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October 2007

Presented at
REBELLIOUS MACROECONOMICS:
MARX, KEYNES & CROTTY
A conference in honor of James Crotty
TARGETING DEVELOPMENT FINANCE FOR EMPLOYMENT EXPANSION IN SUB-SAHARAN AFRICA:
A SYNTHESIS OF MICROFINANCE AND THE EAST-ASIAN MODEL

For Festschrift Volume in Honor of Professor James Crotty

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October 2007

ABSTRACT

Microfinance institutions have achieved significant successes as a tool for promoting economic development. However, considered on an economy-wide basis, the achievements of micro-finance institutions have been modest, especially in comparison with what we may term the macro-finance developmental approach pursued, among other places, in the developing countries that have experienced the most successful growth paths over the past generation. This paper first aims to provide a balanced appraisal of microfinance that acknowledges both its strengths and weaknesses, especially in relation to a macro-finance framework that relies on development banks and subsidized credit allocation programs. The second purpose is to advance a financial market policy framework that incorporates features of both microfinance and a state-directed credit allocation model, and apply this framework to the contemporary economy of Kenya. Kenya operates at present with the most extensive set of microfinance institutions in Sub-Saharan Africa, and therefore offers an excellent case study for observing both the limits of Grameen-style microfinance and the potential for incorporating features of that model within a framework that builds on the achievements of large-scale subsidized credit programs.

JEL Codes: G21, O16, O17
The award of the 2006 Nobel Peace Prize to Muhammad Yunus, founder of the Grameen Bank in Bangladesh, and a former professor of economics at Chittagong University, has brought increased attention to the role of micro-finance institutions as a tool for promoting economic development, and especially as a means of creating viable employment opportunities for the very poor.

There is no question that Yunus and the Grameen Bank have made important contributions to fighting mass poverty. Indeed, as I discuss below, one major purpose of this paper is to propose policies that learn from and build on these achievements. At the same time, the real accomplishments of microfinance are being oversold in many circles. In particular, microfinance has been widely promoted as an effective alternative to what Armendáriz de Aghion and Morduch (2005) describe as the “failures of state-owned development banks” and similar large-scale public policy interventions to allocate credit on a subsidized basis.

This view of macro-level development banking and subsidized credit allocation programs stands in stark contrast to the perspective of Jim Crotty along with other major observers of the operations of the East-Asian-type development model such as Alice Amsden (1989, 2001), Robert Wade (1990), Ha-Joon Chang (1994) and Ajit Singh (2004) on the effectiveness of such measures. Crotty, along with these other authors have identified the policy of granting large-scale credit subsidies in these economies as a major engine of their successful growth paths. Amsden, for example, reaches the following conclusion regarding macro development finance policies in the developing countries that she terms the “the rest:”

From the viewpoint of long-term capital supply for public and private investment, development banks throughout “the rest” were of overwhelming importance….The government’s role in long-run credit allocation was substantial even in parts of “the rest” where development banks were of relatively minor importance (2001, pp. 127-29).

In addition, Grameen-type microfinance institutions are often characterized as being consonant with, and operating effectively within, an overall neoliberal development model that enshrines free market solutions for promoting widespread prosperity in developing countries. This poses a severe problem for microfinance as a policy tool. Of course, Jim Crotty has long been among both the most forceful critics of neoliberalism, which he characterizes as being “built on deregulation, liberalization, privatization, and ever-tighter global integration,” (2000, p. 361). Crotty writes that
The Neoliberal Regime took root in the 1980s and consolidated in the 1990s. Unfortunately Neoliberalism’s promised benefits have yet to materialize, at last for the majority of the world’s people. Global income growth has slowed, productivity growth has deteriorated, real wage growth has declined, inequality has risen in most countries, the less developed nations outside East Asia have fallen even further behind the advanced, and average unemployment is higher (2000, p. 361).

The question this paper will examine is the extent to which features of microfinance and the East Asian model can be successfully mobilized to fight mass unemployment and poverty in sub-Saharan Africa, with a special focus on Kenya. Crotty along with a handful of others have shown that a major factor in the success of credit subsidies under the East Asian model was that it operated with clear performance standards, focused on export success. Incentive and monitoring systems were then established around achieving this overarching goal of export success. To apply such a policy approach within the sub-Saharan African context will therefore entail, most importantly, that incentive and monitoring systems be established that are organized around achieving employment expansion targets as opposed to export targets.

This paper will attempt to lay out how such incentive and monitoring systems can be designed within the Kenyan economic reality to maximize the benefits of subsidized credit policies for the vast majority of people in Kenya, who are working poor. The general approach I outline here for Kenya also has broader applicability throughout sub-Saharan Africa, as my co-authors and I have tried to show in related work (e.g. Pollin et al. 2006).

The paper is divided into two fairly distinct but interrelated parts. The first is to offer a balanced appraisal of microfinance that acknowledges both its strengths and weaknesses, especially in relation to a macro-finance framework that relies on development banks and subsidized credit allocation programs. The second purpose is more positive. This is to construct a financial market policy framework for Kenya that incorporates features of both microfinance and a state-directed credit allocation model. Kenya already operates with the most extensive set of microfinance institutions in Sub-Saharan Africa, and therefore offers an excellent case study for observing both the limits of Grameen-style microfinance and the potential for incorporating features of that model within an overall framework that builds on the achievements of large-scale subsidized credit programs.

