

# AN EXAMINATION OF THE SOCIO-ECONOMIC IMPLICATIONS OF MICROFINANCE PROGRAMMES: AN ALTERNATIVE APPROACH IN NEPAL

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## Introduction

In Nepal, development planning was started with the implementation of the First Five-Year Plan in 1956. Despite experiencing improvements, Nepal still remains one of the poorest countries in the world with a human development ranking of 129 out of 167 countries (UNDP 2001). Since the installation of a multi-party democracy in 1990, the Eighth (1992-1997) and Ninth (1997-2002) Five-Year Plans have shifted policy towards liberalization of the economy and decentralization of power to try and promote development. In particular, poverty alleviation has been the major focus of these two Plans, with a wide range of policies being instituted to try to improve the situation of the poor.

One strategy that the Nepali Government has been following to combat poverty is the use of microfinance as a tool to improve the socio-economic situation of the poor. While the use of microfinance to help combat poverty has become widespread throughout the world, debate still remains as how it can be best used to alleviate poverty in a sustainable manner. On the one hand, it is argued that the creation of a healthy and competitive financial landscape is the best way that microfinance can be used to alleviate poverty, while others argue that the provision of both financial and basic social services can better tackle the problems of poverty. The purpose of this paper is to provide a general understanding of this debate by giving a brief historical account of the development of the microfinance. With the help of flowcharts

the paper also provides an understanding of how microfinance works to alleviate poverty. Secondly, an overview of the various microfinance programmes in Nepal is provided in order to gain an understanding of the Nepali microfinancial landscape and the problems that it is facing. Lastly, from all of these discussions, a conceptual framework for an alternative model is proposed that might help to improve the effectiveness and sustainability of microfinance programmes, given the severe poverty conditions existing in Nepal today.

### **Brief Overview of the Development of Credit Programmes**

The provision of credit to those living in rural areas of the developing world has been a tool that has widely been used to try and promote development. First-generation credit programmes of the 1960's and 1970's provided low interest loans for agricultural purposes to facilitate the adoption of higher yielding technologies. While the intention of these programmes were to enable the poor to gain access to loans, the system utilized to distribute credit was incompatible with their socio-economic condition.<sup>1</sup> In fact, tempted by interest rates that typically went as low as 2%, the rich used their political power to gain access to this credit that was not intended for them. Also, despite the fact that the rich received these low interest loans, the repayment rates were extremely low. Unable to recover money that was lent out, rural financial institutions (RFI) found it impossible to cover their costs of operations and were considered to be a resounding failure.

The development of the Ohio State University Rural Financial Market theory<sup>2</sup> in the early 1980s provided a good understanding of why these programmes failed. While space limitations make it impossible to fully outline the theory, the basic criticism it makes about the first-generation credit programmes is that they did not allow for the proper development of the financial markets in rural areas. The subsidization of interest rates only served to distort the credit market leading to the mistargeting of credit to the rich. It is argued that rural financial institutions (RFIs) need to provide good quality banking services<sup>3</sup> in rural areas and charge interest rates that reflect the cost of doing business in these areas. In doing so, RFIs will be better able to serve the rural population and overcome the problems experienced in the past.

At around the same time that this theory was being proposed, the Grameen Bank in Bangladesh was experiencing success in lending small amounts of money (microcredit) to the poor, without collateral, while experiencing high rates of repayment. Poor people borrowed money from the

Grameen Bank, using a group lending methodology<sup>4</sup>, and invested it into a microenterprise<sup>5</sup> activity. With the extra income earned from this activity, people were able to pay off their loans and get new ones. Through the repetition of this cycle, studies showed that programme participants were able to slowly improve their socio-economic condition. These successes, along with donor enthusiasm for the potential of microfinance to help alleviate poverty, paved the way for the establishment of second-generation credit policies aimed toward the development of the microeconomy by providing credit for investment into microenterprise. Since that time, many microfinance programmes have sprung up all over the world and various systems of lending have been experimented with to try and deliver these microfinance services in an efficient manner.

### **Two Categories of Microfinance Programmes**

From all the experimentation with different types of lending systems conducted in the past two decades, there are two general types of microfinance programmes that can be discerned. The first are welfarist institutions that provide both financial and social services to the poor. Although the nature and degree of services provided by welfarists differ from one institution to another, they generally provide "services and training related to nutrition, health, literacy, group formation and client training."<sup>6</sup> The main interest of such institutions is on improving the social well being of participants, "with less interest in banking than in using credit as a means to effect fundamental social and economic changes for borrowers and communities. The result is a continued reliance on subsidies and reluctance to raise interest rates. Welfarists focus on outreach (targeting women and the poor) rather than financial sustainability" (Morduch, 1997).

The second type of microfinance programme is known as institutionalists, which focuses upon the provision of basic financial services of deposit and loans. The main focus of such institutions is that of sustainability and believes that as long as sustainable financial services are provided, the entrepreneurial abilities of individuals is sufficient to bring about development. As Morduch (1997) argues, the focus of such institutions is on:

creating financial institutions to serve clients who are either not served or under-served by the formal financial system...leading to achievement of scale (number of clients) over outreach

(levels of poverty) and relegates client impact to the back burner.

In order to attain this goal, institutionalists need to provide high quality financial services and charge interest rates that reflect the cost of doing business in rural areas. This is a view that is touted by supporters of the Rural Financial Markets theory mentioned earlier.

In order to better understand the difference between these two methods of thought, the next two sections of this paper will describe the flowcharts shown in figures 1 and 2. These charts are an attempt at bringing about a more complete visualization of the socio-economic forces at work and how microfinance programmes impact upon those who participate in them. Since poverty is not only an economic issue but also a social one<sup>7</sup> (Chambers 1983), the flowcharts try to take this into account with the left-hand sides of these flowcharts showing how programmes combat the economic aspects of poverty and the right-hand sides delineating how the social aspects of poverty are overcome.

