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“Financial inclusion does not come easily”

An institutional analysis of the development of the microfinance markets

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Award date:
2012

Awarding institution:
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**“Financial inclusion does not come easily”:
An Institutional Analysis of the Development of the Microfinance Markets
in Bosnia and Uganda between 1997 and 2007.**

Ruth Goodwin-Groen

A thesis submitted for the degree of Doctor of Philosophy

University of Bath

School of Social and Policy Studies

May 2012

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List of Acronyms

AfDB	African Development Bank
AFI	Alliance for Financial Inclusion
AFD	L'Agence Française de Développement
AMFIU	Association of Microfinance Institutions of Uganda
ASCA	Accumulating Savings and Credit Association
AsDB	Asian Development Bank
ATM	Automated Teller Machine
AusAID	Australian Agency for International Development
BAM	Bosnian Mark
BoU	Bank of Uganda
BRAC	Bangladesh Rural Advancement Committee
CBBiH	Central Bank of Bosnia and Herzegovina
CEO	Chief Executive Officer
CGAP	Consultative Group to Assist the Poor
CKR	Central Kredit Registry
CMF	Centre for Microfinance
CPI	Corruption Perception Index
DANIDA	Danish International Development Agency
DFCU	Development Finance Company of Uganda
DFID	Department for International Development (UK)
DIA	Deposit Insurance Agency
DM	Deutsch Mark
DP	Democratic Party
DPA	Dayton Peace Agreement
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EFSE	European Fund for Southern Europe
EU	European Union
FAULU	The Swahili verb meaning 'to flourish'
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
FEX	Foreign Designed and Exogenously Introduced
FIA	Financial Institutions Act
FIEG	Financial Inclusion Experts Group of the G20
FINCA	Foundation for International Community Assistance
FOCCAS	Foundation for Credit and Community Assistance
FSAP	Financial Sector Assessment Programme
FT	Finance Trust
FX	Foreign Exchange
G20	Group of 20 (leading economies)
GDP	Gross Domestic Product
GoU	Government of Uganda
GTZ	Gesellschaft für Technische Zusammenarbeit (German Technical Cooperation)
HDI	Human Development Index
IAS	International Accounting Standards
ICRG	International Country Risk Guide
ICTY	International Criminal Tribunal for the former Yugoslavia
ID	Identity Document
IDA	International Development Association

IEN	Indigenously Designed and Endogenously Introduced
IEX	Indigenously Designed and Exogenously Introduced
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
INGO	International Non-Government Institution
IRIS	Institutional Reform and Informal Sector
KfW	Kreditanstalt für Wiederaufbau (German Reconstruction Credit Institute)
KM	Konvertible Mark
LIBOR	London Interbank Offer Rate
LID	Local Initiatives Department
LIP	Local Initiatives Project
LSMS	Living Standards Measurement Study
MED-Net	The Micro Enterprise Development Network
MCC	Microfinance Competence Centre
MCO	Micro-Credit Organization
MDGs	Millennium Development Goals
MDI	Micro Finance Deposit-Taking Institution
MEB	Micro Enterprise Bank
MFF	Microfinance Forum
MFI	Microfinance Institution
MFNGO	Microfinance Non-Government Institution
MIX	Microfinance Information Exchange
MoFPED	Ministry of Finance, Planning and Economic Development
MOP	Microfinance Outreach Plan
MSCL	Microfinance Support Centre Limited
MTR	Mid-Term Review
NBFI	Non-Bank Financial Institution
NBY	National Bank of Yugoslavia
NIE	New Institutional Economics
NGO	Non-Government Organization
NORAD	Norwegian Agency for Development
NOVIB	Netherlands Organization for International Assistance
NPART	Non-Performing Asset Recovery Trust
NPL	Non-Performing Loan
NRM	National Resistance Movement
OHR	Office of the High Representative
OZNa	Secret Police in the former Yugoslavia
PAR	Portfolio At Risk
PEAP	Poverty Eradication Action Plan
PMA	Plan for the Modernisation of Agriculture
PMT	Performance Monitoring Tool
PRESTO	Private Enterprise Support Training and Organizational Development
PRSP	Poverty Reduction Support Programme
RFSP	Rural Financial Services Programme
ROSCA	Rotating Savings and Credit Association
RS	Republika Srpska
RMSP	Rural Microfinance Support Project
SACCO	Savings and Credit Cooperative
SIDA	Swedish International Development Agency

SME	Small and Medium Enterprise
SOE	State Owned Enterprise
SOMED	Support Organisation for Micro Enterprises Development
SPEED	Support for Private Enterprise Expansion and Development
SUFFICE	Support to Feasible Financial Institutions and Capacity building Efforts
TI	Transparency International
UCA	Ugandan Cooperative Alliance
UCB	Uganda Commercial Bank
UCSCU	Uganda Cooperative Savings and Credit Union Limited
UCSS	Uganda Credit and Savings Society
UGAFODE	Ugandan Agency for Development
UMU	Uganda Microfinance Union
UNC	Uganda National Congress
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UPC	Uganda People's Congress
UPU	Uganda People's Union
USAID	United States Agency for International Development
USD	United States Dollars
UWFT	Uganda Women's Finance Trust
VAT	Value Added Tax
VSLA	Village Savings and Loan Association
WGI	Worldwide Governance Indicators

Acknowledgements

I am deeply grateful to my respondents in Bosnia and Herzegovina, and in Uganda. You all gave freely of your time in sharing struggles, successes and insights – thank you so very very much. What I learned from you has already contributed to increasing financial inclusion. I hope that this study will, in turn, enable you to build more inclusive, responsible, financial systems in your respective countries and that you will continue to make a difference in your clients' lives. Particular thanks to my local colleagues in Sarajevo, Banja Luka and Kampala for your advice, assistance and humour.

I could not have had a better guide on this difficult journey than my supervisor, Susan Johnson. Your rigor and wisdom enabled me to see the forest of policy and theory when I was stuck in the trees of detailed findings. Your consistent encouragement enabled me to persevere – thank you more than I can say.

To all my family, friends and colleagues, too numerous to mention, your unfailing support in many different ways has meant so much - a heartfelt thank you.

This thesis is dedicated to Paul, my beloved. You are living proof that even in the darkest times - love is patient, love is kind, love always trusts, always hopes, always perseveres.

Abstract

Microfinance has grown from a niche development intervention in the 1990s to one that commands global influence and donor support. By 2006 microfinance had become part of financial sector development policy through the concept of financial inclusion. At the same time theoretical analysis of economic development increasingly focused on the role of institutions and getting institutions right - including for the financial sector – which has given rise to attempts to theorize gradual institutional change.

This convergence of policy, and theoretical emphasis on institutions, raises the central question as to what institutions and institutional changes are necessary for the financial sector to effectively serve poor people. The experience of microfinance sector growth over a decade in two countries has been investigated using a ‘micro-ethnographic’ methodology to respond to this question.

The research finds that a focus on institutional functions rather than institutional forms aids definitional precision and allows comparability across markets. Social norms underpinned the development of institutional functions, as theories of social embeddedness suggest. These norms also became integrated into institutional functions through the process of change, adding to critiques of externally imposed ‘best practice’ institutional blueprints. Further, beyond the widely accepted institutional functions which the rest of the financial market needs to operate efficiently, this research highlights the importance of a constitutional function (or law) to include poor people in the formal financial system, appropriate supervision for microfinance providers and support for the development of microfinance.

Recent theories of institutional change offer insights beyond path dependency in identifying spaces for change and how changes will ‘stick’. However, to better analyse change at the level of particular institutional arenas, greater elaboration is needed of: how to incorporate multiple sets of agents (including external development agents) and multiple institutional functions; appropriate time-frames for analysis and processes of actor engagement.

Chapter 1: Introduction

From the early 1990s, the microfinance sector grew from a niche development intervention to one that commanded increasing influence and donor support, extending its outreach to 100 million of the world's poorest families in 2007 (Daley-Harris, 2009 p.3). The potential of microfinance to achieve both financial sustainability and poverty reduction meant it was congruent with the prevailing Washington Consensus principles over those years. However, with approximately 2.5 billion people still excluded from financial services (CGAP 2009), in 2006 donor policy on microfinance shifted towards incorporating it into broader financial sector development policy through the concept of financial inclusion (Helms 2006, UNCDF 2006). This signaled the recognition that the formal financial sector needed to provide all people, including poor people, with financial services, as the microfinance sector had proven this could be done in financially viable ways. Even though rigorous evidence of the poverty reduction impact of microfinance - in particular microcredit - has been limited, financial sector reforms that promote inclusive access to financial services are still at the core of the development agenda (Demirgüç-Kunt, Beck and Honohan 2008 p.2).

At the same time theoretical analysis of economic growth and development has increasingly focused on the role of institutions. As Chang notes, "from the late 1990s ...institutions have moved to the centre stage in the debate on economic development" (Chang 2011 p. 473) and "getting institutions right" (Rodrik 2008a p. 100) has increasingly been emphasized in policy. Financial sector development policies have themselves been centrally influenced by this institutional focus with particular emphasis on the effectiveness of legal and regulatory frameworks as well as the wider institutional environments needed for financial sector development to support economic growth.

Given this new policy focus and theoretical emphasis, a key issue that arises is what institutions and approaches to institutional development are necessary for the financial sector to effectively serve poor people. This research sets out to examine this issue at the intersection of institutional analysis, financial market development and microfinance. It does this by examining the experience of two countries where the development of the microfinance market was relatively successful by 2007 and which had been strongly supported by donors for a period of ten years. The research investigates the development of these markets using institutional analysis in order to identify what institutions have influenced their development and how institutional change has occurred.

This chapter starts with an overview of two areas of financial sector development policy which have converged in the late 2000s. Microenterprise credit was a small corner of international development practice twenty years ago, but microfinance in the form of a financial inclusion agenda (as a broad range of financial services that poor people need - savings, credit, payments and insurance) has now become a focus of the Group of 20 leading economies' (G20) policy making since 2009. However, since many of the origins of poor people's exclusion lie in key historical challenges and policy failures in developing the financial sector, the trajectory of policy in this sector is reviewed in the second section.

Analysis has made it increasingly clear that the underlying institutional framework is a key feature of deficiencies in economic development. I therefore turn to the role of institutions in the third section – introducing and discussing the emergence of this line of theory and analysis and its relation to financial sector development. Starting with the role of institutions in economic growth the discussion covers the complex relationship between financial market development, economic growth and poverty reduction and concludes with the importance of sound institutions for financial development. Further, given that attempts at creating institutional change have been a key feature of development policy, I briefly assess the dominant method of institutional change undertaken to support such development, that is, institutional “blueprints” (Evans 2004 p. 30). This is the practice of identifying (so called) best practice institutional forms from developed economies and transferring them to developing economies.

This review of financial sector policy development, alongside the emergence of institutions as a central analytical approach and focus of much policy implementation, frames the research questions of this thesis at the intersection of these three areas which is a gap in current research. A chapter by chapter overview of the rest of the study then shows how the research questions have been addressed.

1.1 Microfinance policy: from microcredit to financial inclusion

Microfinance policy originated in Non-Government Organization (NGO) promoted microenterprise credit schemes over twenty years ago and now encompasses multilateral statements on financial inclusion. This section explains how it grew from a specific niche in international development practice to become central to the global development agenda despite extensive debate over its effectiveness in reducing poverty.

Poor people in developing economies have a long history of indigenous forms of savings and lending - from rotating savings and credit associations, to *susu* collectors, burial funds and money lenders (Rutherford 2000)¹. Adams and Fitchett (1992) are among those who document the many different forms of informal finance and recognize that “informal finance makes an important contribution to development” (*ibid* p.1). The potential to develop financial services for poor people in developing economies (largely based on informal financial mechanisms of group-based financial intermediation) was quickly recognized when NGOs in South Asia and Latin America reported that groups of women micro-entrepreneurs typically paid back on-time when lent small sums of money (e.g. Khandker, Khalily and Khan 1994, Otero and Rhyne 1994). Funders started supporting the provision of “microfinance”, based on the logic that access to financial services enables poor and low-income people

¹ Rural and urban moneylenders differ in that, in rural areas, moneylenders tend to accept less regular repayments because their clients (usually farmers) earn income in irregular, though larger, increments than do urban workers such as market traders. Moreover, the close community ties that exist in rural areas make it easier for moneylenders to trust their clients because they know them and their families so well. (Rutherford 2000)

and their families to make everyday decisions about schooling, healthcare, inventory for a microbusiness or home repair so they can “chart their own paths out of poverty.” Helms (2006 p.1) ^{2 3}

The two simple ideas that inspired the development of the microfinance sector, were poor households’, particularly poor women’s, ability to profit from access to finance and financial institutions’ ability to profit from serving poor people (Armendáriz and Morduch, 2005 p.16). These ideas were consistent with key principles of the Washington consensus (Williamson, 1990 and 2003) including: *privatization* - as the private sector would provide the financial services to poor people, and private businesses would be funded and poor people would help themselves; *liberalization of interest rates* - as financial service providers needed to be free to set interest rates that would cover the cost of serving poor people and; *deregulation* - as a range of different financial service providers were needed to reach poor people not just government or commercial banks. Microfinance neatly conformed to the zeitgeist of bilateral and multilateral funders’ policies.⁴

To bring together best practice knowledge on how to fund microfinance, donors developed guiding principles for selecting and supporting microfinance providers, based on business principles (World Bank, 1995) and founded the Consultative Group to Assist the Poorest (CGAP) in 1996, housed at the World Bank. CGAP was an independent policy and research center dedicated to advancing financial access for the world's poor.⁵ By 1997 there was an upsurge in donor funding for the microfinance sector (Helms 2006) ⁶ with a focus on funding individual microfinance organizations to reach scale and sustainability (CGAP 1998). The World Bank’s revised policy in 1998 for financial sector operations referenced the development of microfinance schemes (Weber 2006 p.50) and Robinson (2001) documented the paradigm shift from subsidized credit for poor people to the development of sustainable financial intermediaries. Examples of sustainable microfinance include: a government-owned and prudentially regulated bank, Bank Rakyat Indonesia - “one of the most successful microfinance institutions in the world” (Patten *et al* 2001 p. 1057); village-level self-reliant savings cooperatives in Mali - providing rural finance in low density regions (Chao-Bérouff, 1999); and in Bangladesh the Safe-Save NGO proved the value of a savings-led approach for very poor clients (Rutherford, 1999, 2004) and the Bangladesh Rural Advancement Committee (BRAC) NGO, with 8.4 million depositors in 2009, had the largest number of microfinance depositors of any self-selected microfinance organization in the world (Bangladesh Rural Advancement Committee 2009).

² Nancy Barry was President of Women’s World Banking (WWB) between 1990 and 2006 explained “that over 500 million poor people, especially women, needed credit and savings services for their tiny enterprises (selling milk, mending bicycles or sewing clothes), and could “repay market-based loans, and use the proceeds to increase their assets, their living standards and their roles in shaping societies” (Barry 1995 p 1)

³ To illustrate the contribution of credit to poverty alleviation, heart-warming stories of women microentrepreneurs who used their small loans to increase their income and educate their children were frequently used by practitioners. The 1997 Microcredit Summit is one of the leading exponents of this art form. (<http://www.microcreditsummit.org/video/odette.htm>).

⁴ More detailed histories of the origins of microfinance can be found in Helms (2006) and Roodman (2010).

⁵ Poor was changed from poorest and CGAP is now supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty.

⁶ When funding agencies time horizons are shortened, ‘proven’ approaches (conditional cash transfers, micro-credit) in one context are expanded and replicated elsewhere and pressures mount for clear metrics of ‘success’ (because ‘what gets measured is what gets done’). Woolcock 2009b p. 11

The early messages on developing regulatory structures for microfinance were that there was no need for prudential oversight of credit-only MFIs and that savings, when taken as collateral, also did not need to be supervised (Otero, Rosenberg and Rock, 1996, Christen and Rosenberg 2000). In my experience with the donor community funding microfinance in the late 1990s, this was a commonly held assumption, because their focus was on improving microfinance performance first, not developing legal frameworks. However, this hands-off approach to regulation was later criticized as being a feature of microfinance's serviceability to the neo-liberal⁷ or libertarian agenda, emphasising free markets to reduce poverty (Weber (2006) Karnani (2009), Bateman and Chang (2009)). It was argued that microfinance had become part of the drive towards financial sector liberalization and commercialization and, accordingly, there was insufficient emphasis on legal, regulatory mechanisms and the role of the government to protect the poor as vulnerable consumers. This was a valid critique, but it also missed the pragmatism of Christen and Rosenberg's (2000) caution. Christen and Rosenberg had worked extensively with Central Bankers in Latin America in the aftermath of their regional banking crises who did not want to regulate what they could not supervise, and regulators had no hope of effectively supervising the many NGO Microfinance Institutions (MFIs). (*ibid* p.2)

The convergence of microfinance sector development and broader financial sector policy can be seen coming together in 2005. Armendáriz and Morduch (2005) noted that the world of the microfinance practitioner had largely been separate from that of academic researchers. So when, at the UN International Year of Microcredit conference in New York in 2005, researchers had the opportunity to explain to practitioners how "overall financial development matters for economic success" (Demirgüç-Kunt and Levine, 2001, p.12) and that "that finance-intensive growth (at least measured by banking depth) is empirically associated with lower poverty ratios" (Honohan, 2004 p.30) there was a realization they had a common goal of increasing financial depth, increasing access to financial services for poor people and of overcoming financial exclusion⁸. Financial

⁷ According to Pritchett and Woolcock (2004) many academic commentators regard the 'neoliberal' agenda as harmful, exploitative, 'de-politicised' and pro-capitalist. A less insidious interpretation is that large agencies are primarily following a strong internal logic to render a diverse assortment of problems responsive to the instruments, models, assumptions and discourses over which they preside, which in turn are predisposed to generating policy/project responses readily amenable to being implemented, administered, and assessed by bureaucratic means. 'Technical' problems that happen to fall safely within the bounds of this logic—building roads, administering inoculations, reducing hyperinflation—will be strongly promoted; those that do not - engaging with customary legal systems, negotiating peace settlements, encouraging more effective local government—will face a constant uphill battle for resources and legitimacy. This is because "careers are sustained, extensive (and expensive) educations are justified, and political needs are satisfied when problems can be persuasively explained by the experts, readily managed by the technocrats and safely administered by the bureaucrats". Woolcock (2009b p. 10)

⁸ The term 'social exclusion' (attributed to French sociologist Richard Lenoir, 1974) gained popularity in Europe in the 80s (Saith, 2001). In 1991 the European Commission established an Observatory on National Policies to Combat Social Exclusion and later the UK established a Social Exclusion Unit in the Department for Communities and Local Government which also addressed financial exclusion (Fuller 1998). The term exclusion was a "polyvalent and ubiquitous concept" (Watt and Jacobs 2000 p.25) so in 2001 the Laeken European Council identified eighteen indicators to measure social exclusion, including "social rights" such as access to banks and insurance (Siewertsen 2004 p. 7). DFID then commissioned a report on lessons from the work on overcoming financial exclusion in industrialized countries which could be applied to developing economies (Kempson *et al* 2004) and started integrating those lessons into its financial sector work.

inclusion became a unifying concept both for those whose focus was increasing access to finance for poor people and also those whose focus was financial system development⁹ (Helms, 2006; UNCDF, 2006; Rhyne & Otero, 2006, Dymiski, 2005). At this time it appears that there was a critical moment when the strength of the micro-credit movement, the rigor of financial market specialists, and the accepted language of “inclusive” or “inclusion” were joined. Even before the Nobel Peace Prize being awarded to Prof. Muhammad Yunus and Grameen Bank in 2006, microfinance’s place in the global development agenda had been affirmed, as examples of financially profitable MFIs using a range of different methodologies existed in every region (Helms 2006). Perhaps the evidence that financial inclusion has indeed been accepted as important to the global development agenda was the adoption by G20 leaders of the Principles for Innovative Financial Inclusion in 2010 (Goodwin-Groen 2010)

However, the meaning of success for microfinance, often referred to as impact, became more diffuse as there were several different types of players working for financial inclusion. For the Micro-Credit Summit, the key indicator of success was the number of poor women and their families with access to micro-credit and other financial services with stories of clients lifting themselves out of poverty (Daley-Harris 2009). For those committed to financial sustainability, such as CGAP, one of their goals was for microfinance to be “funded mainly from domestic sources such as public deposits, bank loans, bond issues, and equity investment.” (Helms 2006 p. 142). Those committed to simply increasing inclusion tracked the number of poor people with deposit accounts and found at the end of 2008, between 2.5 and 2.7 billion poor people had no such account (CGAP 2009p. 23) meaning that half the world was unbanked (Chala, Dalal, Goland, Gonzalez, Morduch, and Schiff 2009)¹⁰. Those who cared about formal financial sector deepening found that “financial development disproportionately benefits the poor; improvements in the functioning of the formal financial system exert a particularly beneficial impact on the economic opportunities of the poor.” (Demirgüç-Kunt and Levine 2008a p.2). For those with a women’s empowerment agenda the

⁹ It is important to note here that inclusion does have a negative side in developing economies (Wood 2003), there can be adverse inclusion. Poor people sometimes have to choose between adverse inclusion within the social, political and economic system to meet their immediate short-term needs or not meeting those immediate needs. One example is dependency upon patron moneylenders for funding “rites of passage”. As a result, land assets, as collateral, become exhausted often via mortgage/high interest conditions which prevent any realistic prospect of reclaiming mortgaged out land. In short this means an overall loss of autonomy, and a deepening of alienation through the re-affirmation of dependency. Wood terms it the “Faustian bargain” “staying secure or staying poor”. (ibid: p.456). Preparation for the future is continuously postponed for survival in the present - the Faustian bargain. This example occurred in the informal financial sector but as inclusion in the formal financial sector increases the links have been shown to directly affect each other. Andhra Pradesh, in India experienced a crisis in the microfinance sector in 2010 for many reasons, one of which was that clients continued to borrow from money lenders, when simultaneously borrowing from MFIs and government programs (CGAP 2010).

¹⁰ Volumes have been written about the challenges of a common definition of financial exclusion or financial access or usage and of collating robust comparable global data. These volumes include papers by CGAP (Kneiding, Al-Hussayni, Mas 2009), the World Bank (Beck, Demirgüç-Kunt Peria, 2005 and 2006, Beck Demirguc-Kunt and Levine, 2007, Demirgüç-Kunt *et al* 2008, de la Torre 2007), academic researchers such as Claessens (2005) and Honohan (2008), funders including the UK’s Department for International Development (DFID) (Stone 2005) and a consortium of funders including L’Agence Française de Développement (AFD), United Nations Capital Development Fund (UNCDF), DFID and the World Bank (Claessens 2005) and financial institutions such as the World Savings Bank Institute (Peachy and Roe 2004) .

key to success was changes at the household level. (For example, randomized controlled trials in the Phillipines to assess women's empowerment as a result of saving by Ashraf, Karlan and Yin (2009) found an increase in female decision-making power particularly for women who had below median decision-making power in the household.¹¹) For each of these meanings of success, there is a wide literature and ongoing active debate amongst practitioners on defining success, evaluating different measures and also assessing weaknesses.

Despite the “apparent success and popularity of microfinance” (Duvendack *et al* 2011 p.1) and the inspiring individual stories, many policy makers were concerned that there was little rigorous, quantitative evidence on how poor people benefited from access to finance. The UK's Department for International Development (DFID) therefore commissioned a systematic review of microfinance impact studies. 3,000 such studies were found but only 58 were deemed rigorous by the consultants. They concluded that “we can neither support nor deny the notion that microfinance is pro-poor and pro-women” (Duvendack, *et al* 2011 p. 2)¹² and recommended more and better research. Copestake and Williams (2011) subsequent analysis of Duvendack (2011) together with other reviews also found that the overall evidence of poverty reduction impact of microfinance was “limited - in scope, quality and generalizability” (Copestake and Williams 2011 p.27). However, they conclude that there is evidence of positive impact on several well being indicators including reduced vulnerability through the ability to smooth consumption over time. This was highlighted particularly by Rutherford (2001) and Collins, Morduch, Rutherford and Ruthven (2009). In summary then, “evidence suggests that financial development facilitates consumption smoothing and investment in human capital accumulation..... Small enterprises not only benefit from increased direct access, but also from the increased growth opportunities generated by financial development.” (Demirgüç-Kunt and Levine 2009 p.39)¹³.

With the framing of a financial inclusion agenda, many saw formal financial services as the only long term solution to sustainably reach more clients (Isern and Porteous 2005 p.1). “Microcredit is simply “a segment of the broader personal credit market” that will need an institutional framework “to promote healthy market development” (Porteous 2009 p. 19). But with commercial financial institutions in microfinance or “mainstreaming” microfinance (Copestake 2007) there was a fear amongst other stakeholders of “unproductive” and “usurious” lending to poor clients. This fear was not unfounded given the Bolivian experience in the 1990s (Rhyne 2001). Academic work also

¹¹ Other examples include Swain and Wallentin (2009) who defined women's empowerment as “when women challenge the existing social norms and culture, to effectively improve their wellbeing”), significantly increases with membership of a Self Help Group under the Bank Linkage Program in India, and de Haan and Lackwo (2010) undertook a gender power relations analysis in Uganda and revealed that in spite of marginal well-being gains, women clients achieved more emancipation.

¹² The full paragraph of their conclusions: “The majority of the microfinance impact evaluations included here investigate group lending and credit only interventions which do not reflect the diversity of the sector, and hence this does not allow us to reach a conclusion as to the impact of the microfinance sector as a whole; individual lending is a more recent phenomenon that has not yet been evaluated widely. Paired with doubts about the research designs and analytical methods used by the various microfinance impact evaluations, we can neither support nor deny the notion that microfinance is pro-poor and pro-women.”

¹³ Demirgüç-Kunt and Levine (2009) also comment that there is startlingly little research on how formal financial sector policies – such as bank regulations – affect inequality and on what changes enable informal or semi-formal finance which serves poor people, to become part of the formal financial system.

identified behavioural biases that would induce over borrowing (Karlan and Zinman 2009). Careful regulation would be required to prevent such abuses. But perhaps a greater challenge was that most banks in developing countries were not willing to move into this market, even after microfinance was shown it could be financially sustainable almost anywhere in the developing world. They were not even lending to creditworthy potential borrowers and so had no incentive to lend to low income clients who they regarded as uncreditworthy (Freedman and Click, 2006, Honohan and Beck 2007) The primary reasons were: (i) high reserve requirements to manage risk; (ii) significant deficiencies in the legal and regulatory environment which make it difficult to enforce contracts and foreclose on collateral; (iii) widespread availability of government bonds which crowded-out private investment; (iv) lenders often knew little about prospective borrowers; and (v) inadequate skills for assessing risk and managing such loans. These types of barriers for formal sector lending to low income clients draw attention to the inadequate policy and regulatory framework for financial inclusion and requires an understanding of the history of financial sector policy and why it had resulted in such high levels of exclusion.

1.2 Financial sector policies: repression, liberalization and institutions

This section, therefore, explains some of the key historical challenges in financial sector development which have contributed to the exclusion of the majority in developing economies, one of which is an inadequate institutional framework.

The financial sectors of developing economies in the 1970s and 1980s were largely characterized by the existence of an oligopolistic banking system, (often state owned) with interest rate ceilings, high reserve requirements, directed credit policies and discriminatory taxation of financial intermediaries - often accompanied by ongoing price inflation which reduced the attractiveness of holding claims on the domestic banking system. This was termed financial repression by Mckinnon (1973) and Shaw (1973). They both argued that these policies resulted in negative real deposit rates, a fragmented domestic capital market, and a reduced size of the banking system in relation to the rest of the economy, stifled financial intermediation and a reduced real rate of growth. In other words financial repression had stopped or gravely retarded the development process (Fry 1995, Shaw 1973 pp. 3-4)¹⁴. The principal form of ‘repression’ in their theory was interest rates ceilings (Shaw, 1973: 81ff) which distorted the economy.¹⁵ Shaw and McKinnon agreed that the reliance on informal credit markets with very high interest rates in developing economies was due to financial repression (Tressel, 2003 p. 224) and used the term “economic dualism” to describe the effect of financial repression creating two types of financial markets (Fry, 1995 p. 35 – 38).

¹⁴ Johnson notes that “[o]ne of the underlying ‘stylized facts’ of the analysis of financial repression is that financial systems in developing countries are dominated by commercial banks (Johnson, 2005b, p.316, quoting Fry 1995 p.4). But she disputes this ‘fact’ because “evidence suggests that the size of flows circulated through informal finance within the household and non-corporate sector is substantially larger than flows channeled through formal institutions” (Nissanke and Aryetty 1998 p.279).

¹⁵ Interest rate ceilings distort the economy in four ways: “they produce a bias in favor of present consumption against future consumption and so reduce savings; lenders engage in direct investment instead of depositing money in the bank; borrowers will invest in capital intensive projects and; it encourages entrepreneurs with low-yielding projects who would not borrow at higher rates” (Fry, 1997, p.755) ¹⁵.

Their simple solution to financial repression was to liberalize interest rates and allow the market to operate freely, which, they believed, would increase both savings and investment and/or reduce the rate of inflation (Fry, 1997 p.756), and it would also enhance the development of the banking system by increasing the volume of bank assets and liabilities (Arestis *et al* 2002 p. 111) and “contribute to higher economic growth” (McKinnon 1986 p.207). The timing of the publication of their theories coincided with the resurgence in popularity of neo-classical approaches in economics in the 1970s and 1980s and the Latin American debt crisis (Powelson, 1997 p. 328 - 329). In that context, McKinnon and Shaw’s policy prescriptions were compelling and “gained wide acceptance at the conceptual level” (Seck & El Nil, 1993 p.1867). They were embedded within the “Washington Consensus” document which articulated ten policy elements agreed by the international development agencies in Washington (Williamson, 2003 p.10). Financial liberalization or financial sector reform became an important component of the structural adjustment programmes initiated by the International Monetary Fund and World Bank in the 1980s designed to create stable long-run growth in developing countries (Green, Kirkpatrick, and Murinde, 2005 p.4 and Johnson, 2005b p.248). McKinnon was even so bold as to say in 1986 (p.205) that his “strictures for liberalizing the financial system seem now like mere truisms to most economists”.

Financial repression may indeed have had a negative effect on the long-run growth rate but Roubini & Sala-i-Martin (1992) and others showed that governments might choose to repress the financial sector in the context of a high budget deficit and significant tax evasion – which was the case in most developing economies. The incentives to perpetuate financial repression included “high inflation, large deficits, and limited access to foreign capital markets” (Seck & El Nil, 1993 p.1877). Regardless, there was wholesale implementation of financial liberalization by the World Bank and the International Monetary Fund (IMF). The possibility that financial liberalization policy could fail to achieve its goals was not considered although Arrow had warned that “in a strictly technical and objective sense, the price system does not always work” (Arrow 1974, p.22). It was also well known that “[e]xternalities, whether positive or negative, render the market (at least partially) inefficient” (Callon 1998 p.247)¹⁶.

Financial liberalization had a serious “destabilizing effect” on financial markets, especially in Latin America where “the whole financial system reached a near collapse” (Arestis and Demetriades 1997 p.790). In 1998 the IMF recognized that the greater frequency of banking crises worldwide since the 1980s “is possibly related to the financial sector liberalization that occurred in many countries during this period” (Bird and Rajan 2001 p.889). By 2006 the analysis was conclusive. The World Development Report stated that “rash or premature liberalization in a context of low political accountability” resulted in concentrated control of the banking system. “In all these cases the rise in low quality liabilities ... became a major factor in the subsequent financial crises” (World Bank, 2005a p.182). Typically, economic growth has fallen dramatically in the aftermath of

¹⁶ Stiglitz showed that, fundamentally, because of informational asymmetries, some markets, especially for risks, will be missing and many other markets will be thin and imperfectly competitive, there will be market failure (Stiglitz, 2003).

financial sector collapse, severely affecting the most vulnerable and poorest people, and resulting in an increase in poverty levels in the crisis-hit countries (World Bank, 2001a)¹⁷.

On the available evidence, the removal of controls on interest rates (without other related changes), did not increase the volume of savings or access to credit in rural areas either, except by those who already had collateral (Mosley 1999 p.382). Formal financial institutions were not lending to the rural poor after deregulation of the financial systems, and informal credit markets were still thriving in many developing countries (Tressel, 2003 p. 224). After liberalization, it was not the formal financial sector which deepened, but the informal sector which expanded to meet greater small-scale service and manufacturing activity, itself expanding because of liberalization of markets in general (Steel, Aryeetey, Hettige and Nissanke (1997), Nissanke & Aryeetey (1998) Lawrence (2006 p. 1001, 1007). Clearly, financial liberalization “could not address the fundamental problems facing financial systems” (Nissanke, 2001 p. 348).

Despite these findings, financial liberalization still had its supporters. An analysis by Auerbach & Siddiki (2004) concluded that generally financial liberalization *enhanced* financial development and was seen by many “as having an important role in liberating economies from the ‘grabbing hand’ of government in financial affairs, most especially in developing nations.” (*ibid* p. 259). A consensus position in 2002 was provided by Jalilian and Kirkpatrick (2002) that the results of financial sector reform have been *disappointing*, falling well short of expectations. In many cases, a failure to recognize the underdeveloped and imperfect characteristics of financial markets led to premature deregulation, with serious adverse consequences for the stability of the financial system as a whole (Brownbridge and Kirkpatrick, 2000).¹⁸

An examination of the liberalization-induced crises identified pre-requisites for successful financial liberalization (Fry 1995 pp.454 – 460). These included: adequate prudential regulation and supervision of commercial banks, implying some minimal levels of accounting and legal infrastructure; profit maximizing competitive behavior by commercial banks and a tax system that does not impose implicit or explicit taxes on financial intermediation. As Fergusson (2006 p.63) summarized “financial liberalization, if adopted without the proper institutions in place, can lead to increased macroeconomic instability”. Examples of African and Eastern European regional studies that reflect these conclusions are: Nissanke and Aryeetey’s (1998)¹⁹ careful empirical analysis of four African countries which found that the financial reform programmes did not adequately address the underlying institutional and structural constraints, and in particular the resulting market

¹⁷ Arestis *et al* (2002 p.111) outlined what happened. The intense competition that followed financial liberalization lowers profits for banks which in turn erodes their franchise values, increasing the premium for external finance, and thus lowering banks’ incentive for making ‘good’ loans. This exacerbates the problems of moral hazard and gambling behavior in the banking system, thereby increasing the riskiness of banks’ portfolios which in turn may affect adversely the public’s perception of the soundness of the banking system. Consequently, prudent bank behavior is undermined with the probability of financial crises being enhanced substantially.

¹⁸ Moore’s (2009 p. 260) more recent quantitative analysis of McKinnon’s theory found it to be invalid when “conditioned by factors such as financial development, different income levels across developing countries”,

¹⁹ Also, Nissanke 2001.

structures; and Denizer *et al* (2000) finding that there was inadequate regulation and supervision during financial liberalization so the elite perpetuated a system of implicit subsidies for themselves in Eastern Europe and the former Soviet Union.²⁰ So, financial systems with a higher degree of institutional development benefited more from financial liberalization than those with a lower one (Chinn and Ito 2002).

Therefore, one of the reasons many financial systems in developing economies failed at financial inclusion was financial repression followed by financial liberalization without an adequate institutional framework. This appears to indicate that an adequate institutional framework is essential to building a more inclusive financial sector. Therefore, a clearer understanding of the relationship between institutions and financial market development is needed.

1.3 Institutions, economic growth and financial market development

The significance of institutions - including both formal and informal rules and norms together with their enforcement characteristics - is introduced here and explored in greater detail in the next chapter. Starting with the role of institutions in economic growth the discussion briefly covers the complex relationship between financial market development, economic growth and poverty reduction and concludes with the importance of sound institutions for financial development.

Douglass North in 1990 was one of the first to theorize the role of institutions as rules and their enforcement characteristics (as part of New Institutional Economics (NIE)) and their importance to economic growth.

Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions) and informal constraints (norms of behavior, conventions and self-imposed codes of conduct) and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies” (North 1994, p.360).

In less than fourteen years the question as to whether institutions matter for economic development was not in dispute.²¹ By 2004, Rodrik, Subramaniam & Trebbi had declared that “institutions rule”, trumping geography or trade in the contribution to average national income levels. Specifically they found that property rights, whether private or public, were the key institution that affects economic performance because when investors believe their property rights are protected the

²⁰ However, in India, (Arun & Turner 2002) and in MENA (Berthelemy 2004) found that implementation of financial liberalization was very slow because of complex political economy issues, and thus they avoided financial sector crises. South Korea is the only clear example of a successful liberalization process because, ironically, the “government maintained tight control over the interest rate” (Aretis 1997 p.791).

²¹ The 2002 World Development Report (2001b), "Building Institutions for Markets", brought institutions to the forefront of development policy and poverty reduction debates. The findings of North (2000), Williamson (2000), Meier and Sitglitz (2001), Chong and Calderon (2000) and others had all supported the conclusion that the poorer the country the higher the influence of institutional quality on economic growth, although there is also reverse causality with economic growth improving institutional quality.

economy ends up richer.²² Rodrik *et al*'s conclusions were questioned by Sachs (2003) amongst others, but since then using a range of different methodologies researchers have continued to show that institutions exert a profound influence on economic performance and other measures of development, (above and beyond feedback effects).²³ Therefore, it has now become common practice to recognize that “institutions matter” for economic growth and poverty reduction (Johnson 2009, Jameson 2006, Licht, Goldschmidt and Schwartz 2007, Acemoglu and Robinson 2008, Savoia 2009, Woolcock, Szepter and Rao 2009). And “the focus of reforms in the developing world has moved from getting prices right to getting institutions right” (Rodrik 2008a p.100). Pande and Udry (2006 p.350) argue that the findings of this literature are “of fundamental importance for development economists and policy practitioners in that they suggest that institutional quality may cause poor countries and people to stay poor.” Governance reform is the more accessible, but less precise, “buzzword” used by funders (Rodrik 2008a p. 100). It “deals with institutional process and the rules of the game for authoritative decision-making” (Grindle (2007 p. 555) and because it so closely mirrors the importance of institutions, governance is considered to be critical for successful development.

However, Chang (2011) has identified two theoretical problems with much institutional analysis which raise interesting questions for researchers. The problems, he argues, are that the dominant discourse “assumes that the causality runs from institutions to economic development, ignoring the important possibility that economic development changes institutions” and that “the relationship is theorized in a rather simplistic, linear, and static way” (*ibid* p. 4). The issue of bi-directional causality in the methodology was also identified by Honohan (2004), Lawrence (2006) and others in the context of financial market development and economic growth and is discussed further below. The second problem of overly simplistic theorization of institutional change is addressed directly by this research.

Markets at all levels have consistently been considered to be institutions fulfilling specific functions. For example, Coase (1988 p.7) “Markets are institutions that exist to facilitate exchange; that is, they exist in order to reduce the cost of carrying out transactions” and Dorward, Kydd, Morrison and Poulton (2005 p.1) consider “markets are also institutions fulfilling exchange and co-ordination functions in an economy”. Hodgson (1988),²⁴ Pujo (1996),²⁵ Wood (2000), Chang (2002a),

²² Much of their paper is dedicated to checking the robustness of their findings, but their econometric analysis has proven the test of time. For this analysis they used Kaufmann *et al*'s (2002) institutional indicators of strength of property rights and the rule of law, and GDP per capita for national income. The strengths and weaknesses of the Kauffmann *et al* (2002) indicators will be discussed in the Methodology chapter.

²³ For example, in a comparison of transition economies it was the quality of the legal system, the protection of private property rights and the structure and stability of the financial system, with a modest and supporting state which was found to contribute to a stable and high long-run economic growth (Redek and Sušjan 2005). Tebaldi and Mohan (2010) added income inequality to their growth and poverty reduction analysis and found that corruption, ineffective governments, and political instability will not only hurt income levels through market inefficiencies, but also escalate poverty incidence via increased income inequality

²⁴ Hodgson's (1988 p.176) institutional definition of a market was “sets of social institutions in which a large number of commodity exchanges of a specific type regularly take place and to some extent are facilitated and structure by those institutions.” These definitions capture the exchange but not the coordination functions of markets as identified by Dorward (2005).

Porteous (2004 p. 8)²⁶ and Hodgson (2008) all take an institutionalist perspective on markets. Wood (2000 p. 221) places markets as one of the “four institutional domains of state, market, community and household” which, when they fail can reproduce widespread poverty. Even Williamson’s (1975 p. 20) well known dictum “in the beginning, there were the markets” recognizes that markets were institutions embedded within societies.^{27 28} Fergusson (2006) found that one of the channels whereby better institutions may have an effect on economic development is through the consolidation of larger and better financial markets²⁹. Therefore the relationship between financial market development, institutions and economic growth needs some exploration.

One hundred years ago Schumpeter (1911 p.74 cited in Arestis 2005 p.2) argued that the banker is “the ephor of the exchange economy” and since then the role of financial markets in the economy and particularly the role of financial markets in growth and poverty reduction have been hotly debated. Knowledge about the relationship between financial development and sustainable economic growth has progressed rapidly in the last twenty years. In 1993 King and Levine found uniquely in cross-country regressions of the drivers of economic growth, that financial depth was a driver of economic growth (as measured by ratio of liquid liabilities to Gross Domestic Product (GDP) in 1960³⁰ and average GDP growth from 1960 and controlling for other variables explaining growth), and growth in turn is a powerful mechanism for reducing poverty (Honohan, 2004). Ten years later Levine’s (2005) overview of the subsequent research again suggested that financial development could robustly explain differences in economic growth across countries. Honohan (2004) however, recognized that depth alone was an insufficient measure of financial development and that problems of reverse causality plague the analysis. Lawrence (2006) concurred, emphasizing the methodological and analytical problems with the research which showed the causal

²⁵ Pujo (1996 p. 132) stated “markets should be defined as exchange processes (of commodities services, money and labour) which are partially determined, regulated and perpetuated by a wide set of social institutions.”

²⁶ Porteous (2004 p. 8) identifies three elements of markets, in addition to consumers:

- An *institutional foundation*, which comprises the laws, rules, regulations and regulatory enforcement capacity to establish and sustain the market. (In recognizing the sociology of markets Fourcade (2007) notes that it is the institutionalization processes which stabilizes markets);
- *Organizations* which provide services in the market: although the market structure—in terms of number, size and type of organization—will vary greatly among market sectors, based *inter alia* on their history, their stage of growth and the barriers to entry in the sector;
- *Support organizations* that provide intermediate services to market players and regulators: these range from the basic required services (audit, legal, IT) to market research and intelligence.

This understanding is helpful for practitioners and donors who want to “make markets work for the poor”, which was Porteous’ goal, and shows how an institutional approach provides a useful beginning.

²⁷ Swedberg (2005 p. 234, citing Weber (1978).) identified trading between communities as the earliest type of market, noting that markets soon came to acquire a complex social structure needing political as well as legal regulation.

²⁸ An institutional approach to markets differs only marginally from mainstream neo-classical economic theory’s view of markets which is “that markets exist in which prices arise from the interaction of supply and demand and that prices so generated lead to the efficient allocation of resources in the economy as a whole and hence to maximum welfare.” (Johnson, 2009 p. 179)

²⁹ It is necessary to point here that out in relation to market formation of any type “that getting the institutions right for market-led development offers no guarantee that desired forms of economic practice or desired economic subjectivities will emerge”. Rankin 2008 p. 1969

³⁰ Honohan (2004) also discusses alternative composite indicators that better measure financial development.

relationship is likely to vary by country and time period and that “a large part of the empirical literature, actually shows that there is plenty of evidence for causation running from growth to finance, and for bi-directionality” (*ibid* p.1013). Other researchers including Deidda (2006), Mehl *et al* (2005), Green, Kirkpatrick and Murinde (2006) Luintel *et al* (2008), Odihambo (2009), Wolde-Rufael (2009), Gries *et al* (2009) also emphasized the complexity and bi-directionality of the relationships between financial development and growth.

The connection from financial development to poverty reduction continued to be tested, for example, Jahlian and Kirkpatrick’s (2005 p. 636) empirical results found that, “up to a threshold level of economic development, financial sector growth contributes to poverty reduction through the growth enhancing effect.” Beck, Demirgüç-Kunt and Levine’s (2007 p. 27) landmark paper found that “[f]inancial development³¹ disproportionately boosts incomes of the poorest quintile and reduces income inequality.” They found that 60% of income growth was due to the impact of financial development on aggregate economic growth and about 40% was due to the long-run impact of financial development on the income growth of the poorest quintile as the result of reductions in income inequality. Furthermore, “financial development is associated with a drop in the fraction of the population living on less than \$1 a day.” (*ibid*). In addition, Demirgüç-Kunt *et al* (2008 p. 109) found that “almost 30 percent of the cross-country variation in changing poverty rates can be attributed to cross-country variation in financial development”. She asserts that the empirical evidence shows “improved access to finance is not only pro-growth but also pro-poor, reducing income inequality and poverty” although she also recognizes the possible variations in interpretation stating that the results are “still far from conclusive” (Demirgüç-Kunt *et al* , 2008 p. 138). Honohan (2008) more specifically analyzes both greater access, (measured by a composite access index,) and financial depth (measured by private credit as a percentage of GDP), and finds that financial depth has a greater effect on absolute poverty. Evaluations on a country level of the relationship between financial development policies and poverty reduction has been limited (McKenzie 2010). However, in India, Burgess and Pande (2005 p. 791) have provided “robust evidence that opening branches in rural unbanked locations in India was associated with reduction in rural poverty.” In particular that a one percent increase in share of savings held by rural banks reduced rural poverty by 2.22 percent (*ibid* p. 790) and that rural branch expansion “can explain a 14 to 17 percentage point decline” in rural headcount poverty (*ibid* p.793). This builds on their 2003 work which found that “rural branch expansion significantly affected economic growth”. (*ibid* p.793) Even allowing for margins of error and lack of conclusiveness, taking all the evidence into account Claessens and Feijen (2007) were convinced that financial development can contribute to poverty reduction and several other of the Millenium Development Goals (MDGs).

If one accepts, to some degree, that the emergence of financial systems may be a significant factor in accelerating economic growth and poverty reduction, “the growth-maximizing mixture of markets and intermediaries may depend on legal, regulatory, political, and other [institutional] factors that have not been adequately incorporated into current theoretical or empirical research”

³¹ As measured by “Private Credit” which captures the amount of credit channelled by financial intermediaries to private firms by, divided by GDP (Beck, Demirgüç-Kunt and Levine’s (2007 p. 31).

(Levine 2005 p.920)³². Clearly much more contextual research is needed. However, if the claims that financial development plays the chief causal role in economic growth were to be proved false, and “instead all of the causality came from the underlying institutional framework, then at least an emphasis on ensuring financial performance is likely to select growth-effective institutions” (Demirgüç-Kunt *et al* 2008 p.147). Adjusting institutions in directions that clearly help improve the functioning of finance is likely to be a highly effective pro-growth strategy. Demetriades and Law (2006 p.245) researched this relationship and concluded that financial development has larger effects on GDP per capita when the financial system is embedded within a sound institutional framework. They also found that in low-income countries the influence of financial development is at its weakest, and so sound institutions are critical to the financial system delivering long-run benefits. However, one then has to address the bi-directional causality challenges leveled at the relationship between institutions and economic growth (Chang 2011). More research into the political economy of institutions for financial development would clearly be highly beneficial (Andrianova *et al* 2008 p. 249).

This introductory chapter started with an overview of the rapid development of microfinance, including the challenges it faces. There was great demand for microfinance in part, because the majority of economically active people in developing economies were financially excluded. To understand that context, the history of financial repression and liberalization which left financial sectors without an adequate institutional framework and the majority financially excluded, was summarized. This section has now attempted to address the importance of the institutional framework to both financial development and economic growth and the relationship of bi-directional causality between them.

Given this overview, building sound institutions for financial market development will not only deepen the financial market and provide access to financial services for those who are excluded, but is also likely to contribute to economic growth, at the same time that economic growth will also contribute to building institutions for financial market development. This raises the issue of how institutional change takes place to support such development, both more generally as part of the governance agenda but also for financial market development.

1.4 Institutional change in development practice

The dominant method of aid donors trying to build institutions in developing economies has been institutional transfers (Moore 2001), transplants (Gibson and Woolcock 2008), or the imposition of uniform institutional “blueprints” on the countries of the global South without recognition of the

³² NIE theory suggests that financial systems would influence growth by easing information asymmetry, and reducing transactions costs and thereby improving the acquisition of information about firms/clients, governance, risk management, resource mobilization, and financial exchanges. However, too frequently empirical measures of financial development do not directly measure these types of financial functions (Levine 2005). Honohan (2004) noted current theories which identify four key functions of finance whereby the financial sector effects growth and poverty reduction: mobilizing savings; allocating capital; monitoring the use of loanable funds by entrepreneurs; and transforming risk by pooling and repackaging it.

role of underlying social norms (Evans 2004 p. 30).³³ This is largely because of the predominance of a “best-practice” mindset at the World Bank and International Monetary Fund which presumes it is possible to determine a unique set of appropriate institutional arrangements *ex ante*, and that those arrangements are inherently desirable (Rodrik 2008a p. 100)³⁴. Chang (2011 p.474) identifies these “Global Standard Institutions” as typically found in Anglo-American countries with the agenda to maximize market freedom and protect private property. Other negative assessments of these institutions are that they are “static accretions of norms and values” (Rankin 2008 p. 1975) from the originating economies. In financial markets the practice has been no different. “Much of what is held to be good practice for the development of financial markets still amounts to a transplant of models that have been successful in advanced economies” (Demirgüç-Kunt *et al* 2008 p.147) with minimal regard for cultural norms. In microfinance there has also been a predilection for transplanting supposedly successful models with minimal regard for cultural norms, in this case from Bangladesh, for example, the Grameen Bank model (Grameen Trust 1989) and the BRAC model (Bangladesh Rural Advancement Committee 2011a,b).

Bräutigam and Knack (2004) and Djankov, Montalvo and Reynal-Querol (2008) are unequivocal in their analysis that the ‘best practice’ approach to institutional change has failed. Their research found foreign aid had resulted in institutional weakening³⁵ and had a negative impact on institutions³⁶. Conyers and Mellors (2005), Collier (2006a) Birdsall (2007) and Booth (2011) are in general agreement with these findings. Booth (2011 p.4) specifically states that importing institutional ‘best practices’ from the outside, typically fails and in the African context has found that “institutions that have been designed elsewhere or with little or no connection to the specific factors in play will be unlikely to meet the real needs of the situation.”

Instead, of these largely unsuccessful ‘best practice’ approaches Conyers and Mellor (2005 p. 88) suggest donors work through existing recipient country structures and procedures on interventions which demonstrate genuine recipient ownership and commitment and are appropriate to the local environment. Collier (2006b p.209) wants to make aid conditional upon “processes of governance that make them realistically accountable to their own citizens”. However, neither of these approaches addresses the fundamental problem that power is still held by the government and their experts. As Bastiaensen, De Herdt and D’Exelle (2005 p. 984) observe such a “simplistic understanding of power... is incapable of capturing the complexity of local power relations” and starting a process of change.³⁷

³³ So, the institutional problems that take years (even decades) to resolve, that have no known solution *ex ante*, and that entail protracted negotiations, contests and experimentation - as did the formation of most institutions in the now-rich countries – never get addressed (Woolcock 2009b p. 12).

³⁴ This mindset presumes the primary role of institutional arrangements is to minimize transaction costs without paying attention to potential interactions with institutional features elsewhere in the system.

³⁵ Bräutigam and Knack (2004) used the ICRG Quality of Governance Index to assess whether volumes of aid have improved this Index. This Index includes three elements: Corruption in Government, Quality of the Bureaucracy and Rule of Law (*ibid* p.279).

³⁶ Djankov *et al* (2008) found that for political institutions, aid is a bigger curse than oil.

³⁷ Bebbington (in Hickey and Mohan (eds) 2004 p. 278) recognizes there is a “tense interface between theory and practice... in discussions of participatory development” as between some who see the need to “theorize strategy carefully” and others who view such abstraction as “tyranny that obstructs change-oriented action” and “privileges elite form on knowledge” (*ibid* p.278)³⁷. Indeed, Bebbington recognizes that “the values that

In response to the flaws in the “blueprint” approach (Hickey and Mohan 2004 p.4), a range of participatory practices were introduced at both project and policy levels as means of attempting to ensure more owned, and locally embedded solutions. Indeed participation became “mainstreamed” into development practice (see Hickey and Mohan (2004), Tandon (2008) Morrison (2010) and Eversole 2010). There has been some success with this approach to power sharing particularly at the local project level as Tandon’s (2008) reflections on 25 years of participatory approaches finds and recent successes have also been reported by the Africa Power and Politics Programme (Crook and Booth 2011) such as with “‘co-production’ or multi-agency, multi-actor collaboration” (*ibid* p.97). However, Grindle (2007) like Bastiaensen *et al* , (2005) and Robins *et al* (2008) found that “token ownership and participation”, (Grindle 2007 p. 561) were sometimes only window dressing for the adoption of changes initiated and pressed upon countries by international agencies. A local “participatory” process could still result in endorsement of an expert’s “blueprint” (Bastiaensen *et al* , 2005 p. 984) or “extension of the party political game” (Coehlo and Favareto 2008 p.2937). Even with good intentions the experts were the “de facto owners of the institutional terrain” (Eversole 2010, p. 35) and it was the government’s or experts’ own “rules in use” (*ibid* p. 35) which determined the set of possible outcomes. Therefore, Eversole (2010) appealed for “remaking participation” so it is “multidirectional” (*ibid* p.38) where learning, engagement and empowerment are mutual between all types of institutional stakeholders. This seems highly ambitious, but the experience of Crook and Booth (2011) indicates this could be possible in highly localized problem solving contexts.

The dominant blue print method is one of the “absurd extremes” that Chang (2011 p.494) identifies in donors’ approach to institutional change. He states that most are “hopelessly optimistic” (*ibid*) assuming institutions can be changed easily (and have typically taken a blue print approach to institutional change). In contrast, others are “unduly fatalistic”, assuming that “institutions are determined by immutable things such as climate and culture” (*ibid*) so only external shocks like colonization can change them. These assumptions of donors about how institutions change are based on theoretical views that Chang identifies as “simplistic, linear and static” (*ibid* p.4). These theories will be explored further in Chapter 2, but as yet there does not appear to be a robust theoretical debate about institutional change which could usefully address some of the problems with the change practices³⁸. So with the limited success in institutional change processes and serious critiques of the both the practice and its theoretical basis, there is clearly a need for new theories of institutional change that can usefully engage development practice.

dominate academic assessment push academics away from practice” (*ibid*. p. 281) but despite these challenges he states that “theory workers and practice workers ought never to lose touch” (*ibid* p.281) and particularly in the field of participatory development.

³⁸ Bebbington (in Hickey and Mohan (eds) 2004 p. 278) has identified a “tense interface between theory and practice.... in discussions of participatory development”, between some who see the need to “theorize strategy carefully” and others who view such abstraction as “tyranny that obstructs change-oriented action” and “privileges elite form on knowledge” (*ibid* p.278). Indeed, Bebbington recognizes that “the values that dominate academic assessment push academics away from practice” (*ibid*. p. 281) but despite these challenges he states that “theory workers and practice workers ought never to lose touch” (*ibid* p.281) and particularly in the field of participatory development.

This chapter started with an overview of microfinance policy over the last thirty years which, in providing financial services for poor people, was seeking to overcome financial exclusion. Some of the historical challenges in financial sector development have contributed greatly to that exclusion, an inadequate institutional framework being one of them. Understanding the importance of the institutional framework for financial development and financial inclusion focuses attention on which institutions are most important for financial inclusion and the practice of institutional change. But, unfortunately the dominant methods of attempting to bring about institutional change have largely failed. So there is some urgency to progressing the theoretical and policy agenda to provide insights into institutional change for financial inclusion.

1.5 The research questions

This research will address a gap at the intersection of three fields of academic research and policy in international development: institutional development, financial market development and microfinance, now known as financial inclusion. More specifically, this gap has three dimensions: first the need for understanding the institutions needed to promote inclusive financial market development; second, better understanding of how institutions change; and third, the role external agents such as donors can play in this process.

Chang (2011, p.494) has asked institutional economists to “pay more attention to the real world” and to “recognize the complexity of the nature and the evolution of culture and institutions”. Leading institutionalists have also advocated the analysis of country-level institutions (Pande and Udry 2006)³⁹ particularly highlighting the need for comparative case studies to progress understanding of institutional functions (Shirley 2005). Therefore this research undertakes a comparative analysis of country-level institutions in two real world microfinance markets that expanded significantly over a period of ten years and in which new formal institutions have been established.

The criteria for choosing two microfinance markets in which to undertake such a comparative analysis included: microfinance markets where the researcher had access to key informants; those with significant size, meeting Honohan’s (2004) significance criteria of over 1% of the population; rapid growth, so there would be institutional change to study; which had a self-defined sub-culture of providers of microfinance and their stakeholders⁴⁰; and which provided useful contrasts to be able to start to draw conclusions. The two microfinance markets which met these criteria were Uganda and Bosnia and Hercegovina, hereafter referred to as Bosnia. Microfinance only started in

³⁹ Pande and Udry (2006 p. 351) acknowledge that cross-country regressions have been useful to understand the institutions which matter, but argue that work is now essentially complete.

⁴⁰ It is important to note that this self-defined subculture of microfinance providers and their stakeholders did not include microfinance clients and consequently neither did this research. Furthermore, given that the research was already encompassing two markets, robust client surveys were not practically possible. This is elaborated further in Chapter 3, However, to gain a deeper institutional understanding of these microfinance markets, further research would be greatly enhanced by including clients.