**MICROFINANCE AND MACRO DEVELOPMENT FINANCE**

**Is Unsubsidized Microfinance Profitable? Should it Be?**

Mumahhad Yunus launched the Grameen Bank in Bangladesh in 1976. The industry’s growth has been explosive since Grameen opened its doors. As of 2002, there
were roughly 2,600 micro finance institutions worldwide serving about 68 million clients.¹ These institutions have made important advances relative to the array of moneylenders and pawnbrokers that had previously controlled the provisioning of banking services to the world’s poor. The first contribution of Yunus and the Grameen Bank model is simply to have recognized that credit and related services—including bank accounts and insurance policies—can be important resources for advancing the well-being of the poor, just as they are with everyone else. The second is in targeting women as loan recipients, empowering the women within their families and helping them to sustain their home-based micro enterprises.

The most important advance is in developing an alternative to traditional collateral as a basis for lending to the poor. Under a traditional system, people obtain loans only if they have sufficient assets to surrender to the bank, moneylender or pawnbroker in the event of default. But poor people, by definition, have few assets to pledge—perhaps a few livestock animals, a small plot of land, or jewelry. Losing these few assets to a creditor is likely to bring destitution. Grameen’s innovation was to create borrowing groups, typically of five women. Each group member could receive loans only as long as everyone made payments. This promotes both mutual support among group members as well as peer pressure to keep up with payments. It also created opportunities for large numbers of poor people to become creditworthy for the first time.

Counteracting these positive innovations, lending rates charged by Grameen and other micro finance institutions far exceed standard measures of affordability. Nimal Fernando of the Asian Development Bank, arguing in defense of high interest rates on microcredit, nevertheless acknowledges that:

> The nominal interest rates charged by most MFI in the region range from 30 – 70 percent a year (on a reducing balance basis). The effective interest rates are even higher because of commissions and fees charged by the MFIs. Other factors—such as the compulsory deposits for obtaining a loan, frequency of repayments and the systems adopted to collect repayments, also raise the effective interest rates (2006, p 1).

These rates are lower than what moneylenders typically charge, but remain punishingly high. Defenders of such arrangements contend that, accounting for the risks to the lender, these rates are appropriate; and that anything less will not attract profit-seeking bankers into this market. They also claim that subsidized rates will invite rent-seeking, such that those favored with political connections, rather than those in need, will end up as the actual recipients of the subsidized credit.²

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¹ See the survey feature “The Hidden Wealth of the Poor,” *The Economist*, 11/5/05
² See, among others, von Pischke, J.D., Evans and Donald (1983); and *The Economist* survey, 11/5/05. Armendáriz de Achion and Morduch (2005), passim, also summarize this perspective.
Despite charging such high rates, the Grameen Bank, among others, has long prided itself on maintaining repayment rates as high as 95 percent. However, these figures have been disputed, including in a careful *Wall Street Journal* investigative report in 2001.\(^3\) The report found that, in fact, Grameen allows distressed borrowers to roll over or stretch out their repayments rather than declaring them in default. This may well be the most effective and humane approach under the circumstances. But it is clearly inconsistent with a hard-nosed business model supported by a large proportion of microfinance enthusiasts.

Moreover, interest rates and other financing charges for the poor—and correspondingly, default rates—would be higher still if microfinance institutions did not themselves operate with subsidies. As Armendáriz de Aghion and Morduch write:

> The reality is that much of the microfinance movement continues to take advantage of subsidies—some from donors, some from governments, and some from charities and concerned individuals. *The Microbanking Bulletin*, for example, shows that sixty-six out of 124 microlenders surveyed were financially sustainable, a rate just over 50 percent. For microlenders focusing on the “low-end,” just 18 of 49 were financially sustainable as of the July 2003 accounting, a 37 percent rate (2005, p. 232).

Morduch’s own research finds that the Grameen Bank would have needed to increase their lending rates by about 75 percent in order to break even without subsidies between 1985 – 95 (Aghion and Morduch 2005, p. 237).

It of course makes sense that microcredit loans to the poor can be made profitable—truly profitable, without benefit of subsidies, hidden or open—only if the poor pay extremely high interest rates and other charges. Even when microfinance institutions utilize creative systems of collateral, such as those developed by the Grameen Bank, the information costs, transaction costs, and risks of such loans remain very high. Considered strictly as a profit-seeking activity, the repayment rates for borrowers of such loans would have to fully reflect these costs and risks to lenders. At the same time, borrowing rates that fully reflect these costs are likely to be overwhelming burdens to the poor. Putting such heavy financial burdens on the poor in turn defeats the purpose of the enterprise.