**Welfarists**<sup>8</sup>: By examining the experiences of welfarist programmes around the world, figure 1 is an attempt at providing visual picture of how welfarists try to alleviate poverty. Looking at figure 1, the situation of the rural poor in the developing world can be characterized by a situation of low income<sup>9</sup> and low social status<sup>10</sup>. These two factors combined define the socio-economic condition I<sup>11</sup> box. Those entering a welfarist programme go through a screening<sup>12</sup> process. Those who are screened-out are rejected due to economic<sup>13</sup> and/or social<sup>14</sup> reasons. This means that these people revert back to their original socio-economic condition of low income and low social status.

Those who pass the screening process, however, receive credit that can be used towards productive investment in a microenterprise and also receive training and welfare<sup>15</sup> support. Typically, a small portion of the loan is deposited with the bank to hedge against default.<sup>16</sup> Also, regular deposits<sup>17</sup> are usually required to instil a savings habit. These deposits, along with the money deducted from the loan, can be considered as forced savings, which can be used as a source of capital to cover any emergencies that may arise. In terms of the microfinance programme, these forced savings play a dual role by affecting both the manpower ability<sup>18</sup> and the investment of a person.



rural poor that they are trying to serve. For example, the amount and frequency of loan instalments may not fit the income cycles of the borrower or the methods used to collect instalments may be inconvenient. Such barriers can either hamper investment or lead to loan default and thus hurt the viability of the RFI.

The second are member<sup>20</sup> problems, which are particular to programmes utilizing group-lending methods. Incidents such as irregular attendance to weekly meetings and lateness in paying loans instalments can be detrimental for other members trying to obtain loans. Also, there is always the possibility of wilful default where the borrower never has the intention of repaying the loan in the first place.

Geo-environmental barriers, as the name suggests, are those that relate to geography and the environment. If a village is located in an isolated area, such places typically have poor transportation and marketing facilities. This means that there is a less developed rural economy and hence less self-employment opportunities. Environmental factors deal with calamities that Mother Nature can bring. Floods, diseases and the like can destroy the investment that a person makes and hence reduces or eliminates ones ability to repay loans.

Social barriers include things such as religious prejudice, socio-political interference and lack of family support. Such pressures can hamper a person's ability to make a success out of a microenterprise. For example, if a woman does not have the support of the family, especially the husband's support, it may make it difficult for her to make an investment in a business succeed.

Finally, there are entrepreneurial problems such as difficulties in selecting, implementing or changing investment activities as the market may require. Poor entrepreneurial skills have a direct impact upon the ability of a business to heighten ones socio-economic status. If a person does not have sufficient entrepreneurial talent to start-up or change to other activities when the market for what they are doing becomes saturated, this can lead to the failure of the business.

All of the above mentioned factors are problems one encounters when entering into a microfinance programme. The inability to overcome such investment barriers can eventually lead to loan default. This means that the individual has failed to reap the benefits the programme has to offer and/or the programme design has failed to meet the needs of borrowers. As the dotted lines leading from the individual programme failure box show, such a situation leads them back to their original socio-economic condition of low income and low social status.

While there may be those who fail to succeed in a microfinance programme, there are others who are able to overcome all the above-mentioned investment barriers. The manpower ability of an individual plays a vital role in helping one overcome these barriers and ideally lead to income creation and loan repayment. If all goes well, a person is able to save some of the profits, which can then be deposited in to a savings account, as depicted by the loan repayment/savings box.

From the economic viewpoint, the repayment of a loan and possible accumulation of savings allows the borrower to build some creditworthiness with the RFI. This creditworthiness enables one to gain more credit, possibly of a larger amount. This new loan can then be invested into improving the existing microenterprise or the starting of a new one. If a borrower is able to successfully repeat this cycle of credit, income creation, loan repayment/savings, creditworthiness, that person will eventually improve their household income. On the social side, continual participation in a programme also allows for continued access to training and welfare, which will steadily improve ones manpower ability.

After repeating this cycle, borrowers will eventually be able to experience improved household income and success in a microenterprise also leads to a change of attitude in ones abilities. Prior to obtaining a loan, the borrower may not have had much confidence in their abilities due to their low social status. By succeeding in a microfinance programme, a person is able to obtain higher income and higher social status, which in turn leads to the socio-economic condition II<sup>21</sup> box, as is depicted in the bottom section of the figure 1.

**Institutionalist:** The way that institutionalists try to alleviate poverty is to provide quality credit and deposit facilities for their rural clients. The institutionalists method is depicted in Figure 2, with the credit functions on the left-hand side and savings functions on the right. The initial socio-economic condition<sup>22</sup> of the poor who participate in institutionalist programmes is defined by a situation of low income and low social status. A person who wants to obtain a loan has to go through some kind of screening<sup>23</sup> process; the rules and regulations regarding this process will differ from one institution to another. The Bank Rakyat Indonesia Unit Desas (BRI-UD), for example, requires some form of collateral<sup>24</sup> and a recommendation from the village head. This recommendation is needed because if a person is late in their payment, the village head along with the bank worker will go to





screening process, however, obtain credit and can invest it in a microenterprise.

As with any investment, there are barriers that have to be overcome and this is where the key difference between the welfarists and institutionalist models to financial intermediation can be found. In general, it can be said that those with a higher level of manpower ability will have a greater chance of succeeding in a microenterprise. While welfarists, through their welfare and training programmes, actively try to raise the awareness level of the poor in order to improve their manpower ability, institutionalists are content with simply offering savings facilities, which act as a consumption-smoothing<sup>25</sup> tool. In recent years, some institutions have started to offer insurance and remittance services as well to improve the consumption smoothing ability of clients. Institutionalists believe that by having savings to cover such costs or by receiving credit for such purposes, delineated by the dotted line extending from the credit to consumption smoothing box, the manpower ability of that person can be enhanced.

This difference in ideology, however, has also led to a difference in the population that each institution serves. When looking at the poor, it becomes obvious that they should not be seen as being homogenous group and that within the poor, there are three basic subgroups that can be ascertained. These are the "extreme poor"<sup>26</sup> whose income is 40% below the poverty line; the "moderate poor" living just below the poverty line; and the "vulnerable non-poor" who are living above but close to the poverty line and constantly risk falling below it. (Woods and Sharif 1997:67). Due to the fact that institutionalists do not offer training and welfare services similar to that of welfarists, experience has found that they typically exclude the "extreme poor" from programme participation. Although the people who borrow from institutionalist programmes are poor, they typically belong to the non-vulnerable and moderate poor groups and thus the degrees to which they are affected by each of the elements in the investment barriers box are less. For example, a person participating in an institutionalist programme would find institutional and entrepreneurial barriers as being the most difficult obstacle to overcome. Social and member barriers would be less of a concern, while the ability to cope with geo-environmental barriers would be similar to that of a person participating in a welfarist programme.