Bosnia in 1997 soon after the war ended and in ten years the microcredit market had grown from nothing to reach 294,330 borrowers, or 363,082 borrowers if the specialist small enterprise bank is also included (MIX Market 2011). The Bosnian population in 2007 was 3.779 million (UNDESA 2011) so that means approximately 9.6% of the population were micro-credit borrowers. A MicroCredit Organization (MCO) Law had been passed in 2000 and another in 2006 with regulations at the end of 2007. Microfinance had started earlier in Uganda but grew slowly at first, but with significant donor funding starting in 1997 by 2007 microfinance NGOs alone reached 385,201 savers. If the savers in the rural development bank, cooperatives and VSLAs (also funded by donors) are also included then there were approximately 1,709,778 microfinance savers. The Ugandan population in 2007 was 30.340 million (UNDESA 2011) so that means approximately 5.6% of the population were microfinance savers. A Micro Finance Deposit-taking Institutions (MDI) Act had been passed in 2003 with MDI regulations in 2004. Since, I had worked as a microfinance consultant in Bosnia between 1998 until 2005 and in Uganda first in 1994 and then for longer in 2004, my experience also made these cases particularly appropriate to investigate as I knew many of the key stakeholders. Moreover, these two markets in quite different geographical regions, with different histories, sizes and challenges, so they provide strong contrasts for analysis.⁴¹

Therefore, the research questions this investigation set out to answer in the microfinance markets of Bosnia and Uganda were:

- What institutions matter most for increasing financial inclusion?
- How have rules and norms governing the microfinance markets in Bosnia and Uganda changed between 1997 and 2007?
- What has the role of development agents been in catalyzing this change?

1.6 Outline of the following chapters

With the policy context outlined, Chapter 2 interrogates the theoretical literature on institutions in more detail, discussing the definition of institutions, differentiating between institutional form and function and explaining the social embeddedness of markets. A framework for analyzing four levels of institutions in markets is chosen and detailed and then the specific institutions considered to be critical for financial market development, including social norms, are put into that framework. It shows that the relationship between the different levels of institutions for financial markets fills a gap in the literature. Finally, recent theories by Mahoney and Thelen (2010) and by Boettke, Coyne and Leeson (2008) about gradual institutional change are presented and discussed.

Chapter 3 discusses the choice of methodology for this investigation. It makes the argument for a social constructionist ontology and interpretivist epistemology in the analysis of institutions and for a micro-ethnographic method to answer the research questions. In this case a relatively short 'micro' ethnography involved semi-structured key informant interviews which allowed the stakeholders' perspective on the effectiveness of the formal institution in the form of rules as well

⁴¹ Interestingly both these markets experienced a slowing of their growth after 2007 for different reasons which provided an additional opportunity to understand the quality of their respective institutional frameworks.

as informal institutions such as social norms to be explored in depth. As a starting point, I asked respondents what they considered to be the building blocks (Grindle 2007 p. 567) for the development of microfinance since 1997 and this led to wide ranging and free flowing discussions about how microfinance had developed. It is fair to say that all of the respondents were both proud of some achievements and frustrated with others. Several were angry with donors, politicians or others whom they felt had betrayed their trust. These were often not easy discussions, but very rich in understanding of institutional change processes. I am indebted to the respondents for their time and honesty.

The body of findings on each of the country case studies is presented in parallel sets of chapters. First (Chapters 4 and 7) are the historical political, social and economic contexts within which the microfinance markets are operating. This historical perspective is vital to understanding the underlying social norms. The complexity of the history of the former Yugoslavia and the current Bosnia is necessary to make sense of the development of microfinance market there. Uganda's complex history also provides important insights into the evolution of its microfinance market. Second, (Chapters 5 and 8) I present a descriptive account of the key features in the development of the financial and microfinance markets between in these two countries between 1997 and 2007. Bosnia struggled with the simultaneous tasks of reconstruction after war and post-socialist reforms, and Uganda struggled to find ways to expand access to a largely poor and rural population. Finally, (in Chapters 6 and 9) is an analysis of the respondents' perspectives of the institutional "building blocks" that were key to the development of these microfinance markets.

Chapter 10 draws together the findings from these two "real world" cases to address the research questions in a comparative manner and examine the implications of these findings for both the static and dynamic institutional theories presented in chapter 2. This comparative analysis reveals some fascinating insights into the ways in which institutional development has taken place and also makes sense of apparent inconsistencies to challenge technocratic notions of "best" practice institutional development.

Finally, in Chapter 11, I conclude with further reflections on the empirical findings and their implications for theory, before discussing the methodological strengths and weaknesses of the study and then its policy implications.

Chapter 2: Financial Market Development: An Institutional Perspective

This chapter interrogates the literature on institutions, institutions for financial market development and institutional change introduced in the first chapter. The findings in response to the research questions can only be fully understood within the theory and practice discourses of these arenas. The chapter starts by describing three different schools of institutional thought, it then proceeds to discuss the definitions of institutions and the difference between institutional form and function. I then review literature discussing the role of social institutions in creating market embeddedness, which is an essential issue that has been neglected in much analysis of institutional development. The chapter then moves onto review research on the role of institutions in financial market development and uses Williamson's (2000) framework, identifying four levels of institutions to organize this review. It shows the different levels of institutions found to be important for financial market development, filling a gap in the literature. It also provides researchers a framework to map institutions in particular financial markets. This framework will be used again in the analysis of microfinance markets in Bosnia and Uganda. Finally, two recent institutional change theories are presented. These seek to address the limitations of earlier theories and are examined and critiqued. These are an important advance on the current theoretical understanding of institutional development.

2.1 Schools of institutional thought

The three main schools of thought identified are: historical (or old) institutionalism, sociological institutionalism, and rational choice institutionalism (Hall and Taylor 1996), a categorization now used extensively (e.g. Mahoney and Thelen (2010), Greif and Laitin (2004), Srivastava (2004), Campbell (2004)). The 'new institutionalism' in NIE is subsumed under the rational-choice category. These approaches are briefly outlined below, positioning this research within those approaches.

An historical institutionalist (the more common term is old institutionalism, (Johnson 2009)), approach to understanding institutions and institutional change, well articulated by Steinmo and Thelen (1992), is that institutions are relatively persistent features of the historical landscape and that "power instantiated in existing institutions give some actors or interests more power than others over the creation of new institutions" (Hall & Taylor 1996, p.21) Institutions are one of the central factors pushing historical development along a set of 'paths'(e.g. Collier and Collier, 1991) and thus change is largely 'path dependent' (Hall & Taylor, 1996 p.9)⁴² . Powelson's (1997) "power-diffusion-process" is an example of a theoretical framework firmly within this approach. He defines institutions as "an accepted mode of behavior protected by the culture" (*ibid* p.6) and argues that institutions are created slowly by continuous negotiation between mutually-dependent groups over centuries in a path dependent process. The idea of dependency between groups is central and "if the power diffusion process operates successfully, economic institutions become negotiated by many interest groups whose powers become more diffuse over time" (*ibid* p.7).

⁴² Path dependence was short hand for saying that current institutional arrangements in any one place are there for unique historical reasons as they are dependent on their particular historical path.

Sociological institutionalism, as Hall and Taylor (1996) explain has three aspects: first, that they include culture as institutions; second, cultural institutions are considered to “provide the very terms through which meaning is assigned” (*ibid* p.15); and third, that organizations embrace specific institutional practices because they are widely valued within a broader social environment. In some cases, these practices may actually be dysfunctional with regard to achieving the organization’s formal goals. Such an approach goes a long way toward explaining much apparent inefficiency in social and political institutions.⁴³ Campbell (1998) describes it as social appropriateness in contrast to the logic of instrumentality. Recognising Douglas’ earlier work on institutional *bricolage* (*ibid* p. 383), Campbell (2004) and Cleaver (2002) subsequently focus on the role of institutional entrepreneurs, or institutional “bricoleurs” (*ibid* p. 11) to describe institutional change agents within this ‘school’. The critique of this approach, however, is that while this concept can be retrospectively woven into a coherent tapestry, it has no predictive power (Crouch, 2007).

Rational choice institutionalism as exemplified by North (1990), Williamson (2000), Ostrom (1990) and Knight (1992)⁴⁴ has developed a generalizable set of concepts that lend themselves to systematic theory-building according to Hall and Taylor (1996 p.18). The defining features are that: it is “functionalist”, focusing on the effects that follow; it is “intentionalist” in that it is purposive; and it is “voluntarist” and “rational” (*ibid* pp. 19, 20). Rational choice institutionalists including North and Greif (2006), have produced “elegant accounts of institutional origins” (*ibid* p.19), typically focusing on the benefits they provide. This approach has real strength for explaining why existing institutions continue to exist, since the persistence of an institution often depends upon the benefits it can deliver. Two critiques of rational-choice institutionalists have been that they did not explain institutional inefficiencies, nor adequately recognize that power vests some actors with more influence in institutional change. However, more recently Acemoglu, Johnson and Robinson (2005) and Acemoglu and Robinson (2006a) and have incorporated the use of power by political elites and North (2003) has long moved away from an efficient, rational-choice position. North (2003 p.7) writes that “the rationality assumptionis a devastating shortcoming in dealing with most of the major issues confronting social scientists and policy makers, and it is a major stumbling block to the path of future economic progress.” Given that the protagonists are still building theories but rational choice is no longer a binding assumption, this approach could, perhaps more precisely, be referred to as post-rational choice institutionalism.

⁴³ Meyer and Scott’s (1983) work on ritual and rationality in organizations might be considered an example of this ‘school’.

⁴⁴ Knight (1992) has written a critique of classical theories of institutional change by economic theorists, that has been summarized by Argandoña (2004). He generally categorizes them into a.) change processes based on interest coordination in order to obtain collective benefits, and b.) change based on conflict or competition between opposing interests. Hobbes, Hume, Adam Smith and Spence are considered to be in the first category and Marx and Weber in the second. Then Knight classifies the modern theorists into those who support a market-driven theory in which institutions reduce transaction costs (North and Williamson); those who argue for spontaneously-emergent institutions, (Hayek) and those, like himself, who see the importance of conflict.

This research is positioned where historical and rational choice (or post-rational choice) institutionalism converge, while also recognizing the important of social institutions. The convergence is where historical institutionalism's understanding of the persistence of institutions and a power-distributional approach to institutional change, and rational choice institutionalism's concepts that lend themselves to theory building, are used together to build theories for institutional change that move beyond path dependency. Two such institutional change theories are discussed later in this chapter.

2.2 The contested definition of institutions

From these three different schools of institutional thought, the definition of institutions developed by Douglass North (1990, 1994) has become the dominant approach (Johnson 2009, Acemoglu and Robinson 2008, Boettke, Coyne and Leeson 2008, Chang 2007, Greif 2006, Ostrom 2005a, Rodrik 2004, Menard and Shirley, 2005).

Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions) and informal constraints (norms of behaviour, conventions and self-imposed codes of conduct) and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies” (North 1994, p.360)

Richter's (2005)⁴⁵ useful summary of one debate about this definition is that while North agrees with Williamson's approach that institutions reduce the cost of cooperation and reduce uncertainty of human interaction, North's definition recognizes that the rules and norms are humanly devised so will inevitably be imperfect and inefficient. Indeed, Stiglitz (2003) showed how information asymmetries and transaction costs together explain the persistence of inefficient institutions, missing markets and market failure⁴⁶. Acemoglu and Robinson (2008 p. 2) identified the “humanly devised” aspect of North's definition as one of its key features in contrast to other potential fundamental causes, (like geographic factors,) which are outside human control. Another key feature of this definition is that the institutions' major effect will be through “incentives”. The notion that institutions define incentives is critical to economists; it means that institutions should have a major effect on economic outcomes, including economic development, growth, inequality,

⁴⁵ North and Williamson are the two most prominent expositors of new institutional thought according to Richter (2005) and Furubotn and Richter (2005). Williamson theorizes that institutions are designed to reduce transaction costs and increase economic efficiency but that approach does not provide a way to understand the prevalence of inefficient institutions, (Hall and Thelen 1996, Bowles and Gintis, 1993 p.97, North 2003 p.7).

⁴⁶ Information asymmetries and transaction costs in financial market especially detrimentally affect the poor and micro and small enterprises that lack collateral, credit histories, and connections. They explain money-lender interest rates, borrower behavior, informal financial arrangements & microfinance in financial markets (Armendáriz and Morduch 2005, Johnson 2005b). For example, using a group-lending methodology to lend to micro-entrepreneurs in developing economies allows the lender to overcome information asymmetry by using the “insider” knowledge members have about each other to screen members, and allows the lender to reduce transaction costs by using the members to monitor each others' behaviour. Compliance is then enforced through the use of local social sanctions, such as non-cooperation in other aspects of daily life (Johnson (2005b) Ghatak (2000) Stiglitz (1993)).

and poverty. Indeed, markets themselves are institutions fulfilling exchange and co-ordination functions in an economy (Chang 2002a, Dorward *et al* 2005).

Another strength of North's definition can be seen in contrast to historical institutionalism (Hall and Thelen 1996) which assumes that institutions are exogenous and very slow to change whereas North's definition makes no such assumption. The division between old and new institutionalists might be cast similarly to the structure and agency debate in sociology (Chang 2002a, Dolfsma and Verburg 2008). The old institutionalists follow Durkheim's structuralist approach that actions are determined by the structure of predefined institutions, not individual actions which is "unwarranted structural determinism" (Chang 2002a, p.554). Many of the new institutionalists follow Weber's agency approach that institutions emerge from the agency of individuals. But this can be problematic too if it is interpreted as one-way causation from individuals to institutions. A reductionist view based on either of these approaches is clearly inadequate. North and Chang recognize that there is two-way causation between individual motivation and social institutions (Menard and Shirley, 2005).

But two weaknesses have been identified in North's definition. The first weakness is that it is a vague concept (Sachs 2003, Portes and Smith 2008), without clear differentiation between the rules and the players, nor between "formal rules" and "informal norms" (Hodgson 2006) and the second weakness is that it has led to a preoccupation with defining "best practice" institutions, which are, by definition, non-contextual (Rodrik 2008a p.104, Bardhan 2005 p. 500, Evans 2004). The first weakness, the lack of clarity, has meant that the terms institution and organization are used loosely and sometimes interchangeably without an explicit understanding of their meaning consistent with North's definition⁴⁷. For example, in microfinance the providers of financial services to poor people are called both institutions and organizations interchangeably. Hodgson engaged North on this lack of clarity. They agreed that organizations are *both* players that follow institutional rules and norms *and also* a special type of institution with internal systems of rules and players.⁴⁸ Specifically organizations have a) criteria to establish their boundaries and to distinguish members from non-members, b) principles of sovereignty concerning who is in charge and c) chains of command delineating responsibilities within organizations (Hodgson, 2006 p.18).^{49 50}

⁴⁷ North attempted to explained the difference: "*If institutions are the rules of the game, organizations and their entrepreneurs are the players. Organizations are made up of groups of individuals bound together by some common purpose to achieve certain objectives.*" (North 1994 p.361). But this differentiation between institutions and organizations was not clear enough for Hodgson (2006) or Portes and Smith (2008).

⁴⁸ Greif (2006 p.31) came to a similar conclusion that organizations have a "dual nature", they are both "components of institutions" and "institutions with respect to their member's behavior".

⁴⁹ This definition is also consistent with the Grindle's (1997) research on organizational culture and Knight's (1992 p.3) recognition that some organizations "can be conceptualized as both an institution and an organization, such as a church or a university".

⁵⁰ This differentiation helps clarify the "institutional arrangements" term used by Dorward to describe the particular sets of rules and structures governing particular contracts (Dorward *et al* 2005 p.2). With Hodgson's clarification, these arrangements are the rules which operate within an organization.. For example, Dorward characterizes microfinance contracts linking borrowers, groups and microfinance providers as *institutional arrangements* - but which we now understand are rules within an organization - and the *institutional environment* as the microfinance policy context of allowing NGOs to engage in these activities or

The lack of clarity has also resulted in debate over the difference between “formal rules” and “informal norms”. Ostrom (2005b) and Hodgson (2006) have noted that there is huge variability in enforcement of both formal and informal rules. They offer the alternative terms of “working rules” and “social rule-systems” respectively. Unfortunately new labels do not solve the problem. While enforcement is indeed variable, perhaps one reason is that the effectiveness of institutions “depends crucially on the legitimacy of the institutions in the eyes of those living under them” (Woolcock 2009b p. 13). In a research context, therefore, when a specific rule or norm is identified, both the legitimacy of the institution and the quality and consistency of enforcement in that particular local context, would need to be explicitly discussed. The key issue however, is that North’s definition of an institution includes both formal and informal rules and norms.

The second weakness is that the application of North’s institutional approach has led to a preoccupation with defining “best practice” institutions, which are, by definition, non-contextual (Rodrik 2008a p.104, Bardhan 2005 p. 500, Evans 2004). Rodrik (2008a) argues that no single set of any practices will serve the needs of all countries at all times, “as the variety of institutional forms that prevail in the advanced countries themselves suggests (Freeman 2000; Hall and Soskice 2001 cited in Rodrik 2008a p. 100). Evans (2004 p.30) sees this best practice approach of exporting legal codes and organizational blueprints on the global South as institutional “monocropping” which is bound to fail. This weakness is not inherent to the definition of an institution but how others have interpreted it.

2.3 Institutional form and function

Building on North’s definition, Rodrik *et al* (2004), Sindzingre (2005), Acemoglu and Robinson (2008) and Chang (2006, 2007) are all clear that it is institutional functions which are more important than the institutional form and there is no basis for the importance of any particular institutional form, (recognizing the differences even between developed economies). As Cleaver (2002) and Rankin (2008) respectively recognize institutions are “multi-purpose” and “invested with a purpose” (*ibid.* p. 1975). Chang (2006 p. 3) states the same function or purpose can be served by different institutional forms in different societies (or in the same society at different times). For example, Rodrik *et al* (2004) emphasized that the function of property rights was important, not the form and so their research did not provide an institutional recipe. A further example is the function of a stable political system, found by Tebaldi and Mohan (2010) to be important for economic growth, did not necessarily mean its form was a democracy since Decker and Lim (2008) found the effect of democracy on growth is insignificant⁵¹.

new financial regulations which have followed the new institutional arrangements - which are institutions under North’s definition (*ibid* p.18-19).

⁵¹Although Bhagwati (2002) and Acemoglu and Robinson (2005) found that a political democracy provides the best prospect of achieving the efficient, dynamic society that allows development to thrive when combined with the institutional functions of markets and openness (information flows) (Bhagwati 2002, pp. 151–152).

Highlighting the role of function rather than form reprises the "structural functionalism" of anthropologists such as Radcliffe-Brown⁵² (Radcliffe-Brown 1961) and meta-theorized by sociologist Talcott Parsons (Parsons, 2006). They understood sociological structures in terms of the functions they played in maintaining the stability of a society. The shift from a focus on the form of social structures and institutions to recognising that it is functions that are critical, therefore, has an important sociological history.

However, the recognition of the importance of function in new-institutional theory is relatively recent and far from systematically integrated. Chang (2006 p.4) noted there are those with a "form-fetish" who promote "global standard institutions" which he asserts has led to a dangerous denial of institutional diversity.⁵³ Likewise, Chang (2007) rues the unfortunate tendency to assign a single function to each institutional form and that this is mistaken because there is not one inevitable and simple relationship between a desired institutional function and an institutional form. He uses an example in the financial market literature where it is generally argued that the function of the central bank should be to focus on inflation control, but actually there are many developmental functions that the central bank can and does play including the promotion of financial inclusion. Also in financial market development Demirgüç-Kunt and Levine (2008 p.2) concur that it does not matter who provides the functions necessary for financial development. Indeed they argue that at a conceptual level it does not matter if they are formal or informal.

However, it has often been a challenge to "clearly distinguish between the forms and the functions of institutions" (Chang 2006 p. 3) which has led to some confusion and this has been the case in microfinance too. The more generic term "role" has typically been used instead of function, for example, "The Role of Central Banks in Microfinance in Asia and the Pacific" (Goodwin-Groen, 2000a,b). The "roles" in this case appeared to be institutional functions and the central bank was the institutional form. This will also be a critical point for the analysis of the research data because a *de facto* or informal institutional form can perform important institutional functions as well as a *de jure* or formal institutional form. It will therefore be essential to clearly distinguish functions from form. The form matters insofar as it enables the key functions required in the financial market to be carried out, but this has not been explored in the financial inclusion literature to date. However, recognizing the importance of institutional functions also raises the question of whether and how the boundaries of functions can be defined. Cleaver (2002) would argue that for a socially embedded multi-purpose institutional "bricolage" (*ibid* p. 11) the boundaries will be clear to those who operate within that cultural context.

North's definition of institutions will be the basis for the remainder of the literature review and research because it explicitly recognizes the importance of both formal and informal rules and

⁵² Radcliffe-Brown built on Durkheim's definition of functions in society by defining social functions as life-processes. "The concept of function as here defined thus involves the notion of a structure... the continuity of the structure being maintained by a life-process," (Radcliffe-Brown 1961 p. 180)

⁵³ Furthermore, in Nelson's (2007) opinion, the "analyses that purport to identify the "right" institutions are superficial and unpersuasive" Nelson (2007 p.313).

norms with their enforcement characteristics which means that it can be applied to the multiple levels of a financial market. It recognizes that institutions are humanly devised and imperfect and allows a focus on institutional function so it can be applied to methodologies which work with culturally determined institutional functions and boundaries. This definition also reflects the positioning of this research at the convergence of historical and rational choice institutionalism and is a useful basis for theories of institutional change that move beyond path dependency.

2.4 Social norms embedded in markets

The importance of informal rules and social norms was clear in the discussion about defining institutions. This section therefore gives an overview of the understanding of social norms and the social embeddedness of markets. Social norms have moved from being ignored to being understood as essential, notwithstanding the substantial methodological challenges of identifying their multiple functions and their boundaries.

It was Polanyi (1957) who first identified the social embeddedness of economies and Stanfield (1980) who systematically analyzed the significance of Polanyi's work for institutional economics and economic policy (O'Hara 2006 p.512)). For Polanyi, "markets are articulated through social institutions and legal and political strategies" (Slater and Tonkiss, 2001 p. 104), which is Polanyi's notion of institutedness. He fundamentally rejected the key assumption of classical economics that there is a clearly delineated socially disembodied sphere of economic relations. He described a "double movement" in Europe which illustrated his thesis. A first movement from a heavily regulated and controlled market in the 18th century to a virtually unregulated market in the 19th century was, in itself, a planned process rather than the arrival of a natural phenomenon; and a second movement in which the market was once more brought under control because people resisted the disembedding from their social context and the poverty, unemployment and insecurity brought about by the unregulated market (Stewart 2006). In other words, the first movement resulted in attempted disembedding of the market from its earlier institutional context and the second counter-movement which this process catalysed, resulted in social relations being re-embedded within the economic system or market system. This Polanyian double movement—of deregulation followed by reaction to crises—is now recognized as a common feature in national and global economies (O'Hara, 2006). Building on Polanyi's distinctive approach to comparative economic analysis (Jessop 2002), researchers such as Granovetter (1985, 1992), (to whom Williamson (2000) refers) and Slater & Tonkiss (2001) and Johnson (2005a) have also shown how economic institutions are social constructions and how markets are articulated through social institutions and embedded in local cultures.

Granovetter's (1992) understanding of embeddedness is that networks of social relations penetrate irregularly and in differing degrees in different sectors of economic life. He concluded that social relations are a necessary component in understanding the link between macro-level and micro-level theories and that power derived from social relations such as class, gender and ethnicity is not limited to the micro-level, but patterns entire sets of market operations and so influences the entire economy (*ibid*, p.370). Institutions in markets are "cultural embodiments" reflecting the value

systems and historical antecedents of the societies (Platteau 2000, p. xvii). It is therefore essential for any discussion of rules and norms in financial markets to recognize their social embeddedness.

Even with these insights and with the explicit recognition of social norms in North's definition of institutions, social institutions have until recently, largely been ignored by many institutional economists. They have been "taken-for-granted" (Scott and Meyer *et al* 1994 p.27), considered a "black box" (Greif 2006 p.380), there has been a "norm against norms" (Eggertsson 2001 p. 77) because values and norms were taken as "given" (Williamson, 2000, p. 596) with no recognition of internal differences or sub-categories within the norms (Dequech 2005)⁵⁴. However, institutionalists such as Braverman and Guash as early as 1993 (Hoff, Braverman and Stiglitz 1993, p. 53) had recognized the "apparently large influence of social and cultural factors on the performance of financial institutions," and called for more research, they also recognized that they did not have appropriate tools for this task. Granovetter (2005) observed that social structures within which institutions are embedded "remain largely unexplored, and pose one of the greatest intellectual challenges to the social sciences." (*ibid* p.47).

Two barriers to a greater understanding of the social embeddedness of markets are a lack of understanding of the way social rules can constrain or enhance economic opportunities and methodological challenges of operationalizing informal institutions (defining their functions and boundaries) and discerning causality. The methodological challenges are being overcome in several ways. They include: the use of proxy indicators for social constraints such as ethnic fractionalization (see Easterly *et al* (2006) and Licht *et al* (2007)⁵⁵); game theoretic approaches such as by Hoff and Pandey (2005)⁵⁶ and Ostrom (2005b); detailed ethnographic and survey field work such as by Wood (2003) Tsai (2004) Johnson (2004b, 2005a)⁵⁷ and historical analyses by North (2005) and Greif (2006) . Recognition of the importance of informal norms and enforcements

⁵⁴ For example, Acemoglu and Robinson (2006b) asked why many societies adopt policies that discourage investment and maintain institutions that cause economic backwardness. They appeared not to recognize that there are informal norms underpinning those formal rules which are more important to the powerful people within those economies.

⁵⁵ Licht *et al* (2007) have designed a measure of the cultural differences. They characterized the cultures of different societies according to three categories: Embeddedness / Autonomy; Hierarchy / Egalitarianism; and Mastery / Harmony. ("Embeddedness" in this paper means embedded within the local group and ethnic fractionalization - because ethnic fractionalization increases people's in-group affiliation). Using these dimensions they found two cultural "mega-regions". One consisting of the English-speaking and West European nations; the other consisting of the remaining regions. By definition then particular cultural profiles in major world regions are less compatible with "good governance," than the profiles in West European and English-speaking countries. This over simplistic conclusion appears to be a clear example of the challenges of operationalizing informal institutions,

⁵⁶ Hoff and Pandey (2005) found that a belief system or social norm that considers a social group as inherently inferior is self-fulfilling, because these belief systems lead individuals to expect their efforts to be rewarded in a biased way and mistrust then undermines their motivation. So opportunity is not everything, the cultural legacy contributes maintaining a social group in a subordinate position to a degree out of proportion to the elite's actual, contemporary political power and wealth.

⁵⁷ The financial market research of Johnson (2004b, 2005a) and Tsai (2004) found that gender norms embedded within the societies of the rural villages in Kenya and China respectively differentiated the demand for and supply of financial services. Specifically, gender norms of control over resources affected the demand for financial services and the informal norms of interaction between men and women affecting the type of services supplied.

has also been provided by economists respected for their methodological rigor such as Rodrik, Subramaniam and Trebbi (2004 p.158) and also Akerlof (2007)⁵⁸.

The ethnographic research has greatly expanded our understanding of the way social rules constrain or enhance economic opportunities in rural financial markets in Bangladesh (Wood 2003), China and India (Tsai 2004), Kenya (Ensminger 1992⁵⁹ and Johnson 2004b, 2005a). North (2005) and Greif's (2006) detailed comparative historical institutional analyses of economic development also explicitly address the role of social norms⁶⁰. (For example Greif (2006) compares the norms of the Maghribi traders' coalition and the Genoese bilateral contract-enforcement, which can be seen as similar institutional functions with different forms.) These and other detailed historical analysis has broadened our understanding of the importance of social norms to economic growth. Heydemann (2008) and Nugent's (2008) critique of Greif's analysis is that it appears to 'blame' the prevailing cultural norms for the failure of key institutions, such as property rights to evolve amongst the traders. This is a thinly veiled accusation of western imperialism which is unhelpful, because it does not recognize Greif's (2006 p.404) explicit acknowledgement that the institutional forms best fitted to achieving a particular outcome or function, depend on the contextual norms and can differ from those currently prevailing in the West⁶¹.

Cleaver (2002) finds socially embedded "multi-purpose institutions" (*ibid* p. 11) elaborated through processes lead by agents who are institutional "bricoleurs" with "multiple identities" in different economic and social arenas, are robust and enduring institutions. Therefore she recommends that institutional change interventions undertake "socially informed analysis of the content and effect of institutional arrangements rather than on their form alone"(*ibid*). Kelsall (2008) has undertaken such analysis across Africa and highlights the "complex and sometimes self-contradictory subjectivities" in defining them (Kelsall 2004 cited in Kelsall 2008 p. 648). He also brings to light their *increasing* complexity with urbanization, demographic changes, women's rights (etc.) and the contested nature of those norms. Recognizing the complexity of norms embedded in other informal norms and in formal institutions which change over time, Ostrom (1990 p.51, 2005a p.842) uses the concept of nesting to make sense of this complexity. "All rules are nested in another set of rules that define how the first set of rules can be changed." This concept of nesting allows researchers to identify the plethora of connections between norms and between norms and institutions at other levels. Ostrom (1990 p. 52-3) also highlights the complexity of operationalizing the concept of social norms, but the key point is that informal norms and their enforcement activities are

⁵⁸ Akerlof (2007) recognized that norms are generated and known by a whole community and that these norms affect macroeconomic variables.

⁵⁹ For example, Ensminger (1992) describes changes to economic and social institutions occurring between 1981 and 1987, including institutions that decrease transaction costs such as "the simple notarizing of legitimate traders and property rights by third party agencies, security forces that reduce banditry, banking facilities that extend credit and reduce the dangers of travel with cash...courts that enforce contracts and property rights" (*ibid* p. 27); as well as the changes to "gerontocracy, clan, lineage, patron-client relations, and, marriage." (*ibid* p.169).

⁶⁰ Cleaver's (2002) analysis of natural resource management institutions in the Usangu Basin, Tanzania and Kelsall's (2008) analysis of common norms across Africa and how they affect economic decision making have also both provided careful analysis of socially embedded institutions.

⁶¹ Likewise, Kelsall (2008 p. 627) finds that "in general, Western institutions sit ill with these [i.e. African] traditions".

foundational and that all institutions are nested within others. This point is essential for any framework that provides a heuristic device for research. As a result of these and similar findings, researchers such as Casson *et al* (2009 p.138) unequivocally state that “it is clear that informal institutions in developing countries play a very significant role in shaping formal institutions and in the operation of markets,” and that “informal institutions must therefore be included in all socio-economic analyses of institutions” (*ibid* p.137). However, as yet, there has been no analysis of the function of informal social norms in the development of inclusive financial markets.

The first four sections of this chapter have provided the theoretical foundation for this research. This research was positioned where historical and rational choice institutionalism converge, (which are two of the schools of institutional thought outlined by Mahoney and Thelen (2010)). The definition of institutions used in this research is that of North, and the outstanding contested issues with this definition were addressed. The importance of differentiating between institutional form and function (as Chang and Rodrik have emphasized) was explained and will be increasingly important for the research agenda. Finally, the Polanyian insight that economic institutions are social constructions and that markets are articulated through social institutions and embedded in local cultures will permeate every aspect of this research because without that understanding the research questions cannot be adequately answered. The next section considers a range of frameworks for categorizing and comparing institutions across markets and chooses one that best reflects these issues.

2.5 Framework for institutional functions

As Ostrom points out, researchers need an institutional framework that is both an aid to expanding theoretical understanding and a heuristic device for applied research. Ostrom (2005b p.22) warns that any such framework must be more than a method for imposing superficial order onto an extremely large set of seemingly disparate rules, what Bastiaensen *et al* (2005 p. 979) called the “polycephalous nature of the institutional landscape”. The litmus test is that the enforcement mechanisms of formal rules must be a validation of the underlying social norms (a supplement for the informal enforcement of norms) Platteau (2000 p.290).

Williamson (2000), Wood (2000) and Ostrom (1990, 2005a) designed such frameworks for generic institutional analysis. Rodrik (2005) developed a “market-enhancing” institutional function categorization and Fergusson (2006) an institutional analysis approach for financial market development. Rodrik’s (2005) market-enhancing institutional function categorization provides a four-way classification of institutions: market creating, market regulating, market stabilizing, and market legitimizing institutions. These were tested empirically by Bhattacharyya (2009) for their relative contribution to growth. For example, strong “market creating” institutions characterized by the function of adequate protection of private property and contract enforcement were found to be growth enhancing. Or for a “market regulating” institution such as competition, there exists a growth maximizing level to promote competition but beyond that it increases red tape and kills the incentive for investment. But these categories do not explicitly recognize the role of informal norms. This is the same problem with Ostrom’s (1990) categories. She postulates: 1) Constitutional

rules in which the collective action and operational rules are embedded. The constitution in turn, has a set of rules about how it can be changed. 2) Collective Choice rules used in making policies and the management and adjudication of policy decisions. 3) Operational rules that affect day to day decisions regarding access to resource units, monitoring and sanctions and processes of appropriation, provision, monitoring and enforcement. Ostrom (2005) lists at least seven groups of “working” rules that “affect the structure of any repetitive action situation including markets” (*ibid* p.834). These are position rules; boundary rules; authority rules; scope rules; aggregation rules; information rules and payoff rules (*ibid* p.835). Ostrom’s working rules classifications would be useful for a deep analysis of those rules, but this study is trying to understand the whole set of institutions including social norms for the microfinance market and needs a framework that specifically includes them. Wood’s (2000) approach has the opposite problem in that is a “metaphor” (*ibid* p. 221) for the institutional governance challenges in Bangladesh and a not detailed enough framework for the purposes of this research. He shows how those in poverty are “entrapped within the problematic social embeddedness” of four institutional domains of state, market, community and household” (*ibid*). Appealingly he identifies how those entrapped “prisoners” can become “escapees” (*ibid* p.224) but unfortunately this metaphor cannot easily be translated into a generic microfinance market.

Williamson’s (2000) framework identifies the various levels of institutions and explicitly includes informal norms as the foundational incentives of the economy, which is consistent with the theoretical progress on social norms in the institutional literature discussed above. Fergusson (2006 p. 30) includes fundamental institutions (social norms); as well as institutions which provide the legal framework; and institutions which are policies and regulations in his approach. He identifies key linkages between them but not the nested nature of the different levels of institutions. Since these three levels are the same as Williamson’s and, Williamson has more explicit links to the norms, this is the framework chosen as the most useful heuristic device for the analysis of financial markets available. As Joskow notes “[t]he division of social, political, legal and economic institutions into four levels is necessarily somewhat arbitrary” (2003 p.12), but it provides a useful framework. Joskow also notes that Williamson’s framework “makes it clear that the speed and direction of changes at these levels is not exogenous or necessarily monotonic” (Joskow 2003 p.13) which is important to remember when examining institutional change.⁶²

Williamson’s (2000 p.597) first level in Figure 1 below is the “Embeddedness” level which includes informal social norms, customs, traditions (including religious traditions) which impose constraints on the next levels. The title “Social Foundation” better represents the role of this level (Joskow 2003 p.12). For example, there may be a social norm that loans are paid back on time or that loans need only be paid back when they can be paid – such norms provide a foundation for the financial market. To ensure consistency in languages this paper uses the definition of culture in Guiso, Sapienza and Zingales (2006 p.23) “those customary beliefs and values that ethnic, religious, and social groups transmit fairly unchanged from generation to generation.” Zingales also works

⁶² Campbell (2004) argues that researchers must be able identify three dimensions of any institution– namely the regulative pillar that constrains it; the normative pillar that prescribes goals and how to achieve them and; the cultural pillar of the taken-for-granted-assumptions about reality. (Campbell 2004 p.36, citing Scott 2001). These categories do not appear to be substantially different from Williamson’s levels of institutions.

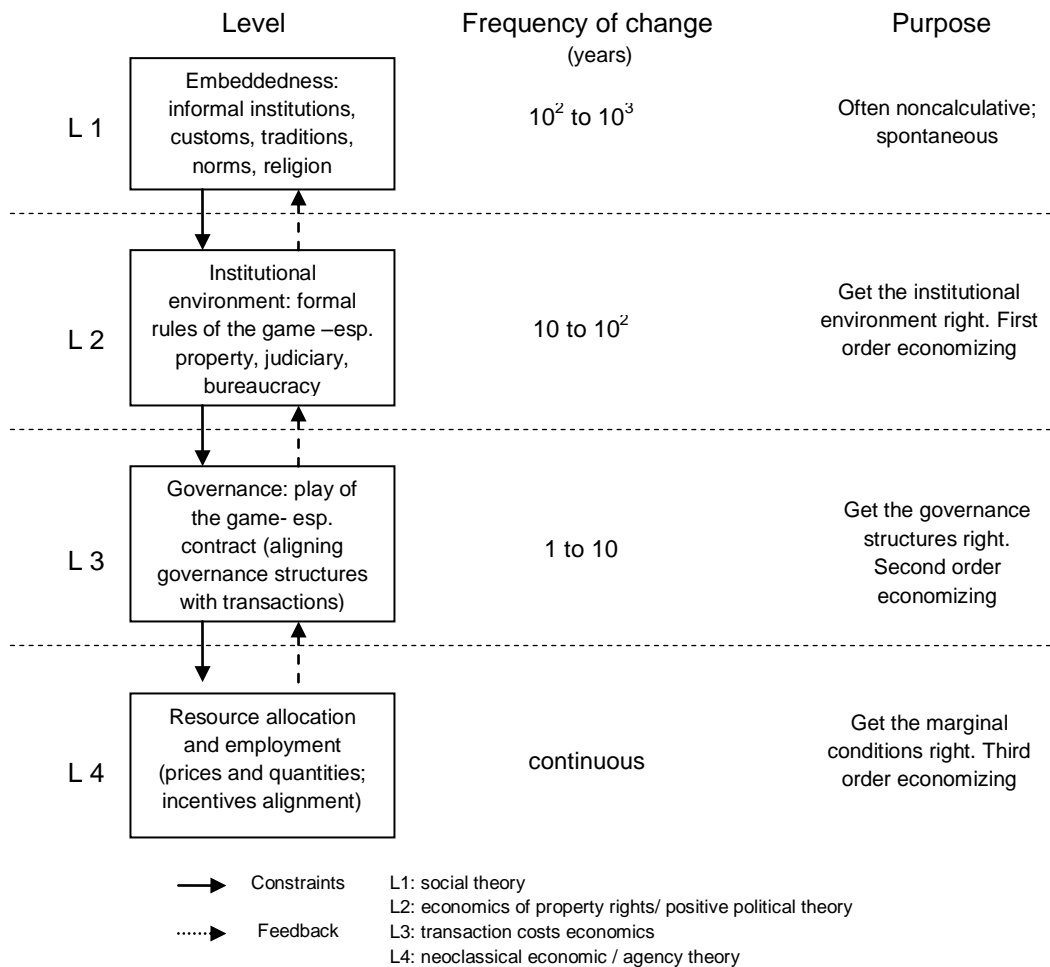
within an NIE framework and this definition focuses on those norms that can affect economic outcomes and so can be applied to financial markets.

The second level is what Williamson entitles the “Institutional Environment” which Joskow (2003 p.12) renames the “Formal Rules of the Game” that includes constitutions and laws. This is equivalent to Ostrom’s constitutional rules. Constitutional rules will be used as the most appropriate title because all levels are “institutions” so that is not a helpful title and operational rules can also be “formal” as distinct from informal which is also not helpful. This level includes the rules conventionally recognized as institutions critical to economic growth such as property rights and contract enforcement as well as laws (rules) on different types of company or financial service provider which are enforced by the court system. Fergusson (2006 p. 62) notes that macroeconomic stability cannot be considered an institution in this category because “it is more appropriately described as a symptom of underlying institutional problems rather than a fundamental contributor to financial development or backwardness.”

The third level is what Williamson entitles the “Governance level” or “How the Game is Played” (Joskow, 2003 p.12) or “Operational level” (Ostrom 1990 p. 52). The term Governance has subsequently become a more general term (Grindle 2007 p. 555) so the term Operation rules will be used. This level includes the rules implementing the constitutional rules e.g. regulations implementing the laws. In financial markets these regulations are enforced by the Central Bank or Bank Supervisor.

The fourth level of “Pricing”, is the domain of neo-classical economic analysis where there are adjustments to prices and output. These are therefore seen to arise out of the deeper institutional levels and in a dynamic way will also feedback into sustaining institutional arrangements at lower levels as they sustain the incentive structures involved. Given that it is the limitations of focusing on output and prices that has given rise to much institutional analysis, it is the first three domains that are emphasized in what follows. .

Figure 1 Williamson’s Institutional Framework



Source: Williamson 2000 p.597

Williamson’s implicit assumption in this framework is that all social norms take from a hundred to a thousand years to change in contrast to operational institutions which take from one to ten years to change. Roland’s (2004) approach does not put numbers on categories. Instead he recognizes that change in social norms is “slow moving” as compared to politically driven institutions which are “typically fast moving” as they can even change overnight. More importantly he recognizes that they are not independent speeds, rather, the interaction between the different levels of institutions at their different speeds will be affected by the other and also that this will vary in different economies and cultures.

Williamson’s framework has been chosen, therefore, because it most closely reflects the theoretical understanding of foundational role of social norms and that the enforcement of formal rules is dependent on the social norms. It also provides a useful heuristic device differentiating between

different levels of institutions in financial markets, which can be used to compare institutions across markets. There are an abundance of institutional functions found to be important for financial market development so this framework will now be applied in reviewing the literature on institutions and financial market development.

2.6 Institutional functions critical for financial market development

Rodrik (2008a p. 100) has identified the functions good institutions perform for economic growth: secure property rights (or give investors confidence), enforce contracts, stimulate entrepreneurship, foster integration in the world economy, maintain macroeconomic stability, manage risk-taking by financial intermediaries, supply social insurance and safety nets, and enhance voice and accountability. But he is clear that each one of these functions can be achieved in a large number of different ways (Rodrik 2007, 2008a).⁶³ These are very similar to the institutions Law and Habibullah (2009) found were a statistically significant determinant of banking sector development. But Grindle (2004, 2007), Bardhan (2005) and Fergusson (2006) (and many national policy makers), do not find such long menus helpful and instead ask what institutions “matter most”. “Given limited resources of money, time, knowledge, and human and organizational capacity, we need to know the best ways to move ...in a particular country context.” (Grindle 2007 p.554). Fergusson’s (2006) survey also asked the question “[w]hich institutions are important” for the financial market (*ibid* p. 29). One of the reasons that researchers are not able to identify the institutions that matter most is that they typically rely on cross-country regressions using general indicators of institutional quality. Honohan’s (2004 p. 30) opinion is that “[p]robing financial development by means of cross-country regressions has greatly enriched our understanding of the processes most likely to be at work” but it does not help us focus. (The strengths and weaknesses of this method are discussed in Chapter 3.) The alternative has been a singular focus on a particular institutional form, such as an independent central bank, but which may not be appropriate in every context (Rodrik 2008a p. 103). Honohan and Beck (2007) are an exception in that they recommended “short cuts” (*ibid* p.194) or priorities for financial sector development that includes contract enforcement and credit registries. In the microfinance community, the institutional or policy framework has been labeled a legal and regulatory one and is led by lawyers (e.g. Lyman 2005). There does not appear to be an understanding of the importance of institutions or research identifying which of these institutional functions are needed to support the expansion of financial sector to reach the excluded. There is a gaping hole in the literature about the institutions that matter most for financial inclusion. To begin to address this gap, Williamson’s framework was populated with the institutional functions frequently identified as affecting financial and microfinance market development in expanding to reach poor clients – see Table 1 below.

⁶³ Law and Habibullah (2009) used the ICRG institutional indicators discussed in Chapter 3.

Table 1 Institutions found to affect financial market expansion to reach low income clients ⁶⁴

Levels	Institutions found to affect financial market expansion to reach low income clients
<p>Level 1: The Social Foundations</p>	<ul style="list-style-type: none"> • Gender, age, ethnic group; religion, education; employment largely determine the operational rules and their enforcement mechanisms in each of the organizational forms providing microfinance - Johnson (2005b), Johnson and Nino-Zarazua (2009). For example, in Kenya, women have difficulty borrowing from financial intermediaries that require physical collateral because it is a social norm that they do not have property rights. • Trust (Fergusson, 2006). Trust increases people’s perception that others will cooperate and is important for financial contracts which are “trust intensive” (<i>ibid</i>, p.43) with clear enforcement mechanisms⁶⁵. For example, in Bangladesh Woolcock (1999, p.36) found that trust between group members and between Grameen Bank staff and group members was a key institutional link that shaped how microfinance worked to prevent default and subsequent enforcement of payment rules. In the Zambian microfinance market Van Bastelaer and Leathers (2006 p. 1788) found that “community-based cognitive social capital is shown to be strongly associated with repayment performance”. • Social norms which support obeying the law, prevent numerous small defections, even when trust is low (Platteau, 2000) • Loyalty to institutions and organizations that presently work and deliver livelihoods, whatever the longer term cost”. (Woods 2003 p.455) This norm can have severe negative implications for poor people. <p>The researchers above had specifically examined social norms and their enforcement characteristics in microfinance or related markets. The researchers below are examples of those have written about the social institutions / norms seemingly accidentally, but none the less importantly, either in the context of financial market development or development more broadly</p> <ul style="list-style-type: none"> • Regulations on disclosure (Beck, Demirgüç-Kunt and Peria 2008 p.399) are unrealistic unless clients are literate (Demirgüç-Kunt <i>et al</i> 2008 p.162) and have the power to hold financial institutions accountable (Honohan and Beck, 2007 p. 198). These require norms about transparency and accountability. • A “culture” of corruption (together with other higher level institutions) has been found to “escalate poverty incidence” (Tebaldi and Mohan, 2010 p. 1063). However, Wood (2000 p. 222) warns that concepts like corruption can be derived from an assumed rationality and used as a critique without understanding the underlying “range of commitments, obligations and therefore motivations for behaviour in societies”. • Ethical business (Argandoña 2004) “ethical institutions will constrain the behavior and actions of men and women, driving them to efficiency and to social stability” (<i>ibid</i>, p.200) • Norms around open private-sector led development critical for financial markets (Rajan and Zingales, 2003) and also norm of protecting markets critical for growth (Chang 2002b)

⁶⁴ Levels by Williamson (2000 p.597).titles by Joskow (2003 p.12).

⁶⁵*Ipsa facto*, trust is especially important where legal enforcement is weaker, which is the situation in many developing economies.

<p>Level 2 The Constitutional Rules. Basic Institutional Environment for Financial Market Development:</p>	<ul style="list-style-type: none"> • Rule of Law (North 1990, Platteau 2000, World Bank 2004a, Redek and Sušjan 2005, Fergusson 2006, Demirgüç-Kunt <i>et al</i> 2008, Tebaldi and Mohan, 2010, Barth, Caprio and Levine 2006) For financial markets of all types the “rule of law” function is critical for them to be effective and may need the threat of coercion for its effective enforcement (Platteau 2000, North 1990). Rule of law can also be used as a proxy for economic stability (Tebaldi and Mohan, 2010) (although Worldwide Governance Indicators (WGI) treat political stability separately). Households will not give up control over their savings for longer time-periods without the rule of law, and financial institutions will not commit beyond short-term contracts given funding uncertainties (Demirgüç-Kunt <i>et al</i> 2008). Rule of law could also include the private market’s ability to discipline banks (Barth <i>et al</i> 2006). The rule of law is particularly crucial when the social norm of “trust” in a society is low (Fergusson 2006 p. 44). The two main institutional forms which fulfil the rule of law and stability function in microfinance markets are the judicial system and an independent central bank (Honohan and Beck 2007). An independent central bank, which itself is financially stable is critical to the rule of law and stability in the financial system (Berger <i>et al</i> 2001, Arnone <i>et al</i> 2006, Kluh and Stella 2008) although Rodrik (2008a p.103) argues this may not always be the case. • Certainty of contract enforcement^{66 67} Platteau (2000), World Bank (2004a), Arnedáriz and Morduch, (2005), Fergusson (2006), Honohan and Beck 2007, Vatnick (2008) and Demirgüç-Kunt <i>et al</i> (2008 p.147 - 149). What all agree is that enforcement of contracts is imperative for financial market development⁶⁸. Security of contracting may include legislation that defines the rights and responsibilities of financial market participants, but alternatively writing specific laws for financial contracts may improve the functioning of the financial market. (Fergusson 2006 p. 38) For example, commercial courts with simplified judicial and asset recovery (Platteau 2000)⁶⁹.But it also may mean improving the basis for relational contracting such as information exchange not a major legal overhaul that is unsustainable (Rodrik 2008a). • Functioning collateral laws with registries (Platteau 2000, Haselman <i>et al</i> 2006, Arnedáriz and Morduch, (2005), Fergusson 2006, Honohan and Beck 2007 p.197, and Demirgüç-Kunt <i>et al</i> 2008) Closely associated with contract enforcement, since collateral is pledged in event of default, collateral laws with functional registries (including mobile collateral registries) have been found to be more important than property rights. When bankruptcy codes are complex, the collateral regime acts “as a kind of substitute” when there is also security of contracting. (Demirgüç-Kunt 2008<i>et al</i> p.151). The value of access to some form of formal collateral (of all forms) by microfinance service providers has also been found to improve their financial sustainability (Andersen & Malchow-Moller, 2006)
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⁶⁶ As discussed in Chapter 3, the ICRG institutional quality indicators gives contract enforcement a separate category but WGI indicators includes contract enforcement under its ‘rule of law’ indicator.

⁶⁷ Loan contract enforcement is more important than property rights for financial markets (Demirgüç-Kunt *et al* 2008 p.152) see discussion after table.

⁶⁸ The majority opinion is that “countries with stronger creditor protection enjoy deeper financial markets” (Fergusson 2006 p. 37), although the opposing view is that strict protection of creditor rights leads to more defaulted loans and insolvent business. But all agree on contract enforcement.

⁶⁹ A new expedited mechanism for loan contract enforcement was implemented in India in the 1990s and this new procedure bypassed dysfunctional court procedures and resulted in a considerable increase in loan recoveries (Demirgüç-Kunt *et al* 2008 p.152)

<p>Level 3 The Operational⁷⁰ Rules. Institutions of Governance - how the game is played.</p>	<ul style="list-style-type: none"> • A regulatory framework to support increased access includes: ensuring independent supervision (Honohan & Beck 2007); fostering “transparency and defines clear-cut accountability” (Vatnick (2008 p. 115); providing incentives for competition to broaden access (Demirgüç-Kunt <i>et al</i> 2008); and ensuring “local financial institutions act in a manner conducive to sustainable local economic development and to building and retaining local social capital” (Bateman 2011 p. 4). <p>Banking and microfinance regulation and supervision /enforcement can encourage prudent financial market development for poor people, or hinder it. For example, Burges and Pande (2005) found it could increase rural outreach,⁷¹ and Nair and Koeplinger-Todd (2009), Hirshland, Chao- Béroff, Harper and Lee (2008) and Vogel (2002) found it could improve the financial and outreach performance of financial cooperatives. But others find that regulation and supervision had a direct negative effect on microfinance institutions’ reaching poorer clients because of the increased costs of supervision Cull <i>et al</i> (2009), although, Mersland and Øystein Strøm (2009) found that average loan size remained static under supervision. Tsai’s (2004) work in China and India and Wood’s (2003) in Bangladesh concluded that only when microfinance programs are able to be structured according to local needs (i.e. when regulations allow such structuring) will it have the potential to displace ubiquitous usurious forms of informal finance. Marr and Tubaro (2010) found the regulatory environments determined whether microfinance providers were able to access a wider range of funding partnerships and so achieve their dual goals of financial sustainability and poverty alleviation. Similarly, Lascelles and Mendelson (2011) found that regulation which fails to take account of microfinance’s social role, (i.e. which does not recognize a diverse ownership structures and different cost bases of socially conscious organizations) is stopping its expansion. In a global survey of microfinance stakeholders they report that “[b]ad or nonexistent regulation was hindering the growth and profitability of microfinance, it was stifling MFIs, holding back innovation, preventing it from competing with new entrants, like commercial banks, where regulation was more highly developed.” (Lascelles & Mendelson 2011 p.28).⁷²</p>
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⁷⁰ Some operational institutions for facilitating financial market activity are generally unproblematic from a policy point of view, and their implementation is constrained only by government capacity. These measures include putting in place the legislation, taxation, and other rules needed for specific financing tools such as leasing and factoring that are particularly suited to small and medium enterprises. So long as the tax arrangements are not unduly generous, these improvements will be uncontroversial. (Demirgüç-Kunt *et al* 2008 p.153).

⁷¹ Burgess and Pande (2005) provide robust evidence that banking regulations in India encouraging the opening of branches in rural unbanked locations was associated with reductions in rural poverty linked to increased savings mobilization and credit provision in rural areas between 1977 and 1990 (Burgess and Pande 2005 p. 791). They conclude that “the Central Bank’s licensing policy enabled the development of an extensive rural branch network, and that this, in turn, allowed rural households to accumulate more capital and to obtain loans for longer-term productive investments. (Although they point out that whether the state monies invested in the banking sector would have generated greater poverty reduction if spent elsewhere is not a question they can address.)

⁷² “Microfinance needs to find its place in the global financial system. Either there has to be a clear regulatory environment distinguishing and recognising the microfinance sector, or the industry needs to mainstream itself as part of the banking or non-banking segment as the case may be in each country. The risk of an unclear regulatory environment is probably the main risk at the moment. Prashant Thakker - Global business head, – microfinance Standard Chartered Bank (Lascelles & Mendelson 2011 p.28). Also Scott Richards, an associate at Developing World Markets, a US microfinance investment firm, said that “many countries lack microfinance-specific regulations, and in our experience, the regulatory regimes in place to govern deposit-taking banks and other financial institutions do not fully or effectively address the specific regulatory needs of the microfinance industry.” (ibid p.27)

- **Transparent accurate audited financials** (Platteau 2000, Rajan and Zingales 2003, World Bank 2004 a p.122, Honohan and Beck 2007, CGAP 2006, Demirgüç-Kunt *et al* 2008, Andrianova *et al* 2008 p.248, Beck Demirgüç-Kunt and Peria 2008, Barth *et al* 2006.)

An enforced requirement for transparent accurate audited financials that meet international standards, with rigorous audit quality and procedures. Such disclosure contributes to accountability for both profit and not-for profit organizations. Without such disclosure it will not be possible to assess whether the organization is working efficiently to serve clients, to compare the relative efficiency of different organizations or organizational types or to consistently track performance over time. Transparency in both financial and social performance is one means to increase competition and interest rate transparency is an important component of consumer protection (see below).

- **Credit registries – with as diverse a range of client history as possible** (Platteau 2000, McIntosh and Wydick 2005, World Bank 2004a p.122, Honohan and Beck 2007, Djankov, McLeish and Shliefer 2007, Demirgüç-Kunt *et al* 2008 p.153)

Credit registries, public or private, through which lenders share information about their clients' repayment records—are an established way of enhancing the ability of borrowers to signal a good credit record. Registries should include not only banks but also microfinance providers and utility operators. Credit registries are particularly important in poorer countries and have been shown to increase lending (Djankov *et al* 2007). In microfinance, Luoto, McIntosh and Wydick (2007) and de Janvry, McIntosh and Saduloet (2010) documented the beneficial effects of credit information systems for lenders, and that these gains were augmented when borrowers understood the rules of the bureau. ⁷³ ⁷⁴ **A uniform personal identification** giving very person a unique identity is considered one form to make credit registries more effective (Rajan 2006, Mylenko 2007, Demirgüç-Kunt *at al* 2008 p.154). It can dramatically improve the ease and effectiveness of the operation of the credit information industry with regard to individual or microfinance borrowers. For example India's national Unique Identity Document (UID) effort will both enable better targeting of government programs and provide the option of a bank account (Gerdeman 2011)

- **Financial Consumer Protection:** Interest ceilings have in the past been the means by which regulators have attempted to protect poor consumers from abusive and usurious practices (Mavrotas 2005). But they have failed to address the problem adequately and can be counterproductive by reducing transparency for clients (Demirgüç-Kunt *et al* 2008). Substantial research is now underway on appropriate rules and enforcement mechanisms to protect financial consumers in low-access environments⁷⁵. To date evidence shows three key goals: 1. Transparency: Customers know what they are getting. 2. Fair Treatment: Customers are treated fairly and are not sold inappropriate/harmful financial services. 3. Effective Recourse: Customer complaints are resolved fairly. However, it is important to note that adoption of laws and regulations from elsewhere is rarely appropriate due to differing social, legal, and economic contexts. The capacity of the regulator in question to implement and supervise is also critical (Brix and McKee 2010 p. 1).

⁷³ In some countries barriers to credit registries include privacy laws or incumbent banks not wanting to share information about good clients, so the government may have to make information sharing mandatory (Djankov *et al* 2007). Some authors have recommended penalties for financial service providers that fail to participate in a credit information bureau (Freedman and Click 2006).

⁷⁴ With the advent of extensive mobile phone access in poor communities, if the payment and transaction records of financially excluded clients were included in credit registries, these records may indicate a person's creditworthiness. (Liu and Mithika 2009).

⁷⁵ Karnani (2009 p. 84) argues that a libertarian mindset is the reason there not been an emphasis on legal and regulatory mechanisms to protect poor consumers, romanticising poor people as 'resilient and creative entrepreneurs' and 'value-conscious consumers' instead of vulnerable consumers needing protection.

- **Access to Payments System** (CGAP 2007, Mendoza and Thelen 2008, Stone 2010 Alexandre, Mas and Radcliff, 2010) There are typically high barriers to entry for access to payments systems ⁷⁶. Payments are particularly important for domestic and international remittances received by the rural poor from relatives in the city or who have migrated and at their Cannes 2011 meeting G20 Leaders have now committed to reducing global remittance costs (G20 2011). Mendoza and Thelen (2008) found mobile phone payments have many advantages for low income clients over conventional payment systems. Allowing such innovation is critical to expanding access (Goodwin-Groen 2010, Stone 2010) Alexandre *et al* (2010 p. 1) outline the banking laws and regulations which need to be adapted to these new possibilities of banking beyond bank branches.⁷⁷
- **Fostering Competition:** (Rajan and Zingales 2003, Demirgüç-Kunt 2008 p. 179, World Bank 2004a p.119, CGAP 2004). Micro-credit clients benefit from increased access, improved services and eventually improved prices due to competition (Porteous 2009 p. 11) However, Porteous (2009)⁷⁸ also notes downsides to competition in this market. For example, it can reduce access to the poorest clients by removing incentives for cross-subsidy within organizations (McIntosh and Wydick, 2005) Regulators must achieve balance. Options include: **permission for foreign-owned banks to enter the financial market**, (Freedman & Click 2006), **transparency in pricing** (see consumer protection), **mass financial literacy campaigns** (such as in Ghana, Goodwin-Groen 2010); and undertaking a **regulatory impact statement**. (Porteous 2009, Demirgüç-Kunt *et al* 2008, Cull *et al* 2009, Lascelles and Mendelson, 2011)⁷⁹.