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\(^3\) Pearl and Phillips (2001). Rahman (1998) reaches a different conclusion regarding high repayment rates at the Grameen Bank—that the borrowers face intense pressures to maintain regular repayment schedules. Rahman concludes that these pressures “increases the debt-liability on the individual households, increases tension and frustration among household members, produces new forms of dominance over women and increases violence in society.” Establishing which perspective is more generally accurate remains an important task for future researchers.
But this doesn’t mean that microfinance is not a viable tool for fighting poverty. It rather means that, given that it is indeed a viable tool, as the Grameen Bank and allied institutions have demonstrated, that government policy should openly subsidize these activities. The real question therefore becomes how best to establish such subsidy programs—how large should the subsidies be, what should be the subsidized interest rates, and who should bear the costs of the subsidies. These are among the questions I address below in the context of Kenya.

**Microfinance Requires a Supportive Policy Environment**

But whether the credit terms are low or high, micro enterprises run by poor people cannot be broadly successful simply because they have increased opportunities to borrow money. For large numbers of micro enterprises to be successful, they also need access to decent roads and affordable means of moving their products to markets. They need marketing support to reach customers. They need a vibrant, well-functioning domestic market itself—i.e. enough people with enough money to buy what these enterprises have to sell. Finally, micro businesses benefit greatly from an expanding supply of decent wage-paying jobs in their local economies. This is the single best way of maintaining a vibrant domestic market. In addition, when the wage-paying job market is strong, it means that the number of people trying to survive as micro entrepreneurs falls. This reduces competition among micro businesses and thereby improves the chances that any given micro enterprise will succeed.

These additional measures for supporting micro enterprises—a decent transportation infrastructure, support in marketing the products of micro enterprises, a high level of domestic demand, and an abundance of decent wage-earning jobs—were, in various forms, all closely associated with what used to be termed the “developmental state” economic model. Different versions of the developmental state model—including state socialism, import-substituting industrialization, and the East Asian state-directed economies—prevailed in developing countries for the first thirty years after World War II, before these models were overtaken by neoliberalism. Each of these developmental state models encountered serious problems. But on balance they all achieved successes in promoting economic growth and greater equality. This is in contrast with the neoliberal record of declining average growth rates and rising inequality. ⁴

We can observe the relative achievements of a micro-finance model operating within a broadly neoliberal policy framework as opposed to a developmental state framework by comparing the experiences of a few Asian countries. In pointing out the gains achieved through microfinance in developing countries, a recent article by Sam Daley-Harris (2007), director of the U.S. Microcredit Summit Campaign, focuses on the case of Bangladesh. Of course, Bangladesh is where the microfinance movement began in the mid-1970s under Professor Yunus. At present, according to Daley-Harris,

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⁴ Some basic figures and references on this, as well as further references, are provided in Pollin (2003), Chapter 5.
Bangladesh is “the world’s most saturated microfinance market.” Daley-Harris argues that Bangladesh has made dramatic advances in reducing poverty reduction since the microfinance movement began there, though he recognizes that factors in addition to microfinance itself have also made contributions. Daley-Harris cites the following indicators of success in Bangladesh:

- By 2004, according to UNICEF, Bangladesh had already achieved the Millennium Development Goal on gender parity at the primary and secondary educational levels; the fertility rate in Bangladesh has fallen from 6.4 in 1970 to 3.2 in 2004; and the number of deaths of children under five per 1,000 live births has fallen from 239 per thousand in 1970 to 77 in 2004.
- More than 13,000 women have been elected to local government positions.
- Bangladesh has overtaken India in reducing its child mortality rate.

While these accomplishments are real, it is also helpful to consider these simple comparisons. In 1965, the average per capita income in Bangladesh was $269 (in inflation-adjusted 2000 dollars).\textsuperscript{5} In that same year, per capita income in Indonesia was $195, 28 percent lower than that in Bangladesh. As of 2004, Bangladesh’s per capita income had risen to $402 while that in Indonesia was at $906. In other words, Bangladesh’s per capita income had risen by 50 percent between 1965 – 2004, while Indonesia’s had risen by 365 percent. But more to the point regarding poverty reduction: in the most recent years for which the World Bank reports figures, in Bangladesh the $1 dollar/day poverty rate was 36 percent (2000) while in Indonesia (in 2002) it was 7.5 percent. Indonesia, moreover, is by no means a star in the firmament of East Asian Tigers. If we consider Thailand, for example, in 1965, its per capita income was about 50 percent higher than that in Bangladesh. By 2004, it had risen to almost 600 percent higher than Bangladesh. More importantly, as of 2002, Thailand had pushed the $1 dollar/day poverty rate down to only 2 percent.

What is responsible for the far greater economic achievements of Indonesia and especially Thailand relative to Bangladesh over the past 40 years? Without pursuing here an extended debate about developmental strategies, we can at least say that Indonesia and Thailand achieved their successes despite the far less extensive role for Grameen-style microfinance institutions serving their countries’ poor. This does not mean that we should gainsay the real contributions of the Grameen Bank. But it does mean that our attention should focus to a far greater degree on the overall development strategy in which microfinance institutions operate and less on microfinance \textit{per se} as a tool of poverty reduction.