Those participating in welfarist programmes, however, have all five of these barriers working against them. In particular, the social barriers that members of welfarist face are quite considerable. Gender, racial, and religious

prejudices can play a disruptive role in enabling one to succeed in a microenterprise. Thus, the training and welfare activities conducted in welfarist programmes attempt to increase the social awareness level of their participants so that they can overcome such social barriers.

Nevertheless, those who fail to overcome these investment barriers follow the dotted lines of loan default, individual programme failure, and revert back to a socio-economic status of low income and low social status. Those who overcome investment barriers and are able to succeed in income creation are able to repay their loans, save money (if enough profit is made) and gain creditworthiness with the financial institution. Any savings that are accrued can be deposited in the savings facilities, which will enhance ones consumption smoothing capabilities and in turn increase their level of manpower ability to overcome investment barriers. On the economic side, creditworthiness leads to access to more credit, which can be invested in the same or different microenterprise, and lead to income creation, loan repayment/savings, and so on. The last portion of the flowchart is the same as the welfarist model. After going through the institutionalist cycle a number of times, the borrower will eventually find his/herself in an improved socio-economic condition<sup>27</sup>.

### **Microfinance and Poverty Alleviation in Nepal**

In Nepal there are a wide variety of institutions that are trying to utilize microfinance as a poverty alleviation tool. The Intensive Banking Programme (IBP), Small Farmers Development Programme (SFDP), Production Credit for Rural Women (PCRW), Microcredit Project for Women (MCPW), Grameen replicators consisting of five Grameen Bikas Banks and two NGOs<sup>28</sup> (Nirdhan and Centre for Self-Help Development) are examples of the best-known institutions that provide financial services to the poor in Nepal. There are also a wide range of saving and credit organizations, cooperatives and NGOs providing financial services to those underserved by formal financial institutions.

Looking at table 1, it is evident that the three major poverty alleviation microfinance programmes in Nepal, the IBP, SFDP, and PCRW are experiencing problems in their viability due to poor repayment rates and difficulties in covering their costs of operations. Seibel et. al. (1998) in their study of microfinance in Nepal state that the "remedies to the disease of unviability seem clear: insistence on, and incentives for, timely repayment; elimination of interest rate subsidies in favour of cost-covering rates of

interest; and lowering of transaction costs" (Seibel et. al. 1998:308). The recent successes experienced by the transformation of SFDP sub-project offices (SPOs) into autonomous cooperatives, called Small Farmer's Cooperatives Limited (SFCL), is cited as an example of how such a remedy can be achieved.

The same study also takes an in depth look at the Purbanchal Grameen Bikas Bank, a Grameen replicator located in the plain area of Eastern Nepal. A comparison is made between the performances of the Purbanchal with that of the NGO run replicators, two NGOs supported by the Rural Self-Help Fund<sup>29</sup> (RSHF), i.e., Adarsha Krishak Samanwaya Samiti (Adarsha) and Vyccu Bachat Tatha Rin Sahakari Samstha (Vyccu), and two cooperatives operating in Nepal, i.e., SFCL in Bhumisthan, Dhading and Navajiban Cooperative Limited (Navajiban) in Dhangadi. It is found that government-owned poverty lending institutions have a much harder time in achieving viability in comparison to NGOs and cooperatives. As can be seen from table 2, the cooperatives seem to be performing the best in terms of financial self-sufficiency, followed by the two NGOs supported by the RSHF. Even among the Grameen replicators, the financial self-sufficiency figures are higher for the NGO run replicator in comparison to the government run bank.

The main conclusions and recommendations from this study are in line with the institutionalist mode of thinking. The study recommends a need to remove all interest rate subsidies and charging of rates that over costs of operation, which not only distort the rural financial markets and set up unfair competition to market-oriented establishments but also undermine the mobilization of savings. Looking at table 2, institutions such as Navajiban and Adarsha, which have the highest degrees of self-sufficiency, also have 100% of its loans financed from savings collected and thus mobilization of savings can be seen as a key factor in helping microfinancial institutions reach self-sufficiency. Thus Seibel et. al. argue for the privatization of government-owned institutions and a stop to all practices of using MFIs as channels for programmes with emphasis placed on internal resource mobilization and promotion of linkages between institutions belonging to various financial sub-sectors. They also argue for a need to select and test successful microcredit, microsavings and microinsurance products and strategies and their dissemination throughout the formal, semiformal and informal financial sectors (Seibel et al. 1998:327).

Table 1: Lending and Viability Figures of Major Poverty Lending Programmes in Nepal (1995/96)

Program	Loan Disbursement			Repayment (NRs. million)	Overdue (NRs. million)	Recovery rate (%)	On-lending interest rate (%) <sup>2</sup>		Subsidy dependency index <sup>3</sup>
	No. of borrowers	Amount <sup>1</sup> (NRs.)	Avg amt (NRs.)				Actual	Required	
IBP	37,082	975.92	26,318	529.69	605.60	46.66	18.10	42.5	1.35
SFDP	63,497	690.21	10,870	503.53	364.19	58.00	15.55	43.5	1.80
PCRW	9,270	74.64	8,052	34.27	19.65	63.56	15.55	72.4	3.66

Source: Sharma and Nepal (1997) and Seibel, Pant, and Dhungel (1998)