⁷⁶ In South Africa the National Payment System Act was amended in 2004 to force the four tier-one banks to relinquish their monopoly of the national payments system so that tier-two and tier-three banks could also participate. The tier-one banks' cartel had created high barriers to savings services for poor people and so needed legislation to increase access to savings services (Goodwin-Groen 2006 p. 10).

⁷⁷ Alexandre *et al* (2010) highlight five areas where sharpened regulatory analysis would help strike a better balance between maximizing the opportunities of these models and containing risks: 1. branching regulations which distinguish between pure transactional outlets and full service bank branches; 2. regulations which permit banks to engage third-party retail outlets with minimal financial risks for both banks and their customers; 3. consumer protection regulations that help customers understand and act upon their rights in a more complex service delivery chain, without burdening banks with unnecessary provisions; 4. tiered know-your-customer (KYC) regulations that permit immediate account opening with minimum barriers for poor people, with a progressive tightening of KYC as their usage of financial services grows; and 5. creating regulatory space for a class of non-bank e-money issuers authorized to raise deposits and process payments, but not to intermediate.

⁷⁸ According to Porteous (2009), (who uses Porter's (1980) five forces analytic framework,) most of the features of micro-credit markets make it difficult for regulators to foster competition include: difficulty for clients to switch lenders; the limited bargaining power of clients; high barriers to entry and; the ease of clients finding substitute products in the informal a sector. For example, if group-lending in micro-credit predominates then social norms of the group means clients cannot leave their obligations to other members which also increases switching costs and create a barrier to entry. Another example is that the government may have a direct role in the market (such as though an Apex that controls the supply of funds) which may create barriers to entry so new providers find it difficult to enter. The downsides to competition listed by Porteous (2009 p.11) and Chen, Rasmussen and Reille (2010) can include multiple indebtedness of borrowers and a breakdown in the internal control systems of microfinance service providers, but not always.

⁷⁹ Many microfinance respondents felt that poor MFI regulation was putting them at a disadvantage vis-à-vis these new entrants, for example in the range of products they could offer and in their access to funding, and even their ability to move into new areas like mobile banking. (Lascelles and Mendelson, 2011)

Table 1 provides a summary of the research on the institutions which are most important for the expansion of the financial market to reach low income clients. It identifies constitutional institutional functions of: the rule of law, (with examples of forms for achieving this function being the judicial systems and independent central bank); certainty of contract enforcement and; functional collateral registries. The operational institutional functions include a regulatory framework to support increased access with effective supervision, transparency and competition.⁸⁰ The basic contents of this Table 1 may be well known to those who work in financial market development and microfinance, but it has never been structured and presented in this way before. This framework provides a new perspective on institutions for inclusive financial market development, for example, it shows there is nothing at the constitutional level which specifically addresses inclusion. Indeed, the differentiation between levels opens up challenging questions about what are appropriate levels for institutions supporting financial inclusion? For example, does the function of financial consumer protection need to become a constitutional function for financial inclusion? What this framework cannot do, however, is provide insight into the relative importance of these different functions for increasing financial inclusion.

On the issues of property rights, it is worth pointing out that the conventional wisdom of property rights being critical for financial market development is changing. The form of property rights for the financial market is now considered to be less important than the function of loan contract enforcement (Demirgüç-Kunt *et al* 2008 p.152). After Hernado de Soto's (2000) book, "The Mystery of Capital", many assumed providing land title would give increased access to credit. But land titling has, unfortunately, not fulfilled the hope of enabling poor farmers to use their land as collateral (Platteau 2000 p.181, Guirkinger 2008 p. 1448) Farm households still face myriad risks, combined with the high cost of formal loan application and the inability of banks to offer low risk loans to borrowers. Even though several cross country regressions on key institutions show property rights critical to economic growth (Rajan & Zingales 2003. Rodrik *et al* , 2004, Redek and Sušjan 2005,), Rodrik *et al* (2004) were careful to point out that it was the function of what they termed "credibly signaling that property rights will be respected" (*ibid* p. 157) was much more important. Demirgüç-Kunt *et al* (2008 p. 152) conclude that "the single reform of titling has in these documented cases not had the impact anticipated in the literature." So the options are either a comprehensive set of policy reforms or shortcuts to improve the functioning of the credit market by improving loan contract enforcement.

The purpose of populating this framework was both to facilitate our theoretical understanding of institutions and, at the same time, to test its use as a heuristic device for applied research. On its

⁸⁰ On regulation, Bateman (2011 p. 4) argues that the function of microfinance regulation should be to ensure "local financial institutions act in a manner conducive to sustainable local economic development and to building and retaining local social capital". In other words, it is no longer adequate for the function of regulation to be compliance with the Basel Common Principles (Basel Committee 2011) as required under Financial Sector Assessment Programs (FSAPs) <http://www.imf.org/external/NP/fsap/fsap.aspx> [Accessed on 25 April 2012]), but microfinance regulation should take the next step to actively promote local economic development. These ideas are still at an early stage and the pragmatic outworking of such ideas has yet to be done, but these proposals are consistent with the broader political commitments to greater inclusion.

theoretical contribution, Table 1 does enable the links to be made between social or local informal institutions and other institutions. For example: a culture of transparency greatly facilitates enforcement of the operational regulations requiring accurate audited financial statements or; gender norms are key determinants in access to payment systems or that; corruption has a fundamental effect on the effectiveness of mobile collateral registries. But it is a static framework so it cannot define those relationships. It also raises questions about path-dependent approaches to institutional change theory because it shows spaces for change between different levels and because the constitutional and operational functions are clearly different so will require differentiated change processes. On whether this framework is a useful heuristic device for framing the institutions for financial inclusion, the examples above show its usefulness and it does facilitate the comparison of institutional functions at the different levels across markets. Such a comparison will be undertaken in the Bosnian and Ugandan microfinance markets.

The first four sections of this chapter provided the theoretical foundation for this research. The subsequent two sections considered a range of frameworks for categorizing and comparing institutions across markets and choose Williamson's (2000) as the one that is best able to incorporate the theoretical understanding of social norms, to use institutional functions instead of forms and to work as a heuristic device for applied research on institutions for financial inclusion. The framework was populated with research data and more than adequately achieved its purposes. Interestingly the framework also appears to challenge path-dependent theories of institutional change processes which are discussed in the following section.

2.7 Theories of institutional change

The different levels of institutions forces researchers raises the issue of how institutional change might be different for each level, which requires the theoretical question of how institutions change to be answered first. In the previous chapter current practices in institutional change generally and specifically in financial market development were described and assessed as largely failing. So there is a need to step back and find new theoretical frameworks for institutional change, which in turn will be assessed to see if they provide more useful practices for institutional change. Shirley (2005 p.631) comments that the "specifics of institutional change fall through a gap in the literature", which is not surprising given the speed with which the field has developed. But it is still a gap which must be filled so in the next section three types of institutional change theories will be identified and two recent theories are examined and critiqued. These two theories were identified because they address the limitations of earlier theories and include important advancements on the current theoretical understanding of institutional development. As funders' efforts to undertake institutional change have had many reported failings, an assessment of relevant theoretical models is a necessary step to making improvements to institutional change practices.

The three institutional schools of thought identified by Hall and Taylor (1996) and outlined above provide Mahoney and Thelen (2010) a basis for analyzing more recent theories of institutional

change. Mahoney and Thelen (2010) find that all three categories of research provide useful answers for what sustains institutions over time and cases in which exogenous shocks prompt institutional change. They identify some convergence between the approaches, for example, rational-choice researchers see the value of including the power dimension of historical institutionalism and the institutional entrepreneurship of the sociological institutionalism in their analyses. But none of the approaches has, according to Mahoney and Thelen, developed a theory of gradual change. This is because each approach assumes that only an exogenous shock to the economy, such as war or other crisis or disaster, can challenge basic institutional stability and bring about “radical institutional reconfigurations” (Mahoney and Thelen 2010 p.2)

- Sociological institutionalists, interested in “non-codified, informal conventions and collective scripts that regulate human behavior” (Mahoney and Thelen 2010 p 5), often point to an exogenous entity or force which imposes their alternative scripts on the pre-existing ones. But a framework has not yet been developed for understanding what makes some of the pre-existing scripts more vulnerable to the imposition of new scripts than others.
- Historical institutionalists emphasize the importance of historical processes when studying institutions “over a substantial stretch of years, maybe even many decades or centuries” Pierson and Skocpol (2002, p. 698). But Greif and Laitin (2004) find that the historical institutionalist focus on process is “inadequate” to answer questions of how and why institutions change. Scholars have tended to frame change in terms of enduring historical pathways periodically punctuated by discontinuous shocks. As remarked above, Powelson’s power diffusion process falls firmly into this category as he considers it takes centuries to change apart from an exogenous shock.
- Rational-Choice institutionalists also typically focus on the exogenous shock as the trigger to institutional change. Williamson states that there are “rare windows of opportunity to effect broad reform... such as massive discontent, civil wars, occupation, breakdowns, a military coup or a financial crisis” (Williamson, 2000 p.598). Greif and Laitin’s (2004 p.633) analysis of a typical rational choice approach was that changes in self-enforcing institutions “must have an exogenous origin”.⁸¹ But Greif and Laitin (2004), like Ostrom (1990, 2000)⁸² (and earlier Hayek) differentiate themselves from other rational-choice institutionalists as they have identified the possibility of endogenously emergent institutional change.

Chang (2011) concurs with the historical institutionalists that path dependence “operates at a more fundamental level than we normally think”, and that “the constitutive role of institutions, the inherent change resistance of designed institutions and the interdependence between institutions” (*ibid* p. 18) means that institutional change does not happen easily. He concludes that the dominant practice of institutional transfers approach to institutional change is fundamentally at odds with everything we know about institutions. But he does not agree that only exogenous shocks can change institutions, a position he refers to as “unduly fatalistic” and “simplistic” (*ibid* p.22). He points to elements in a country’s institutional complex that internally generate change as

⁸¹ Greif (2006) also critiques North’s monolithic and immutable view of cultural norms that does not recognize endogenous mechanisms for institutional change. This immutable view of cultural norms is one of the reasons for North’s focus on “path dependence” in institutional change discussed below.

⁸² To Ostrom exogenous appears to mean outside the nested set of rules and norms which comprise the action arena, which would which gives even greater space for change.

well as the effect of economic development and to human agency. He is following Greif and Laitin (2004) and others in identifying the importance of endogenous change and following Cleaver (2002) in identifying the dynamic human “bricoleurs” (*ibid* p.11) who create “institutional bricolages”, multi-purpose institutions which intersect both economic and social, formal and informal, tradition and modern domains. Chang (2011 p.494) concludes: “[o]nly theories that take both structural constraints and real human agencies seriously can help us”. Two recent theories which attempt to meet this standard are critiqued in the following sections

2.7.1 Mahoney and Thelen’s theory of gradual institutional change

Mahoney and Thelen’s (2010) purpose is to create a gradual theory of institutional change that builds on common themes in all three schools of institutional thought but, most importantly, moves beyond the theoretical view of institutional change that is path dependent until punctuated by exogenous shocks. They build on Greif and Laitin’s (2004) work which focuses on endogenous sources of change. Mahoney and Thelen’s (2010) critique of Greif and Laitin’s (2004) framework is that it has no predictive power whereas Mahoney and Thelen (2010) claim their theory of gradual institutional change, in contrast, has some predictive power.

Their central argument is that the basic properties of institutions contain within them the possibility for change, particularly “the power-distributional implications of the institutions” that animates the change (*ibid.* p.14). To support this argument they carefully identify several attributes of institutions which allow space for change including:

- Whether institutions are rules or norms, they will have unequal implications for resource allocation and ongoing mobilization of resources is needed to maintain institutions and their relative position vis a vis other institutions, so this creates space between institutions for change.
- Actors with different endowments pursue different kinds of institutions and the institutions created reflect the relative power of those different actors (sometimes as a result of conflict), which creates space for change. For example an independent central bank usually has strong veto power in the financial market institutions but not with welfare institutions.
- Actors face information processing limits and cannot foresee all the future possible situations that the rules as written will be asked to address, so new situations will challenge those rules.
- Institutions represent compromises that are always vulnerable to shifts and are inherently dynamic.
- Formal rules are embedded in social norms that are often only implicit understandings held by the relevant community, so leave space for change.
- The enforcement mechanisms (or compliance) for the rules or norms are a separate variable and have their own dynamic of potential change.
- Enforcement is typically undertaken by actors other than the designers – who may contest or be uncertain about enforcement, so this creates space for interpretation and thus change to occur in implementation.
- Rules and norms can never be precise enough to cover all the complexities of life which complicates enforcement / compliance.

Given that enforcement can be uncertain or contested, the meaning of an institution can be undecided, an actor's interest in continuity may be equivocal and, that institutions are nested - there are multiple spaces where change can occur. This approach recognizes that the source of institutional change does not need to be exogenous, by any definition of the term.

However, there are two other aspects of institutions which contribute space where change can occur, neglected in both the mainstream discourse and also by Mahoney and Thelen (2010). These are the multiple functions of institutional forms (Chang, 2007) and the differences in spaces at the different levels of institutions. The functional multiplicity of institutional forms may make the task of institution building difficult, but with the flexibility to perform multiple functions also comes the flexibility to provide some space for change⁸³. In addition, Mahoney and Thelen (2010) do not appear to have recognized that different levels of institutions may have distinctive spaces or that there may be spaces between nested levels. For example, they note that rules and norms can never be precise enough to cover all the complexities – but how does the space created differ between, say, a law and a social norm? Furthermore, spaces for change could be expanded if the endogenous institutional change involves power sharing. Cornwall (in Hickey and Mohan (eds) 2004) noted how participatory approaches to development were explicitly “creating spaces where there were previously none, about enlarging spaces where they were previously limited opportunities” (*ibid* p. 77) to create “innovations in institutional design” (*ibid* p.85). So these spaces for change identified by Mahoney and Thelen (2010) are not static as engagement in those spaces can generate increased opportunities for change.

Mahoney and Thelen go on to create a typology of four ways institutions change: Drift - neglect of old rules; Displacement - removal of old rules and introduction of new ones; Conversion - changed impact of old rules; Layering- introduction of new rules on top of old ones. Institutions will change in these ways depending on two key parameters: the possibility of the change being vetoed and the level of discretion in the institution's enforcement characteristics⁸⁴. This is presented in a two by two matrix -see Table 2 below. The matrix shows, for example, that when there is a strong likelihood that any institutional change will face a political veto and there is little discretion in how the institution is enforced, change will more likely come from adding another layer of rules.

⁸³ Mahoney and Thelen (2010) do not use the terms institutional form and institutional function but in their examples they do outline institutional functions. For example, “the laws were designed to bolster the voice and power of labour at the plant level” (Mahoney and Thelen 2010 p. 27)

⁸⁴ Mahoney and Thelen 2010 p.19 are careful to state that this typology applies both to formal and informal institutions as there are also social actors with veto power. In addition to players, veto possibility also means veto points.

Table 2 Mahoney and Thelen’s typology of institutional change

	Characteristics of the Targeted Institution		
		Low level of interpretation/enforcement discretion	High level of interpretation/enforcement discretion
Characteristics of the Political Context	Strong Veto possibilities	<i>Introduction of new rules on top of old ones</i> - Layering	<i>Neglect of existing / old rules</i> - Drift
	Weak Veto possibilities	<i>Removal of old rules and introduction of new ones</i> - Displacement	<i>Active change in functions of existing rules</i> - Conversion

Source: Mahoney and Thelen 2010 p.19

When discussing institutional change Chang (2007 p.9) states that “human agents are certainly capable of developing ideational discourses that are not totally ‘structurally’ determined”. Recognizing the role of human agency, Mahoney and Thelen (2010) have created an additional typology of human change agents, either internal or external, whom they classify as either seeking to preserve the institution or not and either following the institutional rules or not⁸⁵. Although useful to identify different types of change agents and their associated strategies Mahoney and Thelen only describe this part of their theory as one that “calls attention” to the different types of change agents, in contrast to the “crucially important” (*ibid* p. 31) focus given to the two other aspects described above.

Mahoney and Thelen’s theory is useful because it describes ways an institution can change over time driven by several endogenous attributes (listed above) and they have identified the most important factors as the strength of veto power degree and degree of enforcement discretion, recognizing human agency. The typology can provide guidance about what type of change process is possible given the amount of veto power and level of enforcement discretion. For example, if there little possibility of a veto and low enforcement discretion it would make sense to try to remove old rules and get new rules passed instead – the displacement option. Mahoney and Thelen (2010) give a range of historical examples of institutional change to support their theory from the British House of Lords to a package of laws passed in France in 1981. This range of examples implies that the authors have an ambition for their theory to apply to an equivalent range of situations as they also believe it has the potential for some predictive power.

Two key points appear to be missing from this theory however; a discussion of time frames within which their theory operates and, the link between their theoretical recognition of the power-distributional implications of institutions and changed institutions. In other words, what are the processes which translate their theory into changed institutions? This missing link is hardly surprising because, as yet, no consensus on what type of institutional change processes are effective in tapping the spaces for change, nor what role external development agents could

⁸⁵ The four categories of change agents identified are: Insurrectionaries, Symbionts, Subversives and Opportunists.

usefully play, although there is some interesting research on the issue (Bastiaensen *et al* , 2005, Eversole 2010, Crook and Booth 2011).

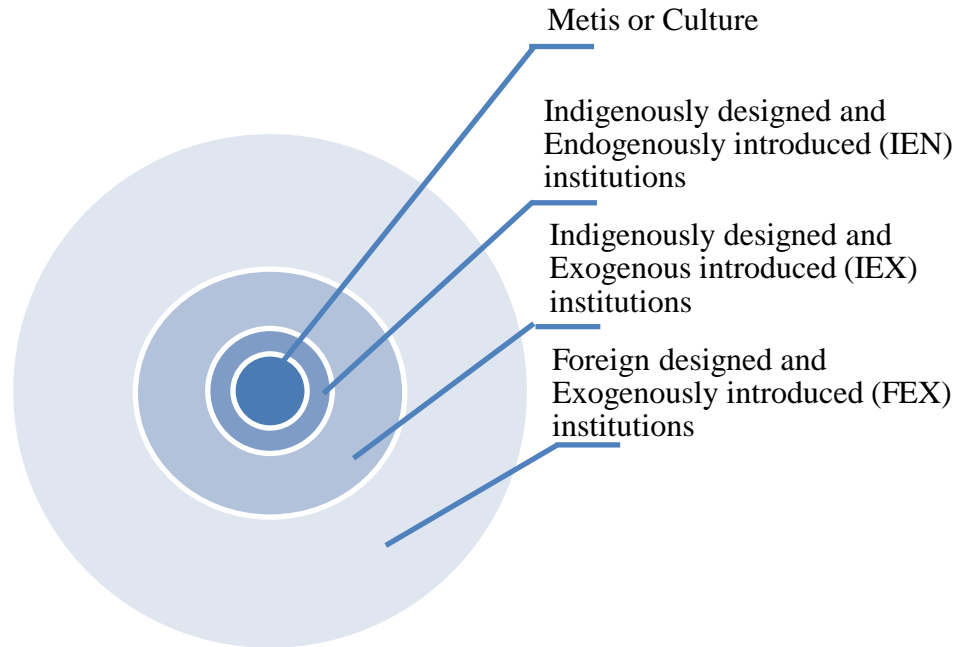
2.7.2 Boettke, Coyne and Leeson's regression theorem of institutional stickiness

In contrast, Boettke, Coyne and Leeson (2008) have focused on theorizing “the missing how” of institutional change (*ibid* p. 331). They too acknowledge the key features of each of the three schools of thought (although they do not classify them in this way)⁸⁶. Coming from the rational-choice school of thought, they recognize the importance of path dependence, but they also embrace sociological and historical institutionalism in their recognition of the importance of embedded norms and history to institutional change recognizing that culture and history matter. They theorize that institutional changes are more likely to “stick” (*ibid* p. 343) when the process is indigenously developed and endogenous. They consider endogenous institutions as those which “emerge spontaneously as the result of individuals’ actions, but are not formally designed. Thus, by their nature, endogenous institutions are indigenously introduced.” (*ibid* p.335) In contrast “exogenous institutions are constructed and imposed from above.” (*ibid* p.335). Indigenously introduced endogenous (IEN) institutions will “stick” because they are close to the *mētis* i.e. culture, norms, and conventions. In contrast foreign introduced exogenous (FEX) institutions will rarely stick because they are so far away from the culture. In between are the indigenously introduced exogenous (IEX) institutions which are more likely to stick because they have formal authority (e.g. internal policies created by national governments). They recognize that these are purely conceptual categories as shown in Figure 2 below⁸⁷ that will change over time and be different in different places.

⁸⁶ Boettke *et al* (2008) consider their work as following that of Hayek in the “spontaneous” institutional change category as well as that of Elinor Ostrom (1990, 2000) and James Scott (1998) who have highlighted the importance and success of endogenously-emergent institutions (*ibid* p.5). In addition they recognize their work is consistent with the recent work of North (2005).

⁸⁷The labels for their categories IEN, IEX and FEX are confusing and do not help the reader easily come to terms with their argument and using the term *metis* instead of culture appears pompous! However, these issues should not detract from their theory.

Figure 2 Boettke, Coyne and Leeson’s theorem of institutional stickiness



Source: Boettke *et al* 2008 p. 344

In summary, they theorize that new institutions are more likely to “stick” the closer the design is to the existing culture and the greater the degree to which is seen to be endogenous.

This theorem appears to embody Chang’s (2007), Woolcock (2009b) and Booth’s (2011) views that “institutions work better when they build on what exists, make use of indigenous institutional creativity or are otherwise rooted in their sociocultural context. They work badly when they rely heavily on the implantation, without major modification, of models that have worked well in other times and places.” Booth (2011 p.2) In order to gain legitimacy, “the new institution has to have some resonance with the existing culture/institutions,” (Chang 2007 p.30) Chang sees this as limiting the possible scope of institutional innovation but it still gives room for innovation within these parameters. This recognition that for the institutional change to stick it has to be close to the culture also means that congruence with social norms is essential. (However, there is no explicit recognition of the different levels of institutions discussed above, the theory is effectively demonstrating that the norms in the culture are all important and that institutional change without them will not stick.)

By using an impressive range of historical examples, Boettke *et al* (2008) show that their theorem correctly identifies the stickiness of institutional change. However, they provide only very general guidance to those who want to catalyze institutional change - be they governments or donors – as to how to maximize the chances of the institutional change sticking. In the following section, these two theories will be examined in the light of empirical institutional change examples to assess whether they can be usefully applied.

2.8 Applying institutional change theories

Roland (2000) analyzed what had been learned about institutional change during the transition process to a market economy in many of the economies of central and eastern Europe. He compares the approaches to transition based on what he terms the Washington Consensus which others refer to as the “exogenous shock” approach with the “Evolutionary-Institutionalist” approach, similar to Boettke’s IEN category. The Washington Consensus approach was external agents designing new institutional rules based on a ‘market economy’. But the political elite either did not have the power or did not want to enforce those reforms. The goal was what Mahoney and Thelen (2010) categorize as the “Displacement” type of institutional change, but their theory does not tell us how to assess whether this change would last. Roland (2000) contrasts this approach with what he calls the “Evolutionary-Institutionalist” approach to institutional change which means working with the existing institutions and enabling them to adapt – not forcing them to change. This is consistent with Boettke’s theory of indigenous and endogenous institutional change. What Boettke *et al*’s theory tells us is that since the adaptations were co-designed with local leaders – indigenous - and the design was an endogenous adaptation not an exogenous design, (IEN), then it should “stick”. Roland found that the Evolutionary-Institutionalist approach was indeed more effective at bringing about effective institutions.

McDermott’s (2007) analysis of institutional change focuses specifically on the responses to banking crises in Hungary and the Czech Republic and compares them to Poland. He found that the ‘participatory restructuring’ approach used by the Polish authorities fostered innovative, cost-effective monitoring structures for recapitalization, a strong supervisory system, and a stable, expanding banking sector. The process of ‘participatory restructuring’ was based on “distributed authority and rules of information sharing” (*ibid* p.220) and used “collective problem solving and mutual monitoring” (*ibid* p.222). The keys were: transparency and information sharing; accountability; conditionality; mutual evaluation and learning. To use Boettke’s terminology, the institutional change was indigenously developed and endogenous because the changes arose from the banks themselves so there was a high probability that they will “stick”. To apply Mahoney and Thelen’s terminology there was flexibility in how the enforcement was designed and weak political veto power so the goal was again “Displacement” but with ability to assess whether it would last.

Grindle’s (2001, 2007) research focuses on the political economy of institutional change in developing economies. Initially in 2002 she realized not enough was known about institutional change so urged political economists to “consider where the initiative for institutional change comes from, how new institutional models are created” (Grindle 2001 p. 372). By 2007, building on her 2004 “good enough governance” agenda, she urged that before embarking on a process of institutional change good political economy analysis was needed and that analysis needed to bear on the change process (Grindle 2007, p. 569). Also before embarking on an institutional change process Grindle states it is critical to “identify domestic sources of leadership and strategic action for reform” (*ibid* p. 571)⁸⁸. In Boettke’s terminology, the change process advocated by Grindle is

⁸⁸ Acemoglu and Robinson (2006a,b) have also found that political elites will stop externally imposed institutional change when their power is threatened.

one that is indigenously introduced, although it may be exogenous in origin, which will give it the best chance of sticking. According to Mahoney and Thelen's (2010) theory, Grindle is suggesting that institutional change will be most productive when there is weak political veto power (since the leadership supports the change) and *yet al* so a high level of discretion about enforcement (since enforcement is within their discretion). The outcome would then indeed be an active change in functions of existing rules. Therefore, it seems both theories seem to apply to the institutional change processes Grindle has recommended.

Before rushing to prescribe solutions without a basis, Chang (2007 p.4) takes a step back. He says "[w]e need more case studies on actual experiences of institution building.....from the recent experiences of developing countries themselves". Again in 2011 Chang appeals for more attention to be paid to the "real world" and to "recognize the complexity of the nature and the evolution of culture and institutions" (Chang 2011 p.494). Similarly Portes and Smith (2008) argue that the functions of specific institutions within particular markets over time need to be examined and Gibson, Andersson, Ostrom and Shivakumar (2005), advocate for donors to support "research on indigenous institutions, norms, and local knowledge systems" (*ibid* p.232) to provide essential understanding for building contemporary institutions⁸⁹. The value of historical and social research is also consistent with Grindle's (2007) findings.⁹⁰ The most productive option would be to follow Chang's (2007, 2011) and Grindle's (2007) recommendations together and undertake more developing country case studies, carefully understanding the context and content, with the specific goal of testing recent institutional change theories.

2.9 Conclusion

This research is situated where historical institutionalism and rational choice (or post-rational choice) institutionalism converge. Deficiencies of current institutional change theories which focus on extremes in these institutional approaches were addressed. Two new theories at this convergence were promulgated and critiqued. They both integrate rational choice institutional concepts, recognize the persistence of institutions and the power distributional aspect of change, and include social norms. These theories are consistent with the definition of institutions chosen, and can accommodate the precision needed to separate institutional form and function, which has not been adequately addressed before. Institutional changes in the Bosnia and Uganda case studies will be used as real world tests of the usefulness of these theories.

⁸⁹ It now appears that Burnside and Dollar's (2000) recommendation to make aid contingent on good policies, negates both the accountability of governments to their own people and local institution building-processes.

⁹⁰ One example of a donor following this recommendation to research indigenous institutions, norms, and local knowledge systems is described by Adler *et al* (2009) in Indonesia and Cambodia. They took this step as part of a process to try to "identify effective strategies for institutional reform that derive their content and legitimacy from the historical and cultural context in which they are embedded, and which take seriously the need to provide tangible incentives and transparent rules systems to structure and mediate interaction between parties when their respective interests, resources and power may be otherwise qualitatively different and/or fundamentally misaligned." (*ibid* p.25)

A survey of the institutional functions identified as important for the financial market to reach low income clients was presented. This fills a surprising gap in the literature on institutions for financial market development. It was presented using Williamson's (2000) framework which usefully identifies four different institutional levels for institutional mapping. This framework shows, for example, that no research was found on constitutional institutions that specifically address financial inclusion. It also highlights the social norms which have been identified as affecting financial inclusion. This is consistent with theoretical recognition that markets are embedded in social norms, a critical issue for financial inclusion which has been neglected in much analysis. This framework will also be used in the analysis of microfinance markets in Bosnia and Uganda to compare the institutional functions across markets.

Chapter 3: Methodology

This chapter makes the case for a social constructionist ontology and interpretivist epistemology in the analysis of institutions, and for a micro-ethnographic methodology to answer the research questions. It argues that ethnographic methods will best enable the role of social norms within the microfinance market to be explored in depth, as well as provide the market participants' perspectives on the effectiveness of the formal constitutional and operational rules. The criteria for and choice of the two case study microfinance markets are examined and the process of data collection and analysis is reported. It builds on the previous chapter's review of the literature on our understanding of the institutions for inclusive financial market development and of institutional change theories.

3.1 Ontology and epistemology for institutional research

Grindle (2007 p.555) states that "Methodological choices about how to study the issue of governance and development have considerable impact on findings". Therefore a discussion of the merits of different ontological and epistemological foundations for studying institutions in financial markets is an important starting point. Grindle (2007) also highlights the different results generated by "large cross-country statistical analyses" as against the "country case studies and focused comparisons among a limited number of countries to explore what can be learned from their governance and development histories." (*ibid* p.555) These two methods reflect differing ontological and epistemological world views and addressing them is critical to a robust methodological foundation.

3.1.1 Positivist financial markets research

An objectivist ontology "asserts that social phenomena and their meanings have an existence that is independent of social actors" (Bryman 2004 p.16); they have the characteristics of an object. Even culture "has tangible reality of its own" (*ibid*). An objectivist ontology is typically associated with a positivist epistemology which applies the methods of natural sciences to social sciences. It assumes "an objective external world that exists independently of human perception that is amenable to measurement" (Gilbert, 2001 p.32) and uses the experimental method.

Researchers with an objectivist ontology and positivist epistemology studying financial markets typically take a deductive approach to the development of theory. They use standard 'objective' indicators to measure financial market development and undertake quantitative analysis of those indicators using experimental methods. As discussed in the previous two chapters, there is a substantial body of work on the relationship between financial market development and economic growth using cross country studies; panel and time-series investigations as well as industry and firm level analyses (Levine 2005). The cross-country studies test hypotheses about this relationship and come to conclusions such as "in countries with better developed financial intermediaries, the income of the lowest quintile grows faster than average GDP per capita and income inequality falls more rapidly (Beck, Levine and Demirgüç-Kunt 2004 p. 21). Honohan

(2004 p. 30) states that “[p]robing financial development by means of cross-country regressions has greatly enriched our understanding of the processes most likely to be at work”. Grindle (2007 p.555) also considers that large cross-country statistical analyses are “perhaps the most influential strand” of recent development thinking (still recognizing the “problems of definition, measurement and inference”). But “one problem plaguing the entire study of finance and growth pertains to the proxies for financial development.” (Levine 2005 p.922)⁹¹. Too frequently empirical measures of financial development do not measure the financial functions deemed important by theory. In other words, there are serious challenges with the indicators used for financial development in cross-country studies and the inference that they measure financial development.

When it comes to a positivist study of institutions in financial markets, Shirley (2005 p.633) acknowledges that thanks to the “cross-country studies coupled with increasingly detailed databases, we are progressing in understanding how specific institutions affect specific behavior”. But the challenges of finding proxies for institutions are also complex. Shirley (2005 p.626) finds that “many of the explanatory variables are not institutions” at all and researchers “seldom provide evidence that these variables should be seen as proxies”. Furthermore, because institutions affect economic performance the analysis of institutions is “plagued by the endogeneity of institutions to growth” (Casson *et al* 2010 p.137).

Notwithstanding the challenges, data sets of ordinal indicators of institutional quality have been compiled and are used in analyzing causal effects in economic growth and financial markets. For example the Institutional Reform and Informal Sector (IRIS) Center of the University of Maryland publishes institutional quality indicators monthly in the International Country Risk Guide (ICRG)⁹². The ICRG indicators are: (i) Corruption, (ii) Rule of Law⁹³, (iii) Bureaucratic Quality, (iv) Government Repudiation of Contracts, and (v) Risk of Expropriation. Kaufmann, Kraay and Mastruzzi (2008) at the World Bank Institute have also developed WGIs where governance is defined as “the traditions and institutions by which authority in the country is exercised” (*ibid* p.7) The December 2007 indicators were sourced from thirty five data sources that measure aspects of institutional quality. The six indicators are: 1. Voice and accountability⁹⁴; 2. Political stability and absence of violence⁹⁵; 3. Government effectiveness⁹⁶; 4. Regulatory quality - measured by “the

⁹¹ For example, how can “private credit” (which tracks the total amount of private credit from financial intermediaries to the private sector, and is used by Beck *et al* 2007) be an indicator of the development of the whole financial sector when it could just be measuring increases in lending to large companies?

⁹² According to Demetriades and Law (2006) these indicators follow Knack and Keefer’s (1995) approach.

⁹³ According to Andrianova *et al* (2008 p.232) this indicator “reflects the degree to which the citizens of a country are willing to accept the established institutions to make and implement laws and adjudicate disputes”. Higher scores indicate: “sound political institutions, a strong court system, and provisions for an orderly succession of power”. Low scores indicate “a tradition of depending on physical force or illegal means to settle claims”.

⁹⁴ Voice and accountability - measured by: ability to select government, freedom of expression and association and a free media (Kaufmann *et al*, 2008 p.7).

⁹⁵ Political stability and absence of violence - measured by: “likelihood the government will be destabilized by unconstitutional and violent means, including terrorism” (Kaufmann *et al*, 2008 p.7).

⁹⁶ Government effectiveness - measured by: “quality of public services, capacity of civil service and independence from political pressures and the quality of policy formation”. (Kaufmann *et al*, 2008 p.7).

ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development” (Kaufmann *et al*, 2008 p.7); 5. Rule of law - measured by “the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence”; and 6. Control of corruption⁹⁷.

The ICRG and WGI indicators are highly correlated (Rodrik *et al* 2004 p. 138) and have been used extensively by donors and policy makers to track aspects of their institutional performance over time. For example, Rodrik *et al* (2004) used Kaufman *et al* ’s (2002) QGI indicators for their landmark study showing that “institutions rule”. Demetriades and Law (2006 p. 250) used the ICRG indicators to conclude that financial development has larger effects on GDP per capita when the financial system is embedded within a “sound institutional framework”. Andrianova *et al* (2008 p. 244) used subsets of both the ICRG indicators and the Kaufmann *et al* (2006) indicators to measure institutional quality, as “the overall quality of regulation or the broader rule of law indicator, and stringent disclosure requirements”.⁹⁸ Although these findings are useful, they “cannot tell us which [institutional] arrangements are right for which group of countries at which stage in their development process” (Booth 2011 p.3)⁹⁹ which is why Pande and Udry (2006 p.350) have argued that this work is complete.

Furthermore, Chang (2006 p.3) points out that Kaufman’s indicators “mix up variables that capture the differences in the *forms* of institutions (e.g., democracy, independent judiciary, absence of state ownership) and the *functions* that they perform (e.g., rule of law, respect for private property, enforceability of contracts, maintenance of price stability, the restraint on corruption).” Shirley (2005) further questions whether these are actually measuring institutions at all and questions why they might be proxies for institutions¹⁰⁰. Of particularly importance for this study, are the critiques by Williamson (2000) Greif (2006), Casson *et al* (2010) and others, that social norms in which the institutional framework is embedded, have largely been ignored, treated as a black box or taken as given. Without explicit means to include the underlying social norms and their enforcement characteristics into this analysis, actions based on this positivist approach will be fundamentally flawed.

⁹⁷ Control of corruption – is measured by “the extent to which public power is used for private gain including both petty and grand forms of corruption, as well as “capture” of the state by elites and private interests.” (Kaufmann *et al*, 2008 p.7).

⁹⁸ In addition to the quantitative work on institutions and financial markets there has also been quantitative work on the effect of donor interventions on institutions. Bräutigam and Knack (2004) use ICRG institutional data and econometric techniques to assess their hypotheses about the institutional impact of high levels of aid to Sub Saharan Africa. They find “two major effects of aid: institutional weakening and perverse incentives. The high transaction costs that accompany aid programs, as well as the fragmentation, poaching, and other direct effects of a large number of donors competing for the typical aid-dependent government’s limited number of high-level, skilled officials, can weaken institutions that were not strong to begin with. (Bräutigam and Knack 2004 p. 277)

⁹⁹ More pointedly, Booth (2011 p. 3) questions whether good advice on governance for development can be derived by fitting trend lines to large sets of cross-national statistical data.

¹⁰⁰ Although Rodrik (2004), exceptionally, argues that the indicator for the quality of property rights more accurately measures the degree to which the institutional function of protecting property will be enforced.

The cross-country regressions use an ontological and epistemological framework that has limitations for studying institutions because they are attempting to measure an “objective external world that exists independently of human perception” (Gilbert, 2001 p.32). Institutions are embedded within culture, which is dependent on human perception. We therefore need to move beyond cross-country studies to “explore the heterogeneity of institutions in different countries, which is best achieved through studies based on micro-data” (Casson *et al* , 2010 p. 137). Campbell (2007 p.561) argues that “If one is interested in determining the degree to which an institution as a set of rules, monitoring and enforcement procedures has changed, then tracking objective indicators will suffice” But he goes on... “If one is interested in determining the degree to which an institution as a meaning system has changed, or whether actors believe that an institution is legitimate, then tracking the subjective perceptions of the actors involved is more important. It all depends on the dimensions of the institution with which the analyst is concerned.. An interpretivist epistemology which allows measurement of “the subjective meaning” (Bryman 2004 p.13) of what is being researched, would appear better able to identify embedded social institutions than a positivist epistemology.

3.1.2 Interpretivist financial markets research

A social constructionist ontology believes “everything we consider real is socially constructed” (Gergen and Gergen, 2004, p.10). In other words, “social phenomena and meanings are constructed by the perceptions and actions of social actors and are in a constant state of revision” (Bryman, 2004, p.17). They are not independent of human perception. From a practitioners perspective, “the world is as we see it and as we construct it through interaction with others” (Drinkwater 2003 p.64). Burr (1995) takes social constructionism a step further and argues it should also be an epistemology because “our experience of the world is...intangible without the framework of language to give it structure and meaning”. An interpretivist epistemology, however, does not consider language to be the only means of interpreting our experience of the world, but rather it “requires the social scientist to grasp the subjective meaning of social action” (Bryman 2004 p.13).

A social constructionist ontology together with an interpretivist epistemology for institutional analysis, means researchers can use a range of qualitative methods in “attempting to makes sense of, or interpret, phenomena [i.e. institutions] in terms of the meanings people bring to them.” (Denzin and Lincoln 2005 p.3). It takes an inductive approach to the development of theory. The two best example of this approach to analyzing institutions in financial markets are by Ensminger (1992) and Johnson (2005a,b). Ensminger’s (1992) landmark ethnographic study of the making of a market in a formerly nomadic culture is meticulous in its detail. Ensminger finds that “The speed and success of their economic transition are controlled not just by technological innovation, the adoption of new governmental institutions, and entrepreneurial ingenuity, but also by the process by which the new institutions are legitimized” (*ibid* p.180). This process is embedded in the social structure. She concludes that “in the real world economist’s predictions falter because of the unanticipated consequences of institutional, organizational and ideological constraints, as well as the pre-existing distribution of power.” Johnson (2005a) undertook a qualitative institutional

analysis of the financial markets of Karatina, Kenya to understand the “the embeddedness of financial intermediaries in social relations” (Johnson 2005a p. 357). She systematically analyzed how the rules, monitoring and enforcement mechanisms of financial intermediaries are “embedded in wider social relations and in cultural and political factors” so that the performance of the market could be better explained (*ibid* p.373). In other words Johnson was able to explain how these embedded institutions structured the market. The Ensminger and Johnson studies both used qualitative approaches with an interpretivist epistemology to understand institutional change in financial markets, and both included social norms and their enforcement characteristics in their analyses and also identified the means by which the social institutions effected change.¹⁰¹ Therefore, qualitative approaches are entirely appropriate to use to answer the research question about how rules and norms have changed.

Qualitative methods are also appropriate for answering the research question about the role of external funders in institutional change. Birdsall (2007) comments that: “outsiders are unlikely to help if they try to push institutional forms and norms that have worked for them, in one place and time, as the solution for others at another place and time”. (*ibid* p.7) Similarly Shirley (2005 p.631) observes that “absent a powerful local supporter however there are few instances where aid or advice alone has made enduring improvements in another country’s embedded institutions”. It would seem, therefore, that only researchers who are able to understand embedded social institutions will be able to assess the relative role donor agencies may have played in catalyzing institutional change in financial markets.

These questions require an approach that will make the process of change visible and “make sense of, or interpret phenomena in terms of the meanings people bring to them” (Denzin and Lincoln, 2005, p.3). They need the multiple research methods of qualitative research to provide the rich, thick and triangulated understanding of the complexity of answers from different social actors. Qualitative research is also particularly appropriate for inductive research agendas which seek to build towards the theories that will consolidate new institutional economics’ position within economics (Furubotn and Richter, 2005), as this study does¹⁰².

3.1.3 Adopting an interpretivist epistemology - reflexively

Qualitative researchers understand that “researchers own accounts of the social world are constructions” (Bryman, 2004, p.17), that any research which “presupposes an objective or value free observer is invalid” (Drinkwater 2003, p.64). So “research is an interactive process shaped by his or her own personal history, biography, gender, social class, race and ethnicity and those of

¹⁰¹ These detailed ethnographic studies of institutions in specific markets should be clearly differentiated from institutional analysis which takes on the broad sweep of institutional development in human history and relies on quantitative analysis (e.g. Acemoglu, Johnson and Robinson. 2005, Acemoglu and Robinson 2006a)

¹⁰² Wolcott (2001, p.75) urges researchers to “hold off on introducing theory” until it is quite clear how it relates directly to what there is to report, which is what has been done in this study.

the people in the setting” (Denzin and Lincoln, 2005, p.6). Before continuing I therefore need to provide a summary personal history to elucidate my cultural context in constructing the research design. I am a Caucasian Australian/British/American woman who has worked in the field of microfinance for the last eighteen years, since graduating from Harvard Business School with an MBA. From 1992 to 1996 I was based in New York at an international NGO network of women-led microfinance organizations and from 1997 to 2010 I worked as an independent microfinance consultant and facilitator. As a consultant my primary client has been the Consultative Group to Assist the Poor (CGAP), a global resource centre for microfinance housed at the World Bank and funded by over 35 development agencies. I have also worked for many of the major multilateral and bilateral funding agencies including: Asian Development Bank (AsDB), Australian Agency for International Development (AusAID), DFID, Kreditanstalt für Wiederaufbau (KfW) (the German Reconstruction Credit Institute), United Nations Development Programme (UNDP) and the Soros Foundation. After finishing my field research and analysis I was recruited as the Financial Inclusion Adviser to the Australian Co-Chair of the G20 Financial Inclusion Experts Group. This enquiry reflects my lived experience of the tremendous growth in awareness of microfinance and my close working relationship with CGAP; NGOs; G20 government officials and retail providers of financial services for poor clients. I find an interpretivist epistemology liberating. I do not have to pretend to be ‘objective’ but more accurately can acknowledge my observations are mediated by my own culture, experience and language (Fontana and Frey 2005). I can recognize that the actors in the microfinance markets are the experts on the institutions and co-construct the findings with them.

Therefore, qualitative methods will be used that reflect a social constructionist ontology and interpretivist epistemology to answer the research questions. Bryman (2004 p.268) outlines the main steps in qualitative research after identifying the research question and appropriate qualitative methodology as site selection; data collection; interpretation of data, conceptual and theoretical work (and, if necessary, tighter specification of the research question and collection of further data) so this structure provides of the remainder of the chapter. The next section is on how the methodology decision was made.

3.2 Qualitative methods for institutional research

In categorizing the major methodological challenges of institutional analysis Ostrom (2005a) has, *de facto*, outlined the requirements of a methodology for institutional analysis. They include: “Institutions are invisible”– they exist in the minds of participants and are sometimes shared as implicit knowledge or mental models, but they can be deeply buried under the regularities of observed behavior. Therefore, researchers need to focus on “rules-in-use” rather than “rules-in-form”. “Institution” has multiple definitions - some scholars use the term “to refer to an organizational entity” and others use the term “to refer to the accepted rules, norms, and strategies adopted by individuals operating within or across organizational settings” in repetitive situations (Ostrom 2005a p.823). As discussed in the previous chapter this research is using North’s definition (1994 p. 360).

Institutions can operate at multiple levels and can be nested. “The nested structure of rules within rules, within still further rules, is a particularly difficult phenomenon to understand for those interested in institutions” (Ostrom 2005a p.825). Thus institutional studies need to encompass multiple levels of analysis. Combinations of institutions are configural, not additive which makes institutional analysis more complex. Cleaver’s (2002) concept of “institutional bricolages”, multi-purpose institutions which intersect both economic and social, formal and informal, tradition and modern domains is useful here as it recognizes that due to human agency (the dynamic human “bricoleurs” (*ibid* p.11)) institutions do not conform to researcher’s categories.

But Jameson (2006) and Grindle (2001) go further and highlight the particular complexity of institutional analysis in development. For them a methodological approach must be able to make sense of a wide range of unstable and frequently changing institutions. Jameson (2006 p. 373) urges researchers to be open to “a wide range of...institutional structures that can characterize a society” and Grindle (2001 p. 355) explains that in developing countries “[i]nstitutional change is promoted when actors with power perceive that their interests can be better achieved through alternate sets of rules” (*ibid* p. 362). This could include adopting an institutional blueprint recommended by an international funding agency or ensuring rules do not change to maintain their own power.

Of the many different possible qualitative methods each has its strengths and weaknesses relative to the research questions. For example, one strength of Cooperative Enquiry is that “*all* those involved with enquiry endeavor to act a co-researchers, contributing to the decisions which inform the research and the action which is to be studied” (Reason, 2003, p.205). But the value of cooperative enquiry is primarily in studying action in the present, not reflecting on change over time as this study requires, so is not an option for this research. Another example is Discourse¹⁰³ Analysis, a strength of which is that in discourse “power and knowledge are joined together” (Carabine, 2001, p.280 citing Foucault 1990). But its weakness for this study is that Discourse Analysis is dependent on language alone to give meaning and in financial markets there are also other indicators of meaning, such as financial statements.

Following Ostrom (2005a) and Grindle (2001) the research requires a qualitative methodology that is able to access rules-in use within the society and economy and is also able to track the changes in those rules. Willis and Trondman (2000, p.9) state that “no social relation or process can be understood without the mediations of culture”. The observation of a culture (as defined by the researcher) has been the mainstay of ethnographic research (Angrosino, 2005). The strength of ethnographic methods is its focus on the participant’s perspective, seeing it through their eyes and understanding the meaning they give to it all (Spradley, 1980). Currently ethnography encompasses both the researcher’s reflexive observations and interviews of informants on issues not amenable to observations and the collection of documentation about the group (Bryman 2004 p.292). This methodology appears to be able to serve the purposes of the research question. Ethnography also appears to meet the challenges identified by Ostrom (2005a) Jameson (2006) and Grindle (2001) outlined above. The rules-in-use and their changes can be identified by the

¹⁰³ A discourse is “a group of statements which provide a language for talking about – a way of representing the knowledge about - a particular topic at a particular historical moment” (Hall, 2001 p.72)

members of the sub-culture, as well as their configuration at each level in the Williamson framework.

Ethnography's major weakness, however, is that it has historically served as "a metaphor for colonial knowledge, for power, and for truth". (Denzin and Lincoln 2005 p. 1) "The observer went to a foreign setting to study the culture customs and habits of another human group." This was often a "racist project". Thankfully, ethnography as a method has been able to transcend that history and become part of a "decolonization" process. (Denzin and Lincoln 2005 p. 2) Lewis and Mosse (2006) state that now ethnographic research "is not constrained to privilege authorized interpretations, it can throw light on areas of development practice that are hidden or silenced by policy, but are critical to understand how events actually unfold in particular settings" (*ibid* p.15). It can also "bring fresh insights into the social processes of policy, offering a "methodological deconstructionism" that draws attention to the nature of policy language (or discourse) that reveals how particular policy ideas....work to enrol supporters, ... forge political connections and create common realities from heterogeneous networks" (*ibid* p. 15 -16). To achieve this, ethnographers need to find ways to write that work "against the typifications of communities" so they are not made into "distinct and alien" cultures (Abu-Lughod 2000, p. 262 and 2006)

Wolcott (2001, p.90) introduces the term "micro-ethnography" as a branch of his research methodology tree and argues that with a tightly focused research question field-work can range from two weeks to a few months (Wolcott (1995) in Bryman, 2004 p 293). He also argues that, rather than claiming to demonstrate all the nuances of seasoned ethnographers, micro-ethnography type research is best represented as "in the manner of" ethnography (Wolcott, 2001 p.92).

In choosing to use a micro-ethnographic approach one key issue is defining the boundaries of the culture or sub-culture to be studied, which will then determine the level of analysis of the institutions (Campbell 2004). Bryman (2004, p.17) importantly points out that under a social constructionist ontology, culture is not an inert objective reality but "an emergent reality in a continuous state of construction and reconstruction". For this research the focus chosen was the sub-culture of microfinance service providers within the microfinance market. In my experience this sub-culture is distinct because of its purpose to serve poor clients excluded by the formal sector (and often funded by donors), and also, the members belong to a local microfinance association where their identity as a group is reinforced. They typically track both financial and social performance in contrast to the rest of the financial market and stakeholders have historically come from non-banking backgrounds. Interestingly, this self-defined subculture does not include microfinance clients themselves. The clients, low-income, rural and often illiterate, are engaged in other ways but were not part of the microfinance associations and consequently were not included in this research. Like other cultures, this one "is always in the process of being formed" (Bryman 2004 p. 18). At the boundaries of this sub-culture in different markets, organizations and individuals may define themselves differently. For example, Equity Bank now has a commercial banking license in Uganda, no different than any other commercial bank and yet in 2009 was named the "Best Microfinance bank in Africa" at the annual African Banker Awards because of its commitment to inclusive financial services. Equity clearly defined itself as a member of the microfinance sub-culture. From an institutional perspective it is important to identify boundaries

that are both meaningful and pragmatic in answering the research question while also recognizing that this is a socially constructed boundary. Therefore, I will focus on the self-defined sub-culture of providers of microfinance and their non-client stakeholders. However, this choice creates a challenge. While the socially constructed boundary around the microfinance service providers' sub-culture is meaningful for the providers and pragmatic¹⁰⁴ for this research, by excluding clients the findings on underlying social norms could be limited. Therefore, it will be important to undertake robust client research in future to expand this aspect of the institutional analysis.

As noted above, currently ethnography encompasses both the researcher's reflexive observations and interviews of informants on issues not amenable to observations and the collection of documentation about the group (Bryman 2004 p.292). Therefore I need to examine the nature of the interview process as a key part of an ethnographic approach. Fontana and Frey (2005 p.695) have declared metaphorically that traditional interviewing has been killed. No longer is the interview a neutral tool. Rather an interview is two (or more) equal participants "involved in this process and their exchanges lead to the creation of a collaborative effort called *the interview*" (*ibid* p.696). This is an active process that leads to a "contextually bound and mutually created story". Indeed there is now recognition of a place for "empathetic approaches". In this case "the interviewer becomes an advocate and partner in the study, hoping to be able to use the results to advocate social policies and ameliorate the conditions of the interviewee" (*ibid* p.696). Interviewers are urged to "be reflexive not only about what the interview accomplishes but also about how the interview is accomplished, thereby uncovering ways in which we go about creating a text" (Holstein and Gubrium 1995 in Fontana and Frey 2005 p.697). This approach to interviewing sanctifies the mutually created story by the ethnographer who is a participant – researcher.

Therefore, the self-defined sub-culture of providers of microfinance and their non-client stakeholders will be studied using a method "in the manner of ethnography" (Wolcott, 2001 p.92) to answer the research questions. The next section will explain the site selection process for this method of research.

3.3 Site selection

Booth (2011 p.5) found two methodological extremes in governance studies, "multivariate statistical analysis requiring large datasets" or "intensive studies of single cases". Grindle (2007 p.555) recognizes limitations in both as "'large-N' studies tend to find consistent correlations between development and good governance"¹⁰⁵ and, in contrast, "'small-N' studies tend to demonstrate that development is not fully dependent on 'getting governance right'" and Pande and Udry (2006) came to the same conclusion. From their perspective the cross-country data on

¹⁰⁴ It is pragmatic because the research was already encompassing two markets, so additional robust client surveys in these two markets were not practically possible in the time available.

¹⁰⁵ Indeed Grindle (2004 p.528) lists twenty one different institutions that scholars have found to be important for good governance!

institutions has helped us realize that institutions matter – but that the measurement of institutions at the country level has necessarily been “coarse” and “typically unable to isolate the causal effect of any single institution” (*ibid* p.360). As a result “there remain a number of unanswered questions about which institutions matter most” (Grindle, 2007 p.554). Grindle (2007 p.555) advocates for “focused comparisons among a limited number of countries to explore what can be learned from their governance and development histories”. Furthermore, Pande and Udry (2006) suggest that a unit of analysis “smaller than a country” will “reveal more about the causal role of that institution” (*ibid* p.398). Therefore, a comparative analysis of institutions in two microfinance markets that have established new institutions would be a useful place to begin understanding which institutional functions are critical to increasing financial access, the role of social norms and how institutions change.

However, Shirley (2005 p.634) warns of the possibility of selection bias when choosing comparative case studies for such analysis, and Booth (2011) although he agrees that “a systematic approach to small-N comparative studies” was a practical middle way, found that “to arrive at a sufficiently plausible set of explanatory variables with which to approach case selection” (*ibid* p. 5) was a challenge. Therefore the criteria for choosing two microfinance markets in which to undertake such a comparative analysis need to be carefully established.

Bryman (2004 p. 294) states that “one of the key and yet most difficult steps in ethnography is gaining access to a social setting that is relevant to the research problem”. Key informants are those informants who become particularly important to the research because of their insight into the research question; knowledge of the cultural context and; willingness to help make contacts for the researcher. If access to key informants is critical to ethnographic research then it would be a tremendous advantage for me to research countries where I already had such access. So the first criterion was microfinance markets where I had access to key informants (which largely included countries in Africa). The next set of criteria related to size and growth of the microfinance markets so there would be institutional change to study. These included: markets which had grown relatively fast within a comparable time frame; which met Honohan’s (2004) significance criteria of reaching over 1% of the population; which had a self-defined sub-culture of providers of microfinance and their stakeholders and finally; which provided useful contrasts to be able to start to draw conclusions. The two microfinance markets which best met all these criteria were Bosnia and Uganda.

Microfinance only started in Bosnia in 1997 after the Yugoslav civil war ended. The banking system had not yet been restructured after the former socialist system. Murinde and Mullineux (1999 p. 4) in an overview of bank restructuring in the region noted that the three main problems were the accumulation of bad loans, uncertainty about the structure of the banking sector and building non-bank financial institutions and markets. The World Bank and other funders started a pilot microfinance project in 1997 which ended in 2005.¹⁰⁶ In ten years the microcredit market had grown from nothing to reach 363,082 borrowers, (or 294,330 borrowers if the specialist small enterprise bank is not included) according to their financial reporting to the Microfinance

¹⁰⁶ IDA loans from the government to the MCOs were still outstanding.

Information Exchange (MIX Market, 2011) which checks the quality of reported data. The Bosnian population in 2007 was 3.779 million (UNDESA 2011) so that means approximately 9.6% of the population were microcredit borrowers. (This number of borrowers equates to approximately 30 percent of the 1.196 million economically active population estimated by the International Labour Organization (ILO) in 2007 (International Labour Organization 1996 – 2012a)). There were several large financially viable MCOs with entrepreneurial leaders which dominated the sector and competition between them had brought interest rates down. A MicroCredit Organization (MCO) Law had been passed in 2000 and another in 2006 with regulations at the end of 2007. The Directors of all the Bosnian MCOs met regularly so there was a self-defined MCO sub-culture, even though there was not an effective association. I had worked as a microfinance consultant in Bosnia regularly between 1998 until 2005 and knew most of the stakeholders.

Microfinance had started earlier in Uganda but grew slowly at first with microfinance focused NGOs (MFNGOs) reaching only approximately 50,000 savers by 1999 (MIX Market, 2011).. Brownbridge (1998a), writing the Uganda chapter on Banking in Africa, was pessimistic about the increasing access to financial services for the majority - “the economy is too underdeveloped, incomes too low and lending opportunities too few to provide sufficient incentive for private banks to compete for business throughout the country and provide a comprehensive range of a banking services.” (*ibid* p. 142). However, in 1997 (approx.) several major donors (including the US Agency for International Development (USAID); DFID; the European Commission (EC) and the International Fund for Agricultural Development (IFAD)) started focusing on microfinance as the way to provide low income clients with access to financial services. (This funding largely continued until 2007 when their projects terminated including: USAID’s Rural Support for Private Enterprise Expansion and Development (SPEED) Project; DFID’s Financial Sector Deepening Trust; EC’s Support to Feasible Financial Institutions and Capacity-Building Efforts (SUFFICE) Project). With these significant donor commitments, in the next ten years MFIs alone reached 385,201 savers but if the savers in the rural development bank, cooperatives and VSLAs (also funded by donors) are also included then it had reached 1,709,778. The Ugandan population in 2007 was 30.340 million (UNDESA 2011) so that means approximately 5.6% of the population were micro-savers. (This equates (very) approximately to 15 percent of the economically active population in 2007¹⁰⁷ (International Labour Organization 1998- 2012))¹⁰⁸. An MDI Act had been passed in 2003 with MDI regulations in 2004. The Association of Microfinance Institutions of Uganda (AMFIU) was an active network of which MDIs and the majority of larger Tier 4 NGOs were members, so its membership comprised a self-defined subculture. I had worked in Uganda

¹⁰⁷ The Ugandan Labour Force Survey used by the ILO (ILO 2011) and by Ugandan Government publications (GoU 2006) was dated 2003, so there are not accurate numbers for 2007. The ILO’s estimate of for 2003 was that 38% of the population was economically active, which, assuming approximately consistent percentages, would equate to 11.529 million in 2007. (ILO 2011)

¹⁰⁸ To improve the quality of data on financial access Finscope has been undertaking household surveys in selected African countries to assess the extent of financial service usage. In Uganda the 2006 Finscope found: 18% use formal services; 3% use semi-formal and 17% informal. (Johnson and Nino-Zarazua 2009) The 5.6% of the population as micro-savers estimated here would include the 3% semi-formal plus some of the formal service that focus on low income clients.

first in 1994 and then for longer in 2004 so knew many of stakeholders. These two markets in different regions, with different histories and challenges would provide a great contrast.