\textbf{Learning from State-Directed Credit Subsidy Programs}

\textsuperscript{5} All figures in this and the following paragraphs come from the World Bank’s \textit{World Development Indicators}, 2006.
As I stated at the outset, one of the key institutions of the developmental state model that was largely dismantled under neoliberalism is the state-directed development bank. State-directed development banks provided cheap long-term credit for domestic businesses that enabled these businesses to expand their productive and marketing capabilities at a sustainable pace. This is the policy approach that Amsden describes as having been of “overwhelming importance” to the development path both of countries that relied on development banks for allocating credit, as well as those where development banks per se were of minor importance. In this latter set of countries, Amsden writes that “when necessary, the whole banking sector in these countries was mobilized to steer long-term credit to targeted industries, acting as a surrogate development bank,” (2001, p. 129). Amsden describes Indonesia as among the countries that made effective use of its state-led development bank, the Indonesian Development Bank, along with the cases of Mexico, Chile, South Korea, and Brazil. Amsden also includes Thailand as among the countries that did not rely on a state-led development bank per se, but rather deployed “the whole banking system” to channel subsidized credit for development purposes. The other cases in this category cited by Amsden include Malaysia, Taiwan and Turkey.

It is true, as Amsden’s discussion makes clear, that this macro development finance approach in “the rest” was targeted primarily at promoting manufacturing capacity and exports, as opposed to be directly aimed at reducing mass unemployment and poverty. This is a crucial point, because what Amsden emphasizes as being key to the success of these models was that they operated under what she terms a “reciprocal control mechanism,” whereby “subsidies were conditional on the fulfillment of performance standards, which were widespread both by industry and country,” (2001, p. 160). It is when such control mechanisms and performance standards were not established or did not function effectively that subsidized credit allocation policies in developing countries failed. Amsden cites Argentina as a case where effective measures were never developed and India where they operated to an excessive, stifling extent.

Following Amsden’s discussion, it seems reasonable to conclude that establishing reciprocal control mechanisms and performance standards as a precondition for obtaining subsidized credit can be relatively straightforward when the performance standard is itself straightforward—such as achieving a well-defined level of success in selling to export markets. But can such control mechanisms be made workable when the purpose of the policy is less well targeted—specifically, when the aim of the credit subsidies is to promote poverty reduction and the expansion of decent employment?

This is the most basic question that needs to be explored if large-scale subsidized credit allocation programs are to be made workable in behalf of microfinance programs focused on employment expansion and poverty reduction. We now turn to a consideration of this and related questions in the next section of the paper, which describes our approach to subsidized credit allocation in Kenya.
A CREDIT ALLOCATION PROGRAM FOR KENYA

Brief Profile of Kenyan Economy

The economy of Kenya, similar to that of most other low-income countries, is dominated by small-scale agriculture and its informal sector. Total employment in the country as of the most recent 2005/06 survey is 12.1 million, with another 1.4 million openly unemployed. Of those that are employed, 50 percent are engaged in agricultural self employment, 36 percent are in the informal sector, and only 14 percent are in the formal sector.

In terms of employment and poverty, the fundamental problem in Kenya is not unemployment per se or even low hours per se. It is rather that the majority participating in the labor force is indeed working—mostly more than 40 hours per week—but their income from work is very low. Of all Kenyans outside of agricultural self-employment who are participating in the labor force but are unemployed, roughly 65 percent live in poverty. However, the proportions living in poverty are basically the same if a Kenyan is employed and working up to 39 hours per week. Specifically, for those working 1-27 hours per week, nearly 70 live in poverty. Among those working 28 – 39 hours per week, about 66 percent live in poverty.\(^6\)

Among the labor force participants working 40 hours or more per week, the percentage living in poverty does go down, to 46.1 percent. Still, this percentage remains very high. But it is also important here to recognize that a large majority of Kenyans do work 40 hours or more per week. This means, in turn, that even though the chances of living in poverty in Kenya do go down somewhat if one works 40 hours or more per week, it is still the case that the overwhelming proportion of labor force participants in Kenya who live in poverty are also working 40 hours or more per week.\(^7\)

It will also be informative to get a profile of household enterprises in Kenya, which are the dominant form of business enterprise outside of agriculture. Household enterprises can be either informal or formal, and do sometimes operate outside of the home and with several employees. But about 90 percent of household enterprises are informal. More than 80 percent of all household enterprises are providing some service,

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\(^6\) The poverty thresholds on which my colleagues and I based these calculations are from the 2005/06 Kenya Integrated Household Budget Survey (KIHBS). This study measures consumption poverty while the figures we are relying on are employment income figures only. Thus, people could have higher levels of consumption than income through non-labor sources of income and receipt of in-kind consumption goods. Thus, these calculations should be seen as only broadly indicative, not precise calculations of Kenyan poverty rates.

\(^7\) Our approach to studying the Kenyan labor market proceeds very much in the tradition advanced by Professor Hans Singer and his collaborators in their classic 1972 work for the ILO, *Employment, Incomes, and Equality: A Strategy for Increasing Productive Employment in Kenya.*
mostly retail sales. Total employment in these enterprises is 5.2 million, of whom 80 percent are in informal businesses. On average, earnings for these activities are very low. The median level of earnings, at Ksh 2,370/month, is at a level between the poverty line figures for Kenya’s urban and rural regions. And this level of income typically will be used to support more than one person, often an unpaid family member also working in the business.