Note: 1 Amounts are in NRs. Million

2 The interest rates stated are for 1991/92

3 Subsidy dependency index = (Required rate - Average rate)/Average rate (Jacob Yaron, The World Bank)

Table 2: Operational and financial self sufficiency in six MFIs in Nepal, 1995

	Grameen Replicators		Rural Self Reliance Fund		Cooperatives	
	Bank	NGO	Vyccu	Adarsha	SFCL	Navajiban
Lending rate of interest	20	20	18	18	15-18	12-21
On-time repayment rate	100	100	97	100	64	92
Mean loan size (NRs. '000)	3.15	3.39	9.2	13.72	6.66	84.13
Savings (Million NRs.) <sup>1</sup>	13.92	1.03	0.23	1.20	0.56	17.86
Loans outstanding (Million NRs.) <sup>1</sup>	78.74	6.56	0.45	1.19	4.94	17.84
Savings/loans outgoing (%) <sup>1</sup>	18	16	51	100	11	100
Degree of partial financial self-sufficiency (%)	18	64 <sup>2</sup>	103	96	136	127
Degree of full financial self-sufficiency (%)	15	59 <sup>2</sup>	71	84	82	113

Source: Seibel et. al. (1998:320 and 325)

Note: 1 Figures are for December 1995

2 These data pertain to July 1996

While the recommendations made in this study are very important and can go a long way to help develop the rural financial landscape, there are certain things that must be considered when following the institutionalist path to microfinance. Firstly, there are the claims that institutionalist programmes are better in that they can reach large numbers of people and in this manner have a positive impact on poverty alleviation. Studies have found, however, that their outreach<sup>30</sup>, in terms of depth, has been limited to the moderate and vulnerable non-poor households (Hulme and Mosely 1996). This exclusion of the extreme poor is only natural since the institutionalist line of thinking is based on capitalistic principles of free competition, less government intervention, and the leaving of economic development to free market forces. As Johnson (1998: 799) notes, the "economic and social processes in the late twentieth century appear to be producing a 'South in the North' at the same time as rapid development in some contexts is resulting in the emergence of a 'North in the South'". In other words, the institutionalist system inherently makes it difficult for the most vulnerable segments of society to gain access to the financial services it has to offer.

Institutionalists may argue that the exclusion of this group can be considered as an acceptable trade-off to developing a healthy financial landscape, but considering the severity of poverty in Nepal, it is an issue that must be given due consideration. The Nepali government divides those living below the poverty line into two categories, the poor and ultra poor. While the exact definition of the ultra poor is not given, the poverty line<sup>31</sup> is estimated at standing around NRs. 4404 per person per year. From this measure, it is estimated that 42% of the population in Nepal lives below the poverty line, with 24.9% of this group considered being poor and 17.1% being ultra-poor. Considering the large proportion of the population living in such an ultra-impooverished state, poverty alleviation programs need to be able to include as much of this segment of society in their activities as possible.

There are also questions concerning a central tenet of the institutionalist perspective, which insists that credit programs must eventually be able to function without subsidies. The Rural Financial Market theories advocate that institutions should charge interest rates that cover their costs of operations and that the poor are willing and able to pay high interest rates for their loans. For example, it has been found that in some countries moneylenders can charge interest rates of over 100%. If a RFI can cover its costs of operations by charging interest of 30% to 40%, the poor could and would gladly pay this rate of interest.

While it is ideal for an institution to function without subsidies, institutions that provide social services to their clientele can find this difficult to achieve given the costs associated with the provision of such services. This is the biggest dilemma facing welfarists in that while they are able to include more of the poor in their programs, they are not able to sustain themselves without subsidies. The reason welfarist programmes can include more of the poor into their program lies in their provision of training and welfare. As mentioned earlier, poverty is both an economic and a social issue. While credit can improve the economic side of poverty, training and welfare services are required to improve the social elements of poverty. By increasing the consciousness level of the poor through the provision of literacy, health education and child care services, for example, many of the social elements of poverty can be improved. As was seen in figure 1, the provision of such services enables people to improve their manpower ability which can help people to make a success out of their investment and thus impact positively on repayment rates and savings mobilization of the institution as a whole.

Pressures exerted by donors, government and the like have forced welfarist programs to seriously consider the issue of sustainability. In particular, the expansion of lending activities, in order to take advantage of economies of scale, and maintenance of high repayment rates have generally been regarded as key factors in attaining this goal. This pressure can have a positive influence, by forcing programmes to become efficient in its credit operations. However, it can also lead to a dilution in the programme ideology by shift in the focus of attention to the credit aspects of the programme and a reduction in the attention paid to the extent of training and welfare provided. This in turn can force programmes to lend larger loans, which in turn leads to the exclusion of the poorest of the poor; the very group that welfarists were originally designed to help.<sup>32</sup>

However, when looking at the root of the "zero subsidy is best" line of thinking, it becomes difficult to say that this is an absolute truth. Morduch (2000) sums up the argument with an excellent example:

Consider a program lending exclusively to poor borrowers. It would have to charge, say, 30% per year in order to break even. In contrast, a formal sector program aimed at richer borrowers could break even when charging say 15% per year since it can easily take advantage of returns to scale. Loans at 5% per year will seem appealing to *all* households when the alternative

formal sector charge 15%. Nearly without fail, such *absolutely* cheap credit has led to subsidy traps. Loans around 20%, however, are not seen as gifts. The loans are cheap relative to full costs, but they are not absolutely cheap. Mistargeting has thus not been a major concern for those programs providing moderate-size subsidies. The lesson from the failures of the 1960s and 1970s is to avoid excessive subsidies. The lesson is not to avoid subsidies altogether. (Morduch 2000:624)

Therefore, if modest subsidies can help welfarist institutions break even, further thinking and experimentation is needed to see how welfarist institutions can be integrated into the financial landscape.

In order to examine this issue further, the following sections will examine in further detail two of the oldest welfarist style organizations in Nepal, the SFDP and PCRW. From the examination of the experiences of these two institutions, an alternative model will be proposed at the end of this paper to show that further experimentation is needed and efforts should be made to try and help welfarists attain sustainability.

**The Small Farmers Development Programme:** The SFDP, the largest target group oriented poverty alleviation programme in Nepal, was first launched by the ADB/N as a project in 1975 to better enable small farmers<sup>33</sup> to receive credit and other supporting services from line agencies so as to improve their living standards. A sub-project office (SPO), an ADB/N office, responsible for SFDP, is established in a Village Development Committee (VDC) and is staffed by a group organizer (GO) and a women group organizer whenever there is a Women's Development Programme in the VDC. The GO is basically responsible for all aspects of the programme including motivating people, making annual plans, assessing project viability, sanctioning and disbursing loans, collecting repayments and savings, and making line agency services such as training, marketing, raw material supply, family planning, adult literacy available to members.