They were at very different places in their political and economic development in 1997/8. I was first in Bosnia in 1998 when there were still landmines in Sarajevo which had not been cleared since the end of the war in December 1996 and few refugees had returned to a recovering country. It had not undergone the reform phase of other Central and Eastern European countries because of the war. Banks were collapsing and there were many engineers, accountants and doctors who had no work. In contrast, Uganda was starting to flourish under stable political leadership since 1986 and there were many opportunities for the few trained engineers, accountants and doctors, although the banking sector was moribund. Such differences in the economic context had the potential to generate interesting and useful conclusions because if there were similar findings about institutions for microfinance market development and institutional change from such different economic and social contexts it would increase the importance of those findings. Furthermore, in both these two markets funders have used variations of participatory processes to progress microfinance development (as will be discussed in Chapters 5 and 8). There is a strong argument for “situated ethnographic and historical research... to understand better the transformative possibilities of participation” Cornwall (2004 p. 77) recognizing that ethnographic engagement with participation throws new light on the course of participatory interventions (Bebbington 2004 p. 281). So it would be appropriate to use a micro-ethnographic methodology to undertake an institutional analysis of these two markets.

In response to Shirley’s (2005) (and Booth’s 2011) challenge to avoid selection bias one issue remains in the choice of Bosnia and Uganda - that they had both experienced “civil” war¹⁰⁹ prior to the study period. At face value, these conflicts might be interpreted to be exogenous shocks, creating opportunities for institutional change which path dependent processes could not do. However, on deeper analysis there are three reasons why the actual situation in Bosnia and Uganda is actually more complex. First, the causes of both conflicts were endogenous and deeply rooted and in that sense path-dependent, so at the end of the conflicts many of the causes remained, as will be discussed in Chapters 4 and 7. The theorization of shocks as opportunities for institutional change in these, and perhaps many other, cases appears therefore to require careful consideration as to the nature of shocks as exogenous and their relationship to path-dependence. Second, and in a similar vein, in both Bosnia and Uganda the microfinance sector was building on pre-existing long-standing social norms which had not been greatly affected by the short-term conflict, not on formal institutions that might have been affected more directly by the conflict. Finally, in both Bosnia and Uganda although there was new political leadership after the conflict, this leadership deliberately constrained the space for political change: in Bosnia the Dayton Peace Accords were deliberately designed not to allow great changes (Bose 2002); and, as discussed in Chapters 4 and 7, Museveni and the National Resistance Movement (NRM) in Uganda have been in power since the end of the war and have run a virtual one party state to ensure stability and to retain their power (Tangri and Mwenda 2008). So the leadership changes created some spaces for change, but not fundamental changes. Therefore, it would seem

¹⁰⁹ Bosnia and Hercegovina were an integral part of Yugoslavia under Tito, as discussed in Chapter 4, so the term “civil” is referring to the whole of Yugoslavia, not just Bosnia.

appropriate to consider these as useful case studies from which tentative conclusions could be drawn for further testing. Therefore the microfinance markets of Bosnia and Uganda between 1997 and 2007 were chosen to be the two case study countries for this study.

3.4 Data collection and analysis

The data for this research came from two sources: secondary data from governments, donors and retail financial service providers on policy changes and the provision of financial services to low income clients from 1997 to 2007 and; primary data from members of the sub-culture of retail financial services providers serving low income communities in Bosnia and Uganda.

3.4.1 Research on the Bosnian and Ugandan microfinance markets

The initial step was to establish the baseline and factual changes in both microfinance markets between 1997 and 2007 from secondary data. These included the political and regulatory changes that affected the financial markets, as well as the private sector's expansion and changes in donor funding. Once I had returned from undertaking the field work and additional factors became apparent, the original research needed to be supplemented. This data is presented in chapters 5 and 8. As part of this process, a possible set of '*a priori*' causes of the changes in the microfinance market was identified to assist in the field work.

One possible approach to data collection was Ostrom's (2005a p.827) "Institutional Analysis and Development Framework" which required identifying the "action arena" (*ibid* p.828) or "social space where individuals interact, exchange goods and services, solve problems, dominate one another, feel guilty, or fight" (*ibid* p.829). In this research the action arena would be the microfinance market and the actors would be all the participants in that market. Ostrom (2005a) identified three clusters of variables that affect the structure of the action arena:

1. the rules and norms used by the participants to order their relationships;
2. the attributes of the states of the world that are acted upon in these arenas and;
3. the structure of the more general community within which any particular arena is placed (i.e. the culture).

One problem with this framework is that it appears to separate the rules and norms within the action arena from the culture. This is also not consistent with Johnson and Ensminger who found that rules and norms in the market are embedded within the culture. The other is that, from the perspective of answering this research question, despite its level of detail, there does not appear to be any additional value over the Williamson (2000) framework discussed in the previous chapter. So Ostrom's IAD Framework was not used.

Ensminger and Johnson's ethnographic approaches took place with one ethnic group and in one region of Kenya and each researcher spent considerable lengths of time in those regions; but I am looking at a sub-culture in two markets and looking for comparisons across those two markets. It

is a self-defined group of microfinance providers and their non-client stakeholders in each country, but they are often funded by the same international donors and are part of global microfinance networks (e.g. there are Women's World Banking, World Vision and Catholic church related affiliates in both Bosnia and Uganda). This context is similar to Grindle and Thomas's (1991) work on understanding policy change across developing economies. Grindle and Thomas (1991 p.11) used an approach in the manner of ethnography by identifying the subculture of "participants in the reform process" and asking participants a series of questions in each of their case study countries. Theirs is a useful precedent.

Grindle and Thomas (1991 p.11) chose for their respondents, people who had "unique insights and access to information". For this study everyone involved in the provision of microfinance services had unique insights and access to information, so in preparation for field work all the potential respondents had to be identified. This included the leaders of the MCOs in Bosnia and the MDIs and MFNGOs in Uganda, bankers and policy makers who had been involved in regulating this part of the financial market as well as technical service providers. Funders currently in the country were not included unless they had been actively involved in the development of the microfinance market because they were specialists or local staff who had been there some time. Microfinance clients were not respondents because they were not part of the "self-defined microfinance sub-culture" as discussed above.

3.4.2 Scoping mission to Bosnia

The nine respondents selected for the scoping mission were all former colleagues in Bosnia who knew the market better than anyone else. They were also willing to help me to develop an approach that was both respectful of the time of hard working members of the microfinance market and also would provide insights into the development of the market that would lead to a contextually bound and mutually created story Fontana and Frey (2005).

These are the lessons I applied to all future conversations:

- I would invite microfinance practitioners to lunch or to have coffee to indicate that this was to be a relaxed conversation in a setting outside their usual place of work. For government officials or bankers it would be at a time that was most convenient for them.
- At first I had to explain that I was now an independent academic researcher, not a consultant funded by a donor or a trainer in microfinance 'good' practices, as they had known me before. This was for my PhD thesis and would only be used for academic purposes.
- I then had to guarantee the anonymity and confidentiality of our conversation. This was important in Uganda where there had been fraud and in Bosnia where there was frustration with the way the microfinance market had developed and yet they were all close friends.
- In compliance with ethical academic practices I would promise to stop at any time on request; to exclude from the data anything the respondent wishes; provide a copy of conversation for confirmation of accuracy if wanted, as well as a final copy of the thesis.
- I would explain that I had set aside any pre-existing or partial knowledge of the development of the microfinance market and so would need to ask follow-up questions. I would like it to be

a free-ranging conversation that allowed the complexity of the market to surface. If appropriate during the conversation I might explain again that I did not have deep knowledge of how the culture affected microfinance, or the frustrations of what did not happen etc. but I was very open to understanding these issues.

- The approach taken, (following Grindle and Thomas, 1991), was to ask participants in each sub-culture the same question and use that as the starting point for a semi-structured conversation about the development of the microfinance market over the last ten years. Grindle (2004) also recommended a focus on “good enough governance” to refocus research on the priorities for reform. I, like Booth (2011), agreed with Grindle and interpreted this to mean that I should focus on the most important institutional changes needed for expanding access to financial services for the poor.
- As the respondents would not have come across North’s understanding of institutions I decided to use the term “building blocks” instead. This was the more accessible term used by Honohan & Beck in “Making Finance Work for Africa” (2007 p.7) when they were discussing institutions to create the foundation for a more inclusive financial sector such as “rationalization and clarification of laws.... establishment of credit registries” and was also used by Grindle (2007 p 567).
- So I decided to start by asking what they considered to have been the most important “building blocks” within the economy and society for the growth of microfinance in Bosnia / Uganda since it began around 1997. I would explain that these could include functions of any formal rule or informal norm, with a range of enforcement characteristics. If a respondent mentioned an institutional “form” such the Bank of Uganda (BoU), I would ask what function the BoU performed that he/she thought was critical. I would not take their first set of answers as complete but ask many follow-up questions from different perspectives to better understand their responses. Consistent with the interpretivist epistemology, I would focus on listening and understanding the view point of my respondents, rephrasing or summarizing their words to be sure I had captured their meaning.

It was proposed to the scoping mission respondents that they be sent a transcript of our conversation for their feedback. But none of them wanted to read a report on what they had said. All were too busy, and trusted me to report accurately. It may also have been because they were promised the conversation was in confidence and they would not be quoted in a way that could be tracked back to them. Instead, I checked a preliminary summary of findings with just a few of them. To identify which of the building blocks were institutions, in an iterative process the responses were triangulated with other respondents, North’s (1994) definition, the financial market literature and my own experience. A similar process was undertaken to identify which level in Williamson’s (2000) framework those institutions fit.

3.4.3 Micro-ethnographic field work in Bosnia and Uganda

In total I met individually with thirty five respondents who were the major stakeholders in the expansion of the microfinance market in Bosnia in the ten years from 1997 to 2007. This included eleven of the twelve MCO leaders, the five leading banks that lent to MCOs and five private sector players (such as the micro-insurance provider), eight government officials responsible for the oversight of the microcredit sector, and six of the original funders of the microcredit sector. I conducted very similar semi-structured interviews with a total of forty-nine members of the subculture of retail providers of financial services to low income clients and their supervisors in Uganda. This included ten MF NGOs, four MDIs, six bankers, six government officials including the BoU, seven funders, ten private sector consultants, investors related financial service providers and six representative of networks or related associations. The complete list of individuals I met with in Bosnia and Uganda, their organizations and when I met them, is provided in the Appendix. In addition to the recorded meetings with respondents, I also observed them at informal dinner meetings where association matters were discussed and social gatherings where the microfinance community was gathered, which were a natural outworking of the long-standing relationships developed over the years of training and meeting together.

I found that once basic terms were explained in everyday language, respondents in both markets did not need additional clarifications. For example, North's (1994 p. 360) definition of informal constraints – "norms of behavior, conventions and self-imposed codes of conduct" provided enough information for these respondents to understand the concept as it applied to the microfinance market. In many cases microfinance had become their life's work so they had thought long and hard about these issues. The long-standing relationships with these respondents and in the countries were invaluable because the interviews were the end of a long relationship and observations, not the beginning. The respondents did not need to explain their history all over again to a stranger they could focus on the institutional questions knowing that I understood their context.¹¹⁰

As Bryman (2004 p.292) notes, ethnography includes the researcher's reflexive observations, so in the free flowing discussions I would reflect back to the respondent what I thought they were saying to be sure I was not just framing their ideas according to my own cultural frame of reference. Quite often personal stories were shared which were very helpful to contribute to understanding how cultural norms operated, how rules were enforced and if they had changed over time. However, respondents were sometimes contradictory or inconsistent. They framed their responses according to their own mental models so the conversations unveiled a deeper understanding of participants' values, views and meanings and generated rich, detailed qualitative data. Sometimes they were very long lunches! It is fair to say that all of the respondents were both proud of some achievements and frustrated with others. Several were angry with donors, politicians or others whom they felt had betrayed their trust. These were often not easy

¹¹⁰ This is also why there are not more explicit links between chapters 4 and 6 or chapter 7 and 9 because that understanding is was taken for granted by the respondents and myself.

discussions, but very rich in understanding of institutional change processes. I am indebted to each respondent for their time and honesty.

In these discussions, I was aware that I would need to find a way to write about institutions in microfinance that would not make the sub-culture of Bosnians and Ugandans in microfinance into “distinct and alien” cultures as Abu-Lughod (2000, 2006) had urged. That this research “in the manner of ethnography” would focus on the institutional research questions and not focus on telling another story about the otherness of Bosnia or Uganda. Reflecting later on this decision, I am aware it strengthened the institutional focus of the findings, but perhaps diminished the cultural specificity in my engagement with respondents.

3.4.4 Data analysis

For each market, every respondent’s interview and every single one of the institutions discussed was coded into N’Vivo according to the language that respondents used.

- The first phase of the analysis was to identify the possible set of formal and informal institutions. Where respondents were using slightly different language but describing what appeared to be the same rule or norm, then these were grouped together. Each of these institutions were based on the many hours of taped discussion with respondents that covered examples of how it contributed to expanding the microfinance market and its enforcement mechanisms.
- Once that set of possible institutions was drafted, the second phase was to remove from further consideration those which, although interesting, could not be defined as institutions under North’s definition. For example, several respondents commented on the entrepreneurial spirit of Ugandans being one of the building blocks for the rapid expansion of microfinance. (In their opinion Ugandans had been traders and entrepreneurs since well before the British arrived and this was critical to the success of microfinance.) Although interesting, there is no enforcement characteristic for this norm so it could not be considered an institution for this study. (It is however, referred to in the context chapter.) Likewise in Bosnia some respondents felt that the painful loss of the quality of life for clients was a critical building block for the rapid expansion of the sector. But desperation did not appear to be a fundamental social norm across the culture with enforcement characteristics. Also during this phase, points which could not be triangulated with any other respondent or with secondary data were removed. For example, one respondent said that the Insurance Deposit Agency at the Entity level in Bosnia was critical to the development of the financial market, but no one else did. In fact, others said the opposite, that people were only prepared to trust specific banks and not the government because of the history of the government taking their savings. So with conflicting opinions this was not reported as a finding.
- The third phase was to classify the formal institutions as to whether they were constitutional or operational. This was initially challenging simply from inexperience but now that I have lived with this data and the literature for years, it is much clearer.

- Only at the fourth phase of the analysis were the two markets compared to see where there was consistency or not.

Together, the conversations, the secondary data and my own observations of the microfinance sub-culture over the decade achieved the goal of a “complex, dense, quilt-like bricolage, a reflexive collage or montage” (Denzin and Lincoln 2005, p.6)¹¹¹ from which the patterns of key institutions for increasing access to financial services have emerged that are reported in the findings chapters 6 and 9.

3.5 Criteria for evaluating reliability, validity and ethical issues.

The criteria of “trustworthiness and authenticity” for evaluating qualitative research as originally proposed by Lincoln and Guba in 1985 is now accepted academic practice Bryman (2004 p. 273) and Denzin and Lincoln (2005). Instead of internal validity, establishing the credibility of the research was through respondent validation. The first step of respondent validation is first during the conversation. When one respondent’s perspective appeared to be significantly different from either the secondary data or what others were saying (for example about a particular social norm,) the first check was to clarify that I had properly understood what they were saying. The second check was to ascertain whether it was consistent with the whole set of information about institutions in the market and if so, perhaps it so could be a unique insight but if not it could be just an anomaly in their perceptions. It was originally planned that each respondent would be provided with an account of the conversation including both what was said and my observations on the conversation for any feedback so the findings can be validated. However, as with the scoping mission, other respondents in Bosnia and Uganda were not interested in providing feedback on their interview but only on reading the summary findings.¹¹² To arrive at the preliminary findings a triangulation process was undertaken between respondents, the researcher and secondary data. Once the complete findings chapters were drafted, these chapters were sent to key informants who were willing to provide detailed feedback. These key informants spoke both English and local languages, had worked with both clients and with international organizations and had some academic background to understand the research methodology and its potential flaws.

For external validity Lincoln and Guba (1985) recommend transferability. Initially I was concerned that the rich and thick dataset about institutions for expanding the financial market serving low income clients including social norms, might not be comparable between the two markets which would have compromised the transferability of the findings. However, I should have trusted the methodology. The external validity of the result has indeed been tested and proved in the process of comparability between the two markets. There was similarity in

¹¹¹ In this case the term “bricolage” is used to define the structure of the set of institutions in each of these markets not the action of an individual who creates institutions as Cleaver uses the term.

¹¹² One of Cooke’s (2004) “rules of thumb” of participatory development is “Data belong to those from whom they were taken” (Cook in Cornwall and Pratt (eds) 2004 p. 47). In this research the findings were offered to be sent back to respondents but they only wanted a summary when it was all finished.

institutional functions across all levels in both these markets. It would therefore be reasonable to find some similarity with other microfinance markets.

Dependability (instead of reliability) can be tested by keeping meticulous notes on every step of the research process from selection of participants to transcripts and data analysis so that an external auditor is able to track each step and if necessary certify its reliability. Objectivity is impossible in social research so a more useful quality is for the researcher to act in good faith and not allow theoretical inclinations to sway the research or prejudge the findings.

Conducting research with people I have known for many years, and would probably continue to meet in the context of microfinance, presented interesting ethical questions which needed to be addressed before the ethnographic research started: Would former colleagues feel any pressure to tell a positive story – leaving out the negative? Whose “side” would they perceive I was on? Would “anonymity” still be meaningful given we would all continue to work in microfinance? Would my personal relationship with many of those being interviewed bias my ability to listen to the participants? Who would have final control over the publishing of the findings? What are the possible implications of the findings in their financial market once published? (British Sociological Association, 2002) These questions were informally but clearly addressed at the beginning of the “interview” at the same time as the guarantee of anonymity or confidentiality; a promise to stop at any time on request; excluding from the data anything the respondent wishes; providing a copy of research results for confirmation of accuracy if wanted, as well as a final copy of the thesis.

3.6 Conclusion

This chapter has made the case for a social constructionist ontology and interpretivist epistemology in the analysis of institutions and for a micro-ethnographic methodology to answer the research questions. It showed that ethnographic methods will best enable the role of social norms within the microfinance market to be explored in depth, as well as provide the market participants’ perspectives on the effectiveness of the formal constitutional and operational rules. The criteria and choice of the two case study microfinance markets was examined and the process of data collection and analysis reported. Furthermore, the checks and balances in place to provide the reliability and validity of the research were established. In the following sets of Bosnia and Uganda chapters there is a “complex, dense, quilt-like bricolage, a reflexive collage or montage” (Denzin and Lincoln 2005, p.6) that will show strong and clear patterns and regularities about the key institutions for financial market development including social norms, how they have changed - which contributes to theory on institutional change - and the role of funders in that change.

Chapter 4: Bosnia: Financial Market Development Context

This chapter commences the analysis of the Bosnian case study by presenting the political, social and economic context for the institutional development of the Bosnian microfinance market and particularly for its social norms. Significant aspects of the history of the financial market are reviewed, along with key dimensions of social/political and cultural contexts, to present a detailed understanding of the ground in which the microfinance market came to be developed. There is no standard approach for undertaking an historical institutional analysis so Grindle's (2007 p. 567) advice is followed - to address what are considered to be the most important characteristics of the context. Chronology and view point are very important in describing the complex interplay of economic, political, regional, religious and ethnic forces in Bosnia. So this chapter is organized chronologically, starting with the political and economic factors that contributed to the founding of Yugoslavia under Marshal Tito, continues through Tito's rule, the break-up of Yugoslavia and the 1992 – 1995 war. It seeks to respect and balance the different academic discourses on this history.

The following chapter builds on this analysis. It will present an original account of the development of the financial and microfinance markets after the Dayton Peace Accords, as Bosnia struggled with the simultaneous tasks of reconstruction after war and post-socialist reforms. Chapter 6 then provides an analysis of the findings of the ethnographic research with microfinance stakeholders on the building blocks of the microfinance market, including the social norms.

4.1 Bosnia before WWII

Bosnia was first recorded as an independent country in 1180, not under the control of the Byzantine Empire, the Croats on the Dalmatian coast, nor the neighboring Serbs. It was predominantly populated by Slavs. The River Drina was its eastern border. It had "its own customs and government" (Malcolm 1994 p.11) although communication was hampered by the mountainous terrain (add reference map). From that time on a highly complex set of political and economic powers overlapped and combined on that territory including: "the empires of Rome, Charlemagne, the Ottomans, and the Austro-Hungarians and the faiths of Western Christianity, Eastern Christianity, Judaism and Islam" (*ibid* p. xix). In Pre-Ottoman times it was the home of three churches, Orthodox, Roman Catholic and an independent Bosnian church (Mahmutćehajić, 2000). Since Ottoman times (1463) Islam, Orthodoxy and Roman Catholicism have largely made up the pattern of religious life with Sephardic and Ashkenazi Jews also settling in Bosnia after persecution, as well as the Roma. Sarajevo was at the centre of this pluralistic culture with mosques, synagogues and churches all side by side. Interpretations vary as to whether its people were skilled at navigating the differing traditions and celebrated each other's traditions (e.g. Sells 1996) or were deeply segmented, distinct communities which co-existed (e.g. Burg and Shoup 2000). In both cases, a sense of identify came from community belonging.

The assassination of Archduke Franz Ferdinand heir to the Austro-Hungarian throne, in Sarajevo on 28 June 1914, an act reflecting the fierce opposition to the Austro-Hungarian rule in the region,

was the trigger that started WWI. The post first world war settlements of the defeated Austro-Hungarian Empire at Versailles in 1918 resulted in the formation of the Kingdom of Yugoslavia (meaning South Slav) which was ruled by a king and parliament (Crnobrnja 1996). This “epoch making unification” (Pavlowitch 1992) joined the regions of Bosnia-Herzegovina, Croatia, Macedonia, Montenegro, Serbia and Slovenia, with the autonomous provinces of Kosovo and Vojvodina. These regions held a common desire to be free from foreign domination. However, the communists saw the regime as bourgeois and were looking for an opportunity to create a “dictatorship of the proletariat” (Pavlowitch 1992). “Tito,” the *nom de guerre* of Josip Broz, was officially recognized as head of the Communist Party in Yugoslavia by the Comintern¹¹³ in October 1940, because of his allegiance to Stalin and willingness to purge opposition elements. He demanded unquestioning loyalty. When Hitler attacked Yugoslavia on 6 April 1941 it took less than two weeks for the Germans to control the country and then it was divided between the Axis powers. This created an opportunity for Tito start to organize the communists to eventually take power.

During the second world war in Yugoslavia there were many wars “piled on top of each other” (Malcolm 1994 p. 174). These are addressed in great detail in histories of Tito and the war period (Pavlowitch 1992, Malcolm 1994, Crnobrnja 1996, McFarlane 1998). These wars included the war conducted by Italy and Germany on Yugoslavia; the Axis powers’ war effort against the Allies; the Croatian Ustašas (fascists loyal to the Nazis and supported by Mussolini, were led by Pavelić) against the Serbs in Croatia and Bosnia; the Yugoslav Četniks (led by Mihailović, loyal to the government in exile) and Communist Partisans (led by Tito and loyal to Stalin), were both fighting the Ustašas and; these two Yugoslav resistance organizations were fighting each other. Each of these groups were fighting for their futures, committing crimes against civilians not just fellow combatants. But perhaps it was the atrocities committed in Croatia against Serbs and other minorities (allegedly by both Croat and Muslim forces) in an effort at ethnic cleansing that left the most enduring psychological scars. An estimated 600,000 people were killed, of which 25,000 were Jews. (Crnobrnja 1996 p.66)

The Partisans were the ultimate victors. This was in part, because Tito fought under the radar of the major powers and away from other centers of power in Yugoslavia until he was ready to be recognized as the best leader for a new Yugoslav state, with the support of both the British and the Russians (Crnobrnja 1996). Bosnia was the “bastion of the partisan movement” (Pavlowitch 1992 p.36) and Tito’s Partisans were also the only group which fought on the basis of the equality of all the components in Yugoslavia. Tito successfully tied a popular resistance movement to the cause of communism in the struggle against foreign powers and local opponents, with his own ascendancy as the new national leader inevitable. After the war, The Socialist Federative Republic of Yugoslavia (SFRY) was established under Marshall Tito with six republics and the two autonomous regions of Kosovo and Vovodina. Bosnia was recognised as a historically distinct entity and accorded constitutional status as a separate and multinational republic as part of the new Yugoslav federal state established under Tito (Ali, 1994). However, there was no specific

¹¹³ Comintern was short for the Communist Information Bureau, which was an alliance of the nine communist states. It was succeeded by Cominform.

agreement on the relative rights of the republics or regions within the Yugoslav economic space. (Crnobrnja 1996).

4.2 Bosnia under Tito 1945 – 1980

Tito's war was not over once he was in power. Between 1945 and 1946, Tito's regime put to death an estimated 250,000 people (Malcolm 1994 p.193) to ensure there was no ongoing internal dissent, including all the returning soldiers who had fought for anti-Partisan forces, nationalists and many of the bourgeois. (However, discussion of any of the atrocities committed during the Second World War was specifically forbidden in the Tito era. (Sells, 1996 p. 99)). This ruthlessness and absolute control set the precedent for the next thirty five years of his rule in Yugoslavia so a whole generation of Yugoslavians knew no other kind of leadership. Even at the end of his life he continued to be a megalomaniac and despot (Pavlowitch 1992 p.83) But Tito was not just the leader of Yugoslavia, he saw himself as the foremost representative of an expanding communist world. Comintern's headquarters were established in Belgrade, the Yugoslav capital, indicating Tito's leadership.

As a communist under Soviet tutelage, his first economic task was attempting rapid collectivization of agriculture and high rates of investment in new factories, which were designed to both accelerate growth and transform the social structure away from the "class society based on agrarian social relations" (McFarlane 1988 p.11, Milenkovitch 1971). For an underdeveloped country with goals of modernization and rapid growth a central planning model was effective initially in raising output. But centralizing decision-making necessitates huge information collection and processing costs and so the growth came at the expense of quality (Milenkovitch 1971).

The apparent defiance by Marshal Tito of Soviet supremacy in 1948 led to the expulsion of the Yugoslav Communist Party from Cominform. Tito was not contrite, ordering the security apparatus within Yugoslavia to target "Cominformists". He took it as an opportunity to get rid of potential trouble makers. Such repression intensified his dictatorship and increased the power of the secret police (OZNa). "In Tito's own words the purpose of the OZNa was to strike terror into the bones of those who do not like this kind of Yugoslavia." (Malcolm 1994 p. 193). So people lived in fear of the secret police, a fear that became so ingrained it remained long after Tito was gone.

This action meant Yugoslavia was effectively isolated from both Soviet and western support. But the lack of external Soviet pressure meant Yugoslavia could undertake partial reforms in the economy¹¹⁴. Between 1950 and 1954 the centralized system was dismantled, eliminating price controls and theoretically rationalizing costs by introducing loans with interest payments for investments. Power and decision making was decentralized to workers councils within enterprises who could determine what to produce, how to produce it and at what price to sell it, within the

¹¹⁴ The collectivization of agriculture had been "disastrous" (Pavlowitch 1992 p.62)

limits of existing plant and equipment. What evolved was a “market –socialist system” that allowed, even encouraged, private enterprises alongside the state owned enterprises (SOEs). Central planning was abandoned and there were “worker-managed firms competing with each other in the market system recycling earned profits for their own needs and expansion or else, via the taxes they pay, into collective funds for social consumption” (McFarlane 1988 p.90). The larger of these business enterprises in energy and heavy industry were critical to the economy and became very powerful. Smaller businesses also had an important role in the economy, for example, restaurants serving tourists in Adriatic coastal towns.

Yugoslav partial planning - decentralizing production while retaining control over investment was a complex task because of the significant regional difference in growth rates. The more developed regions like Slovenia saw investment planning as a burden that meant high taxes and errors of allocation away from productive investments; whereas poorer, less developed regions like Montenegro and Bosnia saw it as necessary to their growth, which added nationalistic tensions to the mix. (Milenkovitch 1971 p.300, World Bank 2004b OED). For this approach to succeed, the country needed to agree on economic objectives, but the nationalistic issues meant this did not happen. So starting in 1961 investment planning was abandoned and decisions turned over to the market. Effectively this was a defeat for the less developed regions. Milenkovitch notes that partial planning in any context “may well produce a morass from which only two solutions are apparent – back to the plan or forward to the market” (Milenkovitch (1971) p.300). This tough decision was avoided by reliance on international loans. The British understood that if Tito or his economy collapsed, he could be replaced by a regime more subservient to Moscow, so they supported Tito and the economy. He was hailed as a patriotic hero of the Second World War who united his compatriots against Nazi-fascism and warranted soft loans.(Pavlowitch 1992) By 1988 Yugoslavia’s total foreign debt was United States Dollar (USD) 33 billion (with USD 20 billion owed to the West) By 1989, inflation was up to 250 percent.

To Yugoslavians, Tito represented a powerful and united Yugoslavia of which they could be proud. ‘Brotherhood and Unity’ was his slogan (Pavlowitch 1992). They knew he was autocratic but he was not totalitarian and held the country together and enabled everyone to receive a good education and jobs. Under Tito between 1960 and 1980, annual GDP growth averaged 6.1 per cent (Chossudovsky 1997 p.375) and there was increasing consumption. Bosnia was one of the less developed republics with its GNP about 75% of the national average. But everything was taken care of - medical care was free, and by 1981 the literacy rate was of the order of 95 per cent for men and 77% for women. Average life expectancy was 72 years compared to 48 years pre-war. (Chossudovsky (1997 p.375) In the cities there were jobs and salaries with good benefits, 71 percent of the population had a television by 1986.

The Yugoslav government placed many of the armaments factories in Bosnia because it was considered protected from potential conquerors so Bosnia benefited from this considerable investment (Crnobrnja 1996, Burg and Shoup 2000). Industry and mining contributed 43% of the GNP in 1991 and electricity contributed a massive 9%. (Mahmutćehajić, 2000) The government also made great investments in public health, education, technology and social welfare (McFarlane 1988 p.18). Under Tito, Bosnian women were recognized as equals and “aspired to

work in the public sector – whether service provision, public administration or in public companies – or to set up their own businesses” (Pupavac 2006 p.95).

Tito instituted a vigorous campaign against all public forms of religion to build a secular Yugoslavia (Malcolm 1994 p. 193). He largely succeeded in urban areas where 30 percent of marriages were “mixed” and only 20% of the populations were religious believers (Malcolm 1994 p. 222). Bosnia was regarded as an “ethnic scrambled egg” or a “little Yugoslavia” (Crnobrnja 1996) with its rich intermingling of cultures and civilisations. To some, it was an exotic multinational, multicultural, and multireligious mix with its many communities, Muslims, Serbs, Croats, Hungarians and Jews, having lived together for generations (Ali 1994). Ethnicity had ceased to be the defining criterion of identity for Bosnia's new generation of 'Yugoslavs'. To others, although the people shared a common language and lifestyle, the different ethnic communities in Bosnia did not create a multi-tradition society but gained their identity from external loyalties (Burg and Shoup 2000).

4.3 The banking system in Bosnia under Tito

The Yugoslav banking system “bore no resemblance’ in structure, function or management to the system in Soviet Union. Yugoslavia became a member of the IMF and World Bank in 1945 (McFarlane 1988 p. 92. Chossudovsky 1997 Borish & Ding 1997). Under Tito the banking system reflected his unique approach to socialism, it was more open in trade and investment and decentralized, with social ownership. There were three-tiers to the banking system: i) the National Bank of Yugoslavia, which held all the citizens’ foreign currency accounts, in addition to exercising its responsibilities as Central Bank; ii) the national banks of the eight Republics and Autonomous Provinces and; iii) the Associated banks.

The National Bank of Yugoslavia (NBY) complied with the letter of the Yugoslav law requiring it to be independent from government. The three criteria of independence were: *institutional independence*, disclosing the influence of the government (state) on the nomination as well as dismissal of the Central Bank’s senior management; *financial independence*, determined by the access of the government to NBY’s credit lines and *independence in conduct of the monetary policy*, which stands for independence in the selection and use of monetary policy instruments (Šević and Šević, 2000). But in practice, the “vague” legal context made it possible for political factors to exert a strong and destabilising influence, such as the dismissal of the governor by parliament whenever it chose and the appointment of a governor based on his federal origin, not skills (Šević and Šević, 2000 p, 383), so the governor was accountable to the government, not independent. Furthermore, the National Bank did not undertake any prudential regulation, and did not require international accounting norms such a standard Loan Loss Provisioning. The lack of adequate oversight by the Central Bank meant that many lost their savings on fraudulent pyramid schemes and other scams.

Major banks seemed modern with correspondent relationships with the west. They channeled western funding for projects, managed funds from the tourist trade on the Adriatic coast and

received remittances. But the majority of the associated banks were “socially owned” enterprises, linked to the worker-managed enterprises discussed above. They had a social role similar to the enterprises of ensuring the well being of communities and staff, so were also overstaffed and the staff were overcompensated (Borish & Ding 1997 p. 173). They were conduits for directed credits from ministries and from the central bank. They did not know how to make commercial credit decisions regarding their borrowers and rolling over loans was the norm (Murphy 2006 p. 17, Borish and Ding 1997).¹¹⁵ Payments functions were the monopoly of the government payments bureau.

In summary, the banking system comprised banks owned by the worker-managed enterprises had misleading and misguided financial statements and were unable to impose credit discipline. As the country’s debts mounted the banking system was unable to either productively lend the government’s money, or track their use of government funds (Borish and Ding 1997). It was impossible to accurately assess the state of the banking system.

4.4 Bosnia after Tito – rapid economic decline

1980 was the year of Tito’s death and he had not prepared a successor or even set up a process for selecting a successor. A collective leadership was created but there had been such dependence on Tito’s leadership, it was unable to “get a firm grip on the economy” (McFarlane 1988 p.138) and there was an economic crisis. The cause of the crisis lay in the low level of motivation and productivity of the work force, low efficiency in the use of capital, which resulted in both inadequate infrastructure and technical backwardness, and the pervasive interference of the state in economic decisions (Milanovic (1990), Pjanić 1986 cited in McFarlane 1988 p.146). These trends, endemic to the Yugoslav economy, had been masked by easy and cheap external borrowing. Financing from the West subsidized manufacturing enterprises up to 50 percent and net subsidies were 15.6 percent of GDP (Kraft and Vodopivec 1992 p.1). As the economy had decentralized, powerful coalitions had emerged that represented special interests and many new channels to “redistribute” government funds were created (Kraft and Vodopivec, 1992 p.1).

The oil price shock in 1979 and increase in interest rates brought the era of cheap money to an abrupt end, but the structure of the economy did not change. In state enterprises there were only soft budget constraints which, together with a continued failure to correct indiscipline on wages and other spending (Rocha 1991), meant there was *de facto* permission for misuse (perhaps corrupt use) of state resources by senior officials. As oil prices continued rising in the ‘80s, there was hyperinflation, so collapse was imminent. The local currency lost value with the hyperinflation so ordinary people’s savings also lost all their value and the banks had severe liquidity constraints. Further redistribution flows were produced by banks holding financial assets and liabilities in an inflationary environment, but not indexing financial claims. These flows became an even more important source of redistribution than formal taxes and subsidies (Kraft and Vodopivec, 1992). The driving force behind these decisions was the pursuit of job and wage

¹¹⁵ In the early 1950s interest payments were introduced (Milenkovitch 1971 p.293) but were referred to as a “tax on working capital” (McFarlane 1988 p. 225).

security and accordingly there was no increase in the unemployment rate (Milanovic, 1990). These factors, together with hidden losses in the economy due to the lack of transparent accounts, meant that the national budget was spiralling out of control (Rocha, 1991).

The only options were to either allow the market to operate freely or face collapse. This lack of control was exacerbated by the reforms imposed by the country's creditors¹¹⁶ to address Yugoslavia's large external debt. State revenues which would previously have gone as transfer payments to the Republics and Autonomous Provinces were instead channeled into servicing Belgrade's debt. The Republics were largely left to their own devices, exacerbating their economic differences and speeding up the disintegration process of the industrial sector and the welfare state. "In one fell swoop, the reformers had engineered the demise of the federal fiscal structure" and steered the industrial sector into bankruptcy. (Chossudovsky 1997 p.375-6).

GDP growth per capita which had been at 5- 7 % during the 70s, plunged to less than 1% during the 80s. There was almost universal decline in real incomes and increase in poverty with workers' poverty levels doubling from 9% to 20% and farmers' poverty levels at 45% by 1987. Farmers had started at 42% in poverty, so the increase was less apparent. (This official poverty level had no welfare implications, it was simply the subsistence minimum calculated by the Federal Secretariat of Labor Health and Social Policy (Milanovic 1990)). The doubling of urban poverty was much more destabilizing than the rural poverty because it represented a reversal in the standard and culture of the last twenty years. The magnitude of the urban poverty increase in Yugoslavia is illustrated by the actual number of urban poor which increased from 837,000 in 1978 to 2,411,000 in 1987. Accompanying this increase in poverty was a pervasive feeling in the region that the economic situation would not improve (Milanovic 1990 p.17).

Despite these economic challenges, in the city of Sarajevo the evening *passaggiata* continued undiminished. Reflecting its "ethnic and cultural *mélange*" (Garton Ash 1999), 25 per cent of the population in the cities declared themselves Yugoslavs, not one particular ethnic identity. (Burg and Shoup, 2000). There was a clear urban – rural divide in that regard.

A damning characterization of the banks' portfolios at the time included "connected lending, excess concentration and distorted classifications" (Borish and Ding 1997 p. 182) which together toll a death knell for banks. Technical insolvency is the impartial way to describe their position. In March 1990 the last Federal Government of the Socialist Federal Republic of Yugoslavia (then called the 'Federal Executive Council') enacted a new Banking Law to facilitate the formation of independent profit oriented institutions and more than half the country's banks were liquidated (Šević and Šević 2000 Chossudovsky 1997 p.377). But banking reform cannot occur in isolation, so as the economy spiraled down, the banks' portfolios spiraled out of control. By the time of the war the banks were in crisis. (Borish and Ding, 1997).

¹¹⁶ According to Chossudovsky (1997 p.375)" the Reagan Administration targeted the Yugoslav economy in a 'Secret Sensitive' 1984 National Security Decision Directive (NSDD 133), entitled 'United States Policy towards Yugoslavia'. A censored version of this document, declassified in 1990, largely conformed to the 1982 National Security Decision Directive (NSDD54) on Eastern Europe. Its objectives included 'expanded efforts to promote a "quiet revolution" to overthrow Communist governments and parties', while reintegrating the countries of Eastern Europe into the orbit of the world market."

In 1990, annual GDP growth was sharply negative at -7.5 per cent. In September 1990 the World Bank estimated that there were 2,435 'loss-making' enterprises out of a total of 7,531. These firms - with a combined work-force of more than 1.3 million people - had been categorized as 'insolvent' under the provisions of the Financial Operations Act, requiring the immediate implementation of bankruptcy procedures. Given that 600,000 workers had been laid off by bankrupt firms before September 1990, these figures suggest that some 1.9 million workers (of a total of 2.7 million) were classified as 'redundant'. These 'insolvent' firms, concentrated in the energy, heavy industry, metal processing, forestry, and textiles sectors, were among the largest industrial enterprises in the country, then representing 49.7 percent of the total (remaining and employed) industrial workforce. Chossudovsky (1997 p.377) In 1991, GDP declined by a further 15 per cent and industrial output by 21 per cent.

The federal government *de facto* ceased to exist and a strange travelling body consisting of the presidents of the federal units became a power centre, as in the middle-ages when the power was wherever the king was. (Šević and Šević 2000). There was an increasingly impoverished, discontented, and fractured population in Yugoslavia but within that, the Serb population felt they had been the hardest hit economically (Judah 2000). The people longed for decisive leadership – remembering Tito with fondness. The west appeared to do nothing to support the disintegrating country (Burg and Shoup 2000). It was in this dire political and economic situation in 1989 that Milošević became the leader of the Serbian communists. Gathering Serbs into a political unit with his decisive vision, he gained control of four of the eight votes in the federal Yugoslav government¹¹⁷ (Malcolm 1994 p.212)

4.5 Bosnia multi-party elections 1990

The national feelings strongly suppressed under Marshall Tito's rule re-emerged as the economy disintegrated and politicians tapped into people's fear. In 1990 all component republics of Yugoslavia had their first multi-party elections and nationalist parties won in almost all of them. According to pre-polling, people voted for nationalists because they were afraid that if they did not, other ethnicities would vote for their nationalists and the outcome would leave them disadvantaged (Burg and Shoup 2000 p.56). The already shaky federation began to disintegrate (Šević and Šević 2000). The transitional period gave way to a new era of "rival republican ethnarchs" who exploited sectional and nationalist frustrations that thrived on declining economies (Pavlowitch 1992 p.93). In 1991 the Croatian President Tudjman publicly suggested partitioning Bosnia and Herzegovina along ethnic lines and the Serbian President Milošević was adamant that unless Bosnia and Herzegovina stayed in Yugoslavia there would be war (Crnobrnja 1996).

¹¹⁷ Milošević had "learnt the methods of Communist power-politics as he worked his way up the system; the general economic malaise and discontent and the ideology of Serb nationalism, so long frustrated was now finding an expression in a policy which restored Vojvodina and Kosovo to Serbian control. (Malcolm 1994 p. 212)

In 1991 the republics of Croatia and Slovenia (with the active support of Germany) had referendums on separating from SFRY. They both then declared their independence¹¹⁸. Shortly after the referenda Milošević's Serbian paramilitary groups¹¹⁹ fought the Croat army in the Serb majority Krajina region of Croatia (where the Ustašas had been active in WWII). Malcolm outlines the three step "blueprint" to ethnic cleansing later used in Bosnia as part of a "rational strategy dictated by political leaders...to drive out two ethnic populations and radicalize a third" (*ibid* p.252)¹²⁰. Judah (2000 p. 2) explains how impoverished rural Serbs were essentially exploited for their leaders' ambitions. In early 1992, the areas of Croatia which had been conquered by Serb federal and irregular forces were declared a UN-protected zone. (Malcolm 1994 p.238). At the start of these hostilities in 1991, all foreign currency accounts were frozen across all of Yugoslavia by the Yugoslav National Bank. No one could access their hard currency and for many, this was their life savings, gone. The Yugoslav government then used this hard currency to fund their operations (Teschke 2008 p.88).

Bosnia too wanted an independence referendum and followed the instructions of the European Community arbitration commission, which determined that Bosnia had the right to secede but had to ensure the protection of its minorities (Dahlman, 2005 p.575). On 6 April 1992, the day Bosnia-Herzegovina's independence vote (with 99% support (World Bank 2004b OED)) was recognised by the European Community, tens of thousands of citizens drawn from all of Bosnia's nationalities gathered before Bosnia's Parliament on the embankment of the Miljacka River. True to Sarajevo's long tradition of tolerance, the crowd held signs declaring: 'We Can Live Together'. Radovan Karadžić, the Bosnian- Serb nationalist leader, who had boycotted the referendum, had declared that Sarajevo's streets would 'run with blood', if Bosnia's declaration of independence were confirmed by the European Community¹²¹. As the crowd stood before the Bosnian Parliament calling for 'peace' and 'reconciliation' one of Karadžić's bodyguards opened fire from the Holiday Inn. It was the beginning of the siege of Sarajevo. (Dahlman 2005).

4.6 Bosnia at war 1992 - 1995

The origins of the war in Bosnia have generated a great deal of scholarship from a wide range of perspectives, but most scholars now widely dispute the "enduring hatred" explanations of the Bosnian conflict with a number of social scientists finding evidence that ethnic relations in Bosnia were generally cooperative before the war (Whitt 2007 p, 657). There is surprising degree of

¹¹⁸ They were not recognized as independent countries by the UN until May 1992.

¹¹⁹ The best known of these groups in Krajina were Arkan's Tigers who then later moved into Bosnia. In Bosnia there were also several the paramilitary groups such as the White Eagles and there were also militias loyal to Radovan Karadžić and his Serbian Democratic Party in Bosnia (SDS).

¹²⁰ The first step was to radicalize the rural Serb population through (sometimes years of) lies and fear mongering about their Croatian or Muslim neighbors; second by using the guerilla warfare technique of "compromising the villages" and so forcing them to commit to the side of the insurgents and third through creating incidents the enabled the Serb-dominated Federal army¹²⁰ to intervene (Malcolm 1994 p.216-7).

¹²¹ Knowing this was likely Karadžić had prepared for a war in Bosnia a year before the referendum on independence, seeking to partition the country along the lines of a plan later anointed by the Yugoslavian and Croatian state leaders Milošević and Tudjman. (Dahlman 2007)

commonality in the major *external* causes of Bosnia's destruction. These are the political strategy of the Serbian and Croatian leadership¹²² and the role of the West. A common theme on *internal* causes is that the main basis of hostility was economic and institutional as discussed above, not ethnic or religious (Malcolm (1994 p.xxi) and Chossudovsky (1997) p. 375, Mahmutćehajić 2000, Burg and Shoup 2000) and also that "there were belligerents and victims amongst all three communities in the Bosnian war depending on location"¹²³ (Bose 2002 p.21- 22, Whitt 2007). Largely Serbian and Croatian political entrepreneurs translated feelings of economic insecurity into ethno-nationalist resentment as Yugoslavia disintegrated. The distorted worldview they promulgated was that security meant 'national security' of a symmetrically converged ethnic nation and territory - a pure ethnic homeland. But the different ethnic communities were so dispersed across Bosnia that a map of the majority communities looked like "leopard spots" to former American Secretary of State Cyrus Vance (Burg and Shoup 2000). So ethnic cleansing was then simply a necessary founding moment of violent action in order to create the conditions under which this security could be permanently established and achieved. (Dahlman 2005 p.575, Burg and Shoup 2000).

One reading of the action of western leaders is that they were deplorably ignorant believing it was a civil war which arose from "ancient ethnic hatreds" (Malcolm 1994 p. 271, Boyd 1998, Mahmutćehajić, 2000) without any understanding of the mosaic of Bosnian culture or the economic desperation of the population. Another reading is that Bosnia was deliberately abandoned by the West because it was perceived to be predominantly Muslim (Ali 1994). A third is that there was no perceived threat to the security of the USA, so there was no reason for it to intervene. Whatever the reading it is hard to understand how world leaders first enforced a 1991 arms embargo on Yugoslavia, which prevented Bosnia from arming itself against those who had prepared for war before (Malcolm 1994 p.243) and then defined the war as a 'humanitarian nightmare' which only required a humanitarian response. In humanitarian discourse there are no enemies, just victims, but this was not the discourse of Bosnia's nationalist warlords. For them civilians were the enemy (Approximately 10% of the adult population were armed fighters by the end of the war (World Bank 2004b OED)). Humanitarian missions and peace keepers sent by the international community were frequently obstructed by the parties on the ground. Combatants attacked relief convoys, pirating their contents or redirecting their aid to other areas, jeopardizing both the neutrality of their mission and the safety of their staff, as well as attacking safe havens set up by the peace keepers¹²⁴. Since the international community chose not to choose between the parties, the international community *de facto* allowed ethnic cleansing to triumph. (Dahlman 2005)

¹²² It was reported that in March 1991 President's Milošević and Tudjman met to discuss possible ways of dividing up Yugoslavia including Bosnia.

¹²³ Bose concludes that "it is improper to assign the label of 'aggressor' or 'victim' in a blanket sense on a national or collective basis" (Bose 2002 p.21- 22).

¹²⁴ For example, the Srebrenica "safe haven".

From 1992 until 1995 the international community effectively stood by in the face of shockingly gruesome ethnic cleansing tactics of torture, execution¹²⁵ and the systematic rape of women¹²⁶. Sells (1996) provides a gruesome narrative based on evidence given at the United Nations International Criminal Tribunal for the Former Yugoslavia in The Hague as well as the US Department of State and Helsinki Watch.¹²⁷ Witness accounts of the brutal terror tactics are provided by Vulliamy (1998) Maass (1996) and Glenny (1996). The horror of the explicit “testimonies” (Olujic 1998 p.33) of women who had been raped and sexually tortured are given voice and cultural meaning in the South Eastern European context by Olujic (1998)¹²⁸. The detail of life in Sarajevo under siege from May 1992 – February 1996 is well described by contemporary historians like Garton Ash (1999)¹²⁹ and former journalists like Maas (1996) as well as in the records of the United Nations International Criminal Tribunal for the former Yugoslavia (ICTY).

¹²⁵ In August 1992 the skeletal figures in the prisoner camps of Omarska and Trnopolje near Banja Luka were seen around the world. Vulliamy later wrote about what he saw: “they were alive, but decomposed, debased, degraded and subservient” (1998 p.74) but the torture and killing that was not filmed was far worse. “The killings at Omarska were personalized entailing prolonged beating and torture frequently by former associates of the victim.” (Sells 1996 p.13) “Omarska had been a place where a prisoner was forced to bite the testicles off a fellow inmate” (Vulliamy 1998 p. 74). In contrast there were “killing centres” at Visegrad, Zvornik, Foča, where the prisoners were brought for immediate execution (Sells, 1996 p. 19) and there were “concentration camps where killings and torture were common but the majority of detainees survived.”(ibid)

¹²⁶ Olujic (1998 p.4) reports figures released by the Bosnian government in September 1992 that approximately 200,000 individuals, had been confined in concentration camps. Individuals of both sexes were physically and sexually tortured. Tortures included rape and sexual mutilation. Men were forced to watch their female relatives raped multiple times. The same report stated that the number of women who had been raped was at least 14,000. The European Community in December 1992 reported that Serb soldiers were reported to have raped 20,000 women, mostly of Muslim ethnicity. “The organized rape of Muslim women took place throughout the portions of Bosnia occupied by the Serb military as well as in areas controlled by Croat nationalist forces” (Sells, 1996 p.22). For example “In Foča a rape centre was set up in the former Partizan Sports Hall in May 1992. Muslim girls and women were held there underwent continual rape and physical violence and also were sent out to apartments where they were held for several days and then returned to the Partizan Hall. ” (ibid p.21/22). Sells argues that the organized rape of Bosnian women was “gynocidal” – a deliberate attack on women and childbearers - and that it was also a form of “desecration” – closely related to the desecration of sacred spaces symbolized by mosques (ibid p.22). Oluja’s (1998 p.41) interpretation is more stark: “The purpose of systematic rape was to “clean” women of their ethnic identity and humiliate their male kin.”

¹²⁷ Sells (1996) also provides an analysis of the “ideology of genocide” which allowed a people to be dehumanized and justified the use of military power to destroy them.

¹²⁸ Both authors provide grotesque victim and witness accounts too awful to include here.

¹²⁹ “For days on end they sat at home, freezing, in the dark, without electricity, gas, or running water, waiting for a mortar bomb to hit them from the hills. Or they forced themselves to walk to work, although often there was no work to do, risking death by sniper fire at every cross roads... They saw friends wounded or killed. They were degraded in a hundred small, everyday ways. They had to wash themselves and their clothes in a couple of buckets of water. They had to scavenge for firewood. They were impoverished by the black-market prices and the lack of normal incomes. They were humiliated by having to receive charity from foreigners: the discreet envelope, the embarrassed smile. And then there was the noise, early at morning, late at night, and death rained gigantically down. (Garton Ash 1999 p.203)

The siege of Sarajevo started in April 1992 and the official blockade in May and continued until February 1996. Residents and combatants alike were effectively prisoners of war with no access to essential medicine or food and living in fear of death every day.

It was the longest siege of a capital city in the history of modern warfare. The people were reduced to “a state of medieval deprivation” and “constant fear of death.” (UN ICTY 2003 p.5).¹³⁰

The extent of the tragedy is overwhelming. An estimated 250,000 people were dead, 200,000 – 400,000 wounded, 1.5 million were refugees, and almost one million persons were internally displaced (World Bank 2004b OED p. 1, Dahlman 2005 p, 580.) Industrial output had plunged to 5% of 1990 levels with 45% of the industrial plant destroyed. Over two-thirds of homes were damaged with one fifth totally destroyed (World Bank 2004b OED). The people had no savings left because their foreign currency had been taken, money in bank accounts had been lost in bankruptcies, and what cash they had could buy little due to hyper-inflation. If they had invested in housing with their savings, those assets were decimated too. The dominant feature of the rural landscape even in 1998 (when I first arrived in Bosnia) were burned and gutted, roofless homes often with graffiti on them, warning of reprisals if the owners returned, In Sarajevo nearly all buildings had bullet or rocket marks or holes and a large apartment block on the main road from the airport looked like a concrete fountain with the rubble spilling down.

Any interpretation of the history of Bosnia and Herzegovina has the potential to cause some ideological offence because of the many competing histories. The view that the ethnic and religious identity in Bosnia is complex and fluid, differs from those who view identity as more stable, such as the protagonist in Andrić’s 1961 Nobel prize winning novel “The Bridge over the Drina”. However in providing this background I have tried to remain true to my own experience with colleagues in Bosnia and Herzegovina since 1998. Whether over coffee or meals during training courses or traveling with colleagues (most of whom were working in microfinance), my observation is that there is very much more that brings the people of Bosnia and Herzegovina together than separates them¹³¹.

4.7 The Dayton Peace Agreement and starting reconstruction

The Dayton Peace Agreement (DPA) was signed on 14 December 1995 between Croatia’s President Tudjman, Serbia’s President Milošević, and the Bosnian parties to the conflict. Many say it “stopped the fighting” but according to Boyd (1998 p. 43), what it did “with the aid of 60,000 US and coalition troops, was freeze in place an uneasy cease-fire”. War and ethnic cleansing reordered the human geography of Bosnia and were effectively given international approval in the map of Bosnia drawn at Dayton. It created a *de facto* partition of

¹³⁰ The first convoy of ICRC trucks, which made it through to Sarajevo after the siege was bearing the Red Cross flag and carried essential supplies to the besieged city. It was led by Swiss ICRC delegate Frederic Maurice. At the gates to the city it came under fire and, Frederic, like many others, was killed by a sniper. A plaque commemorates his sacrifice there.

¹³¹ During conversations in 1998 a small group of friends that included Bosnians of Serb Muslim Croat and mixed backgrounds who were colleagues were joking about how they were probably fighting each other a few years ago. They were all disgusted with national and international leaders which had put them through the war and put their country so far back. Smith has pointed out that it is only through ethnographic methods such as in-depth interviews and participant observation that we can observe when interpersonal trust enables cooperation in risky environments (Smith 2006 p.331)

Bosnia dividing what had once been a multiethnic country into ethno-nationalist entities that acknowledged and effectively rewarded ethnic cleansing. (Dahlman 2005)

The flawed¹³² process which led to the DPA is carefully detailed by Bose (2002) based on official records and the diaries of Richard Holbrooke, the US negotiator. The complex Dayton compromise was modeled on the confederal, consociational structure of socialist Yugoslavia during the 1970s and 1980s which was administratively inefficient and could be construed as a backward step, not dealing with the issues which led to the war. Yet in that context many believed it was the only way forward (Bose (2006 p.22). The DPA officially established a single multi-ethnic state (with freedom of movement around the whole state) and with the goal of creating a single economic space at state level. But it comprised two entities where most of the power lay: Republika Srpska (RS), comprising 49% of the land area with Banja Luka as the capital and a majority Serbian community; the Federation of Bosnia and Herzegovina (FBiH) with 51% of the country and Sarajevo as the capital of a federation of ten cantons of which eight have majority communities of either Bosniaks or Croats and two with mixed populations¹³³. (Bose 2002, Dahlman 2005). However, included in the DPA (Annex 7, Chapter 1 – Rights of Refugees and Displaced Persons) is the statement that “All refugees and displaced persons have the right freely to return to their homes of origin. They shall have the right to have restored to them property of which they were deprived in the course of hostilities since 1991 and to be compensated for any property that cannot be restored to them.” (USA Govt. 1996)

The state and each entity have a Presidency and Vice President and an elected Parliament. The state level is responsible for foreign policy, foreign trade and customs policies, monetary policy, international obligations, immigration, refugee return, criminal law enforcement, common and international communications, regulation of inter-Entity and international transport and air traffic control. The state was also given responsibility for the central bank and a currency board (Murphy 2006 p. 14). The state was to manage the Constitutional Court of BiH, but it did not have responsibility for defence – that was at entity level. The two entities were to have any powers and functions not explicitly given to the higher level.¹³⁴ In summary there were multiple layers of government and short terms in office (elections every two years until 2002). Sixteen political parties in the Federation and fifteen in RS were established many along nationalist lines and each had a reluctance to cooperate on what should have been issues of common interest (World Bank 2004b OED). This proved to be a recipe for decision-making paralysis.

The DPA also set up The Office of the High Representative (OHR) with responsibility for overseeing implementation of civilian aspects of the DPA. The OHR was under-resourced

¹³² Malcolm goes further and calls the simplistic analysis that led to ethnic separation “poisoned”.

¹³³ With Bose’s detailed analysis of the multi-layered power structures which were established after DPA he includes a complex organigram of the political structure of BiH under DPA (Bose 2003 p. 60). Boyd (1998 p.46 is of the opinion that “partition is what exists in Bosnia today”.

¹³⁴ This hopeful tone in contrast to what he wrote in 2002 when he drew draws a heartbreaking parallel between the bloodshed and grief as a result of the partition of India with the “partition” of Bosnia and Herzegovina.