Especially pertinent for our discussion are the figures in Table 1. This shows the sources of start-up credit for household enterprises. As we see, 80 percent of household enterprises depend almost entirely on their own savings, gifts, or sales of existing assets to start their businesses. Only 3 percent receive funds from Savings and Credit Cooperative Societies (SACCOs), which, as we will discuss more below, are the predominant form of microfinance enterprise in Kenya. Credit from banks or other formal financial institutions is almost non-existent.

TABLE 1 BELONGS HERE

This is the background in which my colleagues and I have developed an employment-targeted economic program for Kenya. Our proposal has a range of components, including large-scale investments in roads and water infrastructure, much higher levels of support for agricultural extension services and marketing cooperatives, more expansionary monetary policy, inflation control interventions through food buffer stocks and incomes policies, and a crawling peg exchange rate regime to promote exports especially within Sub-Saharan Africa itself.

Our proposal for subsidized credit is thus one component of an overall approach. But it is a central feature of the overall strategy. It is the most effective means of expanding opportunities for small-scale enterprises, which would in turn allow for productivity gains through economies of scale. It would also bring an increase in the formalization of these enterprises, since, with opportunity to receive credit subsidies, businesses could have an incentive to then also pay taxes and become registered. The increased tax revenues would then be used to finance the subsidies, as well as the other measures we are proposing. If the average size of these firms is able to increase, it would then also mean an expansion in higher-productivity wage employment. This would mean a contraction in the number of people trying to earn a living through small-scale enterprises, which in turn would reduce competition among the now 2 million such firms.

Whether this is all viable depends on establishing a system of subsidized credit allocation which builds on the positive features of both the Grameen-type microfinance model and the large-scale development banking model with reciprocal controls and performance standards. How we propose that this be accomplished is thus the next question at hand.

Kenya’s Financial System
Kenya’s financial system already has some important positive features. These include:

1) Kenya’s commercial banking system is generally well-developed, and by some standard performance measures, is more focused on lending to the private sector than is the case in other sub-Saharan African countries.

2) Kenya is developing as a regional financial center, with emerging securities markets.

3) Kenya has a widespread system of micro-finance institutions (MFIs) already in place and operating. SACCOs are the most important of these institutions. But there are others, both formal and informal, client- and member-based. These include institutions such as the the KREP bank (formal, client-based) and ROSCAs (Rotating Savings and Credit Associations (informal member-based).

Despite these positive features, the contributions of the financial system to promoting economic growth, employment expansion and poverty reduction are inadequate. The main reasons for this inadequate performance are as follows:

3) The commercial banking system lends more than one-third of its deposit base to the government. This of course reduces the availability of funds for businesses, especially small-and-medium enterprises (SMEs) and small farmers.

4) More generally, the farming, SME and informal sectors are starved for credit. This is due to the fact that a) commercial banks do not generally lend to these sectors; and b) the SACCOs and other MFIs do not have sufficient resources to provide large-scale funds. Moreover, the largest share of the lending done by the MFIs is for personal household purposes or family emergencies.

Given this combination of positive and negative features of the Kenyan financial system, the solution to the problem, at a fundamental level, seems straightforward: to somehow bring into much closer alliance the formal commercial banking system and the MFIs. In fact, proposals along these lines have been suggested by, among others, the World Bank in a 1994 study on Kenya specifically, and the International Monetary Fund in a more general 2005 study on sub-Saharan African finance. This idea has also been raised in some previous research papers by Kenyan scholars (e.g. Atieno 2001). What remains is to flesh out a large-scale program that could be realistically implemented on a short-term basis, but that is also capable of enabling a longer-term transformation of the Kenyan financial system. The proposal that we present here will create a pool of subsidized credit at a level equal to roughly 20 percent of the current level of private investment in Kenya; with a cost to the government of about five percent of the fiscal budget.
This clearly would be a large-scale public subsidy program. At the same time, as I describe below, the program retains a system of market incentives and risks. Indeed—keeping Amsden’s imperatives for successful credit allocation programs in mind—the primarily reciprocal system and performance standard will be the market risks and rewards themselves. However, these risks and rewards will be established within a socialized market setting. As we will see, the loan guarantee program will dramatically lower the level of risk for commercial banks and MFIs who participate in the program. The interest rates charged to borrowers will therefore have to fall commensurately. Beyond this, I also present an incentive-based system for minimizing opportunities to profitably defraud the system.

Basic Features of the Loan Guarantee Proposal

The proposal is for a large-scale policy intervention to link the formal commercial banking system with the SACCOs and other micro finance entities. The MFIs are much more capable of making loans to small businesses, farmers, and the informal sector—and can utilize more flexible systems of collateral for such loans.

As we noted above, something along these lines has been proposed in at least some documents of both the IMF and World Bank (see Sacerdoti 2005 on about Sub-Saharan African finance in general and Fafchanps el al 1994, p. 88).This point is also the main policy conclusion of the excellent 2001 paper by Atieno on Kenya’s financial system. Atieno also intriguingly reports that loan guarantee programs are already being implemented in Kenya, though she does not supply sufficient details. For example, she writes a program of Barclays Bank that offers loans for women entrepreneurs both as individuals and as groups.