Farmers are organized into groups of five to twelve members and loans of up to NRs. 30,000 per member are provided on an individual, group or inter-group basis. Failure to repay loans can halt disbursement of loans to other members or prevent new loans from being disbursed until all loans are repaid. While the group loans were supposed to do away with collateral requirements, the actual reality finds that farmers must also provide some physical collateral



to obtain loans. The average loans size for 1994/95 disbursed by SFDP was NRs. 10,870 and the recovery rate of loans was only 58%.

There are many problems facing the SFDP especially in the management of the programme. It has been found that non-poor are being included in the SFDP groups and the practice of requiring collateral on top of the group formation may be a reason for this phenomenon. The programme tends to work well in areas with a well-trained and dedicated GO, but the lack of incentives for good performance and lack of attention paid by the ADBN<sup>34</sup> to the programme has led to a deterioration of a programme that had experienced success during its project phase.

In light of the problems being faced by the SFDP, the GTZ in collaboration with the ADBN launched a technical assistance project in 1987 to try and transform SFDP SPOs into autonomous financial intermediaries, owned and managed by the members. By creating Small Farmer's Cooperatives Limited (SFCL), this project has been able to implement the SFDP in a more cost-efficient and sustainable manner. As Seibel et al. (1998:310) note, with the implementation of the SFCL concept in four SPOs in Dhading, farmers were able to "mobilize their own resources, which reached 20% of all loans outstanding within the first two years of their existence; the repayment rate of ADBN channelling loans (which continued unabated) virtually doubled; and the repayment rate of loans from internal resources jumped to 98% as of 7/1995."

While problems still exist for these SFCLs to reach full autonomy, the initial success of the project has led to the replication of this concept and provides evidence as to how to transform an unviable government programme into one that covers their costs of operations. According to Kievelitz et al., two important shortcomings are that:

the definition of small farmers seems to have been applied quite loosely. It is quite likely that the program is also benefiting the relatively better off amongst the poor. Further the program as yet has not been able to reach out to the marginal areas of the country. The SFCLs have as yet weak linkages with services agencies, which limits the effectiveness of many investments that the farmers make with their loans (1998:27)

From examining the problems of the SFDP and the successes of the SFCL, poor management can be seen as the major factor that has hurt the

viability of the SFDP. The transference of the management of the SPOs to its members has improved the overall supervision of the programme and thus its viability. However, another reason that can be cited as contributing to the poor performance of the SFDP is the poor linkages that it has had with government line agencies that are supposed to provide training and welfare services to the poor. Even the SFCLs have weak linkages with various service agencies and this can be seen as a problem that was carried over from the SFDP.

Being a programme run under the ADBN, it is only natural that the focus of the programme be placed upon its financial aspects. However, the lack of attention or priority placed on the social aspects of the programme, can also be seen as a contributing to poor loan repayment and the requirement of collateral in spite of the use of a group lending system to try to improve loan recovery; such actions inevitably leads to the disbursement of loans to those who are better off and the exclusion of the poorest of the poor from programme participation. The successes of the SFCL are an encouraging phenomenon but the fact that it is benefiting those who are relatively better off amongst the poor is not surprising. The ability to manage such groups requires a certain degree of education, which is something that those living in abject poverty typically do not have. Even if poorer members are included in the SFCL, such members will typically require a greater degree of assistance in terms of training and welfare activities if they are to overcome the various investment barriers shown in figure 1. Stronger linkages with government line agencies to provide social services are required in the SFCL programme is to see success in terms of the participation of the vulnerable poor.

### **Production Credit for Rural Women**

The PCRW is a programme initiated by the then Ministry of Panchayat and Local Development (now known as the Ministry of Local Development), with the collaboration of the NBL, RBB, ADBN, UNICEF, and other line agencies in 1982. Given the disadvantaged status of women in a male-dominated society such as Nepal, the basic aim of the PCRW was to "institutionalize the programme within the existing financial and institutional infrastructure of the government – to mobilize the government's root mechanisms to serve the interests and needs of the women rather than creating a separate state machinery for women's programmes." (AFDA 1996:50) Thus the program focused on creating women's groups of between four to ten

members who belong to low-income families having annual per capita income less than or equal to NRs. 2,511 with the following broad objectives:

- 1) Improve economic and social status of rural women in the society, accomplished through a combination of income generating activities, training and community development activities;
- 2) Establish self-reliant women's groups enabling them to initiate and undertake productive activities;
- 3) Integrate women into the regular service delivery system for credit and technical support services;
- 4) Develop the capacity of Women's Development Division (WDD) to ensure that women's interest are reflected in the development policies of the country. (AFDA 1996:12)

The large majority of loans are given for the purchase of livestock and the ultimate aim is to develop these groups into "viable saving and credit cooperatives which would thereafter stand and manage on their own without outside help" (Sharma and Nepal 1997:42). The key player in this system is the staff of the Women's Development Section (WDS), which motivate and assist members in selecting the right type of project and recommend them for loans to the IBP or ADBN branch working in the area. Loans that are approved are given under a group guarantee scheme without collateral and the supervision of loans, social and community development activities are carried out by staff of the WDS. Problems have been experienced, however, in developing the leadership capacity of members given the fact that once group leaders are chosen, they tend to remain in that position as opposed to the rotation of leadership roles among group members as envisioned by the programme.

This problem of developing leadership has consequently made it difficult to realize the graduation of groups into autonomous cooperatives and this may in part be explained by the large role that the programme staff have to play in the running of the programme. As was mentioned earlier, the main aim of PCRW was to institutionalize into the overall government infrastructure the development needs of women. In practice, however, the training and welfare aspects of the programme have fallen solely on the shoulders of the field staff due to a lack of cooperation between PCRW and district line agencies; services that members require are not available on a timely basis and any services that are provided were "fulfilled depending upon

personal requests and relationship of WDO and line agency staff. In addition, the WDO's expressed that they had to send repeated requests and reminders for line agency support and cooperation" (AFDA 1998:56). Heavy reliance upon the field staff can be seen as a reason for why field staffs are regarded as "mothers" or "guardians of the group rather than trying to relegate that role to the members themselves resulting in the programme being viewed as a gift from the government rather than creating groups that can demand services that government line agencies have to offer them.