(deliberately) because the Peace Implementation Council (PIC)¹³⁵ members (especially those sending peacekeepers), were uneasy about ceding too much control. The OHR was to coordinate (Article II of Annex 10 of the DPA 1996), without the ability to control, the multitude of international agencies and commissions implementing the various aspects of the DPA (Dahlman 2005 p. 581) As a result of that lack of power, the OHR spent more time building consensus amongst the international community, than developing consensus building processes with Bosnian leaders (Ashdown 2007 p. 242). This was dysfunctional because in the post-war context of fundamental distrust, the two entity governments could rarely reach agreement within the time frame needed to implement reconstruction actions. But rather than give the OHR the power to represent the international community in working with the local leaders, in 1998 the PIC gave the OHR power to impose laws in both entities and the state and the power to remove obstructionist officials who were not fulfilling the requirements of the DPA. These were known as the “Bonn” powers. Examples of important reconstruction actions which needed these Bonn powers include the introduction of a single BiH-wide license plate in February 1998 (to prevent cars being identified as of RS or Federation origin); the new flag design, the national anthem, and passports (imposing a single design in September 2000)

But what the DPA did not do is address the desperate economic plight of the country. The economy, which had been in collapse from Tito’s policies before the war, was then decimated by the war. Approximately 50% of the remaining adult population was unemployed and in poverty. Aggregate production was less than 20% of pre-war levels. The country had “institutional and social meltdown”. People were “severely traumatized and shell-shocked from the bloody implosion of the regime and society that they knew” (Bose, 2002 p.24). Pupavac (2006) also describes the sheer desperation of people after the war – particularly women - because neither they nor their husbands (if their husbands were still alive) had work, nor any prospect of it. Despite all they had been through, somehow they were determined to survive, not to give up.

The twin economic challenges were: reconstruction after the war and transition from a largely socialist to a market driven economy. Either one would be challenge enough, but for this shattered economy with the paralysed political system addressing both simultaneously was asking too much. So the focus of the international community was on the easier part - reconstruction. Re-building blown up bridges, burnt out houses and unsafe schools was the priority. The World Bank, European Union and the European Bank for Reconstruction and Development (EBRD) estimated the required donor assistance was USD 5.1 billion from 1996 – 1999 (World Bank 2004b OED). The World Bank organized donor meetings to mobilize these resources from 50 countries and 14 international organizations. By 2000 most housing, schools, water supply systems, roads telecommunications and electric power supplies had been reconstructed to near pre-war standards” (World Bank 2004b OED p. xi), although GDP had only recovered to about 60% of pre-war

¹³⁵ After Dayton, a Peace Implementation Conference was held to mobilise international support for the Agreement. The meeting resulted in the establishment of the Peace Implementation Council (PIC) which comprises 55 countries and agencies that support the peace process including NATO with a Steering Board to advise the HR in BiH comprising Canada, France, Germany, Italy, Japan, Russia, United Kingdom, United States, the Presidency of the European Union, the European Commission, and the Organisation of the Islamic Conference, which is represented by Turkey.

levels. The World Bank Operations Evaluation Department assessed the World Bank effort in reconstruction as “highly successful” (*ibid* p. 14). But that was the easy part. What would be harder was the process of economic transition to a market economy, building the institutions and businesses vital to economic growth.

4.8 Conclusion

This chapter has presented a chronological story of Bosnia that highlights how social norms affecting the development of the microfinance market have developed including women’s economic activity, the importance of community identity and the lack of trust in banks. Although there is much pain in the Bosnian history, the resilience of Bosnians is major theme in this chapter. Starting with the political and economic factors that contributed to the founding of Yugoslavia under Marshal Tito, this chapter explained the forces resulting in the break-up of Yugoslavia and the 1992 – 1995 war. It concluded with the twin challenges facing Bosnia at the time of the Dayton Peace Accords, reconstruction after the war and transition from a largely socialist to a market driven economy under a structure that was not designed to facilitate change. The following Chapter 5 reports on the milestones achieved in the development of the financial and microfinance markets after the Dayton Peace Accords. Chapter 6 then discusses the findings of the ethnographic research with microfinance stakeholders on the institutional building blocks of the microfinance market between 1997 and 2007, including the social norms.

Chapter 5: Bosnia: Financial Market Development for Low Income Clients 1997 – 2007

The previous chapter described the political, economic and social context for the development of the financial market in Bosnia and concluded with the dual challenge of post-war reconstruction and post-socialist reform at the time of the Dayton Peace Accords in 1996. One indicator of the chaotic state of the financial system in Bosnia was that five currencies were in everyday use: the Bosnian Dinar issued by the National Bank of Bosnia and Herzegovina, the Bosnian Serb Dinar issued by the National Bank of the Republika Srpska, the Yugoslav Dinar issued by the National Bank of Yugoslavia, the Croatian Kuna issued by the National Bank of Croatia, and the Deutsch Mark (DM) issued by the German Bundesbank¹³⁶. This chapter now uses grey as well as published literature to provide an account of how the newly formed Bosnian government with the support of international partners attempted to put the institutional foundations of a new financial system in place; deal with the challenges of a financial market in transition from a socialist to a market system; build confidence in the financial sector and provide access to finance for those affected by war. This chapter concludes with an analysis of the context for and characteristics of the microfinance sector, including reaching approximately 9.6 percent of the population or 363,082 borrowers. This leads into the institutional analysis of the microfinance market in chapter 6.

5.1 Microfinance donors start work 1997

Post war, the banking system was barely functional, had lost all credibility and most people were reliant on cash. There were seventy two small undercapitalized banks in the country, twenty three of which were majority public banks which had ninety five per cent of total assets. The Federation had nearly four times as many banks as the RS, with seventy six per cent of nominal asset values (Tesche 2000). RS had fourteen banks and the Post Office was licensed to perform banking operation (Banking Agency RS 1998). Furthermore, the banks in RS were linked to both the Federal Republic of Yugoslavia and, the monetary system of Bosnia (Banking Agency RS 1998 p. 3). As discussed in the previous chapter, few of these banks had experience making loans other than to the SOEs that owned them. It was almost impossible to borrow from the banks even with land, cash collateral and a regular international income and they were illiquid. Their financial statements were almost worthless. The balance sheets had uncollectible loans and frozen deposits, and the true net worth of the banks was difficult to compute and, in many cases, likely to be negative. For example Kristal Bank was sold to Hypo Bank in RS for 1 Euro without any attempt to estimate its actual value (Pugh 2006). In August 1997, total Konvertible Mark (KM) equivalent demand deposits in all Bosnian banks were just 117.3 million KM. In contrast, demand deposits in foreign currency amounted to 368 million KM, more than twice the amount of domestic currency demand deposits (Murphy 2006 p. 20). With good reason, citizens had no confidence in either the banks or local currencies (Murphy 2006 p. 18)¹³⁷. Furthermore, interbank

¹³⁶ The Deutschmark had circulated in that entire region for many years as a sound currency in which citizens had great confidence (Murphy 2006 p. 12).

¹³⁷ There might have been a savings culture prior to Tito's ascension to power according to Sasa Petkovic, the Vice Dean for Teaching, Faculty of Economics, University of Banja Luka who writes on SME

payments were still processed through three different ethnically based payment systems: the ZPP (Zavod za Platni Promet) in Bosniac areas, the ZAP (Zavod za Platni Promet) in Bosnian Croat areas, and the SPP (Sluzba za platni promet) in Bosnian Serb areas. To say the sector had a bleak future, was an understatement (IMF 2006).

In this context, the World Bank implemented a Dutch funded pilot microcredit program in 1996 to see if there was demand for small loans as part of the reconstruction (Goodwin-Groen 2003). All the loans were paid back on time with huge demand for the loans, and so the Bosnia government agreed to a World Bank microfinance project called the Local Initiatives Project. INGOs had also started microcredit projects as part of the relief and reconstruction including World Vision and Mercy Corps in Tuzla, CARE in Banja Luka and Catholic Relief Services in Sarajevo. And the MicroEnterprise Bank (MEB) focusing on small and medium enterprises was founded in 1997 by a German consulting company with financing from the International Finance Corporation (IFC)¹³⁸.

The Local Initiatives Project, designed by the World Bank Human Development Unit based in Sarajevo, was co-managed with the Federation and RS Government's Local Initiatives Departments. It started in 1997 under the World Bank Priority Reconstruction and Economic Recovery Program (World Bank, 2000). Combined with other World Bank investments, its overarching goal was to assist people to "make the transition away from unemployment and dependency on humanitarian assistance to active employment and income generation" (*ibid* p.2). Its budget was USD 18 million over three years (under an International Development Association (IDA) Credit of SDR 4.9) with funding from the World Bank and seven other donors, including the governments of Italy, Switzerland, the Netherlands, Austria and Japan and "parallel financing" from the United Nations High Commissioner for Refugees (UNHCR), (*ibid* p.1). Its three development objectives were to:

1. address the urgent need to assist economically disadvantaged and war-affected groups in Bosnia re-start economic activity by disbursing 7 – 10,000 microcredits (up to DM 10,000 each) for income generating activities.
2. jump start the process of establishing financially viable microcredit institutions
3. support improvement of the business environment for self-employment and micro/small business development and the legal environment for non-bank microfinance institutions (World Bank 2000 p.2, Dunn 2005 p. 1).¹³⁹

The donors to this project agreed with these goals and allowed the project manager and the World Bank to manage the project to achieve the goals, with their regularly being kept informed of project progress. This project specifically "sought to overcome social exclusion by targeting

development in the RS. But in Dr. Petkovic's view Tito destroyed the incentive to save, and the war destroyed any savings that had not been stolen by the National Bank of Yugoslavia.

¹³⁸ The German company later set up the ProCredit Holding Company and renamed MEB to Pro Credit Bank. IFC funds were transferred to the holding company.)

¹³⁹ It is worth noting that missing from this list of objectives was the formation of a national network or association of microfinance services providers.

groups such as war widows, demobilized soldiers, and other uprooted individuals” (Kuehnast 2001 p.1)¹⁴⁰ Project Implementation Units were set up in the Federation and in RS. These Local Initiative Departments (LIDs) in Sarajevo and Banja Luka were considered by the government and by the banking sector to be the supervisor of the MCO’s under the auspices of the World Bank. Their mandate was to achieve the project goals. They were separated into two parts, one undertaking training of the NGOs and the other monitoring of NGO performance, with a ‘fire wall’ between, to avoid a conflict of interest. The two most important functions the LIDs undertook were: training local NGOs in the delivery of microfinance consistent with standards of international good practice; and to supervise performance and disburse funds based on that performance (because demand was high and the supply was limited). International experts were hired to train the PIUs and the NGOs (Goodwin-Groen 2003)¹⁴¹.

The project operated on performance based funding right from the start. The first eligibility criteria for NGO funding was attendance at a four day “what is microfinance workshop” , writing a business plan, demonstrated knowledge of potential clients and a good accounting system (plus the consultant’s gut feeling) (Goodwin-Groen 2003). Seventeen NGOS met these criteria (12 in the Federation and 5 in RS) and were funded. This comprised a grant to cover 100% of their operational costs the first year, which they understood would go down to 25% in the second year. The NGOs were initially lent funds for the portfolio at an Annual Percentage Rate of 3%, to cover the government’s costs of managing the apex, and so they could learn about paying back loans. The local NGOs were only legally allowed to lend because they were under the World Bank project, otherwise only banks were allowed to lend. (Two international NGOs that did not join the project, were also lending as their credit was desperately needed.)

NGOs funded under the project were required to participate in the training that the Local Initiatives Project (LIP) provided. This training ranged from travel to see microfinance internationally to bringing in local experts on financial management. No one had ever heard of microfinance before but it did not take potential clients long to realize that in a broken economy, microcredit might be their only hope (Pupavac 2006). Clients paid back their loans with impeccable performance. Within the first year the NGOs had disbursed 5,179 loans (World Bank 1998 LIP MTR). NGOs were assessed on portfolio quality, management and progress towards sustainability. They had to submit bank statements to show how the funds were moving in and out and to prevent corruption. They also knew that the project was under the reconstruction program so would end in three years and they had to be financially self-sufficient in that time.

In accordance with World Bank practice a Mid-Term Review (MTR) of the project was scheduled in 1998. As of 31 March 1998 all the MCOs under the project had 3,276 loans outstanding in the Federation and 475 in Republika Srpska (World Bank 1998 LIP MTR). For being in operation only

¹⁴⁰ It was an achievement to get this small project started with a focus on the excluded, because in post-conflict situation funds are typically earmarked for larger governmental reconstruction projects (Kuehnast 2001).

¹⁴¹ The project manager personally hired international experts since she wanted microfinance experts, not post-conflict experts. Ann Duval a microfinance technical and training expert set up the training and monitoring program.

about a year this was impressive progress. The MTR recommended a change in strategic focus from disbursing loans to building sustainable microfinance institutions that would last beyond the project. The choice to deliver microcredit on a sustainable basis beyond the life of the project was made by stakeholders who had been part of a participatory process (Kuenhast 2001). The development objectives of the project were modified to:

1. Provide access to credit to the economically disadvantaged and war-affected, specifically low-income entrepreneurs who have no access to credit from the formal banking sector;
2. Facilitate the development of independent, financially viable microfinance institutions that will continue to provide credit to low income entrepreneurs over the long term; and
3. Create an appropriate legal and regulatory environment for the provision of credit and savings services to low income entrepreneurs.(World Bank 2000, p.2-3)

After the intensive training and their experience of lending in Bosnia, the NGOs understood what was needed to build a sustainable microfinance institution (MFI). So, as part of a transparent, participatory process,¹⁴² performance standards were debated and agreed with NGOs and LIP staff for the MTR (Kuenhast 2001). These performance standards are in Table 3 below. The most difficult of these standards for the MCOs was the requirement for 10% of assets to be funded from local resources. This was difficult because the banking sector was still being reformed and most banks did not have the capacity to assess a small NGO without collateral. But it was included because all the stakeholders knew that diversifying funding relationships, especially to have local funding relationships, was critical to long term sustainability. The importance of the Austrian banks entering the banking sector is discussed later in this chapter. It was an Austrian bank that first to lent to MCOs because it understood how to lend based on cash-flow.

¹⁴² The participatory process for determining objectives and standards built on the highly interactive training experiences of microfinance practitioners and their understanding of the market. It was conducted over a day by a skilled facilitator in English with discussions amongst participants in the local language as needed. While less than an ideal participatory process (as set out, for example, by Chambers (1997)), given that many of the participants would not have chosen to work together at all so soon after the war, the World Bank considered it an achievement to have any degree of participation and consensus. Reflecting on his experience of participatory practice over many years Drinkwater (2003 p. 61) recognized that participatory methods were “inevitably incomplete”, and that the “dilemma of such partial understanding is how much and what part of it can we rely on.” The Mid Term Review team, with local advice, decided there was enough consensus to modify the objectives of the project and recommend their standards.

Table 3 1998 Performance standards for MicroCredit Organizations

AREA OF OPERATION	STANDARD TO BE ACHIEVED BY END OF PROJECT – DECEMBER 1999 – FOR INVESTMENT
INSTITUTIONAL CAPACITY	
Legal registration	Currently legally registered and able to be legally registered as an microcredit / microfinance institutions under the appropriate law once a capital grant is received.
Business Plan	Strategic plan projecting updated financial and institutional goals
Accounting and Internal Control System	Accounting system which meets international standards with internal controls. Audited financial statements for one year.
Loan tracking System	Loan tracking system able to provide weekly situation on total loan portfolio including ageing of arrears
Financial Projection System	System which provides reliable financial forecasting for the institution, especially cash flow.
Governance	Statutes which require an independent Board of Directors and give clear ethical and operational guidelines.
Human Resources	Staff necessary for prudent management of a financially viable MFI within a defined organizational structure
CLIENTS	
Identify clients	Clear commitment to low income entrepreneurs in the business plan and statutes
Loan size	First loan < 5,000 DM. Average loan size < 10,000 DM
FINANCIAL PERFORMANCE	
Portfolio Quality	< 5% portfolio at risk after 30 days. <4% write off (of loan funds managed) – both for last year of operations.
Profitability	Cover all costs from non-grant i.e. operating income, including loan loss reserve and the cost of funds.
Capital Requirement	Minimum of 250,000 DM in capital / equity from any source
Capital / Asset Ratio	Capital /asset ratio not greater than 1:5
Local Resources	10% of assets funded by local resources other than retained earnings

Soure: World Bank, 1998 LIP MTR

Eight local NGOs met these standards, five in the Federation and three in RS. The locations of their headquarters and the names of Board members provided information about the ethnic focus of these NGOs (For example, “Benefit” was based in Sarajevo, but on the RS side of the border, so largely served the Serb population and “AMK” was based in Herzegovina, so largely served the Croat population.) But in all the training there was a deliberate attempt to focus on the needs of clients as people, not their ethnicity. Eight of the others that did not meet the standards were required to repay their loans to the project. In order to survive, all but one merged with one of the stronger NGOs so they could keep serving their clients¹⁴³. This reduction in the number of NGOs helped the project. Training became demand driven with MCOs partially paying for the training in which they participated.

¹⁴³ One large NGO one was allowed to continue lending with the project funds because it was still operating well and had significant international support.

In June 2000 the project officially came to an end. Its achievements exceeded expectations including (World Bank, 2000 p.5):

- 50,261 loans disbursed compared to the original target of 10,000
- 19,361 borrowers outstanding as of 30 June 2000
- 49% of borrowers were women (many of whom were widowed during the war)
- Of the nine MCOs with LIP funding all but one covered their operating costs¹⁴⁴, four were financially self-sufficient
- Average Loan size was approx. USD 1,450 indicating a commitment to low income clients
- Portfolio at Risk (PAR) after 30 days was 0.66%
- An estimated 65,000 jobs were created or sustained.

An independent analysis of the benefit of the loans commissioned in 1999 found 79% of clients considered that the loan had significantly improved their economic situation. On average borrowers experienced a 26% increase in monthly household income (from Bosnian Marks (BAM) 351 to BAM 444) and 10% claimed a 50% increase in business production. There was also social benefit from the group lending in towns where displaced women were placed in groups with local women which helped integrate those different groups. (World Bank 2000 p. 5)

But it did not achieve the goal set by the MTR of creating four options for the delivery of financial services to the excluded namely: a not-for-profit MCO; a membership based credit and savings association; a for-profit microcredit institution and; a specialized MFI providing both credit and savings services. These four options needed to be explicitly identified because one of the legacies of a command-oriented economy was that every institution needed to be officially registered to undertake its exact activity or business.

5.2 Foundations for the formal financial system¹⁴⁵

While microcredit efforts were growing rapidly, progress on the banking side was moving more slowly. The DPA had designed a banking system with an independent state level Central Bank and Currency Board, entity level oversight of the banking sector, and the payment system run by the banks. (A “currency board” is an arrangement whereby a nation has its own currency but ties

¹⁴⁴ The one that did not perform well had corruption issues. The CEO closed down the MCO, took the remaining funds and told the clients they did not have to pay back their loans. He escaped to Croatia and could not be prosecuted.

¹⁴⁵ The governance structure for the Central Bank of Bosnia and Hercegovina (CBBiH) reflects the situation in BiH. There is a governing board on which there will be one Bosniac, one Bosnian Croat, and one Bosnian Serb. However, the governing board and the CBBiH are run by a single person known as the Governor – who cannot be from BiH or adjoining countries and is appointed by the IMF. (Murphy 2006 p. 14) Mr. Peter Nicholl, a New Zealander, held the position from 1997 – 2008.

it to another nation's currency - maintaining full convertibility with that other currency¹⁴⁶. There is a financial benefit to this arrangement since central banks, even under this type of arrangement, hold earning assets and they issue liabilities with little or no interest cost, and they receive net income from their activities. (Murphy 2006 p. 13)). The Central Bank and the Currency Board were not established until 1997. Both were led by the highly qualified and independent New Zealander, Peter Nicholl, from 1997 to 2007 who had no affiliation to any political party or ethnic group¹⁴⁷. These two institutions fulfilled three important functions: keeping inflation in check; maintaining the stability of the state level currency, the Konvertible Mark (KM) and coordinating the two entity Banking Agencies. The KM was established with full convertibility to the Deutsche Mark. The notes and coins, however, were not issued until 1998 because the design of the KM bank notes had to be imposed by the OHR using the "Bonn powers" (discussed in the previous chapter). The two entities could not agree on the design because of differences in politics and ethnicity (Tesche 2004 p.3). Finally by October, 1999, all interbank payments were in KM (Murphy 2006 p. 15).

The entity Banking Agencies were new organizations established under the Dayton Peace Agreement with the function to build a robust banking system. The Law establishing the Federation Banking Agency was passed in late 1996 and in 1998 the RS Banking Agency Law was passed (Banking Agency Fed BiH 1996, Banking Agency RS 1998). USAID was the main funder and brought in expertise from the US Federal Reserve to establish the Banking Agency and start enforcing Basel I standards. For example, starting in 1997 in the Federation and in 1998 in the RS, all banks had to comply with the 12 percent capital adequacy requirement, to calculate their ROE & ROA ratios according to international standards (which they had never done before) and to disclose loans to relatives, or lose their license. These standards were strictly enforced. Funders such as the German KfW and the World Bank required even higher standards for banks to access their long-term credit lines (e.g. for housing). Since these standards were so difficult for local banks and the banks had no experience making loans, the international funders provided technical assistance on how to meet their higher standards and how to design a mortgage and other products. Access to this long term credit from the international funders was much needed liquidity for the banks; so they would whatever was needed to get it. As the banks were forced to meet funders' standards, this supported the work of the Banking Agencies in requiring Basel I standards (e.g. Banking Agency Fed BiH 2002).

It took time to get the Banking Laws passed because politicians were trying to hold on to their influence over the old system (Tesche 2000 p. 322). (They would not have control over a modern competitive banking system, nor would ethnic interests be served.) But once accomplished, the focus became the privatization of the banks and related steps to improve confidence in the banking

¹⁴⁶ This means that all central bank liabilities (in the domestic currency) are set equal (at some fixed exchange rate) to central bank assets in the chosen foreign currency. That is, the central bank's ability to create money is exactly limited by the amount of foreign currency assets it holds. This is a monetary policy that severely restricts central bank discretion. Note that the central bank cannot extend credit to commercial banks under this arrangement nor can it underwrite the government deficits by investing in domestic government securities. (Murphy 2006)

¹⁴⁷ Kemal Kozaric has now taken over from Peter Nicholl and that transition has gone smoothly. Peter Nicholl is now Chair of the Governing Board of the Indirect Taxation Administration.

system. The first step was consolidation so that a viable, competitive banking system could develop. Officially state owned banks had to go through a process of determining the exact value of assets, liabilities, and net worth – although this did not always happen (Pugh 2006). Those with a positive net worth were privatized while those with negative net worth were liquidated. Privatization was aimed at breaking the link between enterprise managers and the banks mitigating the conflict of interest problem. This was supplemented by regulations regarding bank dealing with related parties. Foreign banks were then encouraged to enter the market to provide effective competition for domestic banks, improving both prices and service availability. The credibility of the Banking Agencies in particular spurred the advent of the foreign banks, which, in turn benefited the MCOs.

USAID and other international donors viewed the three payments bureaux not only as an obstacle to the development of a free market and the entrance of foreign banks, but also as source of corruption and illegitimate finance for the political parties who controlled them (Zaum 2006 p.45)¹⁴⁸. They argued that an efficient payment system was crucial because, amongst other things, it reduced transaction costs for businesses. So funders put a lot of pressure on the BiH entity governments to reform the system. In RS resistance to the reform was very high as “politicians preferred to remain in control over financial flows” (Zaum 2006 p.47). The law eventually had to be imposed by the OHR on 20 December 2000 before the 31 Dec deadline. This process was driven by the international community. The reason it succeeded was because the international community was coordinated; had the authority and used it. But the downside is that they failed to develop local capacity to manage the process of agreement and there was a lack of accountability in the process (Zaum 2006 p. 53-54) as will be discussed further in the institutional change section following.

The establishment of the Central Bank, the Currency Board, the Banking Agencies a reformed Payments system and laws governing banks were important foundations for the financial system. But this took five years until the end of 2000. Meanwhile, the only real source of working capital for ordinary people was microcredit from the World Bank Local Initiative Project and INGOs, which had set up their own independent and effective supervisory and accountability structures. Having the basics in place was an essential part of the reconstruction; the next step was the transition from a socialist to a market economy.

5.3 Challenges of a financial market in transition

As discussed in Chapter 2, the importance of building a sound institutional framework for economic growth is now taken for granted and this is a particular important aspect of the reconstruction process. Coyne (2008 p.9) defines reconstruction as “the rebuilding of both formal and informal institutions”. In order to build that institutional framework in Bosnia the OHR relied

¹⁴⁸ As noted at the beginning of the chapter interbank payments were processed through three different independent payment systems based on ethnicity: the ZPP (Zavod za Platni Promet) in Bosniac areas, the ZAP (Zavod za Platni Promet) in Bosnian Croat areas, and the SPP (Sluzba za platni promet) in Bosnian Serb areas.

on the “Bonn powers” to push through actions that were politically sensitive, but everyone knew were needed to implement the DPA. For all political parties in Bosnia, allowing the OHR to make the tough decisions allowed them to “save face”; no one had to look weak, which was culturally very difficult. Indeed, Ashdown (2007) frankly discussed the need to create face-saving devices to allow parties to agree or, at least, not oppose OHR action. But the downside is that the Bonn powers created a “culture of dependency” on those powers, among both Bosnians and the international community, rather than undertake the long-term processes that build consensus (Ashdown 2007 p.238)¹⁴⁹. These powers also created a fundamental contradiction. The contradiction was that in an effort to set up democratic and accountable¹⁵⁰ institutions the OHR was using a process that was not democratic or accountable, and in fact the OHR could largely disregard democratically elected officials if he so chose (Caplan 2006). Such an artificial approach to institutional development, “where the international community assumes executive and legislative powers, makes the development of trust impossible as this process lacks transparency or accountability.” (Chandler 2006 p.97). Coyne (2008 p. 56) agrees in an analysis of several different reconstruction process after war, is unequivocal about the vital importance of integrating local norms in the establishment of formal institutions, arguing that formal institutions must build on the informal institutions otherwise there will be dysfunction and reconstruction will fail. Ashdown, a former politician, describes how he personally respected the results of the ballot box and worked with local political leadership, but he used the powers when there was no alternative to get things done (Ashdown, 2007)¹⁵¹. An alternative interpretation might be, therefore, that since 1945 Bosnia had little history of consensus building because Tito was an authoritarian leader. The HR was able to get things done when he behaved like another authoritarian leader, fulfilling that norm. This will be explored more in the findings chapter.

However, there were success stories. For example, the public-private partnership to change in the business environment: There were a myriad of laws from the Tito regime which were unfriendly to businesses, including many taxes (with the threat of the financial police behind them). So the OHR had identified removal of these laws as a priority for economic reform. A committee of businessmen called the “Bulldozer Committee” was formed in November 2002 (Office of the High Representative, 2003) With the support of technical experts their task was to call on the business community to identify the most egregious laws preventing business growth and then take action to remove or change those laws. The initial target was 50 laws in 150 days which they

¹⁴⁹ This recognition of a culture of dependency on the powers of the international community was also addressed by participants when looking back at developing the microfinance laws.

¹⁵⁰ “Accountability” refers to the “norms practices and institutions whose purpose is to hold public officials (and other bodies) accountable for their actions and for the outcomes of those actions” This includes vertical and horizontal accountability. Accountability requires answerability and “transparency about decision making and mechanisms of enforcement” (although not always sanctions) (Caplan 2006 p.158). The minimum requirement is transparency about how decisions are made.

¹⁵¹ By using his powers to sack obstructionist politicians Ashdown succeed in abolishing the two entities' ethnically separate armies and police, creating unified, state-level Bosnian forces. In contrast, his successor Christian Schwarz-Schilling lost the support of the international community after just a year, and had to leave his post as the OHR because he chose not to use the Bonn powers and as a consequence little progress was made on implementing the DPA. (Ashdown 2007)

met!¹⁵² Their work continued and the bottom-up consultative process with the entrepreneurs which had been set up was considered global good practice in public-private partnerships (IFC 2007) Despite this success there were high obstacles remaining and it was going to take longer for the mindset of lawmakers to devolve some of their power and to allow greater business freedom.¹⁵³

Another success was on property rights. Property rights are considered a corner stone of the formal financial sector but the challenge of establishing property rights after a combination of a socialist economy and a bitter war was (and still is) daunting. The land registry was started 100 years ago but much of the land was still legally owned by worker-owned enterprises, property records from before the war were complicated and incomplete and the problem of who owned what land was compounded by the more than 800,000 internally displaced persons who were occupying residences belonging to other displaced or missing persons, creating a knock-on displacement problem. Many of the areas where squatting was common had been ethnically cleansed and the local war-time councils had sanctioned the reassignment of what was euphemistically described as ‘abandoned property’ to co-ethnic persons displaced from other areas. (Dahlman 2005 p, 584) In 2002 the OHR imposed the Law on Land Registry in both entities in keeping with Annex VII, and set up the Commission for Real Property Claims. Its function was to provide a register of land ownership across Bosnia and the liens on that property. Hundreds of international and local legal and technical professionals created a computerized database of cadastral and occupancy records taking until 2003. This meant that the banking sector had a sound basis to begin tracking land ownership.

Unfortunately, the local (opština) authority was the agency responsible for repossession of property. This meant that if a minority returnee wanted to get her/his house back, the returnee was required to return to a place of fear and request the local authorities (who might be hard line ethno-nationalists who had sanctioned her/his original removal) to evict co-ethnic squatters (who had nowhere else to go) from her/his house,. That is almost asking the impossible. Even if the authorities were not antagonistic, they could simply be corrupt and so obstruct the process endlessly if they did not get some benefit from the process. However Dayton does not provide displaced persons the right to illegal occupation, Annex VII offers a ‘choice of destination,’ including the right to stay put (Dahlman 2005 p. 585) which meant that there could also be protracted legal processes. As a consequence, despite the OHR action, there is still great uncertainty around land ownership issues and banks now get an ‘expert’ legal opinion to check liens on property etc. before taking it as collateral and still there are problems. The “inescapable conclusion was that there was not yet significant expansion of bank credit to the *formal* sector” (World Bank 2004b p.24).¹⁵⁴

¹⁵² For example the Bulldozer Committee actions slashed statutory capital requirements when registering a LLC from \$ 6. 500 to \$ 1. 300. This increased number of registered companies (doubled in some areas) . Also registration of foreign companies which had previously required 3 different institutions, 3 sets of applications and took more than 3 months to complete was changed to 1 institution - 1 set of application –1 month long process (Herzberg 2006).

¹⁵³ It is important to note, however, that there was no specific objection to the work of the Bulldozer Committee because even though there were barriers to business, the private sector was accepted.

¹⁵⁴ Another example of the OHR’s work was the Medium Term Development Strategy (Govts of BiH and RS, 2004), also known as the Poverty Reduction Support Program (PRSP). The World Bank, OHR and key

5.3.1 Corruption

The problem of corruption, particularly economic corruption, is common to many transition economies, but it was greatly exacerbated in post-war Bosnia because of the vast sums of donor funds for reconstruction being given to the country without a functional institutional framework in the financial sector. Misappropriation of funds was almost inevitable. Misappropriation was compounded by asset stripping of SOEs, illegal arms trade, corruption at customs and border posts, the trafficking of women by organized crime, and a network of petrol stations that sent money to support war criminals, as Ashdown's (2007) memoirs graphically report. But it was the level and depth of corruption at all three energy generating companies that had really shocked Ashdown (2007). These companies were national assets that had contributed to 9% of GDP but were now hemorrhaging funds to private individuals. Pugh (2006) also illustrates how criminals (including those who allegedly conducted war crimes) and elites corrupted the privatization process for their own ends, including in the banking sector, with one bank being privatized to an offshore company in the Cayman Islands. Corruption in the political sphere had also been inadvertently facilitated by a DPA provision which gave politicians immunity from prosecution so it had become "advantageous for criminals to get themselves elected to evade prosecution (Ashdown 2007 p.245). The World Bank estimated that approximately Euro 250 million was lost to smuggling per year and that tax evasion was a very serious problem (World Bank 2004b p.22) The honest officials who uncovered high level corruption often received death threats to them and their families. Some commentators argued that corruption became a bigger barrier to economic recovery than ethnic nationalism (Chandler 2006). Bosnia corruption has been deconstructed into three types: mafia rackets and trafficking; corruption and fraud in business life and; survival or shadow economies (Pugh 2006 p.151). The shadow economy although officially illegal, is simply a survival mechanism for many people, enabling them to exist just above the poverty line when there is negligible social protection provided by the government (Pugh 2006). Once the institutions for a viable economy are in place this part of the economy will slowly become formalized.

Broadman and Recanatini's (2001) research on corruption in a cross section of transition economies found "that a well-established system of market institutions – one characterized by clear and transparent rules, fully functioning checks and balances, including strong enforcement mechanisms, and a robust competitive environment – reduces rent-seeking opportunities and, in turn, the incentives for corruption."¹⁵⁵ Bosnia does not even approximate these conditions. So when Ashdown became the HR in 2002 he agreed with the PIC Steering Committee that his first priority would be "the rule of law" (Ashdown 2007 p.242). His two goals were to tackle high level crime and clean up the political space since "huge sums of government money had been lost in

members of the Bosnian governments had engaged in a process of wide consultation with different arms of government and civil society stakeholders in developing the Medium-Term Development Strategy. The focus of the strategy was enticing business and investment to BiH, because that process had largely failed to date, rather than direct poverty reduction (Pugh 2006). But this view was contested as critics claimed there was actually no room for negotiation as it was the strategy the World Bank chose for the country, not a real engagement process.

¹⁵⁵ Similarly Easterly (2001) found poor institutions have an even more adverse effect on growth when ethnic diversity is high.

scandals” to the knowledge of the government and Ashdown decided that “relevant government ministers must be held responsible” (Ashdown 2007 p.235).

Unfortunately, the old laws inherited from the former Yugoslavia were not able to be effectively used to prosecute corruption in Bosnia. The whole criminal code needed to be re-written (Ashdown 2007 p.249). Also in 2002 OHR set up “Anti-Crime and Corruption and Criminal Intelligence Units” worked work with local Bosnian prosecutors to uncover high level corruption. Anti-corruption efforts, however, were hampered by powerful interests and in 2004 the World Bank (2004 OED) reported that corruption remained a serious problem. For example, another major source of corruption was the “complex, inefficient and corruption generating tax system” (Ashdown 2007 p.245) and reform of the system was strenuously resisted. The World Bank (2005b) noted that to enact reforms enabling the State Level Value Added Tax (VAT) will require “difficult and protracted consensus building” (World Bank 2005b p.x). This is partly because of the complexity of the administrative arrangements agreed at Dayton compounded by weak technical capacity and policy coordination failures across the various levels of government but also because it benefited those in positions of power. However, the OHR was eventually able to reach an agreement with both entities on State Level VAT to come into effect in January 2006. One face-saving device used by the OHR to get agreement without having to use the Bonn powers, was that State Level VAT was necessary to comply with eventual European Union (EU) accession –which all parties agreed was a goal.

The OHR’s use of its Bonn powers because political leaders cannot agree, the pervasiveness of corruption and the dysfunction in dealing with conflicting property claims discussed above, are common discourses in Bosnian public life post Dayton. These dysfunctional elements, however, are not the whole story as the positive steps in the financial market are discussed below and they need not be the final story as inclusive change processes are discussed in the following chapter.

5.4 Building confidence in the financial market¹⁵⁶

The importance of Austrian Banks' role in building confidence in the Bosnian banking system is unequivocal (Bray 2005). The major four Austrian Banks were Raiffeisen Zentralbank Oesterreich AG¹⁵⁷ and Volksbank¹⁵⁸ (both entered in 2000), Hypo Alpe Adria Bank (HAAB)¹⁵⁹ (entered in 2001) and Bank Austria Creditanstalt¹⁶⁰ (entered in 2003) (Bray 2005 p.35) The dominant position of foreign-owned bank subsidiaries by 2006 transformed the financial sector (IMF 2006). "The financial system is now more robust to traditional banking solvency crises, as these subsidiaries can typically draw capital and liquidity from their parents as needed, and now risks are primarily to the sustainability of foreign exchange (FX) reserves." (IMF 2006 p. 1). One Austrian banker in Sarajevo was quoted (by Bray 2005 p. 35) as saying that, "banks are among the 'building blocks' that are needed by other international investors. First, it is important to have a clearly defined regulatory environment. Then you need the financial institutions, and then other investors will follow."

As of December 2007 approx 50% of the banks were Austrian owned, followed by 22% Italian banks with other countries less than 10%. (BA FBiH 2008 p. 3) approximately 70% of the assets in the banking sector in the hands of "foreign" investors and 60% of the savings of citizens in four foreign owned banks (Raiffaissen; VolksBank; Hypo Bank and UniCredit). They are increasingly important as sources of loans for local businesses and domestic customers.

¹⁵⁶ This section does not include insurance because it was not a significant part of the financial market. There was no tradition of insurance before the war because the government took care of everything. Even private real estate was not insured. As a result it was a slow moving business. Entity Level Insurance Supervisors (and a State Level coordination body) were not set up until 2005 with functions of issuing licences for car, life and property insurers; collecting insurance data and assessing the insurers. All cars were required to have insurance but most did not. Only about 10 – 12 % of the population officially have life insurance. It is higher if you include those insured by Austrian based insurers but they are officially illegal. Most insurance is business property insurance. Most Insurers do not see an opportunity in the 'mass market'. An exception is the Mikrofin Insurance Company registered in the RS December 2007 (with the first policy being issued on 11 Jan 2008). In 2007, it only operated in RS but next year will be the Federation too. Their first product was an accident insurance policy for Mikrofin clients. If clients die or cannot pay their loan then the insurance pays out. The cost is 45 KM per policy for one year. Now Mikrofin Insurance offers ten different non-life insurance products for property; car; travel; and workers/accident insurance.

¹⁵⁷ Raiffeisen Zentralbank Oesterreich AG entered the market in 2000, when it acquired a controlling share of Market Banka, and then purchased 100% of the Mostar-based Hrvatska Postanska Banka in May 2001. Initially it focused on the Federation, but since 2003 has expanded its network to RS. Among other services it offers Internet banking, and has its own securities brokerage firm— Raiffeisen Brokers. (Bray 2005 p.35)

¹⁵⁸ Volksbank set up in Sarajevo in 2000 and has expanded by setting up two offices in Sarajevo and seven in other parts of the country. (Bray 2005 p.35)

¹⁵⁹ Hypo Alpe Adria Bank (HAAB) based in Klagenfurt, Austria, and—as its name suggests—aspire to expand throughout the Alpine and Adriatic region. It began in 2001 by acquiring Auro Banka in Mostar. In 2002 it acquired a controlling share of the loss-making Kristal Banka in Banja Luka, the capital of RS, for one Euro.

¹⁶⁰ Bank Austria Creditanstalt acquired Central Profit Banka in Sarajevo in 2003, and has since merged it with HVB Bank, its local subsidiary, to form HVB Central Profit Banka. With 33 branches, this is the third-largest commercial bank in Bosnia-Herzegovina. (Bray 2005 p.35)

These Austrian banks have had a long-term interest in the region and Bosnia-Herzegovina fitted into their wider regional strategic plans along with similar moves into neighbouring countries. Many clients from the former Yugoslavia were working in Austria and Germany and sending remittances back to Bosnia through the banks. They knew Bosnia had cheap labour but an educated workforce and access to western markets. They had also seen a rapid rebuilding of the infrastructure of roads electricity etc. after the war. The visible evidence of their impact took the form of smartly refurbished office buildings and a proliferation of Automated Teller Machines (ATMs) which, were taken as a welcome sign of recovery. Their refurbished office buildings also convey a sense of commercial professionalism which goes beyond ethnic particularism. Aura Banka and Kristal Banka, arguably were Croat and Serb banks respectively and now they are part of a national and international network, which were both acquired by HAAB, they can claim that they are not ethnic banks, but professional banks¹⁶¹. But they also brought a fresh perspective to the banking market (Murphy 2006)¹⁶²

The private credit registry (LRC Kreditni Biro) was set up in 2000. It keeps all the credit information submitted to the registry from all sources including the 3,956 participating organizations with which it has information agreements, so it has a comprehensive clients' history (LRC 2008). Most MCOs are members and use it to check whether clients keep paying on time, (not whether the clients might have too much debt). The Central Bank set up a state-operated Central Credit Registry (CKR) in 2006, managed by the banking agencies, which was not initially mandatory. During the financial crisis and due to over-liquidity many MFIs and banks lent to over-indebted clients and were not using the LRC information, so the state imposed mandatory reporting to CRK. It is more comprehensive and is cheaper, but keeps no client history. CRK data was updated monthly but will move to daily updates so financial institutions can better curb over-indebtedness.

In 2005 USAID set up a Mobile Collateral Registry in the Dept of Justice. If a vehicle or business equipment is given as collateral for an individual loan it will be registered immediately. The collateral obligation will also be documented on the vehicle's registration papers so it cannot be sold. With the mobile collateral registry MCO loan officers can register collateral of whatever is appropriate for individual loans, depending on the loan size.

¹⁶¹ Some are less convinced by this professional non-ethnic banks argument claiming that when UniCredit bought Zagrebachka Banker it also inherited the Croats fondness for that bank (B3).

¹⁶² To further develop the BiH banking system the Deposit Insurance Agency (DIA) was established at the State level. The BiH Parliament (State level) passed the DIA law in 2002. All banks operating in BiH became members of the DIA. Coverage is limited to 5,000 KM per depositor in each insured bank. (Murphy 2006 p. 23) The Governor of the CBBiH is an ex officio member of the Management Board of the DIA, and, in addition, the CBBiH appoints one other member of that Board. (Murphy 2006 p. 22). The outcome was one of cautious optimism indicating that the arrangements were prudent and that the DIA was “—a promising start to a viable institution and a positive influence and a positive influence in the continuing repair of confidence in the banking sector in Bosnia and Herzegovina.” (Murphy 2006 p. 24)

5.5 Legal and regulatory changes and MCO law

The legal system still included some laws from the former Yugoslavia. There were two sets of entity laws some harmonized and some not. Even when there was just a single law which applied to a case, the judges had wide discretion on how to apply it depending on the context. This legal uncertainty between entities, created a difficult environment for the financial sector that needed to be able to enforce contracts and also created difficulties for a harmonized MCO Law.

A proposal for four categories of financial institution to serve low income entrepreneurs was submitted to the Federation and RS Governments in 1999. These four were an NGO Micro-Credit Organization, a Finance Company (privately owned, credit only), a Savings and Credit Association (member savings based) and a Microfinance Bank (that could accept deposits). But this was not a high priority for the governments and there was no MCO network or association in the Federation, RS or State wide which could lobby the state or entity governments to be able to provide better services to excluded clients. It was, instead, left to the World Bank to get the regulations passed. Lyman (2005 p. 6) reports that as the draft legislation progressed “it became clear that only a more limited legislative agenda would have any hope of adoption by both Entity-level parliaments. A choice was therefore made to focus only on legislation to clarify the legality of NGO microcredit of the type already widely in practice throughout the country.” (The choice was also made not to allocate the resources to undertake a lobbying effort to get these four options passed and also not to request the use of the “Bonn powers” to get them passed.)

In 2000 both entity governments passed the Micro Credit Organizations (MCO) Law. This law had two functions: to give permission to NGOs to legally lend amounts less than 10,000KMs and by doing so, to facilitate access to loans for the majority who were excluded from the formal sector. Local NGOs that were making these small loans were required to register with the Department of Social Affairs in Sarajevo and the Ministry of Finance in Banja Luka as MCOs. They were then legally permitted to undertake their lending. Taking deposits was not permitted. The only reporting requirement was to use the NGO Chart of Accounts when sending in an Annual Report to the respective ministry. The Ministry of Social Affairs in the Federation was not required to and did not exercise any form of supervision over the fast-developing sector (permitting, for example, numerous phantom MCOs that had fulfilled the minimal prerequisites for registration to remain on the registration books, even though they never became operational). The Min. of Finance in Republika Srpska took a more proactive approach but had no legal backing to enforce MCOs to share information about their financial performance.¹⁶³ The main reason for this lack of supervisory requirement is that microcredit was clearly seen as an NGO activity as part of post-war reconstruction, it was not banking, no savings were involved, and there was little supervisory capacity anyway. What this law did not do, was provide a way for clients' savings to be safely collected either within a cooperative or banking structure as originally planned. This was a major blow for the sector and further reasons for this outcome are discussed in the following chapter.

¹⁶³ The MCOs under the World Bank LIP project had much more rigorous reporting requirements to their funders, which were then accepted by the sector as discussed below.

The Law on Deposit Insurance was passed at the State Level in 2002. After progress was made in dealing with privatization and liquidating insolvent banks, a deposit insurance program was implemented. (Murphy 2006 p. 18-19) The initial amount insured was 5000KM per person per bank backed by a 100 million KM unified deposit insurance fund (funded by USAID and KfW). The amount insured increased to 7500KM and the amendment was before Parliament in May 2009 to make it 10 000 KM. (The goal is 20 000 Euros.) Deposit insurance is managed by the State Level Deposit Insurance Agency (DIA). All the 10 banks in the RS are member of the DIA and 23 of the 31 in the Federation are members, who all pay an insurance premium to the DIA. Member banks hold 98.4% of the total Bosnia savings. In 2005 authority was given to the DIA to monitor the business operations of banks (like the Banking Agencies) to ensure the safety of deposits and they have to comply with requests if they are admitted to the DIA. The Law was harmonized with the Law on Banking at the entity level and with the European Directive on Deposit Insurance. The DIA is a member of the International and the European Associations of Deposit Insurers, so complies with international good practice. Deposit Insurance was obviously important to the government agencies and funders who set it up but the bankers who participated in this research considered that depositors trusted their banks and did not think deposit insurance made much difference.

In the former Yugoslavia, everyone was required to have an Identity Document (ID) card and this requirement for government issued identification continued after the war. In December 2001 the State level Law on Identity Cards which requires a uniform card for everyone in Bosnia which shows where they live. The ID cards provide standard government verified identity information about all clients. This means that MCOs, leasing agencies and banks can establish the identity of the person requesting an account and use it to cross check client information at credit registries and elsewhere.

5.6 Continued growth of microcredit

As the first Local Initiative project was ending in 2000 the economy had not recovered as expected by the World Bank. “Many Bosnians remain worse off than before the war.” (World Bank 2001b, p.2) The commercial banking sector did not provide loans to those without substantial collateral, so there was still huge demand for micro-loans. 72% of the population was in poverty. The majority of those in poverty had some kind of employment but not enough money to keep the household above the poverty level, so they tried to supplement their income (Govts. of BiH & RS, 2004 p. 23). Furthermore, although the MCOs were financially sustainable they were not quite strong enough to stand alone. So a USD 27 million second LIP project was agreed in 2001 with World Bank/IDA financing of 20 million and the remaining co-financed by entity governments and other donors (World Bank, 2001b). Its purpose was to build on the first project and increase the scale, financial viability and social impact of microfinance services in Bosnia. Its specific development objective to: Finance the growth and institutional development of high performing MFIs so they could sustainably reach significant numbers of clients and support the transition to sustainable forms of financing.

This included four components, funding and capacity building of MCO (but not supporting the establishment of a network or association of MCOs or undertaking financial education for clients or public information about how microfinance could best be used), client impact assessment and legal and regulatory reform. The legal reform was designed specifically “to enable MCOs to expand their sources of financing and the types of services they could provide” (World Bank 2005c p.3). Training was opened up to all MCOs in Bosnia, not just those funded under the project. This helped in bringing the MCOs together (so there were not two classes of MCO). A consultancy firm specializing in banking was hired to provide demand driven services. This project also used performance based funding and again there was again a transparent participatory process of establishing performance standards for the project¹⁶⁴. One of the key performance standards was the requirement to have 15% commercial financing. After desk reviews and field visits, seven MCOs qualified for this funding.

The LIP II funded an independent impact evaluation of microcredit on clients using a quasi-experimental¹⁶⁵ design and a combination of a longitudinal survey and interviews from a sample of eleven MCO clients. A total of 4,117 enterprises were in the sample. First a baseline study of clients was undertaken in 2002 (Dunn and Tvrtkovic 2003). This found that 43% of clients were below the national poverty line and 11% were in extreme poverty. Using the Living Standards Measurement Survey (LSMS) survey the national poverty rate was 19% of the population. (This shows MCOs were targeting poor clients and comparable people in similar locations starting small businesses would also have been similarly poor.) In the client group there was an approximately even gender balance in those who managed the business but in the non-client group 63% were managed by men. Women tended to predominate in trade and animal husbandry businesses whereas men dominated in production, services and agriculture. Only 1.2% had ever received a loan from a bank. The baseline survey also showed that 36% of clients were displaced by the war compared to 29% in the population and 81% were demobilized soldiers compared to 73% of non-clients. The report concluded that MCOs were reaching their target clients of economically active, financially excluded poor, who had been detrimentally affected by the war. (ibid p. 42 – 43)

At the time of the Mid Term Review in 2003, it was estimated that 43% of the population of Bosnia lived in rural areas in communities with up to 2,000 people (according to market research firms) (World Bank, 2003). Few banks have branches in such small communities, and none of the larger banks intend to move into this market. The Mid Term Review recommended that there be consolidation and mergers within the sector because the goal of the project was to ensure sustainable long term provision of financial services and size was essential for long term sustainability and reaching rural communities. To this end, after much debate, the commercial funding criterion was increased to 25%. It also recommended focused action on the regulations since that aspect of the project was not progressing as planned. Financing for the MCOs that met

¹⁶⁴Hickey and Mohan (2004 p.4) observe that the “mainstreaming of participatory approaches to development” has resulted in a “broadening of the participatory agenda to encompass. development policy and practice”. The participatory approach to setting LIP standards in 2001 appears to have been part of this broadening agenda.

¹⁶⁵ The consultants had planned to conduct a randomized control trial, but none of the MCOs were comfortable selecting clients as meeting their criteria and then randomly not approving some of them. So alternative approximations had to be used.)

these criteria was long term to attract additional long term financing and so the MCOs could plan their financial structure. Restricted Purpose Loan Agreements with 15 years repayment term and 5 years grace period were signed with the MCOs. The interest rate was fixed at 5% per annum on the outstanding balance.

The second stage of the LIP Impact work was conducted in 2004 (Dunn 2005). This answered questions about whether the microcredit had improved household welfare, promoted business development and eased post-conflict recovery. (The challenge of “selection bias” was addressed through a range of quantitative techniques (Dunn 2005)) Although only undertaken with a two year time frame, the research found that “microcredit helps the citizens of Bosnia and Herzegovina to improve their household welfare, develop their businesses, and contribute to national economic growth and development” (Dunn 2005 p.35) Specifically, those households that accessed microcredit had a per capita income 900 KM more than households with similar incomes in 2002 but who did not access microcredit. (Dunn 2005 p. 25). This is particularly significant given that the national poverty line is households with less than 2200 KM per capita income. With a national unemployment rate of between 20 – 40% self-employment is sometimes the only option to earn an income but those who accessed microcredit invested more in their business and were more likely to register their business than those who did not. Sadly those who were displaced by the war continue to struggle, earning less income, lagging their peers in business indicators such as registering their business and hiring paid employees. (Dunn 2005 p. 36)

Several other independent studies have been undertaken on the impact of microcredit in Bosnia. Matul *et al* (2004) found that for most clients, microenterprise credit provided an efficient and long lasting coping mechanism for households after the war helping to sustain their household self-employment activities. Income generated from micro-enterprises was perceived as the most efficient coping mechanism among households affected by conflict so as to fill some of their most important needs over the reconstruction period. Their conclusion was that “microfinance and related services could play a more substantial reconstruction role in post-conflict” reconstruction (*ibid* p. 429), because there was a significant need for other credit and business development services. Hartarska and Nadolnyak (2007 p. 3) also found microfinance services providers “alleviated microbusinesses’ financing constraint” based on comparing investment sensitivity to internal funds of microenterprises in municipalities with significant presence of MFIs to that of microenterprises in municipalities with no (or limited) presence of MFIs using LSMS and MFI branch location data. However, Bateman (2006 p.43) found that while microfinance in Bosnia “possibly helped to facilitate a number of poverty reduction impacts” in the short-term for those who had no formal sector jobs, it was not translating into long term formal sector employment. One reason for this limited impact was the limited credit product allowed to be tailored for low income clients. For example, appropriate and affordable savings products, remittance based lending, or leasing for small businesses were not permitted.

By 2005 at project completion, there was no new legislation for microfinance in Bosnia, there was no MCO network or association which could lobby on behalf of MCOs and their clients for new legislation and there had been no financial education to help clients or public information to help the general public better understand the purposes of microfinance. Furthermore, the draft new law

did not achieve the project goals of providing MCOs with a structure that allowed deposits and the ability to provide a wider range of services to their clients. According to Lyman at the time (2005 p. 11) a “ broad consensus has emergedto permit the current MCOs to “transform” into a commercial legal form or retain their nonprofit form, should they so choose” but it is not clear who was part of this consensus or how it “emerged”. The draft new law had been prepared by the local lawyers with full cooperation of the international legal advisor, some representatives of the microcredit organizations and project team – but had not been discussed with stakeholders in the government. The draft law was planned to be sent to the relevant ministries for further procedure, and this process was to be monitored by the ongoing LIP which continued with the monitoring function. With the project completed, the World Bank was no longer involved in the legal process for oversight of the sector. Eventually the new law on microcredit organizations was enacted in 2006, with responsibility for oversight given to the Banking Agencies (who had no experience with microcredit). The MCO regulations were promulgated in 2007 by the Banking Agencies. Meanwhile, the MCOs, however, continued to share their quarterly reports and to regularly meet, informally.

5.7 Context and characteristics of the microfinance market in 2007

Ten years after Dayton the Bosnian economy still suffered from the legacy of the conflict that had not only destroyed a significant part of the country’s physical productive capacity, but also depleted human resources and “shattered institutions and social capital” (World Bank 2005b p.i) Bosnia’s economic situation was precarious because of the “dire condition of the economy and mass unemployment; the emigration of highly educated and qualified citizens ...the poor quality of post-secondary education; the low calibre of the political class. (Bose 2006 p.24) An estimated two thirds of official formal employment was still in the public sector (World Bank 2004b OED), and official unemployment was 40% (Dunn 2005) However this percentage is misleading because “evading the registration and taxation of labor is a major industry” (Pugh 2006 p.150). There was continued popular opposition to privatization in general and privatization of the SOEs in particular because many Bosnians still hoped for a return to the Tito era where SOEs had large numbers of employees and looked after the communities. Within these companies the focus was on short-term privileges over sustained output expansion, there was “inadequate managerial behaviour” that included “asset stripping” and this was continuing even in 2005 (World Bank 2005b CEM p.i) Potential investors were discouraged because of the lack of clarity of ownership inherited from the Tito era and the liabilities of unpaid wages. Furthermore, Bosnia’s future was not going to be in heavy industry as it had been under Tito. Bosnia “could only be rebuilt on the basis of small businesses and individual enterprise” (Ashdown 2007 p.254). Its comparative advantages included tourism, forestry and wood products, organic agriculture and electricity generation, as outlined in the 1999 BiH General Framework of Economic Development. But businesses, especially export businesses, were still hampered by the “unfriendly” environment for private sector development (World Bank 2004b OED p.23). The report card found that legal and regulatory burdens and high taxes on enterprises continued to discourage economic activity in the formal sector.

This lack of formal business growth had serious implications for the labour market. Krstić and Sanfey (2007) finding that those in informal jobs are much more likely to suffer from poverty than formally employed people, earnings inequality is more pronounced in the informal sector than elsewhere and the informally employed report lower levels of life satisfaction compared to most other labour market states. Krstić and Sanfey (2007 p.311) conclude that, while the informal sector helps people cope, the formal sector provides better prospects for prosperity and well-being.” Pupavac (2006) argues that when policy makers chose not to expand public sector employment post war they put unwarranted responsibility for employment on the shoulders of individuals and reinforced the reliance of the poor on the shadow economies. Women were typically surviving in microenterprises financed by microcredit in the shadow economy, and did not have access to government jobs (Pupavac 2006 p.92).

The achievements in the ten years post war included: macro-economic stability¹⁶⁶ and low stable inflation thanks to the work of the Central Bank; a competitive banking market including largely robust regulatory and supervisory functions; promising small and medium sized businesses that have adopted a business culture where contracts are honoured and suppliers and workers are paid (in contrast to the corporate sector) and potential for a dynamic labour market (World Bank 2005b). It has been underpinned by the currency board arrangement which contributed to low inflation and confidence in the KM currency. Economic growth had been impressive with GDP tripling since 1995 (albeit from a devastatingly low base) with GDP per capita at USD 4,703 (IMF 2006)¹⁶⁷. Its Human Development Index at 0.725 (UNDESA, 2011) was only a little below the regional average of 0.740, which is remarkable considering its recent history.

The banking sector had recovered well and expanded rapidly over the last few years and the nonbank financial sector had also grown rapidly. Banking assets were around 75 percent of GDP driven largely by the entry of subsidiaries of reputable European banks. As of December 2007 of the 22 banks in the Federation 18 were profitable and 3 were in provisional administration. Of the 10 banks in RS all but one was profitable. The total assets in the Federation banking system were KM 14.2 billion and KM 5.48 billion in the RS¹⁶⁸ (Banking Agency Fed of BiH 2008, Banking Agency of RS, 2006). The IMF considered the development of institutions providing oversight of the financial sector was positive, but was concerned they had not kept pace with the growth of the private sector and they need strengthening if risks to financial stability are to be adequately contained. (IMF 2006). Specifically the World Bank / IMF Financial Sector Assessment Program (FSAP) (*ibid*) recommended unifying the entity bank supervisors so there was a single financial

¹⁶⁶ This economic stability had been hard won. In 2002 the IMF had reported to the OHR that no country other than Weimar Germany has such post-war debts as BiH and the Balance of Payments deficit was as high as Argentina’s before its collapse and so BiH was in danger of collapse. So to come back from those dire consequences was an achievement.