Key Details of Proposal

We propose a loan guarantee fund similar to the one that Atieno reports Barclays Bank had been operating on a small scale. That is, we propose a loan guarantee system, in which the government offers commercial banks something on the order of a 75 percent guarantee on loans that they make to SACCOs and other micro finance entities. The commercial banks would have to demonstrate that the SACCOs are capable of making business loans, rather than simply emergency loans and personal loans.

For the program of this sort to be successful at promoting decent employment and reducing poverty, it needs to operate at a large scale. Of course, any such program will need to be phased-in gradually. But as a matter of principle, it is important to show that it could operate at a large scale without placing excessive strains either on the government budget or the capacities of the financial system.

Scale of operation. Consider a program of roughly the following scale when fully operational. Private investment in Kenya in 2004 (the most recent year with non-provisional GDP data) was roughly 15 percent of GDP.
2004 GDP in Market Prices = ksh 1.3 trillion
2004 Gross Private Domestic Investment = ksh 200 billion

Let us assume that the loan guarantee program is roughly equal to 20 percent of 2004 GPDI of ksh 200 billion. Thus,

Total loans being guaranteed = ksh 40 billion (in 2004 prices)

Following the model from Barclay’s Bank (as reported by Atieno 2001), lets assume that loans are guaranteed at a 75 percent rate. That means that the government is guaranteeing ksh 30 billion in loans.

Let us also assume a default rate on these loans of 30 percent. This is a very high rate, roughly equal, in fact to the actual “alarming” rate reported for 2004 in what had been a confidential memo prepared by former Central Bank Governor Andrew Mullei to former Finance Minister David Mwiraria. According to the official District Annual Reports, the default rates on SACCOs between 2001 – 2005 ranged between 2.8 - 7.5 percent. For the purposes of our exercise, we deliberately assume a very high default rate. This establishes a plausible outer limit of the costs of the loan guarantee program.

Working with an assumption of a high default rate also underscores a key point of this proposal: that for commercial banks to make loans to micro finance entities will entail real risks. Indeed, that the initiative will not be useful unless the commercial banks are willing to accept greater risks, and thus, the reality that defaults will occur. At the same time, precisely because the banks will have a large share of their own funds committed to the guaranteed loans, they will operate with care in entering arrangements with micro-finance enterprises, even though 75 percent of their loans would be guaranteed by the government.

The cost to the to government of 75 percent guarantee with 30 percent default rate on 40 billion in guaranteed loans can be calculated as follows:

\[ ksh\ 40\ b\ \times\ 0.75\ \times\ 0.3 = ksh\ 9\ billion \]

Thus, the direct annual expense of the guarantee program of this magnitude, and building in the assumptions that we have would amount to ksh 9 billion per year. The total government budget for 2004 was ksh 188.9 billion in 2004 prices. Thus, at the 2004 level of economic activity and government spending, the loan guarantee program, at full operations, would be equal to somewhat less than 5 percent of the Kenyan general government budget. If we allow for a lower default rate, at, say 15 percent, then the costs of the loan guarantee program correspondingly fall, to ksh 4.5 billion.

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8 “Three out of 10 Debts Gone Bad as ‘Serial Defaulters’ Run Amok in Kenya’s Banks,” 8/3/06.
**Extent of Credit Subsidy**

The terms of the subsidy must meet four criteria:

1. Subsidies must be large enough such that the program will succeed in building the necessary links between the commercial banks and the SACCOs and other micro-finance institutions.

2. The program must still be seen as providing potential profit opportunities for both commercial banks and the micro-lenders;

3. The loan terms must be broadly consistent with the structure of interest rates, rewards, and risks within the Kenyan financial market as it currently operates; and

4. The terms must be understood simply by participants in the financial system.

A logical starting point for establishing an appropriate interest rate on subsidized loans is the government bond rate. With respect to default risk, government bonds are the least risky asset within the Kenyan financial system. At the same time, the Kenyan government bond rate reflects everything about the general level of risk in Kenya, including both inflation risk and country risk.

A subsidized loan from a commercial bank to a micro-credit lender would also incorporate general levels of country risk and inflation risk. The default risk on a subsidized loan would then depend on 1) the credit profile of the individual borrower; and 2) the extent of the loan guarantee. Based on this, the rate on concessionary loans should be set as an increment above the government bond rate. How large an increment above the government bond rate should then depend on the borrowers’ profile and on the extent of the government guarantee on loans.

To make this clearer, we can stipulate that a government bond issue in shillings faces virtually zero default risk. Thus, the interest rate on a private loan with a 100 percent guarantee should be set at exactly the government bond rate. By contrast, the appropriate rate on a loan with no guarantee is, by definition, the market interest rate on that loan. As such, the government bond rate and the market interest rate define the range within which concessionary rates should be set.