Another problem with the programme is the high cost of service delivery with the World Bank estimating that the PCRW would have to raise their lending rates of interest to 72.4% in order to cover their costs of operations. Sharma and Nepal (1997) estimate that two-thirds of the staff time is devoted to the deliver of social service aspect of the programme which can account for the high costs associated with service delivery. Pressures to attain sustainability, however, have created a need to expand the programme and lend more loans to try and generate income. These pressures, while positive in terms of trying to make the system more efficient, has also resulted in a shift in the programme focus from community development to the credit activities. Given the fact that women are the targeted beneficiaries of the programme, reduction in the social intermediation aspects of the programme will make it more difficult for members to succeed within the programme.

The PCRW is also facing problems with a high rate of staff turnover, which can also be seen as raising the costs of operations due to the expense associated with the training of new people. The major problem is that 72% of the staff members are hired on a temporary basis and whenever new and permanent forms of employment are available, workers tend to leave the programme. The hiring of staff on a more permanent basis with the provision of incentives for good performance can go a long way in reducing costs associated with staff training and thus help to reduce the amount of subsidies the programme is receiving.

### **Conceptual Framework for an Alternative Approach to Microfinance**

As was seen from the descriptions of the SFDP and PCRW, poor management has been a major factor affecting the performance of these programmes. Both of these programmes, when they first started, had met with considerable success and this helped to fuel expansion of programmes to other districts. As the programmes grew in size, however, they tended to lose their

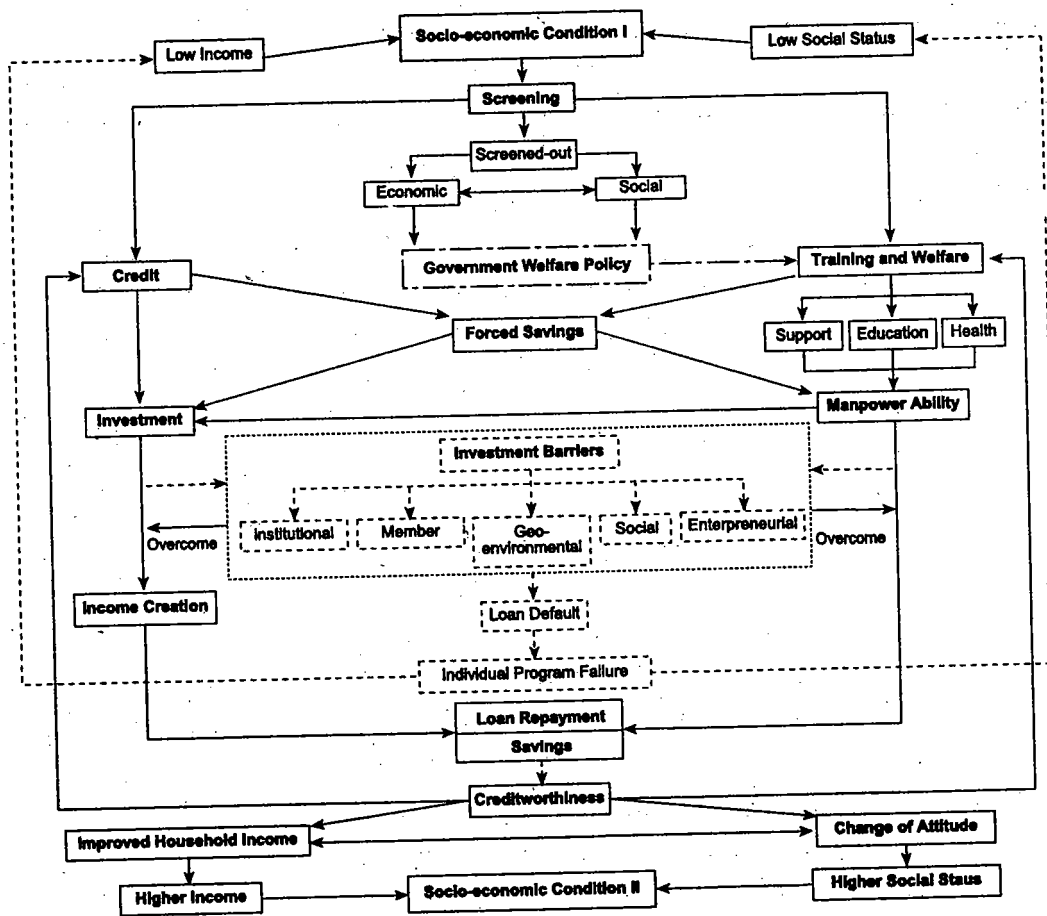
effectiveness and this is a reason for why government programmes have not performed as well as the cooperatives or NGO run institutions seen in Table 2.

There are a number of reasons that can account for this decline in effectiveness. The first deals with the lack of qualified staff to keep up with the expansion of programmes. In terms of the SFDP, the rapid expansion of the programme had forced the ADBN "to place a person from the regular staff pool as a GO. Such a person possesses neither the required skills nor is motivated to work with the rural poor. This practice has an adverse effect on the quality of the programme" (Sharma and Nepal 1997:37). The PCRW, on the other hand, has a problem with a limited number of field staff, which acts as an impediment to the expansion of the programme. At the same time, the high turnover of staff not only adds to the cost of the programme but also affects its effectiveness. Such problems can be addressed, however, through the provision of incentives to workers for good performance.

A more important reason for the decline in performance, however, can be attributed to the dilution of programme ideology. When looking at the history of the microfinance movement, the overall focus has tended to be placed on the financial, i.e. saving and credit, aspects of programmes. While it is realized that the social intermediation aspects do play a positive role, insistence on being able to function without subsidies inevitably leads to a decline in the quality and quantity of services provided; more time spent by staff to extend larger loans which results in a decline in amount of time spent on social intermediation activities and exclusion of the more vulnerable sections of the poor.