¹⁶⁷ According to the World Bank website Bosnia and Hercegovina’s GDP per capita in 2007 was USD 4,033 <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD> [accessed 10 May 2011]. But this World Bank data is not directly comparable with the IMF which uses different data sets.

¹⁶⁸ Using the same exchange rate as the MIX Market (2011) uses for the MCOs of KM/USD of 1.33, that is a total of USD 14.74 billion assets in the national banking system.

space across Bosnia; upgrading the enforcement of the insurance supervisor to combat fraud and address weaknesses in bank governance.

However, there have clearly been real achievements in economic stability and financial market development Boettke (2007 p.23) has concluded that “post-war reconstruction had failed to succeed in developing self-sustaining institutions that facilitate economic development”. There are serious structural problems to developing a consensus on the institutional foundations for economic and financial market growth. The interests of members of the Bosnian governments, the OHR, other international organizations, corrupt officials, the private sector and the ordinary person in the street, appear to be in conflict and there is no obvious process to resolve them.

Despite or because of these challenges the microcredit market thrived. The sector grew from nothing at the time of Dayton to over 360,000 loans outstanding (i.e. loans in the hand of clients) as of 31 December 2007 as can be seen in Table 4 below¹⁶⁹. This means that approximately 9.6% of the 3.779 million population, or 30% of the 1.196 million economically active population (International Labour Organization, 2007)¹⁷⁰ were borrowing from MCOs. Although this is a simple estimate, it still indicates phenomenal success in microcredit terms – but it is only credit, and does not include other financial services. The portfolio volume of USD 637,211 (without Pro-Credit Bank) indicates the MCOs are effectively managing about 4% of the total assets of the banking system¹⁷¹. The top MCOs all have strong positive ROAs, ranging from about 3% to about 8% showing profitable management of portfolios of between USD 7 million and USD 145 million. The consistent high quality of the portfolio as indicated by the low PAR ratios is world standard. This means the MCOs are sustainably serving hundreds of thousands of clients excluded by the formal sector banks in the current economic context. As a note of caution, however, MCOs were aware of some multiple borrowing, but had no system in place to track it or prevent it, so the actual numbers could be lower.

As a result of this high quality performance and the demand from clients the MCOs are each successfully managing portfolios of between USD 7 million and USD 140 million. These assets are funded by the commercial banks in Bosnia; by international commercial and socially responsible microfinance funds and by their retained earnings. The leading MCOs each had up to fifteen different sources of national and international lenders and they are priced at only 7.25% to 8%, which is concrete evidence about the willingness of international investors to put money in Bosnia as a result of the financial stability and functional financial infrastructure. These

¹⁶⁹ Unfortunately one of the original MCOs failed because of a corrupt CEO who took what funds he could and told his clients not to pay back their loans to the World Bank. If this MCO had succeeded the numbers would have been even higher.

¹⁷⁰ This data is from the ILO Labour Force Survey (2007) reported in the ILO’s Labour Stats Database <http://laborsta.ilo.org/> accessed on 29 March 2011. Table 1A reports on the economically active population by age and is described at: <http://laborsta.ilo.org/applv8/data/c1e.html> [accessed on 29 March 2011.] This probably significantly under-represents the labour force participation because of businesses that work in the cash economy.

¹⁷¹ Assuming an exchange rate of USD to BAM of 1.33 <http://www.oanda.com/currency/historical-rates/> and the total assets of the banking system of the Federation of BAM 14.2 billion (BA FiBH 2008 p.2) and of the banking system of the RS of BAM 5.5 billion (BA RS 2008 p.6)

international funders were the “who's who” of microfinance lenders including Triodos Bank, Dexia Blue Orchard, International Finance Corporation, European Bank for Reconstruction and Development, European Fund for Southern Europe, Deutsche Bank, Oikocredit, Calvert and CordAid.

The annual yield on portfolio for these MCOs is a good indicator of effective interest rates and fees. These are very competitive between 20% and 29%, roughly equivalent to credit card providers. They all started with effective interest rates around 1.5% per month which is about 31% and two had extremes at 44% and 57% so most reduced their rates by 30% and others up to 50% which is rare in microfinance. According to the Microfinance Information Exchange (MIX) Market the quality of all the MCOs data reported in Table 4 below has been rated at four or five stars – which means that transparency of the data cannot get better. These are world class in transparency in contrast to many other sectors in Bosnia. Not only do all MCOs report to the MIX Market but they share their quarterly financial performance information with each other. (Partner MCO also had a global Standard and Poors rating of B/stable/B which for an NGO in a country recovering from war is remarkable.) In addition, the MCO leaders all know and respect each other and meet regularly even though there is no functional network that speaks on their behalf.

Based on average loan size, clients were typically poor and working in the informal economy. Average loan sizes range at the low end around 30% of GNI for those MCOs focused on women and their small enterprises, up to nearly 75% of GNI for those with more focused on men's businesses. This is in contrast to ProCredit Bank which specializes in small business formal sector loans and has an average loan size of nearly 100% of GNI. The three MCOs with 100% women clients have a specific mission to work with women. Mi Bospo started as a psycho-social project in Tuzla for women whose husbands had been killed during the war. MIKRA was started by the international NGO Catholic Relief Services which has a focus on serving the most vulnerable populations. The other was also started by an international NGO, Women for Women. The three MCOs with women leaders are Mi-Bospo, Women for Women and EKI. EKI is one of the largest MCOs in the country with over 50,000 clients and the Director is simply the best person for the job and she happens to be a woman.

Table 4 Key Microfinance Indicators for Bosnia, 31 Dec 2007

2007	Borrowers	Avg Loan GNI/ Cap	Savers	% Women	PAR > 30 days	Yield on Portfolio	ROA	Portfolio USD '000
Pro Credit Bank	68,752	91.7%	84,126	n/a	1.6%	18.44%	0.69%	238,379
Partner – MCO	51,982	59.7%		42.5%	0.63%	19.81%	4.5%	117,393
MICKROFIN MCO	51,508	74.3%		35.2%	1.3%	19.8%	5.09%	144,578
EKI – MCO	44,459	69.8%		38.1%	0.4%	21.15%	6.81%	117,319
MI-BOSPO – MCO	30,565	36.8%		100%	0.87%	25.14%	7.02%	42,546
PRIZMA-MCO	29,308	33.4%		82.8%	2.4%	26.13%	4.31%	37,012
LOK – MCO	26,968	64.7%		43.0%	1.3%	27.5%	7.77%	65,950
Sunrise – MCO	23,275	55.1%		38.0%	2.4%	29.01%	6.30%	48,315
MIKRA – MCO	12,403	47.5%		100%	1.51%	28.62%	4.57%	22,264
SINERGJIA MCO	9,778	71.2%		34.1%	0.4%	19.74%	2.94%	26,327
Women for Women MCO	9,235	24.8%		100%	1.4%	27.24%	4.91%	8,677
LIDER MCO	4,849	37.3%		39.9%	0.98%	23.1%	7.44%	6,830
TOTAL	363,082		84,126					

Key: Highlighted cells indicate the best performers in that category for reaching low income clients

Source: MIX Market, 2011

The 2006 MCO Law eventually enacted in both the Federation and the RS was problematic. MCOs had to choose between becoming a Microcredit Foundation (an NGO with a maximum loan size of KM 10,000) or a MicroCredit Company (a Non-Bank Financial Institution (NBFI)) with a maximum loan size of KM 50,000 (Banking Agency RS 2006, Banking Agency Fed BiH 2006), neither of which could take savings.¹⁷² There was no option to take deposits other than becoming a bank or the unofficially member based “village banks”; no cooperative or a deposit-taking institution option or leasing company option or other services clients might need to grow their tiny businesses. The Banking Agency had been given responsibility for supervising MCO NBFIs but, unfortunately they had little experience in supervising this sector focusing on low income clients. However, even though they cannot take deposits they are regulated like banks, with all the associated costs. MCOs recognized that in an emerging market it is sensible to have maximum loan sizes to prevent money laundering, but the combination of no deposits and maximum loan size under banking regulations means that they are unable to compete against banks. It created an unfair market because they had the costs of banks and yet they could not take

¹⁷² A type of savings and credit organization had been approved under RS law in 2007 but none had yet been registered.

deposits so did not have access those lower cost funds. Furthermore, there was still no representative MCO network or association which could undertake advocacy for them or their clients, no system in place to track over-indebtedness, no financial education to help clients or public information to help the general public better understand the purposes of microfinance.

5.8 Conclusion

This chapter started with the chaotic state of the financial market at the end of 1996 with a cash economy, five currencies in everyday use, bankrupt banks which were not trusted, no effective national payment system and no financial services for the hundreds of thousands impoverished and displaced by war. Ten years later there was a stable financial system, trusted international banks leading the banking sector with a standard national payment system, credit reference bureaux and mobile collateral registry. There were ten financially viable microcredit organizations, performing very well by international standards, reaching almost 400,000 clients and continuing to grow fast as they served the credit needs of the low income population. By any standards that is a remarkable achievement. In ten years the foundations of a new financial system was put in place while ensuring access to finance for those affected by war and dealing with the challenges of a financial market in transition from a socialist to a market system. This is a positive story in a context where many of discourses are about dysfunction. But there is also a negative message here from a low-income client's perspective. The microcredit market in Bosnia was not meeting her savings needs or providing other tailored financial services. There were also no checks or balances in the system to see if she was getting over-indebted. Furthermore, because there is also not a single economic space MCOs cannot merge their Federation and RS operations and improve their efficiency and expand services. In the next chapter the institutions which provided the foundation for the expansion of this microfinance market and how they changed, are explicated from the perspective of market stakeholders involved in the micro-ethnographic research.

Chapter 6: Bosnia: Institutional Analysis of the Microfinance Market 1997 - 2007

This chapter provides an institutional analysis of the development of the microfinance market in Bosnia based on the micro-ethnographic research findings. It is the third in the set of Bosnia chapters and builds on Chapters 4 and 5. Chapter 4 presented the political and economic context for the institutional development of the Bosnian microfinance market and particularly for its social norms, prior to the Dayton Peace Accords. Chapter 5 reported on the milestones in the development of the financial and microfinance markets, as Bosnia faced the simultaneous tasks of reconstruction after war and post-socialist reforms. It concluded that the MCOs had grown fast, were profitable, had gained the trust of international and local lenders and were ranked among the best in the world: a considerable achievement in ten years, having started from nothing. Chapter 6 now provides the findings of the micro-ethnographic research with microfinance stakeholders on the institutional foundations of the growth of the microfinance market, including the social norms, to answer the research questions: How have rules and norms¹⁷³ in the Bosnia financial market changed between 1997 and 2007 to enable increased delivery of financial services to poor people? What has the role of development agents been in catalyzing this change?

This chapter starts with the constitutional institutional functions in Williamson's (2000) framework, because that is where respondents started. It moves on to the operational institutional functions for the expansion of microcredit and then the social norms which provided the foundation for all the others. The social norms then, in turn, became embedded in the new institutional functions. Finally, the chapter concludes with a deeper examination of the institutional changes that took place during this time.

6.1 Constitutional institutions - building blocks of the microfinance market¹⁷⁴

Respondents did not differentiate between types of institutions for the sector, which was the task for subsequent analysis, according to Williamson's framework. It was what I have classified as the constitutional or formal rules that respondents typically thought of first when asked about the building blocks for financial market expansion to the poor and how they have changed. Table 5 outlines the institutional form and enforcement mechanism(s), and its intended functions as understood by respondents, which are then subsequently discussed in detail, including the relationship with the social norms (described below) and the effectiveness of the enforcement. The most important were: the MCO Law which gave legal recognition to providers of microfinance; a stable state-level independent central bank and currency board with no interest rate cap and functional payment system; a competent banking supervisor and; the courts being functional as a last resort for contract enforcement. The findings reported in this chapter focus on why

¹⁷³ "Institutions are the humanly devised constraints that structure human interaction. They are made up for formal constraints (rules, laws, constitutions) and informal constraints (norms of behavior, conventions and self-imposed codes of conduct) and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies" (North 1994, p.360)

¹⁷⁴ These are Williamson's Level 2 institutions

respondents considered those institutions fostered the growth of microfinance and also note, several cases where institutional functions were ineffectively enforced or simply missing.

Table 5 Constitutional institutions - building blocks of Bosnian microfinance market

Form	Functions	Comments
<p>1. Micro Credit Organizations Law (2000 in the Federation and 2001 in RS) under Min of Social Affairs in the Federation and Min of Finance in RS</p> <p>-----</p> <p>Replaced by the Law on Microcredit Organizations of the Federation of Bosnia and Herzegovina and in Republika Srpska (2006) enforced by the Banking Agencies.</p>	<ul style="list-style-type: none"> • Legal basis for NGOs to legally lend amounts less than 10,000KMs and; • To expand access to loans for those were excluded from the formal sector (which was the majority of the population after the war). <p>-----</p> <ul style="list-style-type: none"> • Legal basis for two organization types: microcredit companies/associations (for-profit max loan KM 50,000) and microcredit foundations (not-for-profit max loan KM 10,000.) • “Improving financial position of microcredit beneficiaries, increasing employment and development of entrepreneurship and and acquisition of profits” (MCO Law 2006) • Transparency and accountability of the sector in the requirement to disclose effective interest rates and to publish in newspapers the audited financial statements 	<ul style="list-style-type: none"> • Function of legal registration fulfilled for World Bank project • No enforcement for those not under the World Bank LIP <p>-----</p> <ul style="list-style-type: none"> • Missing from both 2000 and 2006 laws was the provision of savings services for those excluded from the banking sector. • Enforcement by banking agencies problematic due to lack of experience with microfinance.
<p>2. An Stable Independent Central Bank and Currency Board enforced by OHR: no interest caps functional payment system</p>	<ul style="list-style-type: none"> • provide confidence to international investors • maintaining the stability of state level currency Konvertible Mark (KM), • coordinate the two entity Banking Agencies. • keep inflation in check; • ensure freedom on interest rate setting; • provision of basic financial infrastructure 	<ul style="list-style-type: none"> • Functions undertaken as intended due to effective enforcement by OHR • Political stability also needed but that cannot be enforced by OHR.
<p>3. Competent Banking Supervisor – the Entity Level Banking Agencies</p>	<ul style="list-style-type: none"> • build a robust banking system • risk based supervision using international standards • enforcement of standards 	<ul style="list-style-type: none"> • Functions effective for regular banking but not for microfinance.
<p>4. Courts for contract enforcement</p>	<ul style="list-style-type: none"> • to demonstrate the rule of law • contract enforcement for commercial contracts 	<ul style="list-style-type: none"> • Courts subject to political interests, not effective
<p>5. Land registry - enforced by OHR Mobile collateral registry – Dept. Of Justice</p>	<ul style="list-style-type: none"> • register of land owners and liens on the property • register of mobile collateral to encourage loan payment 	<ul style="list-style-type: none"> • Functions of land registry only patchy • Functions of mobile collateral also patchy

6.1.1 Micro Credit Organization laws

All types of respondents identified the 2000 MCO law as critical to the growth of the financial market for low income clients¹⁷⁵. The MCO Law was a building block because it meant that NGOs could lend money legally. When the MCO Law was passed there was huge relief on the part of MCOs and the banks lending to them. The Banking Law clearly stated that only banks could lend, so officially until this law, MCOs were conducting illegal banking activities. MCOs were afraid that the financial police would close them down and were convinced it was only the political clout of the World Bank which stopped the government from taking action against them. For example, their loan agreements clearly stated “on behalf of the World Bank” to be clear they were operating under the World Bank’s authority. (This fear of the financial police and the dependency on the international community is discussed further under the social norms below.) With this law the commercial banks were also greatly relieved. They could now lend with confidence to an independent legal entity not just a donor project, which gave them both more confidence and freedom to expand their relationship (MCO7).

Without this law, microfinance would have stopped after the post-war projects ended, developed informally through village saving or had to undertake the long process of establishing a bank. The MCOs provided small simple, fast loans with minimal paper work to those who needed them – regardless of background, ethnic identity or use of the loan. MCOs did not want Bosnia to be labeled by Americans as ‘poor’ and so were careful to say they were working with low-income clients (MCO7) or more simply did not exclude anyone. (MCO4, MCO1)

Even though all respondents recognized the 2000 MCO Law as an important first step of legitimacy for microfinance they also noted it was far from perfect. In particular, there was no way for low income clients’ savings to be legally collected. Savings may not have appeared to lawmakers to have been a high priority for low income clients post-war (especially given the number of times that savings had been lost) but looking back, this limited view of microfinance in the 2000 MCO law set the stage for also the very limited 2006 MCO Law and the lack of diversity in providers of financial services in Bosnia. One respondent regarded the law as a waste of time and money because it did not address savings. In his opinion the World Bank should have started one or two banks with a mission to serve the poor that could have collected savings and been under the Banking Agency right from the beginning.(MCO1) Although it was recognized that informal savings groups in rural areas saved together and lent to each other without needing legal status – they were still not integrated into the formal sector from which they were excluded.

Also missing from the 2000 MCO law was effective supervision for those not under the LIP Apex in either entity. As discussed in the previous chapter the MCO Laws did not set up any form of effective supervision in either entity. Officially it was the Ministry of Social Affairs in the Federation and in RS it was the Min. of Finance who had supervisory responsibility. In the Federation, the Ministry of Social Affairs failed to exercise any form of regulation over the fast-developing sector even though several sizeable Federation registered MCOs were not participating

¹⁷⁵ In the region they were aware that microfinance in Bulgaria had not grown because they did not have a legal framework within which to work.

in the LIP project. (It also permitted, for example, numerous phantom MCOs that had fulfilled the minimal prerequisites for registration to remain on the registration books, even though they never became operational). The sector in the Federation therefore depended exclusively on monitoring and reporting by the Local Initiatives Project (see section below). Meanwhile in the RS, the Ministry of Finance (who wanted to supervise MCOs) complained that its supervisory responsibilities were too vaguely defined (indeed they were not defined at all), that the Ministry lacked the personnel to carry out any meaningful form of supervision, and that the law failed to give them appropriate enforcement powers with respect to problems they did find (such as the phantom MCOs that also existed on the registration rolls in RS). Many MCOs noted this as a positive for the beginning of an industry, because it allowed them to experiment, with different types of loans under 10,000KMs within the parameters of their particular projects. (MCO3, MCO6) Others were afraid that MCOs not under the World Bank project and without supervision, would use MCOs legal structure inappropriately and reduce the credibility of the sector. To have a sector that was unsupervised in this way made many nervous since under Tito there was always supervision of some sort.

The 2006 MCO Law enacted in both the Federation and the RS was also problematic. MCOs had to choose between becoming a Microcredit Foundation (an NGO with a maximum loan size of KM 10,000 or a MicroCredit Company (and NBFI with a maximum loan size of KM 50,000 (Banking Agency RS 2006, Banking Agency Fed BiH 2006), neither of which could take savings. The 2006 law was important in recognizing that larger loans were needed by clients and to allow a for-profit business, but it was fundamentally flawed because it required the MCOs to meet the same standards as banks without allowing them to take deposits (forcing dependence on international financing) which would have enabled reducing costs to clients.

6.1.2 Central bank and currency board

Respondents considered that the central bank and currency board fulfilled three important functions: keeping inflation in check; maintaining the stability of the state level currency, the Konvertible Mark (KM) and coordinating the two entity Banking Agencies. In fulfilling these three functions effectively they saw that the central bank gave confidence to international banks investing in Bosnia (B1) and international lenders to the MCOs. One reason the foreign banks came in was because of the financial stability, despite some inflationary pressure (MCO9, MCO10, MCO6). This stability has become so accepted that 'we don't think twice about using KM now' (F2). No one is worried about stability of the financial system and the currency, despite the political challenges. The fact that there was an effective central bank and currency board which fulfilled its functions to keep inflation under control and the currency stable, meant that MCOs could afford international funds. As of December 2007 Moody's Bosnia Country Rating ran at 6% (MCO10). As noted in the previous chapter, the leading MCOs each now have up to fifteen different sources of national and international lenders and they are priced at only 7.25% to 8%, which is concrete evidence about the willingness of international investors to put money in Bosnia as a result of the financial stability and functional financial infrastructure.

Some respondents also noted that the central bank has been important in ensuring that interest rates could move freely. For an economy used to direct government involvement in banking, it was important that they did not have the onerous obligation of interest rates caps and the rates could come down as a result of competition, not due to supervisory requirements.

The building block of political stability for economic growth was missing. From bankers to MCO leaders to government officials all were concerned that the political situation had not been stable which had negatively affected GDP growth and Foreign Direct Investment (FDI). An international banker spoke bluntly about the political risk. ‘The country is still associated with war and the uncertainty over the country’s future. Will Herzegovina go to Croatia and RS go to Serbia? The price of the risk factor is about 1.85% which has not changed much over the past three years, although over that time LIBOR [London Inter-Bank Offer Rate] has gone down.’ (B1) Of course this is much better than in 1997, but the expectations for greater stability and growth have not been realized. An international official was more blunt ‘without economic growth what are you offering the people as an alternative to reverting to ethnic issues? When the average citizen does not see the benefit of reform there becomes a role for extremists.’ (G3) An government official commented that banks have 30% of their Assets in cash which is more than the 23% required by regulation – hence they clearly perceive there is some risk in operating in Bosnia. (G4). For the older generation who remembered Tito, the lack of political stability was more disturbing and is discussed further under the norms.

6.1.3 Competent banking supervisor

All types of respondents understood the function of a banking supervisor was to build a robust banking system and all banker respondents commented positively on the competency of the entity level Banking Agencies in fulfilling this function. The MCOs understood the Banking Agencies were important for the banks and that the MCOs were dependent on banks for funding, so recognized the Banking Agencies importance. However, that recognition did not extend to their supervision of the MCOs under the 2006 MCO Law. Those in the microfinance sector considered that the Banking Agencies had little understanding of low income clients nor understanding of the nature of risk in lending to such clients, because they were supervised in the same way. (This issue will be discussed further below under the operational institutional functions.) Despite the considerable collaboration between the two entity agencies, most respondents thought it would have been better for the financial sector to have one State Level Banking Agency¹⁷⁶ like the State Level Central Bank. At the moment there is no opportunity for a state level financial institution.

¹⁷⁶ There was opposition in Banja Luka to a State Level Agency because it did not want Sarajevo to be the “financial centre” for Bosnia. Also because there might be Chinese or Russian banks who would come in only to the RS not to the Federation. So it opted to wait for the constitutional negotiations to discuss a state level agency.

6.1.4 Courts function for contract enforcement

MCOs and banks were in agreement that a functional court system was essential to demonstrate the rule of law and to fulfil the function of contract enforcement. But in practice MCOs and banks tried to stay away as far as they could from the courts since they found the courts to be completely unpredictable. The legal system still included some laws from the former Yugoslavia and there were two sets of entity laws. Even when there was just a single law which applied to a case, it could easily take from six months to three years to get it settled, and in the end the judge might give a political judgment not a just one¹⁷⁷. All these factors make it a highly expensive and risky process for the banks. So for small amounts the banks do not go to court, they just write it off. This appears to call into question whether the courts are demonstrating the rule of law or not.

The MCOs also did everything they could *not* to put a client on the court register or take a client to court. By taking a client to court they have not only lost the client but a lot of time and money too. For MCOs, the time and cost of taking a person to court is not worth the few hundred KMs owed to them (MCO 2). The use of the courts is most effective as a threat because clients do not want their reputation tarnished by their neighbors seeing the court police coming to their house or their good name in the courts. So the power of the courts as a deterrent to delinquency is build upon the foundation of the social norm of shame at not being able to pay back loans (see norms below). Clients also do not have the money to hire a lawyer. Despite these major constraints all MCOs have taken a few clients to court in the last ten years (those who had no intention to pay and refused to cooperate), to show other clients that those who do not pay will not get away. As one MCO leader said clients have to trust that we will keep our word too. ‘We have to take them to court because if we didn’t, how many others would not pay back? (MCO9). If they do go to court, getting the decision is easy compared to executing the court order. For example if trucks were the collateral, they have probably been driven out of the country and the court order will not bring them back (B3). There is estimated to be 4 billion KM of internal debt in Bosnia – everybody owes somebody something! (MCO8).

6.1.5 Land registry and mobile collateral registry

The function of the land registry is to provide a register of land ownership in Bosnia which could be taken as collateral and the liens on that property. Most recognized that it was necessary to the formal sector but not so for the microfinance market, although there was great doubt expressed over whether its function was being effectively fulfilled. Even a government official noted that when someone defaults on a loan and that house is up for sale ‘No one wants to buy the house. They think there will be a problem – someone else will come and claim it!’ (G4)¹⁷⁸ (There is

¹⁷⁷ One banker said it was easy to bribe the judges and that there were great regional differences in judgments. For example, the courts in Mostar will judge the case differently whether it is a Croat or non-Croat.

¹⁷⁸ There were lots of land collateral horror stories. One where USAID was directly lending before the banks were functional - criminals borrowed money with land as collateral, but they had taken the land at gunpoint as part of ethnic cleansing, so when they did not pay on their loan and their cases reached the courts, they were found not to be the rightful owners so USAID could not claim the collateral and lost their money (B5).

another problem altogether in rural areas, where it is locals who would be most interested in buying the house, but no-one wants to buy the property of someone they know who went bankrupt.) This means there is no market for foreclosed properties so banks cannot liquidate the asset taken as collateral. The land registry cannot effectively perform its function for the financial sector.

The Mobile Collateral registry has a similar function to register cars, trucks, business equipment even TVs that can be taken as collateral for a loan. Some MCOs take mobile collateral for their loans, not so they can liquidate the asset but for the purpose of encouraging repayment - so they have “something to hold on to”. If they have to liquidate it the client will be lost to the MCO forever and everyone loses. MCOs want a winning situation where even if the client is failing then they do positive things to help her succeed and find a solution– not to take her collateral. It works well for low income clients who do not want to lose face (see norms below) but for larger businesses determined to defraud a bank they can simply drive their asset out of the country before defaulting on the loan.

Together these institutions provided the constitutional basis for the development of the microfinance sector but each one is dependent on underlying social norms for effective enforcement. The social norms which respondents identified as supporting the enforcement of these institutions are explained in detail after the following discussion of the “rules of the game” or operational building blocks for the sector.

6.2 Operational institutions - building blocks for the microfinance market¹⁷⁹

Ostrom (1990) and Williamson (2000) theorized that in addition to the constitutional or formal ‘rules of the game’, there are more specific operational institutions for different sectors which determine ‘how the game is played’. For example, in Bosnia the MCO Law is a formal rule which needs an Act of Parliament to change, whereas the standards of the Local Initiative Department are rules about how the ‘game’ is played and after an appropriate process, these rules could be changed. However, respondents did not differentiate between types of rules that applied to the sector, so it was my task to analyze the data to see if any common categories or patterns were revealed using an inductive iterative process. (Particularly challenging given that institutions are “nested” (Ostrom 1990)) Table 6 below summarizes the three institutional forms, functions and enforcement mechanisms (whether effective or not) which respondents identified for the operation of the microfinance sector.

In another example, a bank was holding title deeds to land but in court the judge returned the land title to an owner from 30 years before so the bank did not have a claim on the land. (B3)

¹⁷⁹ These are Williamson’s Level 3 institutions.

Table 6 Operational Institutions – building blocks of Bosnian microfinance market

Forms	Functions	Comments
<p>1. Local Initiatives Department (LID) - government's microfinance apex which supervised the MCOs it funded:</p> <p>Standards included: International Accounting Standard (IAS) Compliant Financial Statements required for LIP MCOs</p>	<ul style="list-style-type: none"> • Training in performance, standards, transparency, accountability (according to international good practice) • Disburse funds to develop sector • Supervise MCOs and set standards for governance, and performance high enough to encourage international lenders, including sanctioning non-performers. • Internationally standardized, independent, transparent and comparable information about financial performance published in newspapers • Consistent reports on financial performance over time to track trends 	<ul style="list-style-type: none"> • The LID enforced standards with 'carrot and stick' approach backed by the international community • All these functions effectively fulfilled
<p>2. Banking Agencies regulation and supervision of MCOs enforced by 2007 decrees</p>	<ul style="list-style-type: none"> • Registering MCOs – MCFs and MCCs • Regulating MCOs – MCFs and MCCs • Supervising MCOs – MCFs and MCCs. Only coming into effect in 2008. 	<ul style="list-style-type: none"> • These function fulfilled but no capacity building function defined for this institution
<p>3. Regulation of Foreign banks enforced by Banking Agencies</p>	<ul style="list-style-type: none"> • Encourage competition in the banking sector and expansion of safe and sound financial services 	<ul style="list-style-type: none"> • Function effectively fulfilled
<p>4. Credit Registries: - Private registry; not enforced - Government registry not for MCOs</p>	<ul style="list-style-type: none"> • information about borrowers from a complete range of current lenders • to show clients' payments history • to show clients character in loans outstanding • to reinforce the social norm of shame in public knowledge of loan non-payment 	<ul style="list-style-type: none"> • Functions not effective for MCOs had to go through banks (who took good clients) to participate in Govt. registry, or not assess clients.
<p>5. Law requiring ID Cards for citizens</p>	<ul style="list-style-type: none"> • standard identity information about clients, • government verification of identity, • use ID number to cross check client information elsewhere 	<ul style="list-style-type: none"> • Functions effectively fulfilled

6.2.1 Microfinance market development

As described in the previous chapter the World Bank Local Initiatives project undertook two key functions, to develop the microfinance market through training¹⁸⁰ and funding, and to supervise it. I joked once with a colleague at the World Bank that the Local Initiatives project had behaved like Tito – telling the people that if they followed his way they would be led into a glorious future. “Of course!” was the response. Those under the project learned and followed and were rewarded with a degree of success.

The intensive training in good practice microfinance, standards with performance based funding, started before any funds were disbursed. From Day 1 there was the expectation of the MCOs reaching financial sustainability within three years because the grant funding would then stop.¹⁸¹ From Day 1 the MCOs learned that if a loan was a day late, it was a problem for their organization. From Day 1 they tracked the number of clients who were women, returnees, demobilized soldiers and the number of jobs created. MCOs made their own three month projections and were required to submit weekly reports of plan against actual and match that with their bank transaction statements and these were carefully monitored. As one MCO leader put it ‘We felt the responsibility of managing someone else’s money’ (MCO7). This sense of accountability and expectation of meeting financial and social performance targets became part of the DNA of the sector and was still apparent in the quality of the MCOs financial and social performance ten years later. (It also fitted very well with the common practice before the war of the financial police tracking all transactions as discussed below.)

Partly because expectations were set so high right from the beginning, the project attracted people with an open mind, willing to learn, not trapped in ideology of the past. As the DFID Governance Coordinator commented: “You have no idea how different the MCO leaders are from typical government officials. When we try to train public administration officials some of them say “What is wrong with the way we did it in the former-Yugoslavia?” People even say “What is wrong with the Austrian (as in Austro-Hungarian) way?” It is not related to the age of the person but their mentality.¹⁸² These open minded people were nonetheless challenged by their training experiences together.

The World Bank consultant hired to manage the training program, created an intensive, demand-driven training program for MCOs and was uncompromising in ensuring MCOs learned the fundamental microfinance good practices in starting, managing and growing an MCO over three years. The program arranged international field trips, group workshops with world renowned specialist consultants, as well as individual consultations to ensure they were fully equipped to manage on their own once the project closed. Their first field trip to Bangladesh to see Grameen

¹⁸⁰ About US\$900,000, or 4.3 % of total initial project costs, was spent on technical services in three years.

¹⁸¹ MCOs knew they would need commercial funding after three years when the post-war project stopped, so World Bank staff assisted the MFIs by facilitating introductions to international socially responsible investors such as Triodos in the Netherlands.

¹⁸² As an example of most people’s lack of openness to learning he explained that even though there were 40 political parties in Bosnia there are all still structured like the communist party!

Bank in action was a defining moment. They were Europeans who had lived through a war, but nothing prepared them for the poverty: “Out in the village it was a real shock – we learnt how to survive together. It was like Big Brother or Survivor!” From our trip to Bangladesh “I learnt that to be an entrepreneur and start a business you do not need anything! I thought you needed a room and desk and telephone but you don’t! I learnt that you can earn money even if you are poor and that they can earn money from lending to the poor. It was the same for us lending to refugees and returnees – it was just a matter of scale – for them it is five chickens for us it is five cows. I learnt that loan officers can even be illiterate too!” (MCO11)

For the second World Bank Local Initiatives Project, training was opened up to all the MCOs in the sector for a fee – not just those funded by the project – to develop the sector, not just a few of the leading MCOs. Through this joint technical training a common understanding developed on the importance of keeping high performance standards. One smaller MCO commented: “There was seriousness to the sector and a desire to follow good practice that was hard *not* to follow”. An example of this in practice was when one MCO was advertising “no-interest loans” but was still charging an up-front fee. Other MCOs were concerned this would tarnish the reputation of the sector, so friends of that Director talked to him about their concern and that MCO stopped the advertisement.¹⁸³

A practice of publishing comparative financial data started as compulsory financial discipline under the World Bank project. But such transparency is meaningless unless the data is accurate so as part of the financial discipline of the project MCOs were required to have a robust portfolio information system and accounting system. (Initially they had to submit weekly portfolio reports together with bank statements so that the numbers could be reconciled because the honest LID officials wanted to keep tight control so there was no temptation for corruption.) All MCOs under the project also had to submit their data to the MIX market which provided an external assessment of the quality of their data. This practice of publishing quarterly data soon spread to the whole sector. MCOs not under the project, also tracked similar good practice indicators, seeing the value of benchmarking their performance against their peers¹⁸⁴. The smaller MCOs also followed suit: “we followed them because we knew it was proper procedure to track our indicators and benchmark ourselves against the others.” (MCO9)

Even today, all the MCOs in Bosnia share their quarterly financial performance indicators through the Association of Microfinance Institutions of Bosnia – an informal network of MCOs. This is almost like the market discipline of quarterly reporting to a stock exchange (F1) (although it is internal to the MCOs, not public information). Every quarter the MCOs want to know how they are doing compared to each other. As one leader put it “We have always shared quarterly financial performance reports. We look at the others’ expenses and see what they are doing. This pushes us

¹⁸³ However, this concern about tarnishing the reputation of the sector did not appear to be consistently upheld after the end of the project. In 2011 the largest monthly salary in the country at KM240,000 (approx. GBP 95,000) was published and it was earned by an MFI CEO (Radio Sarajevo, 2011). The only positive is that it was transparently available!

¹⁸⁴ There were only two main differences in the reporting requirements: the LIP required monthly reporting whereas other funders only required quarterly reporting and; some other funders required more detailed social impact reporting.

to do better. We have reduced cost per KM lent by 0.04 in the last year! (MCO7) “Transparency has become the culture of the microfinance sector.” (F1) MCOs report that this transparency has been one of the main contributors to microfinance interest rates coming down across the sector and making microcredit more accessible. MCOs have also found that by being transparent with each about their challenges they have developed in parallel and all got higher standards. For some MCOs another benefit of the culture of transparency is that loan officers in the same town or region but from different MCOs talk freely with each other about ‘bad’ clients and how to overcome the challenges of difficult regions¹⁸⁵.(MCO 4) This helps everyone keep their portfolio quality high.

It appears that several MCOs attribute the strong performance of the microfinance market in Bosnia (described in the previous chapter) to the “culture” of transparency in the sector developed by the LIP training and the history of competing against each to access funding – the carrot and stick approach discussed below. If this is the case, then it is also dependent on some of the social norms discussed later in this chapter such as the respect for strong leadership, the desire not to lose face and recognition of the importance of the private sector.

6.2.2 Supervision that enforces performance standards

The LID’s other function was to supervise the performance of the MCOs to ensure they met performance standards. The project implemented what one MCO leader called a “carrot and stick” approach. It proved to be very effective. The carrot: MCOs that kept to the standards and would get more money and training, and would survive. The stick: if you did not keep to the standards then you would not get additional funding and in some cases your funds would have to be returned and the MCO would not survive. Clients were an additional motivation. Every MCO knew they were making a difference in the clients lives and wanted to keep helping them. For some this meant more than for others. (MCO7.) As discussed in the previous chapter, if any MCO protested at the standards they looked weak because they had agreed to the standards beforehand. The apex had all the significant funds so there was nowhere else for most MCOs to go. No other sector had an apex or this level of coordination between funders and between funders and the government¹⁸⁶.

Disbursing of limited funds based on performance meant that MCOs were competing against each other with each one wanting to be the best. They believed this high standard of competition got five of them into the Forbes top 50¹⁸⁷. But they are clear they always compete within the context of mutual respect for each other. “I have observed ethical behavior in the way that they compete

¹⁸⁵ For example several MCOs spoke about the challenges in Gorazde where a weapons factory was closed down and the people were so used to a government sponsored life that they have difficulty adjusting to paying loans on time. In contrast Western Herzegovina had no Yugoslav government subsidy so had to work hard to survive and now even the loan officers grow tomatoes as well as work for us.

¹⁸⁶ A former OHR staff member noted that coordination was limited for all the other sectors because there were no agreed priorities other than increasing returnees. In his opinion, the UN was corrupted and had no credibility. The OHR was not officially responsible for coordination – but should have taken the lead.

¹⁸⁷ Swibel (2007) published a list of the Top 50 MFIs in the world in Forbes Magazine based on a composite index. Bosnia had five on that list. Only India had more than Bosnia’s five.

amongst each other. There is no undercutting the market for others which some of the larger ones could do. When I have asked them why they say they respect each other; they are friends and they share a similar mission.” (F1)

These performance standards were also *de facto* enforced by the local banking system which started lending money to the MCOs. The local market the banks required the World Bank reporting standards from all MCOs together with their audited financials. When international socially responsible investors enter the market (such as the Dual Return Fund) and the more commercially oriented lenders (such as the European Fund For Southern Europe (EFSE) and Credit Suisse) they also required the LIP standards.

Even when the LIP office was closed in 2006 the MCOs had no supervision until the Banking Agency took over in 2008, much of this focus on performance standards continued. They were still accountable to their funders and investors, they still had audits and ratings, they still shared their quarterly financial reports with the MIX Market and with each other (but did not share the information publicly as a sector) and they still competed with each other. Indeed, when the Banking Agency looked at the MCO’s portfolios they were astonished that the quality and the rigor of the standards that the MCOs kept to were higher than the banks.

6.2.3 Banking agency supervisor after 2007

Appropriate supervision for MicroCredit Companies, Associations and Foundations after 2007 was largely missing, as the Banking Agency was not trained in assessing MCOs and the supervisor did not have responsibility for supporting the sector as the LID had previously. Most felt that the Banking Agency has no idea what serving the excluded meant, nor about a non-profit approach to financial services (MCO8). “We are much better skilled at assessing our clients – we are now growing together with our clients and increasing loan sizes.’ (MCO3). Knowing how much training it took for the LID to learn how to supervise MCOs, several expressed the opinion that the World Bank made a mistake when it did not make sure that the Banking Agency, who had ultimately taken over supervision of the sector, had technical assistance on how to monitor the MCOs. (MCO11) As an example, MCOs were very disappointed that the Banking Agencies put a ceiling on loan size in this market when some of their clients need larger loans to grow businesses and did not have relationships with banks to turn to. Nor was there a function of on-going support (such as capacity building) for the sector which was still very much needed.

As of 2007 the international agencies were no longer engaged in this sector and could not provide any leadership on these issues. As a result, the wisdom of the international community was also challenged in the way they had left the sector. The MCOs had carefully developed but the limited the law and supervisors were at risk of seriously damaging the sector. It was felt that, at a minimum, the international community did not have a clear long term financial inclusion strategy (MCO10). Furthermore, there was no recognized MCO network or association of MCOs which had the responsibility of undertaking advocacy on behalf of the sector (either with lawmakers or the general public), so the MCOs were powerless to challenge that regulation.

6.2.4 Foreign banks allowed

The decision by the Banking Agency to allowing foreign commercial banks into the financial market unintentionally fulfilled five important functions for expanding access to financial services for low income clients.

- **They initiated lending to MCOs and became partners.** In the late 90s local banks distrusted the MCOs and did not understand their cash-flow based business. The foreign banks (in particular Raiffaisen) understood cash-flow lending but also understood that the MCOs were effectively supervised by the World Bank and they could rely on the supervision reports.(F1) The excellent performance and accountability to the Bank meant that the foreign banks were prepared to lend to them.
- **They taught MCOs about working with the formal financial sector**¹⁸⁸. (As a result of what MCOs learned about working with banks, when SRIs came looking for investment opportunities the MCOs already had good working relationships with local banks and knew how to prepare reports for these lenders. Thus they were able to expand their services with the significant additional funds available for strong transparent performers.
- **They helped MCOs manage liquidity.** When international socially responsible investors are slow disbursing funds as promised or even change their mind - the banks will lend quickly and ensure the MCOs can fulfil their promises to their clients. As one MCO put it “The local banks are the best financiers. They are good lenders – as long as we repay we can keep getting funds. They just need seven days notice and it is there. Other subsidized funders can take months and then change their mind when a disbursement is due in three days! They clearly do not understand the financial market like the banks do.
- **They were very competitive and moved down market.** There was very fast growth in the banking sector between 2003 to 2007 with many new entrants into the market. The new international banks would try to take market share by lowering prices and moving downmarket. For example in 2004 the smallest loan from a bank would be 25,000KM with the MCOs dealing below that - but by the end of 2007 they lend 2,500KM, and have debit cards and LOCs – directly competing with MCOs. They are also lending long term for housing reconstruction and lots of building is going on. This is all good news for the clients who have become price sensitive. So the business is not as profitable but it is much better for clients! (B5) They were strong competitors, keeping downward pressure on interest rates. Their standards forced everyone to keep up! (B3) This is good for clients (but not for margins). However, some MCOs considered their competitive practices as unethical including: spreading misinformation that the MCOs would be closed so clients would leave them; hiring credit officers from MCOs with the expectation that they would bring their clients to the bank; giving those credit officers a 500 KM bonus if they brought other loan officers and then firing the ones they didn’t want. Finally what infuriated the MCOs most was the bank’s willingness to over-indebt these new clients (and potentially

¹⁸⁸ They lent to the MCOs as early as 1999 because of their strong financial performance, their audited financials and the support of the World Bank. The locally owned private banks had a very bad reputation and took a while to change.

bankrupting the MCOs) by lending more to clients that joined the bank in addition to the MCO.

- **They brought an image of trustworthy financial services** with their shiny new HQ offices and ATMs. This improved the general attitude towards all financial service providers - including MCOs - in a context where the banks had a bad reputation (MCO2) it made it easier for clients to take loans (MCO9). People had lost trust in banks because their savings had been lost through mismanagement before the war.

With twenty two banks in the Federation; ten in RS and ten strong MCOs in a market of 3.5 million people it is inevitable that there will be increasingly intense competition. Managing it with respect will be even more important.¹⁸⁹

6.2.5 Credit registries

MCOs and banks expressed a diverse set of opinions about whether the two credit registries undertook essential functions for reaching low income clients or not. A usual function of credit registries is for financial institutions to check a potential client's credit history before making a decision on a loan¹⁹⁰ Before the national credit registries, MCOs exchanged lists of bad clients, which served their purposes and some were not convinced that the credit registries added value to their sector . But with the intense competition, by 2007 all major MCOs used at least one of the registries for individual larger loans.

Those who expressed reservations about the benefit of a credit registry for low-income clients, acknowledged that knowing a client's other loans and credit history (if any) is useful information but the client's character and cash-flow were better indicators of whether they would pay back a small loan or not. Therefore, some MCOs use the government credit registry as a means to understand the client's character, by seeing if the client is telling them the truth about their other loans outstanding. Others were more direct stating that even if the client has four other loans if s/he has the cash-flow to pay them all back, they would give him/her the loan because if they did not, someone else would. (Another challenge for MCOs with the Government Credit Registry is that they could not use it independently of the banks. MCOs had to use the banks to submit their clients' information rather than doing so directly. As a result, the banks were unethically approaching their good clients. This dissuaded some from participating.)

Those who were more convinced about the importance of credit registries for expanding the market used the two registries for different purposes, listing their bad clients with the private registry and using the Government one for new clients. What is perhaps the most important aspect

¹⁸⁹ In a recent move the Italian bank - Banca Intesa - bought local bank UPI Banka and have borrowed EBRD money to downscale.

¹⁹⁰ In RS before the advent of the Credit Bureau the banks just looked at cash flow and took 130% – 200% of the loan in collateral on long term loans. But with the Credit Bureau they now only require 110% collateral because with their more affluent client the risk profile has been reduced.

of the credit registry is that clients know the MCOs will report them to the credit registry if they are late payers. In the RS the Credit Bureau will put the name of consistently late payers in the newspaper - and no one wants their name in the newspapers. So the power of the Credit Registries as a deterrent to delinquency is built upon the foundation of the social norm of shame (discussed below) at not being able to pay back loans.

6.2.6 Law requiring identity cards for citizens

ID cards meant that MCOs and banks can establish the identity of the person requesting an account and use it to cross check client information at credit registries and elsewhere. MCOs noted that they were more flexible about ID immediately after the war because it was an uncertain situation - but now if people don't have one it means there is a problem and MCOs do not lend to them. Having ID cards have been a fact of life in Bosnia since Tito took power so it is simply accepted as the norm.

The constitutional institutions provided the framework for the formal financial and microfinance market and these operational institutions provided the rules of the game for those under the World Bank project. Underlying each one of the constitutional and operational institutions is one of more the social and cultural norms, discussed below, which has proved an essential foundation for the strong performance of the microcredit sector.

6.3 Social norms - building blocks for microfinance market

The term 'everyday life' norms will be used, (as in Chapter 9), because they were described as part of everyday life as long as respondents could remember, (as were the enforcement characteristics,) regardless of background or status. A particularly important point to note here is that all of these norms preceded the war and several preceded Tito, which reinforces the point made in Chapter 3 that the war did not fundamentally change social norms. In discussing these with respondents, no value judgments were being made about the culture or society; this was simply an analysis of the development of the sector. The NVivo analysis of the respondents' descriptions generally clustered around seven 'everyday life' norms which are part of the way people behave, regardless of community background or status. Each of these norms is a distillation of many hours of taped discussion with respondents that covered examples of the norm and how it contributed to expanding the microfinance market together with its enforcement mechanisms. To represent particular voices I have tried to include a quote or incident that typifies the discussion of the norm. It is fascinating to see how these norms which were noted in Chapter 4 became embedded within the society and, as described in Chapter 5, many of these social norms are reflected in the characteristics of the sector in 2007. Even more so, that several of these norms have themselves now become embedded within the constitutional and operational institutions. Without these norms the sector would have very different characteristics.

6.3.1 Economically active women

The relevant everyday norm about women's economic participation had several facets around equality, surviving and not accepting defeat. During the Tito period in urban Yugoslavia women had the same educational opportunities as men. Women in towns expected to work and were expected by the society to work. There were senior women in every aspect of government and the financial sector¹⁹¹. For example, one of the women leading an MCO was a former senior banker. As another woman leader put it "The discipline of socialism was good. Women were recognized as equals." (MCO9) However, in rural areas the more traditional gender roles continue to predominate. In rural areas, one MCO was establishing informal Women's Associations (which did not need a legal status), run like village banks where rural women could save and lend to each other. These women are closely connected to each other and form groups or village banks to save and borrow. They are very committed to paying on time because they do not want to embarrass themselves, or their family, or their husband's family in front of their neighbors." (MCO8) As of 2008 there was approximately 2 million KM of savings in the internal accounts of the rural women controlled village banks. One MCO which has 100% women clients estimated women's economic role across all their clients as: 30% of the women clients are the main breadwinner (even if they have a husband); 30% of women clients are partners in a family business. 30% of women had no initial involvement with their husband's business but after receiving the loan and being given the responsibility to pay back the loan, the women starts to figure out how to pay it back – she then starts to do the accounts (which her husband does not like doing anyway) and then she becomes a vital partner in the business. (MCO8) Respondents concurred that in Bosnia women were considered to be more responsible with loans and do not take unnecessary risks - "that is perhaps cultural but everyone knows it".

In addition to active economic participation, it was commonly recognized that women typically had an attitude of "not giving up". This has been reinforced in Bosnia after the war with high unemployment. In one former factory town in which the majority of men became unemployed after the factory closed, many men "gave up", even though they had the opportunity to do other things. They had survived a war but were defeated by the economy. In contrast the women did not give up – even though they were scared, they took loans and made their own work. Probably the ultimate (but most tragic) example of women not "giving up" was also demonstrated after the war, when women whose husbands, fathers and sons had been killed or they themselves had been violated, went to work or took loans to start businesses, so their remaining family could survive.

A unique characteristic of the microfinance sector in Bosnia, noted in the previous chapter, is that three of the top twelve MCOs serve 100% women clients and there are three women Directors. This is not just due to the war but pre-existing social norms about women's economic participation that women are equal to men and an attitude of "not giving up" that were brought to the surface by the war.

¹⁹¹ USAID requires gender analysis as part of its projects. According to USAID gender has never come up as a big issue because women are running businesses and NGOs and are workers in banks etc.

6.3.2 Loan repayment and loss of social status

Very high social importance is placed on maintaining one's standing with family, friends and community in Bosnia. Identity is inextricably linked to community so relationships are fiercely protected. Defaulting on a loan can jeopardize those relationships either because guarantors who are your family or friends are called on to pay for you or the court police serve you with a summons at home, so the community can see. These are powerful mechanisms to ensure people pay back. How this norm works is probably best expressed in the words of key stakeholders. "Small people rely on their reputation. In the country their reputation is more important because they are very connected to each other. They help each other."¹⁹² They will give services to each other on credit- fix plumbing and even groceries on credit. They do not want the Court Police to come to their house and for others to see it. Their good name will be gone and it will affect their family and their kids." (MCO10) "Delinquency is low in the banking sector as well as MCOs and this is not because of contract enforcement. This is because they have two friends or family members guaranteeing their loan and for the sake of some KMs they are not prepared to risk losing face in front of them by not paying back their loan. This keeps people honest. They will not take out a loan unless they are sure they can pay it back and if there is a problem they will do everything to keep up the payments."(F1) "No one wants to look weak" (MCO2)

Several respondents pointed out that although this social norm was a major incentive to the high portfolio quality, all clients understood the basic dynamic incentives of microfinance - if they want another loan they had to pay this one back on time. When there was 90% unemployment immediately after the war and people had nothing, ensuring access to future sources of funding was a very powerful incentive for repayment. By 2007 with unemployment still officially at about 40%, many clients depended on microcredit to smooth their consumption.¹⁹³ To be sure there were no problems having access to further loans, some clients would even go into further debt to pay back on time.¹⁹⁴ Together this norm, the fear factor noted below and the economic context contributed to very high portfolio quality that was a hallmark of the microfinance market in Bosnia

6.3.3 Fear of prosecution by the financial police

In the former-Yugoslavia the colloquially termed "financial police" oversaw the transfer of money through the government controlled payment system and checked that all relevant laws were being followed, all taxes paid correctly and there was no fraud. This powerful government agency was effective at finding and prosecuting illegal financial practices. Any business and particularly one

¹⁹² Research undertaken by Whitt (2007) found a shared norm of treating others fairly (even if they are disliked), is widely held in the population. He found this norm of fairness is remarkably strong in Bosnia across ethnicities.

¹⁹³ One respondent noted an exception to this norm for a subset of people who delight in "cheating the system" when paying back is not associated with members of their community.

¹⁹⁴ I was told about a shopkeeper who took many bank loans but could not manage his business so the banks tried to repossess his house. As a result, he unsuccessfully tried to take his life. He was not an MCO client but this has disturbed all lenders.

where there was substantial cash-flow, wanted to be certain that they did not fall into the hands of the financial police. They were afraid of the financial police. As one MCO leader explained “Before the war the government was very strong and people were afraid of the financial police. If people were threatened with the police they were very scared. Before the war the courts could shut down the electricity and phone and they can still do so now!” (MCO10).

However, this attitude was reinforced by a related norm that it was indeed the government’s job to regulate financial transactions. In Yugoslav socialism it was the government’s role to regulate and oversee financial transactions for everyone’s benefit. Yes, there was a role for the private sector, but within the rules set out by the government. So in addition to the fear of the financial police there was also some respect for the government clamping down on people breaking the law.

A remarkable characteristic of the microfinance sector in Bosnia in 2007 is the very high portfolio quality. This was not just due to the desperation of unemployment after the war but also due to pre-existing social norms about losing social status by looking weak if you cannot pay back a loan, as discussed above, but also the fear of the financial police. Even though the “financial police” officially no longer exist, the police and tax authorities continue to be powerful and enforce their power, so the fear remains.¹⁹⁵

6.3.4 Corruption in big business and politics

The social norms of low income people with microenterprises are radically different from the ‘owners of large businesses who are often considered as thieves’ (MCO7) and to politicians who are generally perceived as corrupted. As discussed in the previous chapter, a lot of money was seen to be made by corrupt business people and politicians in the Bosnia privatization process (G3). Also money continues to be made on the Bosnia Stock Exchange where, apparently, insider training is not unusual (G3). It is not just politicians but also the organs of government that are perceived to be corrupt. For example, the government decides to whom the State Bank gives its loans, it does not make strictly business decisions and it is easy to pay off the police if cars without insurance are asked for evidence of insurance (G1). When one of the early MCO leaders associated with one of the political parties, disappeared with much of the money from his organization (MCO11) no one was surprised¹⁹⁶. Respondents noted that it was not unusual for a politician who wanted to be elected to buy a village 100 cows so he/she will get their votes (MCO11), again reinforcing the corruption. During conversations in the late 90s with a small group of MCO friends that included people of Serb, Muslim, Croat and mixed backgrounds - they

¹⁹⁵ One respondent noted that there was a different effect of the rules under the old Yugoslav system on a small subset of people. That small subset took delight in “cheating the system”. There was a sense that in order to get ahead you had to figure out ways of getting around the rules. For this subset they felt totally comfortable in evading their financial responsibility to pay back. Perhaps this is what was behind another respondent’s comment that Bosnia was very different from the culture in Kosovo where they simply do not pay!

¹⁹⁶ These findings are very similar to those of Smith (2006) who documented that people in Bosnia will trust a person in a familial or personal role, but not trust the very same person in a political or public role. She found that this arises from an understandably deep mistrust of public officials.

expressed their disgust with national leaders who had put them through the war and were now personally profiting from kickbacks as part of the reconstruction efforts.

One MCO leader (MCO 10) reflected common sentiment that this political corruption is in stark contrast to the “regular” people in Bosnia who, after the war, have few possessions and only their personal integrity and values to lose. So they do everything to keep those values. They prefer to take small size loans because they are easier to repay and they diversify their sources of income so they can be sure to be able to pay. (MCO10). This difference in values meant that microfinance was able to succeed without political interference because no one thought there would be enough money in microfinance to be worth corrupting (G3). They only supported it half heartedly because of the World Bank (MCO4). Officially the LID project was a government project, but there was also consensus that the authority of the World Bank kept political influence out of the project (MCO11). The initial selection by the government of a World Bank project leader was a person known to be politically motivated and less than scrupulously honest. The World Bank therefore, undertook informal late night negotiations to request an alternative. To the huge relief of all, the new appointee was basically honest and open-minded and led accordingly.¹⁹⁷

The World Bank project was then allowed to operate independent from politicians, which was very rare in Bosnia. For some respondents, “the local leaders - Tinjic, Bogunovic and Ribic, were honest” (B2) and the leaders of the local MCOs - Mi-Bospo, Lok; Sunrise and Sinergija were honest too. But even accepting that some have a broad definition of honesty, this was not a universal opinion. Some remembered the MCO leader who left the country with MCO funds, others saw one combining his MCO leadership with being a politician and others asked questions about why MCO leaders needed such expensive cars? (B5)¹⁹⁸. Particularly “the leaders of the MCOs with international NGO support, saw money as a business and did not take a percentage for themselves. This was unusual for this country.” (B2)¹⁹⁹ Because there was no political agenda the sector was able to expand based on demand. Respondents considered that if the project had been influenced by politicians, it would have been politicians who decided who got the small loans and the project would have failed. Some evidence to support this position is that now the sector is so large there is increasing interest in it by politicians. “The government could not have cared less before! But now that we are bigger the government is taking an interest.” (MCO4) This lack of systemic corruption (compared to the diversion of funds in Kosovo (F1)) is a characteristic of the microfinance sector in Bosnia which has contributed to its strong performance indicators. It was a combination of the lack of interest in small loans for poor people by those who were

¹⁹⁷ Sarah Forster the Project Leader emphasized the lengths to which the World Bank was prepared to go to protect the project’s political neutrality. “The two World Bank resident representatives believed in the importance of financial services for microentrepreneurs. On several occasions, they fought for this project with the Minister of Finance and even the Prime Minister.” (Goodwin-Groen 2003 p.4)

¹⁹⁸ During the Global Financial Crisis the MCO leaders came under great pressure for not being honest about the extent of their lending to over-indebted clients which tarnished their image.

¹⁹⁹ However, once the project finished and there was no further support for reaching low income clients, unethical practices have started to occur such as Board members and management being given new BMWs as their Christmas bonus. This was occurring in a context where there had been no effort on the part of the LIP projects or MCOs to build strategic friendships, to promote the image of the sector generally, or even to undertake financial education for clients who would be facing economic hardship in the GFC. (Natasa)

corrupt, the power of the World Bank to keep political influences out of the project, as well as the values of the clients that kept the sector relatively clean until 2007.

6.3.5 Private sector role in the economy

Most participants noted that the private sector was well established in Bosnia before the war. There were private restaurants, bars, taxi-drivers and dentists etc so after the war they could be “jump-started”. The history of the former Yugoslavia in chapter four explains how Tito moved his country away from the Soviet system and what this means is encapsulated in the story by one MCO leader of his reaction to visiting Moscow and Lodj. “I was a Finance Manager in a business since 1984 and we had standards that had to be followed and had relationships with international suppliers. We bought and sold goods and made profit and workers made decisions. The big companies exported. In the agricultural areas there were both private and state farms. This is in contrast to Lodj (in Poland) where there was a big textile mill – the people were all waiting for a job – for something to happen. In Moscow there was a street with a view of the city not one restaurant to sit and look at the view! Here there would have been at least one. Likewise the state ran the agriculture sector. This did not happen in any of the former Yugoslav countries – all have had successful microfinance like in Montenegro etc.” (MCO11).