The appropriate concessionary rate can therefore be derived simply as follows:

\[ l^{lg} = i^{m} - LC, \]

where

\[ LC = C(i^{m} - i^{b}), \]
and $i^{lg}$ is the rate on loan guarantees, $i^{m}$ is the market interest rate for a loan of a given risk class and maturity, $C$ is the percentage of a loan that the government is guaranteeing, and $i^{b}$ is the government bond rate for a given maturity.

To illustrate this calculation with an example, consider a case, which closely approximates actual Kenyan financial market conditions in July 2007, in which the government 3-year bond rate is 8 percent, and the commercial bank rate is 13 percent. In such a case, and assuming a 75 percent loan guarantee program, the concessionary loan rate $i^{lg}$ would be 9.25 percent.

Of course, the concessionary loan rate would rise if the government guarantee were less. Thus, if we assume that the loan guarantee is 50 percent rather than 75 percent, the concessionary loan rate rises to 10.50 percent.

For the program to operate successfully, the subsidized lending rate that commercial banks make to SACCOs and other micro-finance institutions would then also have to be incorporated into the rate at which the SACCOs themselves make retail loans to small businesses and farmers. Establishing the details of this retail lending rate would have to take account of the specific operations of the micro credit units, including the means through which they establish collateral. Given the large number of micro-credit units operating in Kenya, it may be possible that establishing appropriate spreads for subsidized retail lending rates could result through market competition alone. This is a matter to consider in detail later. For now, it is sufficient to recognize the basic principles presented here on which subsidized lending—at both the wholesale and retail levels—should be established.

C **Creating Disincentives for Fraud**

The obvious way to defraud the system of loan guarantees is for borrowers and lenders to collude in obtaining guaranteed loans from the government, then deliberately defaulting on these loans to collect the government guarantee. As colluders in such an enterprise, the borrower and lender would then share the government guarantee payment.

As a simple example, consider a case in which a commercial bank makes a ksh 1,000 loan to a SACCO, which then will purportedly lend the money to small business owners. But in fact, the commercial bank and SACCO are colluding to collect funds from the SACCO defaulting on the loan. Once the default is accepted as legitimate by the government, the government is then obligated to pay the commercial bank ksh 750, assuming a 75 percent guarantee on the loan. The borrower and lender can then split these funds. Of course, commercial bank and SACCO would have also earlier worked out an arrangement for sharing the 1000 in fraudulent “loan funds.”

A loan guarantee system can be designed to minimize such opportunities for fraud. The first type of disincentive would entail creating an escrow account on the loan, to be held by the government. Once establishing such an escrow fund, this fund can be
used to minimize the incentives for fraud. Thus, if the loan does not go into default, then the escrow funds are released to the borrower when the loan matures. But if the loan does go into default, the government only releases the escrow account funds back to the commercial bank after the conditions of the loan default have been investigated. In addition, this set of incentives can be combined with strict penalties for fraud as well as rewards for people who discover and report on such schemes. We now illustrate these considerations through the following example. We present this example in Table 2.

TABLE 2 BELONGS HERE

As the table shows, the main parameters of this case are as follows:

1. Amount of Loan: ksh 1,000
2. Terms of Loan: 5 years at 5 percent annual simple interest.
3. Government Guarantee: 75 percent of principle on loan
4. Escrow Account: SACCO contributes ksh 100; commercial bank contributes 200 ksh
5. Amount of Funds for SACCO Expenditure: ksh 800

**No Default Case.** With this loan, if there is no default, the SACCO pays ksh 50 per year in interest plus repaying principal. At the end of 5 years, the SACCO also receives the ksh 300 (plus accrued interest) on the escrow account.

**Default Case.** SACCO is out ksh 100 of own money, plus opportunity to receive the 200 ksh additional money in the escrow funds. The commercial bank is out ksh 250, receiving ksh 750 in government guarantee.

**Incentive to defraud the system.** Assume the SACCO and commercial bank are in a conspiracy to defraud the government of the ksh 750 of the loan guarantee. Their arrangement is that each will receive half of the money coming from the government guarantee, i.e. each receives ksh 375 from loan guarantee.

The net outcomes are as follows:

SACCO: Nets ksh 275 (= ksh 375 from guarantee – ksh 100 contribution to escrow)

Commercial bank: Nets ksh 175 (= ksh 375 from guarantee - ksh 200 to escrow).

This incentive to defraud the system could be large enough to encourage this type of fraudulent operation. If so, aside from the punishments to be faced if the fraud were discovered (more on this below) the way to weaken such incentives would,
straightforwardly, entail some combination of either (1) reducing the level of the guarantee; or (2) increasing the escrow fund obligations for both the borrower and lender.

If we assume that the guarantee is only 50 percent of the loan, but the escrow commitment remains the same, the incentives reduce to the following:

Borrower: Nets ksh 150 (= ksh 250 from guarantee - ksh 100 contribution to escrow)
Lender: Nets ksh 50 (= ksh 250 from guarantee - ksh 200 contribution to escrow)

We go through these two examples in Table 2.

From these examples, we can see that by reducing the size of the guarantees or increasing the amount of the escrow commitments, incentives for fraud become diminished. But by pursuing such measures, one also obviously weakens the benefits to be accrued from the loan guarantee program, and thereby the prospect that the program could be used as a major financing tool contributing to economic growth and employment expansion.