The point that this paper is trying to make is that microfinance programmes aimed at the poorest of the poor need to give equal weight to both the financial and social intermediation aspects. In the case of Nepal, however, the focus of the government has been leaning more towards the financial aspects and this attitude is reflected in the government policies towards microfinance. For example, in the IBP, the government requires commercial banks to allocate 12% of their loan portfolio to the priority sector but there has been no policy mandate to direct district line agencies to concentrate a certain percentage of their resources to service provision to microfinance programmes. While the SFDP and PCRW conceptually have linkages with line agencies, the actual practice has seen little cooperation between the SFDP and PCRW with line agencies and has thus contributed negatively to their overall performance.

In order to overcome these deficiencies, figure 3 provides a conceptual framework for an alternative model to microfinancial intermediation. The main idea behind this framework is to have better integration of government welfare policies with the activities of microfinancial programmes. As was mentioned earlier, the costs associated with social service provision has been a major impediment to the sustainability of welfarist institutions and pressures to attain sustainability has led to the exclusion of the extreme poor from programme participation. Government support for training and welfare activities can help welfarists to attain sustainability as long as the financial side of their operation is conducted in a viable manner.



**Fig. 3. Conceptual Framework of the Socio-economic Implications of an Alternative Microfinance Program Model on the Poor**

Looking at Figure 3, we see that the alternative model is based on the welfarist flowchart. The government welfare policy box is catching those who are being screened out with an arrow leading towards the training and welfare box. There are many ways that such a system of cooperation between the microfinance programme and the government welfare policy could be developed. If there is an overlapping of the social services being offered by the government and the welfarist microfinance programme, discussions can be initiated to try to integrate the programmes that each are operating. For example, if a government has an adult literacy programme in place and the NGO is also has a programme of their own, an integration of the two programmes is a possibility. If the government is running a programme that the microfinance programme does not offer, members can be introduced to it and this would further the social empowerment of its members.

Direct subsidies by the government for a social programme offered by a microfinance institution are another possibility. In some cases, the NGO may be better able to provide services in a certain district than the government. Another possibility is that the NGO social programme is of a much better quality and so the government could take the money it spends on its own programme and subsidize the one run by the NGO. Such subsidies, if sufficient in amount, might even enable the microfinance programme to expand the variety of social services they provide<sup>35</sup> and thus lead to further social empowerment for participating members. For such an option to be even considered, however, the NGO running the microfinance programme would have to show a considerable degree of success and efficiency in its lending operations.<sup>36</sup>

For the extreme poor, the extension of loans to them does not necessarily have to occur immediately. Many institutions have found difficulties in lending to this extreme poor group. A more practical solution might be to get them into the welfare programme so that they can gain access to basic health, literacy and other training to improve their manpower ability. Forcing participants to maintain a regular savings habit can also teach them the value of doing so. If a programme is able to improve the social poverty of the extreme poor group, it will have at least had an impact and provide them with better manpower ability to tackle the economic side of poverty.

The politics and logistics involved in such an endeavour may seem quite daunting but also point out that there are alternatives for welfarist microfinance programs trying to obtain sustainability. An environment of mutual trust between government and NGOs would have to be established

before any such alternative could be considered. As was mentioned earlier, the present model for development in most of the world relies upon market forces. This makes welfare programs all the more necessary in order to protect the most vulnerable. This is not to say that all programs must be welfarist in nature but that there is room in the financial landscape for subsidized welfare programmes that are aimed towards the poorest of the poor.

Much of the literature, pertaining to sustainability aspects of microfinance programmes, tends to only evaluate the economic aspects of the programme. Investments are also needed to help people overcome the social side of poverty as well. While the thinking behind welfarist programmes was to accomplish this, the pressure for sustainability has started to exclude the poorest of the poor and this is something that has to be taken seriously. The alternative model proposed in this paper, might be one of the options that are available to include the most vulnerable in the development process.

### **Conclusion**

Throughout this past two decades, there has been much enthusiasm for microfinance programmes as a method to alleviate poverty. To gain a better understanding of the socioeconomic forces at work within microfinance programmes, flowcharts depicting institutionalist and welfarist approaches to financial intermediation were presented. Research into the outreach and sustainability aspects of microfinance programmes has found that institutionalists, by and large, have excluded the poor from participation. Welfarists have also felt pressure from donors to expand their scale of operation and become sustainable. This pressure, however, has led to the exclusion of the extreme poor from programme participation.

Examination of the SFDP and PCRW in Nepal had found that poor management has been a major impediment to programme performance. While the provision of proper incentives to workers can help to overcome some of the problems, the flowcharts showing the socio-economic implications of microfinance programmes have tried to illustrate that the social intermediation aspects of programmes are just as important as the credit side and the lack of cooperation and coordination of these programmes with district line agencies can also be seen as a major reason for poor programme performance. The intent of this paper is not to discredit the valuable contribution that institutionalists can play in alleviating poverty through the development of a healthy financial landscape, but tries to point out that it may not be the only alternative available for the creation of sustainable institutions. The provision



of government subsidies and/or amalgamation of the social services provided by the NGOs and government might be one way to lessen the financial burdens taken on by the microfinance programme. Such an alternative might be an interesting starting point for cooperation between NGOs and government. Further research into how the alternative model presented here could work, might lead to a much more dynamic financial landscape than the one that is presently in existence.

### Notes

- 1 In terms of the system used to deliver credit, in order to gain access to a loan, one needed to fill out paperwork and have collateral. Since many of the poor are illiterate and have very little they can offer as collateral, this system made it extremely difficult for them to access these low interest loans. There are many other reasons why these programs failed to reach the poor and these are extremely well documented. See Frank Ellis (1992), 152-174.
- 2 See Adams et al., eds. (1984) for a full explanation of the Rural Financial Market theory.
- 3 This means that branches have to be located close to the villages of their clients, have office hours that reflect the work schedule of rural people, and generally provide services that are needed by them. This is something that first-generation credit programs failed to provide.
- 4 Group lending is system whereby members of a group are responsible for each other's loans. If a person in their group cannot repay their loan, other members can also lose access to credit. The social pressure that is created to repay takes the place of physical collateral that is common with most bank loans.
- 5 Microenterprises should not be confused with small-scale enterprises. The distinguishing features of microenterprises are that they require small sums of money and utilize very simple technology. Common examples of microenterprises in the developing world would include activities such as chicken rearing, rickshaw pulling, peddle-vending, etc.
- 6 World Bank, "Sustainable Banking with the Poor (SBP): A Worldwide Inventory of Microfinance Institutions," <<http://www-esd.worldbank.org/html/esd/agr/sbp/micro/micro1.html>>
- 7 Chambers (1983) argues that poverty is an inter-linking of powerlessness, vulnerability, physical weakness, poverty, and isolation factors.