This norm of private sector business prepared the MCO leaders because they understood a business approach meant that microfinance had to make money to be sustainable. This norm also helped MCO clients understand why they were given loans not grants and had to pay back on time. One MCO explicitly told their clients that there was a limited supply of funds and their MCO needed to stay in business, so please could they pay back on time so other women could get loans (MCO7). The clients understood and wanted to help other women so paid on time. The result is that unlike other transition countries there was ready acceptance of financially sustainable microfinance and recognition of the importance of international lenders.

However, there is another side to the historical acceptance of a private sector approach and that is the lack of a well accepted role for non-profits. Under Tito there were few charities other than those run by religious organizations and, as discussed in chapter 4, Tito provided everything that was needed. Two MCOs (MCO6 MCO8) commented that the lack of understanding of social services other than commercial credit (such as financial education) was one of the reasons the 2007 MCO Law only had the option of becoming a for-profit NBF and why oversight by the banking agency was problematic.

6.3.6 Lack of trust in banks

As discussed in chapter four, before the war there was a lack of oversight of the financial system and people lost money in pyramid schemes, most of the banks were linked to SOEs and many SOE workers had their pensions in these banks so they lost all their employer-linked savings when these banks failed. Furthermore, anyone with foreign currency held at the National Bank of

Yugoslavia had it frozen then stolen, and those claims are still outstanding. So there is now extreme mistrust of local conventional banks responsible for the loss of most families' pre-war savings. So there was continuous enforcement of this norm. After the war the banks were either bankrupt, did not have the liquidity to lend, did not have the technical capacity to undertake cash flow lending, or were simply not interested in low income clients. To give an example of how difficult it was for anyone to get a loan from the formal financial sector, in 2000 a salaried government worker, who knew the manager of the bank still required the following to get a 20,000 KM bank loan: two personal guarantors; a salary bond; a promissory note and title to her house. There is very low savings rate in banks because, in addition to the impoverishment of war, no one will trust them again for a long time.

Only when the foreign banks came in with the credibility of the Austrian banking system, were the people able to consider trusting banks again quickly. The Banking Agencies are also able to do their job of oversight of the banking systems because there is also the basic attitude that the government's job is to regulate and protect the people's interest. Meanwhile the MCOs were providing low income clients with credit products and cared about them, so it was hardly surprising the MCOs grew so fast, even though they did not offer savings services!²⁰⁰

6.3.7 Tito's legacy of strong leadership

Several participants commented on the longing expressed by older people for the time when Tito was alive. For them Tito represented a powerful and united Yugoslavia they could be proud of. They knew he was flawed but he held the country together and gave everyone a good education and jobs. Some of the older generation have not been able to deal with the loss of the Tito-led life and are spending their life waiting for something to be given to them²⁰¹. But most are not. The financial services sector is now growing fast because people gave up waiting and started something themselves. But what has remained is a cultural norm of respect for strong leadership. Where there is a clear vision and a path to get there explained by a strong leader to whom people can relate people will work for that goal. This can be used for negative purposes as it was in the lead up to the war. But it also could have a positive side with respect to the role of the OHR. Many in the international community complained that Ashdown was too activist in his role as the OHR, but after he was gone and his successor achieved very little in his first year they realized that perhaps his approach may have been the most appropriate in the Bosnian context and some Bosnians made similar comments (MCO1, F1). I joked that the World Bank was like Tito for microfinance setting a clear vision for financial inclusion with financing to make it happen, but there was enough truth in it that no one disagreed.

Respondents identified these seven social norms as building blocks for the sector. Together in a post-war context, they provide a set of powerful explanations for the characteristics of the microfinance market in 2007 and the shape of the constitutional and operational institutions

²⁰⁰ Interestingly MCOs do not appear to have not addressed the public relations issue of how clients lack of trust for banks as financial services providers, has affected clients relationship with MCOs.

²⁰¹ Another respondent jokes with new clients – OK “Tito died” - now what?

developed over these ten years in Bosnia. The fast growth of microcredit with high portfolio quality and the reduction in interest rates have been hallmarks of Bosnian microfinance and yet the essential connection between these hallmarks and underlying social norms has not been identified before. Neither has the connection been made between the shape of constitutional and operational institutions and the underlying social norms. One possible interpretation of these findings is that almost all the effective constitutional or operational institutions are dependent on the international community or social norms for enforcement. The government has played only a limited role in the development of the microfinance market. To illustrate: the effective operational and constitutional institutions were enforced by the Central Bank (which is accountable to the OHR) the Banking Agencies which are accountable to the Central Bank, the World Bank or social norms. Only the MCO Laws were passed by the government and then in a less than satisfactory form and ID cards are managed by the government. But this is a static analysis. To understand if this is actually the case, the processes of institutional change also need to be analysed to find out how they built on the social norms.

6.4 Institutional changes in the Bosnian microfinance market

As discussed in the Literature review North recognizes that “[w]e cannot change the informal constraints, at least not in the short run; and even our ability to control enforcement is very limited so all we can change quickly are the formal rules (North 2003 p.15) so he argues we need to “understand[ing] the process of economic change” as “an essential prerequisite to improving economic performance” (*ibid* p.1) As discussed in the Literature review Boettke *et al* (2008) provide a framework that identifies three key types of the institutional change process. They postulate that new institutions will ‘stick’ best when endogenously designed (emergent) and the introduction process is indigenous (IEN), but, if institutions are exogenously designed they can also stick if the process of introduction is indigenously led and is endorsed by local formal authority (IEX). (They argue that exogenously designed institutions, imposed by foreigners (FEX) have little hope of ‘sticking’.) Mahoney and Thelen (2010) also provide a framework for institutional change processes and they focus on two axes; the possibility of veto and level of enforcement. To interrogate these theories in the context of the microfinance sector in Bosnia, two different institutional change processes will be examined one which led to the 2000 MCO Law and other, in contrast, which led to a financially viable microfinance sector within three years.

6.4.1 Institutional change process for 2000 MCO law²⁰²

The donor sponsors of microcredit in post-war Bosnia, thought the NGO legal form the most useful to serve as post-war lender to displaced people, demobilized soldiers etc. because: mainstream financial institutions were largely insolvent and widely mistrusted; wartime NGOs had proven their capacity to reach the targeted populations of those displaced and traumatized by the war and; NGOs had been the pioneers of microcredit in other countries. This was a pragmatic, short-term post-war choice and little consideration given to the long-term shape of the financial sector. But NGO law was not well-developed in the former Yugoslavia because NGOs were not a significant part of the Yugoslav socialist economy. Several new microcredit NGOs were quickly set up in various forms, including registered offices of foreign NGOs, citizens' associations and humanitarian organizations. The World Bank as the lead donor agency, tried to discuss the specific legal underpinnings of non-profit organizations which could implement microcredit with the Entity-level governments, but failed. There were much higher priorities for the governments and the World Bank. Gradually the Entity-level governments grew acquiescent with the use of Foundations as vehicles for carrying out lending activities. (Lyman 2005)

The LIP project realized that this *ad hoc* arrangement would not provide the regulatory pre-conditions for a strong microfinance sector at national level. The legal reform component of the Local Initiatives Project, therefore, recommended the development of four new legal forms that would provide the basis for a robust microfinance sector:

- a form of nonprofit, NGO microcredit organization;
- a form of commercial finance company capable of serving as a vehicle for specialized commercial microlending, but not restricted to this activity;
- a form of member-owned and governed savings and credit association²⁰³ and
- a specialized form of microfinance bank

But the legal and regulatory aspirations of the Local Initiatives Project proved grandiose in light of the political realities of early post-war Bosnia. The draft banking law for the Federation initially included a provision that would have permitted these four proposed legal forms, but the provision did not pass. Next the USAID-financed Banking Supervision Project drafted proposed amendments to the new banking law. But that was also over ambitious and it became clear that only the most limited legislation would have any hope of adoption by both Entity-level parliaments. There were several reasons why alternative legal options were not successful. The parliament was so divided and dysfunctional that little legislation got passed at all - as is evidenced by the need for the OHR to impose a national driving license and currency using the

²⁰² The following description of the process to develop the 2000 MCO Law is derived largely from Lyman (2005) balanced by input from other respondents. Tim Lyman is a US lawyer specializing in microfinance law, who speaks and read the local language in Bosnia, and was a legal adviser to both the World Bank and the Government of Bosnia at different times between 1998 and 2005.

²⁰³ Theoretically cooperatives were a good idea but there was no general acceptance of the value of cooperatives in Bosnia because "they always think someone will cheat them" (MCO 5). So it is unclear why this option was part of the package.

Bonn powers²⁰⁴. Only those with political connections could lobby effectively for legislation and none in the microfinance sector had or wanted to have those connections and there was no association of MCOs which could have lobbied on behalf of the microfinance sector and its clients²⁰⁵. In contrast, the banks had very good connections with politicians and were effective lobbyist and were against any potential competition in a small market. That said, everyone thought the World Bank and the donor community would get the four options passed and so did not see the need to take action themselves. But it was apparently not a high enough priority for the World Bank to bring to the attention of the OHR. If the World Bank had placed it as a higher priority and requested the OHR to use the Bonn powers to force them through, the four legal options would have been signed into law. One MCO leader (MCO 1) stated it clearly - the World Bank was “project oriented and did not have a clear long term strategy for the financial sector” and so did not understand the national importance of getting these four options passed. The attitude of expecting the World Bank to have taken action is consistent with the role in which the World Bank placed itself - as the technical leader on microfinance which others should follow - as the “Tito” for microfinance.

A choice was made by the World Bank, therefore to focus only on legislation to clarify the legality of NGO microcredit of the type already widely in practice throughout the country. The goal was a law that could be adopted in substantially identical form in the two Entities, with provisions for reciprocity between the two Entities and; a simple system of registration and minimal ongoing non-prudential regulation of MCOs. The MCO law passed the Federation parliament in 2000 and the RS parliament in 2001. During parliamentary debate in the Federation, parliamentarians replaced the Ministry of Finance with the Ministry of Social Affairs as the regulatory body responsible for MCOs. Also, Ministry of Finance personnel in the RS added features not included in the version adopted in the Federation. In particular, the version adopted in the RS reserved for the Ministry of Finance unspecified supervisory jurisdiction over MCOs operating in that Entity, as well as the power to adopt regulations further defining such important concepts as loan size maximums. Despite these differences, the two MCO laws jointly accomplished something pioneering for the country at the time: a system of reciprocity that made it possible for a legal entity formed in one Entity to be registered also to carry out business in the other Entity.

When discussing both the 2000 and the 2006 MCO Law a former government official noted that neither addressed savings. ‘What we should have done was to have savings and credit associations like in Germany, to allow small savings and loans, leasing etc. – but the combination of the World Bank bureaucrats, the Government bureaucrats and the power of the banks - the banks did not want any other type of organization to be able to take savings - this did not happen. We did the minimum but that was it.’ (B2). Other respondents thought that the World Bank left the sector too

²⁰⁴ In Chapters 4 and 5 examples of use of the Bonn powers included a national driving license and national coinage. A more recent example was in 2004 when the Bonn powers were used to revoke the banking license of a corrupt RS bank and institute bankruptcy proceeding at the request of the Banking Agency of the RS..

²⁰⁵ When asked why such as association was not set up to undertake lobbying, respondents noted that Bosnia was still a very divided place. Even though MCO leaders undertook training together and were colleagues, to ask them to set up a joint association so soon, seemed premature.

early, that change processes take a long time and that it should have stayed engaged longer to specifically build the constituency for a regulatory option for poor people's savings (MCO1, MCO8).

This institutional change process was consistent with both Boettke *et al*'s (2008) and Mahoney and Thelen's (2010) theories. To use Boettke's language, the new institution of the basic MCO law 'stuck' because it combined exogenously designed elements of microfinance good practice with already existing indigenous practices, endorsed by local formal authority (IEX). (The other three legal options, exogenously designed by the World Bank did not get approved because there was not widespread indigenous support and no local formal authority to endorse it.) According to Mahoney and Thelen's (2010) theory this was a situation with a strong veto possibility (by the parliament) and a low level of enforcement (because it was not a priority for the government) so "layering" of the new institution on top of the old ones is the best approach. This is indeed what happened because there was just a minor amendment to the banking law allowing MCOs to lend.

6.4.2 Institutional change process for MCO performance standards.

After eighteen months of intensive training, by mid 1998, the MCOs had learnt about their clients, how to maintain a high portfolio quality and manage their costs, they had seen microfinance internationally. Confident of their skills and knowing the importance of this new sector being "owned" by the MCOs, the World Bank initiated a participatory decision making process with MCO leaders on what standards should be applied to qualify for the next tranche of funding.²⁰⁶ The process started with discussing a common vision for a strong sustainable future in microfinance and then there was a facilitated process of discussion on standards. MCO leaders participating in the discussion knew that there was not enough money for everyone in the next round of financing, so they had the incentive to suggest as high standards as they could reach to ensure others could not. As one MCO leader put it "Sarah was not a nice lady asking us what we thought. She understood that including us in the decision-making process was the best way to lead" (MCO7)²⁰⁷. By including us in the process we would agree with the standards" It resulted in high performance standards being agreed by all parties²⁰⁸. Such extensive stakeholder involvement

²⁰⁶ Cornwall (2004), using Habermas' concept of public space, argues that an essential part of providing "spaces for participation" (ibid p. 78) is to also provide "some form of capacity-building in order to make use of the opportunity to take part" because such spaces are "permeated with relations of power" (ibid p.79). Therefore, the World Bank's approach of intensive capacity building of MCO leaders before inviting them to engage in the participatory space appears to have been consistent with theoretical good practice.

²⁰⁷ The project was awarded a "2005 Good Practice Award" by the World Bank's Operations Evaluation Department for "strong Bank performance in program design, implementation, and monitoring and evaluation that contributes to positive development outcomes".
http://www.worldbank.org/ieg/awards/2005_winners_bosnia.html

²⁰⁸ Drinkwater (2003 p. 62) in his reflections on participatory processes, considers that for a participatory process to be worthwhile, as many of those participating as possible should be gaining personal growth and learning from the process. In this case, this MCO leader's reflection shows that at least one was learning about the power of a participatory process! In addition, as discussed in the following paragraph, MCOs were learning about what was needed to participate in the formal financial sector.

at design and implementation phases enabled the project to benefit from local leadership, experimentation, diversity, and mutual learning. (Kuehnast 2001 p.4).

For example, one of the agreed standards was International Accounting Standard (IAS) compliant audited financials prepared by internationally accredited auditors for the year ending December 1998, after only two years in operation. MCOs explained that they agreed to this standard because they knew audited financial statements by quality auditors were critical to showing their seriousness as legitimate providers of financial services. But the big problem was that an international standard audit for one organization would cost 15,000 KM. Four MCOs (Sinergija, Sunrise, Partner and Mi-Bospo) decided to reduce their individual costs by asking auditors to bid for their audit work as a group, thus generating economies of scale for potential auditors. When their first audited financials were published they were so proud they wanted to show everyone! (MCO7)²⁰⁹ This set the precedent in the market. Another difficult standard was the commercial financing requirement of 10% of assets funded by local resources other than retained earnings. Again the MCO leaders knew it was important to build relationships with local banks but they had not done it before so this forced them to learn how to manage those relationships. Every other MCO had to follow these “rules” too – However the smaller MCOs used local not international auditors. These standards (at Annex 2) became the benchmark against which the rest of the market *al* so measured itself because of the competition for funding²¹⁰. From then on MCOs felt they were listened to and their views respected. Interestingly, one MCO leader commented that while these financial performance standards were unambiguous and strictly enforced, the rules about products and clients were “fuzzy” and open to interpretation (MCO3). This meant there was enough flexibility to allow product experimentation and some risk taking with clients, which was a good thing. In the light of the subsequent rigidity of the Banking Agency – it was particularly valued.

The participatory process with MCO leaders to set standards was also undertaken by the World Bank for the second project in 2001²¹¹. It was agreed by the World Bank and MCO leaders that these would be ‘stretch’ targets with incentives built in to prepare MCOs for financial independence. For example, one of the standards was to plan for commercial funding liabilities ratio of at least 25% (“market” rate liabilities / average gross loan portfolio) by end 2004. To get to 25% would be a real stretch. There had been substantial discussion about this standard. One MCO remembered “I felt a participant with the standards. I knew the 25% commercial was a difficult task but I knew it was essential to help us move to other sources of financing and to build

²⁰⁹ Only three years later when they had three years of IAS compliant audited financial and international lenders were taking them seriously did they fully understand the importance of their IAS compliant audited financials. Now the MCOs have years of experience with auditors and can talk to the senior auditors about how to reconcile IAS and with local practices. Other have learnt from that experience and one MCO was the first *local* company in the whole of the country (as distinct from an international bank) to be to be rated by Standard and Poors. They got an impressive rating of BB Stable!

²¹⁰ For example Raiffaisen knew the agreed performance standards (rules) too and asked for the MCO’s reports on their performance.

²¹¹ This is an example of the established practice of ““invited participation”” discussed by Robins, Cornwall and von Lieres (2008 p. 1070) in which selected representatives are invited to help shape specific plans and policies.

the trust from the local financial market.”²¹² Most MCOs however, even though they understood it was good for their long term viability, claim they have no recollection of agreeing to it!²¹³

The IAS compliant statements, the 25% commercial financing and the rigorous transparent reporting standards meant that when SRIs came looking for investment opportunities the MCOs already had three years of financial statements, good working relationships with local banks, knew how to prepare summary reports of their financial performance and were looking for “market” rate liabilities. Thus they were able to expand their services with the significant additional funds and reduce their dependence on the World Bank funds.

What ensured that these standards were enforced is that all the donors stood together on enforcing them. No donor undermined the market. With so much donor money in the country, why did the donors stand firm in Bosnia when they did not elsewhere? Goodwin-Groen (2003) provides four key points: First, the Government and all donors to the microfinance sector were participants in the project. All had agreed to the dual project goals of disbursing loans to the war affected to develop small businesses and to jump-starting the microfinance sector. The performance standards were clearly essential to achieving the goals of the project and the donors had ceded decision making to the project. There were no international donors who did not support the project, directly or indirectly. Donors not in this project such as USAID, focused on building the formal sector institutions such as the Banking Agency. Second, since clients matter to all stakeholders, the benefits to clients of performance-based financing in building strong institutions were explained to all stakeholders, especially donors. Third, donors who contributed to the project had confidence in the World Bank technical staff supporting the project: The strong technical staff on the ground backed by the credibility of the World Bank meant that the smaller donors trusted the Bank. Finally, there was no pre-set disbursement plan and unrestricted funds from donors were encouraged. These two meant that financing could be based on MCOs meeting performance standards not based on a disbursement schedule or on geographic location. Funds restricted to certain geographic areas were allocated first, so that funds with no such restrictions could be lent to others.

6.5 Conclusions

This chapter has built on the historical context for the microfinance market in Chapter 4 and the description of the microfinance market’s evolution in Chapter 5 to present the findings of the micro-ethnographic research on how rules and norms in the Bosnian microfinance market have changed between 1997 and 2007 and the role of development agents in catalyzing this change. The most important constitutional institution which changed was the promulgation of the 2000 MCO Law which had the function of providing legality for lending by non-banks, namely MCOs,

²¹² This MCO leader knew the head of Raiffaissen so had no problems getting the funds which was why he supported the standard. But he also helped the others to get the financing too. Now that bank has 50 million KM in the sector!!

²¹³ By 2001 one of the MCOs without World Bank funding had already had a Microfinance Rating and was borrowing international funds so this was not an unrealistic requirement

for the first time. This was the minimum change possible to provide the function of a legal basis for microcredit but did not allow for any form of deposit taking organization that served low income clients. The change process was not a transparent or inclusive participatory process, but the law was, none the less, important. Other constitutional institutions which have changed and which function to support the expansion of the microfinance market have included the establishment of an independent central bank, entity banking agencies, and a mobile collateral registry with limited functions. The private sector has set up a credit registry which MCOs can use to assess the credit worthiness of potential borrowers (and the government has set up one which MCOs cannot use directly).

At the level of operational institutions the most important change was the establishment of the World Bank's Local Initiative Project (LIP) which had the dual functions of supporting the sector through training and disbursing funds to MCOs, as well as *de facto* supervising the MCOs under the project. This highlights another important finding that it is not the *form* of the institutions but the *functions* they play and their enforcement characteristics which are critical for market development. The participatory change processes used by the LIP to establish MCO performance standards, as respondents reported, were transparent and inclusive ones.

What has been importantly identified is how social norms are not only foundations for the microfinance market but also became embedded in the constitutional and operational institutions which respondents identified as critical to the expansion of the microfinance market. These include women's economic activity, the importance of maintaining community status, the lack of trust in banks and respect for strong leadership. This Bosnian case study has shown that social norms are indeed the foundation of the market. Furthermore the constitutional and operational institutions in microfinance which have successfully contributed to expanding the market are those congruent with social norms.

Both of the two institutional change processes interrogated were catalysed by development agents. Although they "stuck" according to Boettke's framework, they also had flaws for the long-term development of the microfinance market. The MCO Law and the *de facto* supervisor were effective short-term solutions to post-war NGO lending but they were not an adequate institutional foundation for financial services that meet the diverse needs of low income clients. But the MCO law has become the only foundation for the sector and the *de facto* supervisor has gone leaving a long-term supervisor without training. Looking back, respondents are questioning the development agents' decisions.

This is the final chapter of the Bosnia case study and the next three chapters comprise the Uganda case study in a similar structure. Then the findings from both Bosnia and Uganda will be compared.

Chapter 7: Uganda: Financial Market Development Context

This chapter commences the analysis of the Uganda case study by presenting the political, social and economic context for the institutional development of the Ugandan microfinance market and particularly for its social norms. Significant aspects of the history of the financial market are reviewed along with key dimensions of social/political and cultural contexts, to present a detailed understanding of the ground in which the microfinance market came to be developed. There is no standard approach for undertaking an historical institutional analysis so Grindle's (2007 p. 567) advice is followed - to address what are considered to be the most important characteristics of the context. Colonialism and the subsequent central role of government are integral to the complex interplay of economic, political, regional, religious and ethnic forces in Uganda. This chapter, therefore, weaves the fluctuating development of the financial sector into the story of Uganda since the imposition of British colonial power, through Independence, the Obote and Amin years, the expulsion of the Ugandan Asians, civil war and Museveni's election as President in 1996. It tries to be a balanced story, respecting each of the academic discourses in telling this history.

The following chapter builds on this analysis. It will present an original account of the development of the financial and microfinance markets starting in 1997 when many donors entered the market. Chapter 9 then provides an analysis of the findings of the ethnographic research with microfinance stakeholders on the building blocks of the microfinance market, including the social norms.

7.1 Uganda before and during British rule²¹⁴

Prior to the 16th century, the Kingdom of Kitara is believed to have included much of current Uganda and territories in the current Tanzania, Democratic Republic of the Congo, Rwanda and Burundi, but it broke up as the Kingdoms of Ankole, Buganda and Toro became independent. The Buganda kingdom proved expansionary and became the most powerful in the region. Under the Buganda monarch, known as the Kabaka, there was the equivalent of a Prime Minister or Chief Justice, ten chiefs at court who managed the finances and a spiritual leader. There was also a hierarchy of district and village chiefs accountable to the Kabaka. They were responsible for maintaining roads and bridges and sending taxes to the Kabaka as well as exercising judicial functions. In addition to subsistence agriculture, labor was differentiated, including iron workers and potters, and there was vibrant trade across the kingdom. The structures of accountability to the Kabaka were an important part of everyday life and were strictly enforced. (For example, if anyone borrowed money, it was paid back as soon as possible because the borrower was ultimately accountable to the Kabaka.) Gender relations were complementary not hierarchical. Men generally built houses hunted, tended herds, fished and fought. Some traded across the region. Agricultural produce was controlled by women. Women needed to be entrepreneurial as

²¹⁴ The pre-colonial summary is based on Mukherjee 1985 (p.54 – 89) unless otherwise stated and is consistent with Okidi, Ssewanyana, Bategeka and Muhumuza (2005). Mukherjee's analysis is based on accounts from Baker - the first explorer (published 1913) and Roscoe - the first ethnographer (published 1915 and 1923) in the region.

they cultivated, processed and marketed crops; collected fuel and water; cared for children; as well as made pottery, cooked, cleaned and washed (Tamale 1999 p.7).

The slave trade began in 1680 and reached its peak in the late 1700s. During that period there were 192 British slave ships carrying approximately 47,000 Africans between them on each trip. British and French missionaries, however, did not arrive until 1877, more than 200 years after the slavers (Watt, Flanary and Theobald 2000 p.38). British colonialists first arrived in 1890. In 1894 Uganda was declared a British Protectorate, which included the Kingdoms of Buganda, Toro, Ankole and Bonyoro (*ibid*). In 1990, the Independence Constitution (negotiated in London,) allowed the King of Buganda to continue ruling “in a manner approved by Her Majesty’s Government” (Mukherjee 1985, p.25) in a federal relationship with the central government. The Kingdoms of Ankole, Bunyoro and Toro had quasi-federal powers and the rest of the country was to be administered centrally and through district governments (Mutibwa 1992 p.26). But Uganda was not annexed by the British for the sake of slaves or faith – it was annexed to grow cotton and to trade.

British demand for cotton was very high as was the demand for rubber, coffee, tobacco and tea. To meet this demand, the British “indirectly forced” Ugandans to grow cotton as a cash crop on their own land (Mukherjee 1985, p.172). The government managed incentives by distributing free cotton seed so cotton was the best cash crop for farmers to pay substantial taxes and buy essential items (*ibid* 1985, p.185). The pastoralist communities had no idea how to grow cotton or rubber, (cultivation being an antithetical to pastoralist traditions), so the British sent Baganda “agents” to these communities to teach them how to grow cotton and rubber and also to “establish British Rule” (Mukherjee 1985 p.172). The result was that the Ankole and other chiefs were subject to the Baganda ‘chiefs’ sent by the British to impose their economic and political rule²¹⁵. The cotton was sold locally to British or Asian ginneries for a pittance. The cotton lint was baled and then sold to British exporters. About 20,000 Ugandans were also pressed into effective “slavery” working on the road and rail system to support the export of cotton. At least 180 per thousand of them died annually from their harsh treatment (*ibid* p.193)²¹⁶

7.2 Uganda at independence

At Independence in 1962 Uganda had a population of 7 million people. The country’s development indicators at that time compared favorably with those of, for example, South Korea (Okidi, Ssewanyana, Bategeka and Muhumuza 2005a p. 13) The British had brought some economic prosperity, developed an efficient civil service and there was a lively free press. But the economy was dominated by foreign interests with one view being that “foreign interests thrived

²¹⁵ For a more detailed account of how the British managed the agricultural economy through the Baganda ‘agents’ and increased the divisions within the society see Mutibwa (1992).

²¹⁶ Furthermore, during the Second World War approximately 79000 Ugandans fought for the British in all branches of the forces and returned home with little or no benefit. Their service was however understood by ordinary Ugandans. Around 1944 in the South-Western region amongst the Banyankore Bahima nomadic pastoralists (in what was the Ankole Kingdom) a child was named Museveni after the ‘Abaseveni’ who served in the 7th Battalion of the King’s African Rifles during the Second World War.

mainly by plundering the natural resources and labor of Uganda without putting in anything substantial in return” (Mukherjee 1985 p.195)²¹⁷ There were also extreme inequalities.

Inequalities were based on ethnicity, religion, region and gender (Watt, Flanary and Theobald 2000). Ethnic inequalities were evident across government and the private sector. Europeans dominated the top positions in the state sector and banking. Asians dominated commerce, private agricultural processing (including cotton ginneries), and the small number of large agricultural estates²¹⁸. The local rural population was successful at growing cotton²¹⁹. 84% of the acreage under cash crops was cotton ear-marked for export by 1951, but the farmers still lived in poverty. In an attempt by local farmers to regain some control over prices, cotton and coffee marketing cooperatives were formed. By the end of 1961, there were 21 registered co-operative unions, including the Uganda Co-operative Alliance (Uganda Cooperative Alliance, 2009) which had a critical role in giving farmers some power in the economy²²⁰. Gender inequalities amongst Ugandans were shaped by this new agricultural structure because as men grew cash crops, women had to cultivate food crops for the family. As a result, women were largely excluded from the cash economy and the market places where cash crops were sold. This was a significant change to their previous roles in cultivating, processing and marketing crops (Tamale 1999 p.8- 9)²²¹.

Regional and religious inequalities were also exacerbated. High productivity land, access to education and health services and infrastructure were far better in the south than the north (Brett 2005 p.3). And the south was also predominantly Christian (Collier and Reinikka 2001 p. 17). The British used the southern, educated Baganda as agents to implement their policies across the country and the Baganda came to see themselves as “the natural leaders of the country”. (Mutibwa 1992 p.9)²²². This divide and conquer approach by the British sowed the seeds of future retribution (Watt, Flanary and Theobald 2000).

²¹⁷ Museveni’s particular perspective was that “millions were walking barefoot, underfed and suffering from worms without adequate medical services; and their mental world was still dominated by superstitions (Museveni 1997, p.35).

²¹⁸ According to a Uganda Asian commentator who experienced the expulsion of the Ugandan Asians in 1972 “The vast majority of Indian traders were really only interested in making money and recreating India. But the Raj educated professional Indians (some of whom arrived much later than the pioneering merchants, whilst others had come early in the 20th century to work as civil servants for the White Master,) often looked down on these moneymaking traders. Some went a step further in trying to recreate British India, complete with a British class system.” (Siddiqi, 2011)

²¹⁹ In 1927 the British administration forced the parliament to give farmers permanent use of their land and simultaneously reduce the tribute owed to their chiefs, to provide incentives for growing more cotton (Mutibwa 1992 p.7). This significantly changed rural society, reducing the power of the chiefs and marginalizing women.

²²⁰ This included 1,662 primary co-operative societies with a membership of 252,378 (UCA 2009)

²²¹ “Gender analysis in the African context must incorporate a critique of imperialist imposition of Western notions of gender and the effects of neo-colonialism on gender relations” (Tamale 1999 p.3). For example; suppression of a peasant Catholic Sabiny woman in Eastern Uganda includes: Indigenous culture - e.g. clitoridectomy ; Catholicism - which places her value below men , Capitalism - which places her bottom of the hierarchy; Imperialism - with imposes structures that dictate her existence.

²²² For example, when Makerere University was founded in 1922, all the first students were Baganda.

There were three largely British banks in Uganda at Independence which served British interests (Barclays Bank of London; Standard Chartered Bank of South Africa and ANZ Grindlays) and a fourth, Bank of Baroda, which dominated commercial lending (Brownbridge 1998a p.127). These banks were under the oversight of London or South African regulators (Akampurira 2008). The East African Currency Board had been established in 1919 but it had no control over the commercial banks. Its purpose was to issue the East African Shilling and convert it to the British Pound at a fixed rate. There was also the Uganda Credit and Savings Society (UCSS) which had been created by the government in 1950 to extend credit to entities without access to loans from commercial banks. (Akampurira 2008) i.e. to Ugandan businesses which were excluded by the British banks.

Saving among rural Ugandans was an integral part of life (Deshpande, Pickens and Messan, 2006) and almost “every person” saved at home for emergencies (Gifford 2004 p.81). Informal savings mechanisms included building assets that held a reliable store of value (livestock, land); participation in *ebibiina* - Rotating Savings and Credit Associations (ROSCAs), Accumulating Savings and Credit Associations (ASCAs) and similar groups used more by women than men); using a money guard (a family member or other trusted individual); and saving in cash at home, often in clay jars or *mukandala* (money belts worn under clothing). These savings methods were the primary means people had to mitigate risk because they “reduced the utility cost of saving for a lumpy expenditure” (Gifford 2004, Kimunyu 1999 p. 1306) People joined schemes with large memberships and waited for their turn. (*ibid* p.1307). Gifford (2004) describes the wide range of ways poor people managed their limited funds to compensate for the lack of access to finance. This and several other studies which documented savings mechanisms were not undertaken until after 2001 but they were reporting what had been happening for decades so it is appropriate to cover them here (Wright & Mutesasira 2001, Musoke 2005, Pelrine and Kabatalya 2005, Gifford 2004, Deshpande *et al* 2006). These studies consistently found that most Ugandans value savings more than loans. 57 percent of respondents in one study said a secure and convenient place to save money was more important than the ability to obtain a loan (Musoke 2005) and a survey by Pelrine and Kabatalya (2005) of rural households found 80 percent of respondents had saved some money in the past year using a combination of formal and informal mechanisms and that for 60% of them security of their money was the highest priority.

A.M. Obote was elected Prime Minister at Independence in 1962 and the Buganda King, Sir Edward Mutesa, was honorary President (Okidi, Ssewanyana, Bategeka and Muhumuza 2005a). But the election process had highlighted some of the religious, ethnic and regional differences. The first political party was the Uganda National Congress (UNC) - largely Baganda and Protestant. Then the Democratic Party (DP) was formed which was primarily Baganda and Catholic. But there were regional differences. For example, the Bahima chiefs in Ankole made an alliance deal with the Catholic leaders in Ankole against the Protestants (Mutibwa 1992 p.36). Then the Uganda People’s Union (UPU) which was ‘anti-Buganda’ and majority Protestant, merged with the anti-Buganda and Protestant wing of the UNC, led by Apollo Milton Obote to form the Uganda People’s Congress (UPC). Then in an astute political move, he formed a

coalition with the Kabaka Yekka Party - a Baganda national party - against the DP²²³ and this coalition won the democratic multi-party general election (Hansen and Twaddle 1998). Obote took the helm of a country created and ruled by the British for their own ends and whose economy was still largely controlled by foreign interests.

7.3 Obote and General Idi Amin 1966 – 1979

Continued foreign domination of the banking system after Independence led to deep discontent over bank lending policies. Approximately 90% of commercial bank assets were held by foreign banks (Gershenberg 1972 p. 505-6). It became a widely held belief that government intervention was necessary to ensure that the banking system played a more supportive role in the development of the economy, to support Ugandan development, not foreign interests (Brownbridge 1998a p. 127) To promote indigenous interests and extend access to financial services to a wider set of clients, UCSS was converted into the wholly government owned Uganda Commercial Bank (UCB) in 1965 (Gershenberg 1972 p. 506, Clarke, Cull and Fuchs 2009 p. 1508). The UCB focused on financing indigenous businesses and administering government agricultural and rural lending programs.

To get more power over the economy Obote issued a new constitution in 1967 which abolished the country's kingdoms and named him executive president with increased and centralized powers. The Obote government expected the banking sector to fulfil developmental objectives and this was not happening so in 1969 Obote's government took the extreme measure of requiring the banks and insurance companies to register locally and have paid in capital of UGS 20 million held in government securities (Gershenberg, 1972, p. 514). The purpose of this measure was to "better serve" ordinary Ugandans. At the same time, the government was supporting co-operatives as policy instruments for rural development (UCS 2009). The Bank of Uganda Act was also passed in 1969 which established the BoU to defend the value of the Ugandan Shilling and make loans to the government. (Akampurirar 2008). There were direct monetary controls including fixed interest rates, stringent exchange controls and directed credit. Controls over agricultural markets and foreign trade were also imposed (Brett 2005 p.4, Okidi, Ssewanyana, Bategeka and Muhumuza 2005b). In other words, there was financial repression.

In May 1966, Obote's ally, General Idi Amin had stormed the Bugandan king's palace, killing 2,000 people. The army, mostly northerners, then "unleashed a savage slaughter of Baganda" (Museveni 1997 p.40).²²⁴ According to Mutibwa (1992 p.40) a "precedent had been set for atrocities" and Obote's rule was a violent one with summary arrests and imprisonment of many dissident leaders and opposition politicians. So much so that when Major-General Idi Amin launched a successful military coup in Jan 1971, he was initially celebrated (Watt, Flanery and

²²³ From President Museveni's perspective (1997 p.35) this was seen as an "unprincipled marriage of convenience" but as an election strategy it proved successful.

²²⁴ According to Museveni, Obote "was intent on exercising dictatorial powers over the people of Uganda through the sectarian control of military power" (Museveni 1997, p.32) He deepened the northern monopoly of the army – a process started by the British"

Theobald, 2000) especially as he released the many political detainees (Museveni 1997). Within a few months, however, Amin's troops were killing Obote's supporters in the army and were also soon killing other opponents and perceived opponents. (Mutibwa 1992 p.88).

There was great economic hardship. Taxes remained high and there were fewer jobs so the people felt that Amin was not delivering on his promises of a better life. Ugandan Asians probably controlled half the country's wealth at the time and there was a traditional distrust of the Asians who maintained separate lifestyles from the Africans. So Amin turned to them as an immediate source of financial gain which he knew would be supported by the majority. On 4 August 1972 he ordered the expulsion within three months of the approximately fifty thousand South Asians – citizen and non-citizen alike - from bank tellers to industrialists *en masse*. In one act this was perhaps the single event that wrought the greatest change in Uganda (Mutibwa 1992 p.92 -3). He wanted to teach the British “a lesson they would never forget” because most of the Ugandan Asians would go to Britain. In December he also nationalized all British interests in Uganda from tea estates to the Kampala Club. In a long statement later that year at Makerere University he declared that he did these things “to make the ordinary Ugandan master of his own destiny and above all to see that he enjoys the wealth of his own country” (Mutibwa 1992 p.97) and there is little doubt that the majority of the population supported the strategy. (Brett 2005 p.5)

As part of Amin's 1972 program of asset expropriation, all banking activities of government bodies, parastatals and cooperative unions were transferred to the government owned UCB. Foreign banks were forced to either close up-country branches or sell them to UCB so they were each left with only one branch in Kampala. (They ended up lending mostly to the parastatal crop – particularly coffee - marketing boards which had crops as collateral and some of the better managed co-ops.) UCB then expanded its branch network rapidly to fulfil the government's goal of additional upcountry branches to encourage domestic savings. UCB thus became the sole provider of banking services in many locations, particularly in rural areas and was used to perform a variety of functions in rural areas such as paying taxes and school fees. Financial repression continued with high inflation and excessive government borrowing. (Clarke, Cull and Fuchs 2009, Brownbridge and Harvey 1998)

Many potential political opponents were eliminated, even the Protestant Archbishop, Janani Luwum was assassinated early in 1977. With the continuous horrific violence and expropriation – social norms were changing (Collier and Reinikka 2001 p.21). The young were learning that violence was an acceptable way to resolve conflict, pre-emptive violence was rational and plundering others' wealth, not earning it, is the way to prosper. “Violence and murder were virtually institutionalized” (Museveni 1997, p.93).²²⁵ What also became clear is that morality was debased. Violence and death were so prevalent that people were no longer horrified by it. Education was devalued because you did not need it to survive in the economy – to get money you needed influential allies in the government, the ability to be violent, or steal. (Mutibwa 1992, p.122) Professional ethics utterly collapsed. Corruption erupted and the black market became

²²⁵ Amin's reign of terror from 1971 to 1979 has been well documented (Mutibwa 1992) together with the attempts of exiles, including Museveni, to overthrow him. Museveni's perception was that “With Amin you could not even make limited progress using the system because he was a killer” (Museveni 1997 p.33).

pervasive (Tangri and Mwenda 2008). The guiding principle was that “the end justified the means” because people were so desperate to beat inflation and to survive. Mutibwa (1992 p.122) has noted that this attitude still pervades today and many respondents agreed. Amin’s legacy is that he took over a viable economy and eviscerated it with negative impacts lasting for generations with corruption becoming endemic²²⁶.

7.4 Obote returns to power 1980

Unbelievably, and many say fraudulently, Obote was returned to power in a controversial election in 1980 (Hansen and Twaddle 1998, p.2, Okidi *et al* 2005a p.13). He started to implement a Structural Adjustment Program (SAP) in return for IMF lending. This included floating the exchange rate (which resulted in heavy devaluation) and dismantling of some price controls. But there was no reduction in government expenditures and no controls on inflation and an attitude by government ministers of “milking the cow” (Mutibwa 1992, p.153) which resulted in the need for further devaluations and the collapse of SAP lending in 1984. Corruption did much to further discredit Obote and to increase support for the NRM (Hansen and Twaddle 1998, p.2). In rural areas the government continued to use co-operatives as policy instruments, with the cooperatives receiving subsidized funding from the government marketing boards for crop and marketing finance (Uganda Cooperative Alliance, 2009).²²⁷ But “excessive” government involvement “virtually turned them into government parastatals.” (Uganda Cooperative Alliance, 2009 p. 3). When the SAP came into force the cooperatives simply did not have the skills “to seize opportunities that the liberalization policies offered” and rural people did not benefit as had been expected (*ibid p. 4*).

In 1983, Centenary Rural Development Trust was established by the Catholic Church to serve the rural poor by providing savings services²²⁸. In 1984 the Uganda Women’s Finance Trust (UWFT) was started by a group of educated women who wanted to help poor women micro-entrepreneurs with credit and business development skills²²⁹. Local banks were also able to be set up in the mid to late 1980s including Sembule Investment Bank (starting in 1984 which later became Allied Bank) and Nile Bank (starting in 1988, which was taken over by Barclays Bank in 2007). The minimum capital requirements were negligible, so they were severely undercapitalized. Licenses

²²⁶ Transparency International defines corruption as “the abuse of entrusted power for private gain”. (Transparency International 2007 p.xxi) The Transparency International Corruption Perceptions Index ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. It is a composite index drawing on corruption-related data from expert and business surveys carried out by a variety of independent and reputable institutions. The surveys used in compiling the Corruption Perception Index (CPI) TI ask questions that relate to the misuse of public power for private benefit, for example bribery of public officials, kickbacks in public procurement, embezzlement of public funds or questions that probe the strength of anti-corruption policies, thereby encompassing both administrative and political corruption.

²²⁷ Although not well documented the government’s subsidized funding of rural co-operatives through the government marketing boards meant that farmers could borrow cheaply against future harvests which had proved a lifeline for rural communities.

²²⁸ It has not always performed well, but has the capacity to deal with its problems and refocus on its clients.

²²⁹ But without the capacity and financing to manage expansion UWFT remained small with only a few hundred clients until the mid 1990s.

were given by the Minister for Finance without proper consideration of the expertise of managers and directors, so they were not well managed and the framework for their prudential supervision was seriously deficient (Brownbridge 1998a p.134).

The National Resistance Movement led by Yoweri Museveni took to the bush in 1982 to take up the fight to remove the corrupt and repugnant system of government based on violence. The civil war compounded the economic woes of rural communities, disrupting both agricultural production and the functioning of the cooperatives which had been an economic lifeline for farmers. The NRM gradually received more support as atrocities committed by Obote's troops – particularly in southern and western Uganda multiplied and were publicized. (*ibid* p.2-3). Some of the worst atrocities were committed in the area known as the Luwero Triangle (west of Kampala) between 1981 and 1986 (Furley 2006). Most of the women were tortured in some way during the war. 54% suffered sexual violence including rapes, being abducted as sex slaves, forced marriages to abductors and other violations (Liebling-Kalifani, 2007 p.2). The NRM slowly expanded the “liberated zones” of the country, but not quickly enough for these women.

7.5 Museveni and NRM rule

The NRM finally entered Kampala on 27 January 1986, but the country was on its knees. Museveni promised that the people would be in charge of their country's governance and promised the security of person and property. As many as half a million Ugandans had died from the civil wars since 1971, 7% had been displaced and per capita income had declined by 40% (Collier and Reinikka 2001p. 16). The economy had been exploited by despotic leaders and decimated by war since independence and the cooperative movement, which had been an economic life line for the rural folk, was all but destroyed. GDP had declined by 40% from 1971 to 1986 (Okidi *et al* 2005a p.15). Most of the country was inaccessible; the communication system did not work; utilities were barely functional there was only one functioning power station (built in 1956). The economy had retreated to subsistence (Collier and Reinikka, 2001 p.20) and become completely informal. Basic goods like soap and sugar had to be smuggled into the country. Inflation was very high over and when Museveni took over there were only three weeks of foreign exchange reserves left and further devaluation was needed - to highlight just a few of the problems (Furley 2006).

The elimination of corruption and the misuse of power was part of the Ten Point Plan of recovery outlined by Museveni (Tangri and Mwenda 2008) to increase the tax and customs revenue, reduce constraints on business development and ensure that services reached intended recipients (Watt, Flanery and Theobald 2000). To address these and other challenges, twin processes of reconstruction and liberalization were needed simultaneously (Collier and Reinikka, 2001 p 15). A constitutional commission was set up in 1988 to draft a new constitution based on extensive consultations with citizens across the whole country.

Initially, Museveni favored a closed economy model going against IMF / World Bank Paris Club recommendations. For example, the Finance Minister attempted to freeze the value of the Ugandan Shilling against the USD and Sterling and then to revalue it upwards (Hansen and Twaddle 1998, p.7). These efforts failed within months and so Museveni had two options: accept the advice and funds of the IMF/World Bank quickly or accept them less quickly (*ibid*). He chose quickly. In May 1987 the Economic Recovery Program was launched, immediately followed by a sequence of Structural Adjustment Programs. These included credits from IDA and other multilateral and bilateral assistance to stimulate economic growth, financial stability, trade liberalization and lowering interest rates (Okidi *et al* 2005a p. 15). Inflation was brought down from 190 percent in 1986 to 28 percent in 1991 but there were negative real interest rates, the two dominant banks were insolvent and the credit to GDP ratio at 4 percent less than a quarter of its 1970s level (Gulde, Pattilo and Christensen 2006 p.22). Financial Sector Reform was desperately needed.

7.6 Financial sector reform 1991 - 1997

Financial Sector Reform (or financial liberalization) started in 1991 with the support of a World Bank financial sector adjustment credit (Hauner and Peiris 2008, Brownbridge and Harvey 1998). The reform package comprised three elements: reform of the BoU and public sector banks; legislative changes to the Banking Laws and the BoU Act; as well as liberalization of markets, interest rates and monetary instruments (Akampurira 2008, Brownbridge and Harvey, 1998). This was typical of many African government reform programs (Nissanke and Aryeetey 1998). With liberalization, new banks were started including Centenary Rural Development Bank (changed from a Trust to a full service bank in 1993), Orient Bank (started in 1993), Crane Bank (started in 1995) and there were new investors in Allied Bank (starting in 1996) which is now Bank of Africa.

The Financial Institutions Statute was passed in 1993 and gave the BoU more independence and power over prudential regulation and their capacity was upgraded. This was critical as Uganda's banks were 'riddled with nonperforming loans' (Hauner and Peiris 2008 p.2704) Interest rate liberalization took place in the context of reduction in government domestic borrowing and reduction in inflation which enabled positive real lending rates to be achieved without a sharp rise in nominal rates and bank deposits rose from 4% of GDP in 1989/90 to 5.8% in 1993/4 (Brownbridge 1998a, p.139, Akampurira 2008).

In the early 1990s, UCB had 190 of the total 237 bank branches in the country. It held around 50% of commercial bank deposits and 22% of the total system deposits (Brownbridge 1998a p. 130). It was the dominant provider of financial services in the country and had a virtual monopoly on the provision of financial services to the rural poor. A 1992 analysis of the availability of credit for livestock in rural areas, (Jabbar *et al* 2002) found the government-owned UCB was the most important source of formal credit for smallholder livestock farmers. But, it did not have sufficient funds to meet the demand for livestock credit because its loans were subsidized and there was

significant political influence on lending policies²³⁰ (Jabbar *et al* 2002 p. 1029, Brownbridge 1998a p.131). Credit wasn't reaching those who needed it because of "inappropriate screening procedures and criteria to determine creditworthiness" (Jabbar *et al* 2002, p. 1029). Repayment discipline on the part of borrowers was low because they often regarded loans as reparations for war damage or rewards for political support (Brownbridge 1998a p p.131). This was exacerbated by politicians who publicly told their constituents that the loans need not be repaid. Due to such political influence on lending policies as well as poor loan procedures; lack of proper accounting procedures and corruption, UCB's non-performing loans were about 75% of its outstanding loan portfolio (*ibid* p.130).

UCB first tried to reduce its costs by closing over 100 out of its 190 branches, but by 1995 it was declared insolvent and could not avoid radical restructuring. The government established the Non-Performing Asset Recovery Trust (NPART), which assumed UCB's nonperforming assets. The government also sold noncore assets, reduced staffing levels, and invested substantial amounts to upgrade computer systems (Kasekende (2004) cited in Clarke *et al* 2009 p. 1508). Closure and liquidation were not options because of UCB's dominant position in the market, because it was the backbone of the payments system, especially in rural areas and, because the deposit insurance program was not fully capitalized, (meaning that liquidation or failed privatization would have imposed a heavy fiscal burden on the government) (Hauner and Peiris 2008, Clarke *et al* 2009). To preserve confidence in the payments system, the government took a cautious approach towards restructuring UCB, keeping the bank open throughout the process and maintaining its majority shareholding. The government also restored and clarified property rights, an important step for the banking sector, by handing back assets expropriated by Amin, to the former Asian owners (Collier *et al* 2001).

But it was not just UCB which was facing difficulties, between 1994 and 1998, half of the sector faced solvency problems (Clarke *et al* 2009). The smaller local banks were also in financial distress with high nonperforming loans (NPLs), due to moral hazard compounded by insider lending (Brownbridge 1998b p.179) and reckless lending. In 1994 The BoU closed down a small local bank and took over two more for restructuring in 1995. Even Centenary Rural Development Bank had to be restructured with international assistance and new international investors brought onto the Board. After examining the leading causes of the "dramatic increase" in NPLs during the economic and banking crises across many sub-saharan African countries during the 1990s Fofack (2005) came the conclusion that the increase was "largely driven by macroeconomic volatility and reflects the vulnerability of undiversified African economies which remain heavily exposed to external shocks" (Fofack 2005 p.1). This finding may reflect the whole of sub-saharan Africa, but there is no Ugandan researcher who takes that position. Undoubtedly the economic climate for banks in Uganda was very difficult as a result of the protracted economic crises, the disruption caused by war and the weak legal system, but the majority opinion is that the primary cause was internal lending practices rather than exogenous factors (Brownbridge 1998a, p.131).

²³⁰ The government's Rural Farmers Scheme (RFS), first launched in 1987, was one such political source of credit for farmers.

By 1995 there were eight local banks and NBFIs in Uganda. (Brownbridge 1998b p.175) These local banks in contrast to the British banks brought two advantages: they served “small urban-based businesses, which face difficulties in securing credit from the established banks” and; they offered better services in order to attract customers. Opening hours were longer, queues in banking halls shorter and depositors were offered higher deposit rates and lower minimum balances. The local banks provided a more personalized service and loan applications were processed more quickly than in the established banks. (Brownbridge 1998b p.176).

7.7 The beginnings of microfinance

The early 1990s saw the start of donor funded microfinance, particularly for women, as both a replacement for and complementary service to commercial banking (de Haan and Lakwo 2010) and in response to the significant unmet demand for credit (Tumusiime-Mutebile, 2010). The financial lives of the urban poor in Kampala were complex with many different types of informal credit services being used to reduce their vulnerability to risk e.g. pawnbrokers, store credit, landlords allowing tenants to pay rent in arrears, “*munno mukabi*”²³¹, “cash rounds”, as well as loans from family and friends (Gifford 2004). Many of the initial microcredit initiatives were started in Kampala and were subsidized because it was deemed the poor were ‘too poor to save’ and needed subsidized loans (Tumusiime-Mutebile 2010). However Governor Tumusiime-Mutebile considered this approach ill-suited to both Ugandan agriculture and to indigenous culture more generally quoting a proverb: ‘Any wealth that takes only a market week to acquire is sure to contain in it things for which the gods will surely come to make claims’. But the Governor also recognized that despite these serious shortcomings, the services were embraced by microentrepreneurs, because of the dire need for financial services.

Leading international microfinance networks which started operations in Uganda around this time included: Foundation for International Community Assistance (FINCA) in 1992, Faulu (meaning ‘to flourish’ in Swahili) and the Ugandan Agency for Development (UGAFODE) in 1995 with PRIDE and the Foundation for Credit and Community Assistance (FOCCAS) starting in 1996 and UML in 1997. These microfinance NGOs (registered under the NGO Act) were known for proximity to clients, speed and flexibility of service, mutual reciprocity, but with hidden transaction costs (de Haan and Lakwo 2010). Many MF NGOs used a Grameen type methodology with a requirement to save and the savings were not able to be accessed by the clients, effectively being held as collateral, which was one of those hidden costs (Goodwin-Groen, Bruett and Latortue 2004). Hulme (2000) dubbed the 1990s the ‘Decade of Microcredit Complacency’ and in Uganda it appears he was right as funders focused on supporting replication of the Grameen microcredit methodology, not the design of better more appropriate products, nor impact studies, nor to challenge MF NGOs to reach much larger number of clients . AMFIU was launched by governor of the Central Bank in November 1996, and became the primary collaborative

²³¹ “Munno Mukabis” translates to “friend-in-need associations” in Uganda. These provide an opportunity for members to collect funds over time in order to amass sufficient resources to aid their members should a specific pre-agreed upon financial shock occur, such as deaths in the family, weddings, children’s graduations, etc. (Gifford, 2004).

mechanism among MFIs. It was the principal representative of MFIs in collaborative efforts with other stakeholders such as the BoU and with the Donor community. Centenary Rural Development Bank was the major provider of financial services for the rural poor at the end of 1996 with 60,125 savers of which less than 20% were women (Goodwin-Groen 2006).

7.8 Economic growth and *Entandikwa*

The 1992 to 1997 period was characterized by high growth rates that peaked at 10% in 1994/5 (Okidi, Ssewanyana, Bategeka and Muhumuza 2007) when coffee prices were at a peak. It was broad based and accompanied by significant poverty reduction and declining income inequality (Kappel, Lay and Steiner 2005, Okidi *et al* 2007). This pro-poor growth was due to growth in commercial agriculture, particularly high coffee prices, together with structural changes and diversification into non-agricultural activities. Deiniger and Okidi (2003) also identified the importance of improving access to basic education and healthcare as a key part of achieving this pro-poor growth in Uganda, along with electricity and reduction in civil strife. As a result Uganda has often been seen as “an African show case for the beneficial effects of structural adjustment”, specifically market liberalization (Dijkstra and van Donge 2001). However, Collier and Reinikka (2001) are careful to point out that this was a twin process of liberalization with reconstruction after the wars and the two processes cannot be de-linked. Okidi *et al* (2005b p.1) use the term “recovery-based economic buoyancy” to emphasize the point that the initial growth was rooted in the reconstruction process. Not just reconstruction but also the massive inflows of foreign aid estimated at “an annual average of 12 percent of GDP” (Okidi *et al* 2007 p. 179) of which about 28% was budget support in the 1990s rising to 52% in 2001 (Atingi-Eto 2006 p.354). However, for the approximately 75% of Ugandan women who were involved in agriculture and did about 70% of the work (Banthia, Greene., Kawas, Lynch and Slama 2011 p.5), the economic growth in the early 1990s did little to change their economic or social status. Their husbands still controlled that income and furthermore, men typically also controlled the income from women’s micro-businesses such as selling eggs or basket weaving (Banthia *et al* 2011).

It became clear to the government that financial reform on its own would not be sufficient to expand financial sector development (Nissanke and Aryeetey 1998 p.9), so it decided to supplement the problematic banking sector with its own financing to the rural poor through the Entandikwa Credit Scheme in 1995. Originally targeted at Luwero, because of its suffering during the war²³², the Parliament decided it should be for all rural Ugandans. Designed to be a revolving fund, it did not revolve. In Parliament on 3 December 1998 the Minister for Gender, Labour and Social Development responsible for the scheme, gave an assessment of the Entandikwa program:

²³² Although Luwero is now relatively peaceful, research has shown the women still suffer physical and psychological effects. Of the women screened 54.2% had post traumatic stress, as well as physical and gynecological health difficulties as a result of their experiences. Women also experienced physical aches and pains, headaches, genital and abdominal pains, palpitations, chest pains, anxiety, lack of appetite and ulcers. (Liebling-Kalifani 2007 p.2)

“When entandikwa was introduced, some people thought that this was a gift from the President - this is how they conceived it. So, many people who received entandikwa did not pay back the loan. Then we have had climatic changes in this country, and in most cases, these climatic changes affected the peasants who got this entandikwa. So, their crops were destroyed and they had no capacity to pay back. However, some peasants who borrowed this money established some firms, small firms in the villages and this money remains in the counties. Some of this money is there, especially where recovery rate is very high..... But in most cases, the recovery is not encouraging. So far, the recovery is 55 per cent and 45 per cent of the people who got this entandikwa defaulted.”

Goodwin-Groen *et al* (2004) reported the government’s conclusions from the *Entanikwa* program’s performance were that: government credit programs could often be politicized; clients do not feel obliged to repay subsidized loans; the government has neither the human nor the financial resources to run a nationwide loan program; and interest rates must be set at market levels by private service providers or costs will not be covered.

7.9 Museveni elected president

After a long and open public consultative process to draft the new Constitution (Hansen and Twaddle 1998), presidential elections were held in 1996. The new Constitution was based on a framework of rights, including recognizing the status of women (GoU 1995). Seats in the Parliament were allocated to specific groups, including women and persons with disability, to ensure that there was an inclusive approach. Museveni also mainstreamed women within the NRM (Tamale, 1999). The Electoral Commission was dominated by NRM supporters and everyone considered the result a foregone conclusion (Watt, Flanery and Theobald 2000). Museveni was elected President by a large majority and appointed women to important posts in the Cabinet and the Supreme Court (Waring 2010). However, despite the NRM’s commitment to women it has not been able to progress the right for the rural women to equal ownership of the family residence (Waring 2010 p.8). Even with women in prominent positions in the NRM and Parliament and an in-principle commitment to co-ownership of land for women, when the Land Act was actually passed in 1998 co-ownership was missing and nothing has subsequently changed (Waring 2010). For example, women still own only 7% of farmland Banthia *et al* 2011 p.5).