**Incentive-based monitoring.** The way to sustain a more expansionary loan guarantee program—i.e. including a higher guarantee ratio and lower escrow contribution ratios—is to also create severe penalties for fraud along with strong incentive for “whistleblowers” to report abuses of the system. This means mobilizing incentives to monitor the system rather than relying primarily on government investigators to prevent fraud. This approach to monitoring financial market regulations was developed by Dean Baker (2003) with respect to the so-called Tobin Tax—a tax on speculative transactions in global currency markets. A variation on Baker’s idea could be applicable here. For example:

In the case of a ksh 1,000 loan with a 75 percent guarantee:

1. Minimum penalty to commercial bank for gaming the system: “treble damages”—i.e. ksh 2,250
2. Reward for whistleblowing: Full amount of guarantee—i.e. ksh 750

In addition, both the commercial bank and SACCO would lose their licenses to operate.

Through combining the escrow system with the incentive-based monitoring approach, it should be possible to establish a workable set of incentives in place to operate the loan guarantee program.  

**Additional Financial Market Reform Initiatives**

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9 These views are consistent with the concern expressed by the World Bank that credit guarantee systems also maintain workable methods of contract enforcement.
A loan guarantee program of this sort is both feasible and highly desirable for Kenya, and indeed can serve as the foundation for linking Kenya’s well-developed commercial banking system with its similarly well-developed micro-lending institutions. But operating on its own, this measure will not be sufficient to move Kenya’s financial system onto a sustainable developmental path. Other initiatives will also provide important support. Among those that we discuss in Pollin et al. (2007) are establishing reliable private credit-rating operations and revitalizing public investment banks. The approach that we take with the public investment banks here is parallel to the loan guarantee programs operating through the commercial banks and MFIs. That is, we propose that the public investment banks operate as public/private partnerships, to maintain both a large subsidized component as well as private initiative and risk-taking.

Conclusion

The achievements of the microfinance movement pioneered by Muhammed Yunus and the Grameen Bank are real and significant. The Grameen model has brought new opportunities for poor women to earn independent livelihoods and has initiated new thinking on how to establish collateral among the world’s poor. It has also emphasized the role of finance more generally in advancing the well-being of the poor. At the same time, considered on an economy-wide basis, the achievements of microfinance institutions appear to be modest, especially in comparison with the macro-finance developmental policies that were successfully implemented in the countries that Amsden has termed “the rest.”

This paper has explored the relative contributions of micro- and macro-finance institutions as policy approaches for fighting mass poverty promoting decent employment. Drawing from this discussion, the paper then focuses on conditions in Kenya, one of the poorest countries in the world, but one that already has the both most extensive system of microfinance institutions in Sub-Saharan Africa as well as a sophisticated commercial banking system. The paper has explored ways in which these existing microfinance and commercial banking institutions in Kenya might be more successfully integrated and mobilized to promote decent employment creation and poverty reduction. The key idea is to synthesize features of microfinance along with a large-scale subsidized credit allocation program. The credit allocation program would utilize market incentives in establishing effective control mechanisms and performance standards for subsidy recipients. This discussion on Kenya’s situation can perhaps encourage further thinking beyond this particular case on ways to make large-scale subsidized microfinance a more effective tool for fighting mass poverty in developing countries.
REFERENCES


Table 1
Sources of Start-up Credit for Kenyan Household Enterprises

<table>
<thead>
<tr>
<th></th>
<th>Own savings</th>
<th>Family loan or gift</th>
<th>Sale of existing asset</th>
<th>SACCO</th>
<th>Bank, Financial Institution</th>
<th>Money Lender</th>
<th>Other</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>52.3%</td>
<td>21.8%</td>
<td>6.1%</td>
<td>3.2%</td>
<td>0.7%</td>
<td>0.4%</td>
<td>15.5%</td>
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</tbody>
</table>

Source: 2005/06 Kenya Integrated Household Budget Survey (KIIHBS)
Table 2.
Numerical Example on Collateral and Escrow Fund

*Loan Terms: Ksh 1000, 5 years at 5 percent*

*Government Guarantee: Varies, 75 percent versus 50 percent*

*Escrow Contributions: Constant at 10 percent borrower; 20 percent lender*

*(figures are in Kenyan shillings)*

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantee</td>
<td>750</td>
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<tr>
<td>Escrow</td>
<td></td>
</tr>
<tr>
<td>Total escrow</td>
<td>300</td>
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<tr>
<td>Borrower contribution</td>
<td>100</td>
</tr>
<tr>
<td>Lender contribution</td>
<td>200</td>
</tr>
<tr>
<td>If default, govt. pays</td>
<td>750</td>
</tr>
<tr>
<td><strong>Net gains from fraud</strong></td>
<td></td>
</tr>
<tr>
<td>Borrower gain</td>
<td>275 (=375 - 100)</td>
</tr>
<tr>
<td>Lender gain</td>
<td>175 (=375 – 200)</td>
</tr>
</tbody>
</table>