the emphasis on MFIs to tone down their antipoverty agendas. They are advised to concentrate on the bankable poor, commonly defined as the 'not-so-poor' or 'near-poor', i.e. those just around the poverty line, since others are felt to be unsuitable for micro-finance. This static view is hard to accept since it was public investment in the explicit antipoverty agendas of micro-finance programmes in the first place that stimulated the development of a financial technology that now permits more of the poor to be seen as bankable.

If others of the poor remain outside this technology, then clearly the need for innovation is not over. Some of the new innovation may arise in finance, although perhaps not most of it, but the current complacency towards excluded groups seems myopic. The leading emphasis should be to continue to innovate rather than withdraw into the safe margins of financial sustainability. Expecting micro-finance programmes to achieve rapid financial independence, simply because some have the potential to do so (especially if they concentrate on the not-so-poor), ignores potential cost-savings in future innovation and provision of services to the poor. BRAC provides a good example of this, where it has used its micro-finance related outreach, infrastructure (such as village level offices), and local knowledge to innovate and develop, in parallel, a widely acclaimed non-formal primary education service for the poor (Lovell 1992). NGOs are rightly viewed as lucrative sources of pro-poor innovation, but their reliance on justifying donor funds makes them especially susceptible to the current emphasis on financial sustainability, rather than to risky experimentation.

The myopia is costly also in other terms. Investing in pro-poor development, if it helps the poor to make better use of finance, is one way of promoting financial deepening in developing countries. There is growing worry that micro-finance in some places may have reached some kind of maximum absorption levels (Quasem 1991; Osmani 1989; Rahman and Hossain 1988; Abugre 1993). The response has been to emphasise micro-finance-plus programmes, where non-financial services such as training are provided in addition to finance (Gamser 1992). The hope is to fill some of the 'missing middle-sized' enterprises as the poor graduate from micro-enterprise. Some of the problems probably lie in such supply-side issues, and helping people to move from being primarily suppliers of labour (especially in micro-enterprise) towards being suppliers more of capital and management is a major task. The goal of financial sustainability may tempt some micro-finance providers to tone down, in quantity and/or quality, non-financial services, at least the subsidised ones. The effort to research into new non-financial services for the poor may also be undersupplied, for the same reason. But part of the problem may not be supply-side at all. Aggregate demand downshifts may stifle micro-enterprise (Cooper 1990); so may the distribution of that demand between different income groups because of their different consumption patterns, as suggested by Dawson (1994) in Nigeria under structural adjustment. This would require intensifying efforts towards poverty reduction and income equality, so as to raise consumption within the markets which micro-enterprises serve.

Well proven micro-finance programmes such as Grameen Bank are the ones most under pressure for financial sustainability. They are also the ones with the better record of reaching their target population most consistently. In these programmes, therefore, micro-finance represents a fairly well-targeted transfer, and yet also creates incentives for the poor to increase their economic activity. It is not perfect, but compared to other approaches to providing transfers to the poor, micro-finance appears to be doing very well. Given that donors and governments wish to make rapid cuts in consumption poverty, supporting private consumption through the implicit subsidies of well-targeted micro-finance programmes appears to be advantageous. Put another way, where it has worked, micro-finance

offers a way for taxpayers (mainly in rich countries) to be charitable to some of the poor (even if not the poorest), with fewer worries about leakage to the rich. After all, one way to help the poor is simply to give them a break.

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