- 8 In the following description and analysis, the words in bold correspond to the words found in the boxes of the flowchart.
- 9 This is defined as a situation characterized by low savings and poor consumption.
- 10 Low social status is defined as a situation characterized by little power and little awareness.
- 11 Defined as the socioeconomic condition of an individual characterized by low income and low social status, consisting of the extreme and moderate poor.
- 12 The process used to accept or reject potential borrowers. In terms of the group lending method, the members of the group are the ones who decide who gets credit and who does not.
- 13 Rejection due to economic reasons, i.e., a person is too poor, does not have a regular income.
- 14 For example, group members perceive them to be too poor or too far down the social ladder to be accepted.
- 15 Since welfarist programmes give loans without collateral, group-lending methods are utilized. At group meetings, on top of collecting loan installments, various training and welfare activities are also conducted. For example, moral support from group members and bank workers, the forcing of regular savings to teach borrowers the value of saving small amounts of money on a regular basis, literacy and health training, and other activities that can raise the awareness level of the borrower.
- 16 The Emergency Fund of the Grameen Bank, for example, requires borrowers to deposit 5% of a loan over 1000 takas to be deposited. This is collected to hedge against default when accidents, death, or crisis hits a borrower.
- 17 For members of the Grameen Bank, two takas must be deposited in the Group Fund at every weekly meeting. Up to half of the funds in this account can be borrowed, though group approval is needed, to help those that are struggling.
- 18 Defined as the health and knowledge level of a borrower. Good health enables a person to work productively, which enhances their ability to repay loans. The more knowledge one has, the better one is able to deal with the socioeconomic environment around them, which can help to ensure that better quality investment is made. These have a direct impact on the investment; the arrow pointing from the manpower ability to the investment box depicts this fact.

- 19 The oversupply of credit refers to two things: a) the loan amount extended is too big for the borrower to manage. b) The popularity of the microfinance movement has led to the growth in number of programmes available. If a village has numerous programmes, one can borrow from different institutions and end up owing more money than they are capable of repaying.
- 20 Defined as the people participating in the microfinance programme.
- 21 Defined as the socioeconomic condition of an individual who has managed to cross the poverty line.
- 22 The term *socioeconomic condition I* is not used here as it was in the welfarist model. This is because those joining an institutionalist program are not necessarily below the poverty line when they join, i.e., they are from the vulnerable non-poor and non-poor group.
- 23 For programmes, which utilize group-lending methods, members are the ones who screen other members. However, many institutionalists lend to individuals and thus require collateral and/or a recommendation from a village leader or guarantor.
- 24 For the BRI-UD, collateral does not necessarily have to be land, a common practice of most banks. It can be a household item but in actual practice, repossession does not occur because of the role of the village head.
- 25 Defined as money used for emergency consumption needs such as food shortages, sickness, funerals, weddings, that will help to maintain ones lifestyle to meet various contingencies.
- 26 This extreme poor group is also known as the core-poor, ultra-poor, and poorest of the poor in the academic literature.
- 27 The term socioeconomic condition II was not used here because people participating in institutionalist programs are not necessarily those who are moving from below to above the poverty line. For example, a vulnerable non-poor person may be able to get rid of their vulnerability and stabilize their income to that which is above the poverty line and thus the term improved socioeconomic condition is used here.
- 28 Grameen replication is being engaged by both banks and NGOs as a way to test which method is better suited for the situation of Nepal.
- 29 The NRB has tried to support selected NGOs to become financial intermediaries with the establishment of a Rural Self-Help Fund which provides funds at rate of eight percent per annum on loans to NGOs which direct the loans to beneficiary groups at or around the prevailing bank

rates with the difference between borrowing and lending rate to take care of the overhead expenses of NGOs. The study conducted by Seibel et al. refers to this program as the Rural Self-Reliance Fund.

- 30 This term connotes two things, scale and depth. Outreach of scale refers to the overall numbers being reached by the institution. Outreach of depth refers to how well institutions are reaching the extreme poor.
- 31 The poverty line is estimated as being the annual amount of expenditure required to purchase a daily caloric intake of 2124 calories per year and other essential non-food items. Per capita annual expense to purchase 2124 calories per person per day is estimated at NRs. 2637.
- 32 A good example of this can be seen with the Grameen Bank when it needed to expand their scale of operations to address the sustainability issue. Since there are costs associated with the establishment of new branches, as of 1992 the Grameen Bank focussed its efforts on expanding the number of members within its existing infrastructure. This was accomplished by intensifying the workload of bank workers by increasing the number of groups he/she was responsible for from six to eight per center. The problem of doing this is that it reduces the amount of time a bank worker can spend monitoring groups and the uses of the loans. At the same time, there is external and internal pressure to maintain high repayment rates and thus bank workers tend to get appraised on their ability to recover loans as opposed to their supervision of them (Rahman, 1999, 75-76). Thus workers will begin to concentrate their efforts on the credit aspects of the program and spend less time on the social intermediation aspects.
- 33 Small farmers were first defined as those having a per capita annual income of less than NRs. 950, which was raised to NRs. 2,500 in 1991 (NRB, Vol. 2 1994:215)
- 34 The regular lending of ADBN constitutes over 80% of total lending volume and thus the SFDP does not get as much attention as required.
- 35 Karim and Osada (1998), for example, state that the implementation of a formal child-care system could be something that would reduce dropouts of Grameen Bank members and thus positively contribute to the sustainability of the Bank.
- 36 A good candidate for receiving such subsidies would be a programme that shows itself to be financially sustainable but is having problems obtaining economic sustainability.

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