Museveni believed that a multi-party democracy had only served to bitterly divide Ugandans. Much of the terror of the previous regimes was caused by sectarian violence -violence based on religion; tribe; geography or politics. As a result the NRM set up “Resistance Councils” at the village level where leaders were openly elected by their fellow villagers. There was then a five tier system of councils going up to the district level. The combination of economic support for a reforming regime, and a very slow and partial introduction of democratic institutions has been a major element in sustaining the successful shift from the politics of disorder to order in Uganda that took place since 1986. (Brett 2005, Collier and Reinikka 2001). With this stability and

commitment to reform, the tide of private capital flight had been turned by 1997 (Collier and Reinikka 2001).

One downside has been that Uganda was a “virtual one-party state” since 1986 (Tangri and Mwenda 2008 p. 181). Opposition parties are permitted to exist but operated under such severe restrictions that they would not present a political challenge to Museveni and the NRM regime (Mugaju & Oloka-Onyango, 2000). Another downside is that with power unequivocally with the NRM, there would be the traditional pressure requiring leaders to “share their wealth” (which would not be seen as unreasonable or corrupt) (Cammack 2007 p.601). Accordingly by 1998 the World Bank was reporting the existence of high level corruption and the use of “corruptly acquired monies to ensure the Movement government remains in political power” (Tangri and Mwenda, 2008 p. 179).

7.10 Conclusion

Some of the more difficult aspects of Uganda’s history bring into focus Uganda’s economic and political achievements in the early 1990s. But what is important to note for this study is the integral place financial services have had in the everyday lives of Ugandans: from the multiple indigenous forms of savings; to direct political intervention in the banking system; to access to financial services becoming government policy. Financial services are deeply interwoven into the fabric of Ugandan life both urban and rural. Unfortunately the banking sector has never effectively served the majority of ordinary Ugandans, and particularly not women, neither British banks during colonization nor mismanaged local banks. The history of the development of the financial market to this point has been one of disappointment for the poor majority. The following Chapter 8 builds on this analysis, reporting on the milestones in the development of the financial and microfinance markets as Uganda struggled to both reduce poverty and consolidate national unity. Chapter 9 then discusses the findings of the ethnographic research with microfinance stakeholders on the institutional building blocks of the microfinance market between 1997 and 2007, including the social norms.

Chapter 8: Uganda: Financial Market Development for Low Income Clients 1997 to 2007

The previous chapter described the political, economic and social context for the development of the financial market in Uganda, particularly for the social norms, and concluded by noting the important role of financial services in the life of ordinary Ugandans. This chapter now examines the way the government attempted to put the institutional foundations for the financial and microfinance markets in place following the momentum of the Presidential election, significant economic growth and the substantial support of international partners. Both grey as well as published literature is used to chart this course. The chapter begins with the launch of donor funded microfinance projects, recognizing the demand for access to finance in Uganda and the response to that demand by the government. There was significant growth in microfinance, and clients benefited from access to finance, although many providers were not financially sustainable. The MDI Act and regulations sought to bring some rigor to the microfinance market. As the formal financial sector was also facing regular crises, the Financial Institutions Act sought to bring some rigor to the formal financial sector too. But there were major challenges in neo-patrimonial corruption²³³, including corruption within the microfinance market, and challenges with the GoU's direct intervention in microfinance. The chapter concludes with the characteristics of the microfinance market in 2007 including reaching approximately 11% of the adult, economically active population or 1,709,778 savers. This leads into the institutional analysis of the microfinance market in following chapter.

8.1 Microfinance donors start work 1997

The US Agency for International Development (USAID), launched the Private Enterprise Support Training and Organizational Development (PRESTO) in 1997. It established a Centre for Microfinance (CMF) which offered training in micro-lending to all interested organizations, primarily the Grameen model of joint liability lending with savings required. The purpose of the CMF was to support the development of the microfinance sector. It then offered technical assistance and access to a grants program to help the institutions that implemented these “good practices” (Goodwin-Groen *et al* 2004 p.4). Many other donors increased their funding of microfinance about this time too including DFID; EC; German Technical Cooperation (GTZ) / Swedish International Development Agency (SIDA), Stromme and Norwegian Agency for Development (NORAD). No standards were enforced before or after funding nor was there any rigorous monitoring of their activities to check whether they complied with good practices in microfinance or even maintained high portfolio quality. The goal according to agreed principles donors agreed in 2001 was simply to expand access (Uganda Donors, 2001). This was the beginning of a massive donor effort in microfinance in Uganda with 62 financial access programs

²³³ The concept of neo-patrimonialism has been useful in identifying a key common feature of post-colonial arrangements across Africa. It is not by definition negative but in common usage it has negative connotations (Booth 2011 p.3). In this paper it is simply used as a descriptive term, it is the corruption which has negative implications for financial market development. Factors reinforcing neo-patrimonialism evident in Uganda include the legacies of colonial rule, cultural values of reliance on the Kabaka or King and input of large volumes of aid which can be used to ‘grease’ the clientelist machine. (Cammack 2007 p. 601).

and total funding exceeding USD 75 million over the next ten years. It was the largest microfinance donor effort in sub-saharan Africa (CGAP 2007).

As part of this introduction of microfinance in 1997, leaders from the BoU, the Ministry of Finance, local MFIs, and donor agencies attended a World Bank/World Bank Institute training workshop in South Africa on microfinance followed by other workshops and international study tours. These participants became the early champions of microfinance in Uganda. Individuals involved in the process cite the exposure to what was happening elsewhere and the ability to network with a small group of practitioner and government leaders as critical to eventually developing microfinance in Uganda. (Goodwin-Groen *et al* 2004) Informal contacts among donors, MFIs and representatives of the Ministry of Finance were channeled into a more formal mechanism for collaboration - the Micro Finance Forum (MFF) in 1997 chaired by The Ministry of Finance, Planning and Development (Ledgerwood and White 2006). The MFF became the most important mechanism for learning about what was happening in microfinance in Uganda, and no one wanted to miss its early meetings. It met almost monthly and acted as an information clearinghouse and, to some degree, a gatekeeper. It grew and developed several committees (working groups) to deal with specific issues, including finance, capacity building, lobbying and, most recently, consumer affairs. It was at the MFF that stakeholders discussed how to develop a legal framework for microfinance and because of this process the “culture of consultation became deeply rooted among microfinance stakeholders in Uganda” (Ledgerwood and White 2006 p.23),

To illustrate the importance to donor focus on increasing access to finance, more than sustainability of the MFNGOs, by 1999 outreach of reputable MFNGOs had expanded to almost 50,000 borrowers, but none were even approaching financial viability as shown in Table 7 below. Only Centenary rural development bank which started in 1983 was profitable. What is also particularly noticeable about Table 7 below is that for any MF organization that provides both credit and savings services, savings is much more popular. Centenary Bank is exceptional because it has a large rural network but even the small MF NGOs have attracted more savers than borrowers.

Table 7 Key Ugandan Microfinance Indicators after two years of donor funding

1999	Borrowers:	Savers	% Women	PAR after 30 days	Profit Margin
Centenary Rural Development Bank	14,168	192,534	27%	4.24%	10.73%.
FINCA Uganda	18,634	-	100%	0.4%	-7.68%
Uganda Women's Finance Trust	8,022	13,393	90%	7.47%	-58.02%
Faulu/Opportunity Uganda	3,000	5,070	72%	-	-41.54%
PRIDE	19,137	24,319	60%	0.0%	-84.63%
TOTAL	62,961	235,316			

Source: MIX Market 2011

8.2 Demand for and impact of financial services in Uganda

Microfinance started to grow as economic growth was slowing down and the formal financial sector was contracting. Growth had declined to around 5% per annum from 1997 to 2000 and there was increase in poverty, especially in rural areas, together with increasing inequality (Okidi *et al* 2007). In 1999/2000 the Uganda Bureau of Statistics (UBOS) undertook the Uganda National Household Survey, and found an ongoing significant unmet demand for lump sums of money. It found that 90% of those surveyed had not applied for credit in the past year but 56% of them indicated that they needed credit (Okurut *et al* , 2005). Less than 0.5% of the total sample had applied for such credit from banks. The others had applied for credit from NGOs, Savings and Credit Cooperatives (SACCOs) and other “informal” lenders.²³⁴ Okurut *et al* (2005 p. 483) concluded that there was a large unmet need for credit due to “the failure of the formal financial sector to serve the poor”. According to analysts, this was because the liberalization program could not address the problems of information, risk management and contract enforcement, nor the colonial legacy of a focus on export-led projects, unhelpful staff attitudes; inconvenient opening hours; relatively complicated transaction forms (Steel *et al* 1997, Mutesasira, Sempangi, Hulme, Rutherford and Wright 1998). Another survey undertaken around that time (Wright and Mutesasira 2001) found that ninety nine percent of respondents in the survey who saved in the informal sector had lost some money in the past year, as had twenty six percent of savers in semiformal institutions (MFIs and SACCOs). This shows the relative safety of even semi-formal institutions for saving and the high risk of informal saving.

These findings on demand for financial services and the failure of the formal sector to meet that demand, came as the Co-operative Bank and three other banks were closed by the BoU due to mismanagement in 1998 and 1999. The Co-operative Bank had had a long history of financial distress, including insolvency, and had already been recapitalised by foreign donor agencies. It was discovered to be insolvent again by the BoU in September 1998, but remained open in the hope that it could be re-capitalised by further financial support from donors, but that was not forthcoming so was closed in May 1999. UCB’s balance sheet which was again showing high NPLs had been cleaned up and in 1998, 49% was privatized²³⁵. Collier *et al* (2001 p. 25) comment that these problems probably occurred because the Government of Uganda (GoU) at the time placed too much emphasis on liberalization and not enough on supervision as it did not adequately recognize the challenge of the high levels of “opportunism”. (“When opportunism is

²³⁴ These findings contrasted with an assessment of the change in the percentage of rural households who have access to financial services (savings or credit) between 1992 and 1997 (Mosley, 1999) which found an increase from 9 to 21 percent in the sample surveyed. Furthermore in some districts like Nebbi District only 2 per cent of the adult population had access to financial services (de Haan and Lakwo (2010).

²³⁵ In 1998, UCB was recapitalized and a minority shareholding block (49 percent) was sold to a Malaysian Company, Westmont Land Bhd. Unknown to the government, Westmont had borrowed money from Greenland Bank to purchase its equity stake in UCB. Greenland had signed an agreement with the Bank of Uganda (BOU) in that same year to remedy insolvency and correct violations of insider lending and single loan exposure limits (Brownbridge, 2002). After the transaction, UCB began lending to Greenland and its related companies despite the inherent conflicts of interest. Greenland Bank was eventually closed in 1999. Evidence from other developing countries indicates that post-privatization performance improvements are smaller when the government maintains a substantial shareholding (Fuchs *et al* 2007). The privatization of UCB was no exception.

high it implies that many aspects of government will function badly because the professional ethics that normally govern conduct will have eroded” (*ibid* p. 25)) Together, Cooperative Bank and Uganda Commercial Bank had held 70 percent of assets in the Ugandan banking sector. This need to have another major restructuring of the banking system eroded public confidence (Deshpande *et al* 2006 p.4) but it “did not reflect a systemic banking crisis” (Brownbridge 2002 p. 279)

Many heartwarming stories of clients were told by microfinance practitioners in Uganda of women who were able to earn more income from their micro-enterprises thanks to saving and borrowing. Two of the more robust studies on microfinance Lakwo (2006 p.243-4) and de Haan and Lackwo (2010) however, found only marginal well-being gains although the financial asset portfolio of clients relative to non-clients improved and access provided a favourable opportunity for clients to improve their financial, human and political assets. Likewise Grimpe’s (2002) study of FINCA Uganda clients found that ‘loans simply help in muddling through as a short-term relief of securing livelihood’ (Grimpe, 2002, p. 14) These findings are consistent with more recent global studies that show clients often use access to financial services to smooth consumption and manage risk (Collins *et al* 2009).

But de Haan and Lackwo’s (2010) research included an analysis of women’s empowerment²³⁶ and they found it improved dramatically in three ways. At the self image level, they no longer see themselves as ‘mere women’ rather as those who also have recognized status in their marital homes. Their ‘power within’ reflected in their self- image and self-evaluation has improved. Also, through their microenterprises women are gaining the power to change their household livelihood strategies, access better social services, and own and decide about assets in both their marital and natal homes. By so doing, they have established a change in marital relations towards interdependency that reflects a power transformation associated with gains in assuming power over their own lives. This reflects a power transformation associated with gains in ‘power over’ their lives. CARE’s (2009) analysis of their Village Savings and Loan Association (VSLA) program found similar positive social outcomes including improved power relations at the household level, with more consultation between wives and their husbands in addition to increases in children going to school from 75% to 86% to and (CARE 2009 p.96)

8.3 GoU action to meet demand 1999 - 2001

In 1999 the BoU Policy Statement on Microfinance Regulation established the role of the government as an enabler, rather than provider, of microfinance. The BoU supported the view of “micro-finance as a line of business,” and foresaw the creation of a four-tier financial system that included (1) banks, (2) credit institutions²³⁷, (3) micro deposit-taking institutions (MDIs), and (4) all other financial service providers such as NGOs, SACCOs, and private companies, Savings and

²³⁶ de Haan and Lackwo’s (2010 p. 538) used Rowland’s (1997) four-dimensional power analysis to assess women’s empowerment.

²³⁷ These institutions are similar to finance companies in other countries, but are allowed to intermediate deposits

Loan Associations and community-based organizations. The BoU undertook to supervise the first, second and third tiers only. It would not supervise MF NGOs

The decision to enact a separate law for MDIs was to avoid overly burdensome requirements on microfinance business for institutions that were going under prudential regulation for the first time (Tumusiime-Mutebile 2010). To be able to supervise MDIs the Government established a Microfinance Unit under the non-bank financial institutions department and the newly appointed staff were sent to international microfinance training (Ledgerwood and White 2006). Tier 4 was left out of prudential oversight because the institutions were; i) non deposit-taking and unlikely to cause systemic risk to the financial sector; ii) just emerging experimental initiatives that could easily be constrained if legislated too early; while at the same time iii) BoU's principle was to regulate what it could supervise (Tumusime-Mutebile 2010).

The government kept to this decision not to provide funding at the retail level, although it set up a wholesale funder to the sector, the Microfinance Support Center, Ltd (MSCL). The MSCL was a government-owned company but was governed by an independent board, and was funded through African Development Bank (AfDB) loans and grants from the GoU. It was formed with the mission of funding sustainable partner organizations which could serve economically active and productive Ugandans (MSC 2007).

A presidential statement in 2001 was issued that the GoU would inject US \$5,000 in each of the 5000 parishes in Uganda. This statement appeared to contradict the role of the government as an enabler not provider of finance and provoked an immediate fear within the microfinance community that such cash disbursement would undermine the sector and a fear of *entandikwa redux* (described in the previous chapter). Microfinance stakeholders responded quickly, urging the GoU to remember the failed Entandikwa program and to allow the private sector (MFIs) to take responsibility for increasing the outreach of financial services. Eventually the GoU decided not to hand out money and the Microfinance Outreach Plan (MOP) was established (funded by IFAD, Danish International Development Agency (DANIDA), and other donors), to massively increase the outreach of microfinance in rural areas by MFIs, not the government.²³⁸ Other objectives soon were added, including focusing the government's efforts on improving the enabling environment for microfinance and supporting capacity building, as well as increasing rural outreach²³⁹. The MOP was controversial amongst some donors because of concerns that unsustainable institutions would benefit from significant funding, thus distorting the microfinance market. But other donors were fully supportive of the government's approach.

These differences had been in evidence when the Microfinance Donor Committee discussed possible joint donor agreement on good practice guidelines for microfinance. The major

²³⁸ Uganda has a population of nearly 24 million and 86 percent of its working population is self-employed. Close to 1.5 million people—nearly 90 percent of the non-farming active population—are employed in micro- and small enterprises. (Goodwin-Groen *et al* 2004)

²³⁹ Many donors felt sidelined during the development of the MOP and felt that the close collaboration in the MFF which had been central to Ugandan microfinance to date, had been abandoned and some donors did not engage further with the MOP (Goodwin-Groen *et al* 2004)

microfinance donors, including the Austrian Development Co-Operation, DANIDA, DFID, EU-SUFFICE, GTZ, Rural Microfinance Support Project (RMSP) (an AfDB project) and USAID, agreed to “promote a shift from donor-dependent microcredit to microfinance with flexible financial services for low-income people” (Uganda Donors 2001p. 2) and to expand outreach but as can be seen in Table 8 below, there were no reporting or enforcement mechanisms to implement this goal or principles.

Table 8 Uganda Donors’ Principles for Support to the Microfinance Sector

Within this framework of support to the microfinance sector, a set of specific principles of good practice are set out here. These include:

- Transparency and sharing of information on projects, programmes, and other support mechanisms
- Adherence to sound practices of international standards for support to the microfinance sector
- Joint funding or other collaboration with other donors where feasible
- Ensuring that supported stakeholders or MFIs provide a business plan or budget showing all funding sources (MFIs’ own transparency and use of the CGAP guidelines on disclosure should be encouraged.)

Uganda Donors (2001 p.3)

Components of the MOP plan were implemented through existing programs and agencies of donors that supported the government’s approach, such as SUFFICE managing the capacity building unit, the Microfinance Competence Center (MCC) (housed at the Uganda Institute of Banking and Financial Services), and AMFIU setting up a Tier 4 performance monitoring system. By using agencies with appropriate technical expertise and political independence, the MOP hoped to avoid undermining the market for sustainable microfinance providers. But unfortunately these agencies did not themselves have the capacity to implement. The SUFFICE Capacity Building for both SACCOs and MF NGOs, was in operation from 1999 to 2007 but suffered from weak (and allegedly fraudulent) management and their capacity building typically comprised buying computers and motorcycles, so had made little difference to capacity in the sector (Goodwin-Groen, 2007). The MCC did not have adequate skills or funding to make a big difference to capacity building for the sector. As a result, apart from the top-tier MFIs which accessed some training from their global networks, there was no other strategic development of new training content available to help MF NGOs keep pace with the increasing complexity and growth of the sector, (such as portfolio and accounting systems for a large branch network, internal controls, or maintaining a high-quality portfolio while expanding and cutting costs), and there was no mechanism to ensure depth of training among the various respondent groups.

8.4 Overcoming challenges in financial and microfinance sectors

The BoU recognized it needed to reprivatize UCB to more competent owners and in late 2001 Stanbic Bank of South Africa acquired 80 percent of UCB's shares²⁴⁰ (Clarke *et al* 2009 p. 1508). The remaining 20 percent were transferred to a trust to be held for sale to Ugandan residents. Stanbic was also required to combine its existing operations in Uganda with UCB's operations within six months of closing. This privatization led to an improvement in service quality, outreach and efficiency in the banking system (Gulde, Pattilo and Christensen 2006). In 2002, the BoU ordered the restructuring of Post Bank as well - including a reduction from 91 to 20 service locations! (Post Bank is a member of the World Savings Banks and had chosen to indirectly engage with microfinance through lending to sustainable and promising retail microfinance institutions (WSBI 2009)). Unfortunately many member 'owned' rural savings and credit cooperatives (SACCOs) fell victim to poor management, compounding the economic stress on members, but the BoU was unable to take action (Deshpande *et al* 2006)

By the end of 2002 there were more than 1,300 microfinance organizations operating through 500-plus branches, including a specialized commercial bank (Centenary Rural Development Bank), a regulated credit institution (Commercial Microfinance, Ltd., or CMFL), several limited companies, hundreds of NGOs, and over a thousand cooperatives and other community-based organizations (Goodwin-Groen *et al* (2004 p. 4). In 2003, several hundred more SACCOs were founded, bringing the total to over 1,500. Together, these institutions served approximately 935,000 savers and more than 395,000 borrowers. The poor savers of commercial banks like Post Bank would greatly increase this number as would the members of informal ROSCAs. However, only the largest service providers Centenary Rural Development reaching 316,650 savers; Uganda Women's Finance Trust (now Finance Trust (FT)) with 82,220 savers and Uganda Microfinance Union (UMU), (now Equity Uganda) at 47,529 savers were financially sustainable (MIX Market, 2011), all the others, even FINCA and PRIDE which would become MDIs, were still subsidized.

This multitude of microfinance organizations were registered with the government as NGOs and they choose to either specialize in providing financial services or include credit as a component of their development activities. There was no difference in registration. Barr, Fafchamps and Owens (2005 p.676) found that Ugandan NGOs were generally well perceived in the country, but there was no official means of assessing the financial performance of these NGOs. Typically financial statements/reports were of "dubious quality". With 3,000 such NGOs operating in Uganda in 2000 (Collier *et al* 2001) this is alarming. This is an understatement because in 2006/7 two of the larger MF NGOs, considered successful by the sector and which had regularly been submitting

²⁴⁰ The BoU did this only after conducting market surveys to gauge interest and preferred sale options. "The government announced that it would prefer to maintain a 20 percent shareholding although it would consider selling its entire stake." (Clarke, Cull and Fuchs 2009 p. 1508). Under any sales option, recapitalization was again necessary given the extent to which UCB's balance sheet had deteriorated (64 percent of its assets were nonperforming). The effect of ownership on bank efficiency in Africa was examined using 2001/02 data by Figueira, Nellis and Parker (2006). They found that "in Africa, on average, privately-owned banks do not appear to out-perform state-owned banks" (ibid p.37) but foreign-owned banks tend to be more efficient than domestically-owned banks. So in finding a foreign owned bank with a good track record to take over UCB the BoU was giving UCB the best chance possible.

audited financial statements to government and financial reports to funders, were discovered to have fraudulent accounts. Ugandan NGOs are exempt from filing a tax return and in Barr's survey "less than 60% of NGO survey respondents were able or willing to provide any data on their revenues and expenditure" and "for those that did provide accounts, figures on revenues and expenditures seldom agree" (Barr *et al* p.676). This means that the data on provision of financial services by the myriad of small NGOs is highly questionable.²⁴¹

Recognizing this problem with reporting in 2003 AMFIU agreed a common MFI reporting tool with donors, called the Performance Monitoring Tool (PMT). Its purpose was to reduce the administrative burden on MFIs, enable donors to apply consistent definitions and good microfinance practices in tracking the performance of their MFI partners and for there to be comparable data across the sector. Unfortunately it was hardly used because the quality of the data was questionable and AMFIU was not able to get all its members to use it on a regular basis. (Duval 2003). The top tier MFIs would have provided detailed financial performance information to their funders.²⁴²

The 2003 revisions to the Poverty Eradication Action Plan (PEAP)^{243 244} identified challenges in the microfinance industry, including capacity building, outreach, product mix, agriculture finance, regulation of unregulated and unsupervised microfinance providers (known as "Tier 4" institutions), savings mobilization, commercial bank down-scaling, interest rates, credit references, impact assessment, and industry consolidation.(Goodwin-Groen *et al* 2004) The inclusion of such a thorough analysis in the national poverty eradication plan illustrates the seriousness with which financial inclusion was treated by the government in Uganda (Okidi *et al* 2007).

²⁴¹ Barr also found that only 12% of surveyed NGOs have an overdraft facility, and only 15% have ever borrowed. This shows that even if they do provide credit they are not serious financial service providers. This kind of data is evidence of the challenge in tracking down all micro-credit providers.

²⁴² However, three of the leading MFIs and two of the networks in Uganda were five successful bidders out of just twenty organizations selected to participate in a study to explore ways to improve measurement of poverty reduction - Centenary Rural Development Bank, UMU and FOCCAS with the BRAC and FINCA networks (Copestake 2007).

²⁴³ The three major government policy documents that were meant to drive the pro-poor national economic agenda were the Plan for the Modernization of Agriculture (PMA), the Poverty Eradication and Action Plan (PEAP), and the Medium-Term Competitiveness Strategy (MTCS). In the previous decade it was the agriculture sector which drove pro-poor growth since the poorest Ugandans are crop farmers and there were high coffee prices in the mid 1990s. But, two main factors prevented improvements in agriculture. First inadequate funding for agriculture (less than 4% of the national budget when 96% of the poor live in rural areas) which inhibited implementation of innovative aspects of the PMA (Okidi *et al* 2007) And second the focus on decentralization (including the "decentralization of corruption" (Watt, Flanary and Theobald, 2000 p.48)) in the PMA so local power structures, not the poor determined priorities (Baghiigwa, Rigby and Woodhouse 2004).

²⁴⁴ The original PEAP was more strongly owned locally than the later PEAP iterations, which were recognised as PRSPs. The recognition of the PEAP as a PRSP has made the PEAP more development-partner-focused, which has undermined local ownership. When domestic stakeholders sensed that participation was an end in itself, this undermined national ownership. In addition, the political ownership that was a hallmark of Uganda's first PEAP waned in more recent versions of the PEAP. (Goodwin-Groen *et al* 2004). This supports the claim by Cooke (2004 p.44) that the participatory aspect of PRSPs had been co-opted to support the World Bank's "neo-liberal prescriptions".

The IMF's FSAP in 2003 found that the financial system was small underdeveloped and dominated by commercial banks (IMF 2003). Selected indicators of financial depth were significantly lower than Kenya or Zambia. (In other words only the rich could access the formal financial sector.) The financial system is not interconnected – meaning that the banking system's lending to nonbank financial institutions is negligible. Lending to the Private Sector is limited in size and short in tenure. Credit to GDP ratio, although having increased to 7%, is much less than the 12% median of Sub-Saharan Africa (Ellis, Manual and Blackden, 2006 p.45). Distribution of credit is lopsided. Agriculture is 40% of GDP but receives only 10% of the private sector lending. Furthermore, it found that non-bank financial intermediaries including microfinance organizations and insurance companies to be “limited in number small in size and relatively ineffective” (IMF 2003 p.7) This was a negative assessment of the performance of both the formal and informal financial sector and its regulators.

By the end of 2004 IMF economists (Hauner and Peiris, 2008) were more positive about the banking sector. Their analysis found that with the closure of distressed banks, privatization of UCB in 2002 and substantial improvements in supervision, “the health of the banking system has improved remarkably” (Hauner and Peiris 2008, p.2703).) Non-Performing Loans (NPL) had fallen from a high of 29% of the portfolio in 1998 to 2.6% as of September 2004 and high interest rate margins underpinned bank profitability. (Hauner and Peiris 2008). The 7% credit to GDP ratio is almost double where it had been in the early 1990s and the financial sector was one of the most profitable and well supervised in the whole of Africa (Gulde, Pattilo and Christensen 2006). There were 133 commercial bank branches in Uganda at the end of 2004 in 50 of the 55 districts of the country (Deshpande *et al* 2006, Hauner and Peiris 2008 p. 2705). Hauner and Peiris (2008) documented 1.5 million commercial bank deposit accounts also at the end of 2004 which they interpreted as 30% of households which is “good coverage by African standards” (p.2705). In contrast Deshpande *et al* (2006) documented a total of 1.94 million deposit accounts in all forms of financial service providers, calculating an estimated 12.5 per cent of economically active adult Ugandans have direct access to a deposit account, which is “extremely low”, especially among rural Ugandans.

Once Stanbic had turned around the former UCB it wanted to capitalize on the branch network inherited from UCB²⁴⁵. This resulted in increased competition with large MFNGOs into the lower / middle income market place – which was good for clients (Wright & Rippey 2003). It focused on retail savings²⁴⁶ and to attract small savers from commercial banks it reduced or eliminated

²⁴⁵ As of September 2004, Stanbic had closed only one of the rural branches it inherited from UCB and it was increasing its lending to agriculture (Fuchs *et al* 2007 p. 7). Cihak (2005 p.22) found “international banks lend more overall, measured by the loan-to-deposit ratio, and lend more to agriculture— as measured by the share of total loans—than large domestic banks; they have as short a maturity profile of loans as other banks; have lower spreads; and do not have excessive profits as compared to other types of banks.

²⁴⁶ Most commercial banks lent to top-tier MFIs (which became MDIs) rather than develop their own loan products for poor clients, both because the Banking Act does not allow group collateral and because of the time and cost involved in developing new technologies to reach this market segment. Moreover, guarantee facilities available from the EC's Support to Feasible Financial Institutions and Capacity Building Efforts (SUFFICE) project and USAID's Support for Private Enterprise Expansion and Development (SPEED)

minimum deposit balance requirements and offered chequebooks with the savings accounts and also started making salary loans for low wage earners. (This is similar to Johnson's (2004a) findings in Kenya ²⁴⁷). This competition was resulting in better services for MF clients such as longer loan terms, reduced collateral requirements, moving beyond the rigid working capital group loan product. But competition had not yet reduced costs of borrowing and with increased availability of credit, there was also a trend of clients taking loans from multiple MFIs (Wright & Rippey (2003) McIntosh and Wydick (2005)).

8.5 The Microfinance Deposit-taking Institutions Act and regulations

A long process of technical consultations on appropriate microfinance legislation with a wide range of stakeholders started around 1997, led by the MFF, chaired by Ministry of Finance Planning and Economic Development (MoFPED). The consultative or participatory process²⁴⁸ was remarkable because of the willingness of the government to include stakeholders in this process, in other words, for the government to share power with stakeholders. Furthermore, the ability of those stakeholders - government, practitioners, and donors - to work together toward a common goal was also remarkable (given the donor's failure to agree on other issues). This process is discussed and analyzed in detail in Chapter 9. AMFIU played a pivotal role, leading an initiative to educate politicians and the public, particularly on the issue of high interest rates, as reported in Ledgerwood and White (2006)²⁴⁹. (AMFIU received technical and financial support from GTZ and SPEED). The MDI Act passed in 2003 was considered exemplary because rather than concentrate on legitimizing microcredit or other narrow aspects of microfinance (as is common in other microfinance regulation), it focuses on protecting poor people's savings (Mwenda and Muuka 2004, Ledgerwood and White 2006).²⁵⁰ (At the same time as this Act was passed the Parliament requested a new Tier 4 Act to be submitted to them within six months, but this had not occurred by the end of 2007.)

After the euphoria of getting the MDI Act passed the funders were of the opinion that microfinance in Uganda would probably evolve into a dynamic market that was fully integrated

reduced the risk of lending to MFIs. While this capital is not cheap (annual interest rates of around 15–20 percent, with a lien on an MFI's receivables), it can be easily accessed and integrates MFIs directly into the financial system. (Goodwin-Groen *et al* 2004)

²⁴⁷ Johnson (2004 p.515) found in Kenya that the formal sector financial intermediaries are changing their strategy and considering how to tailor their products to the middle and lower income market.

²⁴⁸ This acceptance of a participatory process by all the technical participants would be an example of Tandon's (2008) observation of the mainstreaming of participation in the development discourse.

²⁴⁹ High interest rates are a legitimate concern because there are no alternative risk-hedging mechanisms available to farmers (Okidi *et al* 2007)

²⁵⁰ Mwenda & Muuka (2004 p. 156) argue that "an effective and efficient regulatory framework for MFIs should focus on regulating MFIs that accept deposits from the public.The argument supporting the view that MFIs engaging in deposit-taking should be regulated and supervised is premised on the need to protect the public from risk should such MFIs default. The objective of regulating MFIs is to let only the most trustworthy institutions operate for the good of the community while leaving them enough flexibility for adapted operations. While sound practices of micro-finance call for interest rate deregulation and a freedom for MFIs to adapt to local conditions, regulators must ensure that barriers to entry into the micro-finance sector are not so low that un-viable (or even dishonest) financial institutions flood the market."

into the financial system and provide a wide range of financial services to most of the population, but if not, it would remain a successful, but marginal, development niche (Goodwin-Groen *et al* 2004).²⁵¹

The Regulations were gazetted by the BoU in 2004, and were very similar to the regulations governing regular banks in the requirements for branches, reporting and management. These regulations paved the way for the incorporation of larger MFIs into the formal financial system. In contrast to the Act, the BoU did not lead a consultative, participatory process to develop the regulations. The process is not discussed in Ledgerwood and White (2006) because it was an internal one. Licensing of the first Microfinance Deposit Taking Institution, FINCA, according to the regulations, occurred in November 2004 and the other three MDIs, UMU; FT; PRIDE were registered in 2005 and became able to legally provide savings services. It cost the specially formed committee of donors a combination of USD 4.7 million to turn these four former NGOs into formal financial institutions (a fifth transformed into an NBF). It was such an expensive effort because the NGOs had very few of the systems needed to register. To illustrate the magnitude of the problem, one of the NGOs considered to be on-track to become an MDI was in the following position. It had no information system to track and monitor portfolio performance (e.g. PAR) daily, nor the ability to prepare financial reports daily for management on efficiency or profitability. (It had billions of shillings lent out and several branches and did not have an information system that could provide daily updated reports – it took a week to get base payment information!) Its audited financials were not high quality and it did not report regularly to the MIX Market. It had never had an external rating undertaken of its strengths and weaknesses. It did not have a “Fit and Proper” Board with fiduciary responsibility and no Internal Auditor to report independently to the Board. The leadership was not skilled, competent and had no integrity. There were no standardized procedures across the organization, understood by everyone so that credit officers could move branches and follow the same procedures. (Without this it is impossible to see where there are gaps and where non-compliance is happening.) Finally, there was no organization-wide performance incentive system so everyone could feel as if they were contributing to the goal of the NGO. This was evidence of the failure of effective accountability and capacity building by its international agency and by the donor community in Uganda. It is not surprising that the BoU erred on the side of strict regulations.

Initially, there was intense criticism within and outside Uganda that the regulations were too stringent to be sustained (Tumusiime-Mutebile 2010)²⁵². However, the BoU saw improved loan

²⁵¹ The review did not, however, seriously look at the formal or informal providers of financial services or undertake any analysis of the underlying institutions which were driving the development of the financial market for the underserved. It also did not address the issue of corruption. In May 2003, the donors issued a statement which argued forcefully that ‘corruption is pervasive, institutionalized, and on the increase’ in Uganda and that ‘large-scale corruption and embezzlement at the top is carried out with impunity’ (Uganda’s Development Partners, 2003).

²⁵² Some of the regulations have also been problematic for INGOs that want to ensure the ongoing social mission of the MDI. The maximum ownership requirements are 30%, but if the founding International Non-Government Organization (INGO) wants to protect the social mission of original organization in the new company that is too limited if another investor does not share the same mission. More than one INGO has needed to negotiate with the BoU for a specific exemption from the maximum ownership limit based on the

portfolio management with the MDIs asset quality consistently improving from 2005 to 2009. Starting with a PAR of 5.5% in 2005, the overall PAR had, by the end of December 2009, reduced to 2.4%. Also with regulation MDIs can now access long term finance for their loan portfolios, and most MDIs have arrangements for banks to provide liquidity in case of liquidity constraints. MDI credibility has been further boosted by the “Best Bank in Kenya”²⁵³, Equity Bank acquiring one of the MDIs. (Other MDIs have since then, also been approached for acquisition, but they seem to have more confidence that they can transition into Tier 1 without being taken over.) The negative consequence of the regulation was the very slow expansion of access points. The number of MDI branches was 83 in 2006, and had only risen to 88 by end of December 2007 (Bank of Uganda 2008a).²⁵⁴ However the amount of savings deposits significantly increased by 47% in 2007/8 compared to the previous year (Bank of Uganda 2008b p. 40) AMFIU has argued that the sector has changed rapidly and the factors which determined the regulations in the late 1990s need to be reviewed in a consultative process (Baguma 2006).

8.6 Financial Institutions Act and preparation for Tier 4 regulation

In an attempt to systemically address the insolvency of banks in the late 1990s, there was a review which recommended a much tougher Financial Institutions Act which complied with international standards. Indeed, because it was much tougher and took away the right to issue banking licenses from the Minister and Parliament, it took a long while for the Act to be passed (Hauner and Peiris 2008). Key aspects of the Financial Institutions Act (FIA) and Regulations include the power of the Central Bank alone to license and regulate banks and that financial institutions’ accounts must be IAS compliant (BoU 2006 p.35). The standards of the FIA 2004 are enforced with penalties ranging from fines to, ultimately, removal of the banking license. At the same time as this Act was passed and its regulations promulgated the BoU initiated a moratorium on licensing new banks. The priority was to ensure that the banks and MDIs operating met the standards of performance that were now required.

The MDI Act has seen a substantial investment in extending secure deposit services, although “stakeholders are increasingly aware of remaining challenges to rural outreach, including slowed

NGO’s track record as a successful owner of financial institutions (e.g., FINCA Uganda). However, this was not easy and is likely to depend on the success of the financial institutions owned by the NGO (Lauer 2008) Another challenge was that some donors required grant funds for loan capital either to remain with the original NGO or to “stay in the country”—which typically means that the NGO must, on transformation, own a percentage of the company equal to the grant funds divided by the total initial capital of the transformed institution and be required to retain such ownership position indefinitely. This is what happened to the Ugandan Women’s Finance Trust. (Lauer 2008)

²⁵³ At the 2007 Euromoney Awards for Excellence because of Equity’s achievements in reaching out to the unbanked. (Equity Annual Report, 2007)

²⁵⁴ Another problem with the regulations is that savings used as collateral is not recognised as a deposit in conventional law, there have been cases of illegal deposit taking. Bank of Uganda is currently reviewing these definitions to bring them in line with the special features of microfinance deposit taking business. The benefits of reviewing these definitions is that unsuspecting public can be better protected from being misled into putting money into unlicensed institutions and pyramid schemes that has led to loss of savings. To protect its image as ‘*protector of savers*’, it is important to Bank of Uganda that all attempts to take deposits illegally are minimised. (Tumusiime-Mutebile 2010)

pace of MDI expansion, inadequate regulation and supervision of SACCOs, and lack of clarity on regulation for new high- and low-tech delivery channels.” (Deshpande *et al* 2006 p.1) Furthermore at “the micro level, the primary obstacle is lack of secure deposit-taking institutions in rural areas and extremely low density of financial service access points throughout the country. Linkages between SACCOs and regulated institutions offer promise in this area; incentives and competition could also draw banks downmarket. At the meso level, resources for communicating institutional soundness, consumer education, and access to the payment system are under-developed. The report provides these conclusions based on a comprehensive analysis of all aspects of savings for low income Ugandans from the clients’ preferences to the financial intermediaries that attempt to serve them.

The GoU then realized that it had standard information from formal financial intermediaries but it did not have adequate information about the NGOs MFIs and SACCOs. So the MoFPED undertook a census with the objectives of establishing the geographical distribution of MFIs by institutional type; the extent of outreach and financial performance based on basic indicators; the governance, affiliations, and institutional practices, including sources of funding; understanding the extent of competition (MoFPED 2006) . The main findings of this Census are in Table 9 below:

However there were more SACCOS and MFIs legally registered than were found by the census team. Apparently 57.1% of the “missing” SACCOs and 40% of the “missing MFIs” were currently not operational” (Friends Consult 2007a p.iv) In addition about 1 out of every 3 SACCOs that were considered missing were found to exist but were not open during the time of the census owing to low business activity.²⁵⁵

²⁵⁵ The SACCOs and MFIs that were no longer operational may be the cause of the 6% of respondents in the Census that said they had lost money in SACCOs and MFIs (The Steadman Group 2007 p. viii) or the 26% of respondents who said they had lost money in a semi-formal financial services provider in an earlier non-government survey (Wright and Mutesasira, 2001).

Table 9 Results of 2006 GoU census of financial institutions in Uganda

Number of financial service outlets: A total of 1263 institutional outlets (headquarters and branches) covering all districts in Uganda were found of which 1207 were found active or eligible¹. Of the eligible outlets:

- 676 (56%) were Savings and Credit Cooperatives (SACCOs) (Tier 4);
- 104 (8.6%) were private companies (Tier 4);
- 73 (6.1%) were NGOs (Tier 4);
- 52 (4.3%) Sub-County Integrated Development Associations (Tier 4);
- 97 (8%) were Micro Finance Deposit Taking Institutions (MDIs) (Tier 3);
- 38 (3.1%) were credit institutions (Tier 2); and
- 168 (13.9%) were commercial banks (Tier 1).

Location: The Central and Western regions account for 879 (72.8%) of all the eligible institutional outlets. The Eastern region accounts for 221 (18.3%) while the Northern region accounts for 107 (8.9%).

Depositors: The total number of clients with deposits with SACCOs and other Tier 4 MFIs as of December 31, 2005, was 389,479. The total number of clients with deposits with the regulated sector as of June 30, 2006 was 2,161,274

Borrowers: The total number of reported loans outstanding from SACCOs and other Tier 4 MFIs as of December 31, 2005, was 272,637. The total number of loans outstanding with the regulated sector (commercial banks, credit institutions and MDIs) as of June 30, 2006 was 339,170.

Disbursements: MDIs disbursed UGX 167,995.268 million or 15% of the total amount disbursed, and had share capital of UGX 17,848.412 million or 6.9%. Credit institutions had an outstanding loan portfolio of UGX 83,944.994 million or 8.0% and value of savings of UGX 32,859.172 million or 2.9%. SACCOs disbursed less than UGX 53,860.073 million in 2005 or less than 5%, and had a loan portfolio of UGX 30,754.241 million or 2.9%.

Source: MoFPED (2006)

A Tier 4 Regulation Sub-Committee published a report on principles for a regulatory framework for Tier 4 and in 2006 AMFIU made recommendations to this committee (Baguma 2006). They urged for no regulation of interest rates, not to give powers to a member-based apex organization and not to promise supervision where there was no capacity to provide the supervision.

8.7 Corruption and re-election

In May 2003 Uganda's donors had issued a statement which argued forcefully that 'corruption is pervasive, institutionalized, and on the increase' in Uganda and that 'large-scale corruption and embezzlement at the top is carried out with impunity' (Uganda's Development Partners, 2003). Thus it was hardly surprising that members of parliament were openly bribed to alter the constitution so Museveni could be reelected president in 2006 (Rotberg 2007 p. 46). This has been interpreted or even justified as being due to a cultural practice of "neopatrimonialism" or patronage (Cammack 2007, Robinson 2007); or the need for ongoing political stability after recent

wars (Museveni 1997)²⁵⁶. Others simply see it as corruption by the elite to continue to hold power (Tangri and Mwenda 2008). In its Corruption Perception Index (CPI) 2007 Transparency International (TI) ranked Uganda 111 out of 179 with a score of 2.8 out of a possible 10. It was comparable to Eritrea and Rwanda (Somalia being the lowest in Africa). Such a low score in the CPI indicates that public institutions are heavily compromised. TI estimates that half of the government funds, approximately USD 950million vanish corruptly and the Public Procurement and Disposal of Public Assets Authority estimates that 70% of the government's procurement budget (over USD 184 million) is lost each year due to corruption in the procurement process (Rotberg 2007). Tangri and Mwenda (2008 p.177) provide evidence "that state elites – cabinet ministers, senior civil servants, and army officers – have abused their positions for personal gain". They also argue that part of the corruptly obtained monies have been channeled "to ensure the Movement government remains in political power." (*ibid* p.179). These NRM elites are not necessarily connected to the President by ethnicity or kinship but were appointed by him to represent different regions, religions and gender balance. (Watt, Flanary and Theobald, 2000)

Tangri and Mwenda (2008 p.186) argue that elite corruption is not systemic, but *ad hoc*. They argue that it involves a minority of politicians, civil servants, and military officers, with some political and personal connections to the top political leadership who engage in individually determined ways of accumulating resources²⁵⁷. But the corrupt senior officials are still accountable to the President due to both "neo-patrimonialism" and the desire to maintain power for the NRM (Watt, Flanary and Theobald 2000, Francis and James 2003, Mwenda and Tangri 2005, 2008, Robinson 2007). The interpretation of high-level corruption as "*ad hoc*" belies the donors' experience of endemic corruption. The evidence from Transparency International highlights the corrosive effect of corruption on all aspects of life in Uganda, including in the microfinance market.

Under President Museveni, the management of state institutions is subject to his personal influence and patronage politics and he has used those state institutions to build political support and sustain his power. In the civil service appointments are largely made on patronage networks which are deeply embedded in the social structure (Watt, Flanary and Theobald 2000). Public resources (including foreign aid), have been used in unaccountable and non transparent ways to help the NRM government maintain its political dominance (Tangri and Mwenda 2005, 2008). Furthermore, the slowing of the reform momentum up to this point also lies in the "neo-patrimonial character of Ugandan political culture" (Robinson 2007 p.472) where personalized rule and patronage relations take precedence over reform. Museveni has also relied on authoritarian means, military force, and political manipulations to maintain political control (Tangri and Mwenda, 2008. p.182)

²⁵⁶ As the state was previously synonymous with violence and oppression, it is hardly surprising that people depend on the relationships they can trust instead (Watt *et al* 2000)

²⁵⁷ Accordingly large numbers of honest senior officials have co-existed with corrupt politicians (usually ministers of state) within government ministries.

Patronage is also central to Uganda's decentralization program, a key pillar of the NRM agenda since it took office (Francis and James 2003 p.325 – 326)²⁵⁸. Its five-tier structure of local councils (formerly Resistance Councils) starting at the village level and going up to the district level draws on “the language of participatory planning” (*ibid* p. 326) but is widely regarded as NRM's attempt to widen its support base or the “decentralization of corruption” (Watt, Flanary and Theobald, 2000 p.48)²⁵⁹. It should be noted that the use of decentralization as a vehicle of state patronage is not unique to Uganda as Robins, Cornwall & von Lieres (2008 p. 1077) found “[d]ecentralisation may, in practice, serve to extend and further embed the logic of state paternalism and patronage.”

NRM leaders have also, in various ways, disabled the anti-corruption institutions they have been required by aid agencies to establish to stamp out corruption. Although appearing resolute in confronting corruption ills, they have shown little commitment to act effectively to curb practices which could affect their material and political interests. There has been a close and cooperative agreement between the GoU and the IFIs with the GoU implementing reforms and the IFIs providing large infusions of funds. But aid agencies have not called the GoU to account for the creation of specialized agencies, the expansion of the military²⁶⁰ and of district level bureaucracies and political appointments to public position all of which have supported the patronage-based government (Mwenda and Tangri 2005, Robinson 2007). Transparency International notes. “In countries where public sector institutions were historically based on patronage ...rather than merit, reform takes time and can require a substantial investment of resources, as well as technical assistance.”

As discussed in the previous chapter, there is an acceptance of pervasive corruption beyond patronage, with many aid projects suffering from misappropriation of funds and funding “irregularities”. This included two leading MF NGOs that had international partners which were supposed to be exercising oversight, namely FOCCAS (with Freedom from Hunger) and The Micro Enterprise Development Network (MED-Net with World Vision). In the case of FOCCAS

²⁵⁸ Francis and James (2003 p. 326) found decentralization in Uganda had “no real success stories as far as improved development performance at the local level is concerned” because of inadequate capacity at the local level, insufficient fiscal decentralization along with the other responsibilities decentralized, and a lack of accountability to citizens. Decentralization justifies the President's insistence on a ““no party” democracy” (*ibid* p. 327) to both the highly politicized population and the international donors, who see multiparty democracy as the hallmark of good governance. Francis and James (2003) contrast the patronage system with the “technocratic” (*ibid* p. 334) mode of local governance in Uganda which prioritizes poverty reduction, is driven by national targets, and is closely associated with poverty reduction strategy plans (PRSPs).

²⁵⁹ Hickey and Mohan (2004 p.5) argue that because the notion of participation has become so ubiquitous, “understanding the ways in which participation relates to existing power structures and political systems provides the basis for moving towards a more transformatory approach to development”. Therefore, it is critically important in this context to understand that the language of participatory planning is being used to widen the NRM's political support base (Francis and James, 2003). This is not a unique situation as “abuse of the term ‘participation’ abounds and although is understandable, it is highly dangerous.” (Drinkwater 2003 p. 63) as it debases the work of those who are methodologically rigorous.

²⁶⁰ So called “ghost” soldiers are created by commanders who then draw the wages of these phantoms. It has been estimated that ‘ghost’ soldiers could comprise as many as one third of Ugandan army strength amounting to as much as \$30 million per annum in recent years (Tangri & Mwenda 2008)..

an internationally recognized audit firm was also compromised for providing false financial statements (Goodwin-Groen 2007, Rozas 2009)²⁶¹. Respondents were greatly disturbed by this pervasive corruption and it is discussed at length in the following chapter. Cammack (2007) argues that donors must have an understanding of deep social structures, to address institutional weaknesses and to support processes of positive social change and processes that promote government accountability to the people.

8.8 “Bona Bagawale” – Prosperity for All

On 7th October 2007 “Prosperity for All” was nationally launched to implement President Museveni’s 2006 campaign promise that the government was going to do something more effective to solve their long-standing poverty related problems and provide access to finance (Akandwanaho²⁶² 2006). The “Bona Bagawale” program or “Prosperity for All” program was designed to alleviate poverty in rural areas, since peasant farmers make up the majority of the most poor. Bona Bagawale was to join the existing government efforts (such as the PMA) to transform poor farmers, both men and women, from producing predominantly for the household (subsistence farming) to producing for the market (commercial agriculture). The initial plan was not to disburse the micro-finance Bona Bagawale development funds directly to the people, (as was the case with the failed Entandikwa scheme). But instead, Bona Bagawale would “fund the re-establishment of cooperatives [that had been operating in the 1970s,] through the provision of development grants and loans. Then work with other government agencies and the micro-finance sector to provide a range of other needed complimentary integrated services” (Akandwanaho 2006 p. 12)

This plan was based on the analysis that in “1971 every part of Uganda had strong and vibrant co-operative societies. There were over 2,000 primary co-operative societies. By 1986 there were 3223 Agricultural Marketing Co-operative Societies, 38 District Unions and seven National Unions”. (Akandwanaho 2006 p.7) By collectivizing production, combining it with modern management strengthened by information systems for monitoring and decision making processes, it was hoped that the Unions would prove to be cost effective, have a wide spread and penetration while at the same time ensure that the implementation of modernization of agriculture has a peasant focused approach. As the majority of farmers in Uganda were small holders with an average of just two hectares, it was anticipated that the scale of farming operations will be increased substantially by pooling of resources in farm cooperatives that will offer facilities that otherwise would be inaccessible to peasant. (*ibid* p.8) That was the hope.

But the reality was very different. The Uganda Cooperatives Savings and Credit Union Limited (UCSCU) was appointed by the GoU as the lead agency to implement the formation,

²⁶¹ One way corruption occurred was that “ghost” clients were created by loan officers in collusion with bank staff.

²⁶² General Caleb Akandwanho SS (rtd) (whose *nom de guerre* was General Salim Saleh) was the Minister of State for Microfinance. A charismatic and decorated military commander, he is a half-brother of President Museveni who sacked him from the army for corruption and drunkenness. Allegations of impropriety have swirled around him from plundering natural resources from the DRC to corruption in privatization deals.

strengthening and development of SACCOs under the “Bona Bagagawale” program²⁶³. The other SACCO coordinating body was the Uganda Cooperative Alliance (UCA) and they collaborated with UCSCU in the implementation. However, UCSCU required no formal performance standards that SACCOs must achieve to become or continue being registered and it had no enforcement mechanisms for lack of reporting or incorrect reporting to UCSCU. As a result, there was little standardized information about SACCOs financial performance, it was not transparent, comparable, consistent over time.²⁶⁴ The Microfinance Support Centre had a track record of funding SACCOs but in its 2007 Annual Report it stated that the Portfolio at Risk > 90 days was 22% for existing SACCOs under GoU funding. This is poor performance was due to poor governance and treasury management with inadequate internal controls (MSCL 2007 p.18). This is a polite way of stating that the SACCOs were vulnerable to corruption and mismanagement of funds.

This lack of enforcement of performance standards was based on the ethos of SACCOs, that they are primarily accountable to their members²⁶⁵. But this assumes that the members have both the technical capacity and power to hold the board members to account which is rarely the case in rural Uganda. To address this problem, the government and donors jointly worked on “Minimum Standards of a Good Sacco” which includes PAR at 30 days a maximum of 10percent. (Roberts 2007). These standards would (in theory) be enforced during the annual SACCO Audit by UCSCU/UCA. However, this was recognized to be inadequate supervision and so an independent regulatory agency will be set up to “regulate, supervise and licence SACCOs” (Mbaguta 2007 p.10) UCSCU’s goal was to establish 328 new SACCOs and support a further 620 that were already established within an unidentified timeframe. They estimated that per new SACCO formed it would take approximately two years and UgSh 24 million (Weikeh, 2008). It was originally planned that these SACCOs would receive low-interest loans via the Government owned Post Bank for productive investment for SACCOs. Doubt was expressed, however, about the capacity of Post Bank with just 21 branches countrywide, to reach all 964 sub counties in the current 80 districts within one year, as is expected by the government (Sharma 2007). So responsibility for lending to SACCOs was given to MSCL (see above) which has adequate experience in lending to SACCOs across the country (Mbaguta, 2007).

²⁶³ UCSCU signed a Memorandum of Understanding with Government of Uganda and on behalf of Government undertakes the following mandate: → Mobilising communities and train them to come together as co-operators in order to start SACCOs or to join existing ones and become members; → Install a culture of savings by encouraging members to own shares and also put savings into SACCOs.; → Provide training to SACCOs, and equipment, goods and services, for example, depending on the needs of SACCOs they will be provided with safes, office furniture, counters, filing cabinets, contribution to staff salaries and rent, among others. For the SACCOs which are already in existence and wish to grow and become stronger, they are provided with items like motor cycles, computers, strong rooms and refurbishment of office premises. (<http://www.ucscu.co.ug/index.php?ucscu&as=29> accessed on 25 March 2011.)

²⁶⁴ IFAD had funded a Programme Administration Unit (PAU) charged with provision of Financial and Technical services to UCSCU to support its capacity building efforts for members.

²⁶⁵ But when members and board members do not understand how the saving or lending business operates or, are indebted to village leaders, are unable to understand financial statements or, do not have the time to help the management, then there cannot be effective oversight.

8.9 Context and characteristics of the microfinance market in 2007

By 2007 Uganda's economic success in the 1990s was "old news" (Rotberg 2007). Agriculture was contributing 42% of GDP (PMA 2007) and approximately 85% of the workforce were in rural areas (GoU 2006) but insufficient resources were being allocated to improve agricultural productivity. Corruption was rampant, electric power was short, democracy illusive with Museveni still the President and the war in the north still not resolved. However, criticism from Washington and likeminded donors had been muted because Uganda cooperated in the 'War on Terror' and in 2007 deployed troops to Somalia (Tangri and Mwenda 2008 p. 191). By the end of 2007 Uganda's GNI per capital had reached just USD 370 (up from USD 240 in 1986) as the population reached 30.339 million in 2007 (UNDESA 2011). 76% of this population was still living under the poverty line of USD 2.00 per day (World Development Indicators, 2008). Its Human Development Index (HDI) was 0.42, just below the SSA average (UNDP 2012).

Despite these multiple negative indicators Standard and Poors had rated Uganda as a "frontier market" i.e. a market that is smaller and less liquid than those in the more advanced emerging markets but with strong supervision that promotes financial sector stability and effective intermediation. In their opinion Uganda has political stability and a strong independent Central Bank which also rigorously supervises the financial sector. Such a market offers institutional investors the prospect of good returns and a means to diversify risk through investments in financial markets.(Nellor 2008). Uganda was ranked 118 out of 178 on the World Bank/IFC's 2008 Doing Business Indicators (2007)

As the MDIs were being launched Nile Bank (one of the smaller local banks) made a strategic decision to move quickly and gain the first mover advantage in the expanding Small and Medium Enterprise (SME) market. It needed an IPO to finance branch expansion but Barclays offered to buy the bank before the IPO happened. The announcement was made in December 2006 and by March 2007 the BoU had given its approval and the merger was done. Nile had 18 branches and 25 ATMs and Barclays 7 branches and 9 ATMS. Barclays supported Nile Bank's strategy and decided to aggressively pursue the SME market with the aim of growing to a total of 65 branches within a year. It can be expensive to serve the SME market – since it requires good risk management and underwriting, excellent marketing and sending sales agents out to where the businesses are, but it was an untapped market so there the potential for high margins.

The most comprehensive analysis of financial access in Uganda (based on 2006 data) used the FinScope methodology (The Steadman Group, 2007). It found that 71% of the population saved in some form, the most popular being saving in a secret hiding place by 90% of the savers²⁶⁶. 27% save with an informal group (this includes ROSCAs²⁶⁷ ASCAs and VSLAs²⁶⁸) and 22% save

²⁶⁶ Pelrine and Kabatalya (2005) found that 81% of rural Ugandans save in cash or in kind (based on a nation-wide survey).

²⁶⁷ Ambec & Treich (2007) provide a fascinating analysis of the reasons why ROSCAs are efficient and "sometimes better than organizing a credit market" (*ibid.* p.133)

²⁶⁸ See Kibombo (2007) for a summary of how VSLA's (Village Level Savings and Loan Associations) function in Uganda

with a formal financial institution. The main purpose for this saving is to meet basic household needs; emergencies, including medical emergencies, and for school fees²⁶⁹. Saving was more than twice as important to Ugandans than borrowing, with only 33% borrowing in some form. Of those, 54% of them choose to borrow from friends and family or retailers. Even those who have access to microfinance, may not have access to other financial services their small businesses need. For example, women entrepreneurs have access to small, short term loans but not to larger, longer term loans to significantly expand their businesses. Women also face a clear gender bias in access to formal sector credit receiving only 9% of all available credit and 1% in rural areas (Ellis *et al* 2006 p.45). The FinScope study also found that 62% of adults over 18yrs are “unserved”, or excluded from any form of financial service which rises to 79% when only formal and semi-formal access is counted. (Johnson and Nino-Zarazua, 2009 p.11). At face value this seems to be very high levels of exclusion, but Uganda’s is considered to be a success in microfinance donor circles (Ledgerwood and White 2006). These findings about the importance of saving and also the limited access, correspond with the public data on the performance of microfinance organizations presented in Table 10 below.

In the ten years since donors started funding microfinance in Uganda, MF NGOs, MDIs and Centenary Bank have grown to approximately 310,000 borrowers outstanding. That does not include borrowers in SACCOs and VSLAs - also supported by donors - who have loans which are not publicly recorded. However, what is much more significant, is that this is just a third of the number of savers. Nearly a million people excluded by banks have a safe place to save. When the approximate number of savers under UCUSU and VSLAs are added the total, micro-savers increase to approximately 1.71 million. That means approximately 5.6% of the population not served by banks had a safe place to save. This equates (very) approximately to 15 percent of the economically active population in 2007²⁷⁰ (International Labour Organization 1998- 2012))²⁷¹. The importance of savings is consistent across many different types of financial service providers and the different market niches this is the hallmark of the Ugandan microfinance market. It is important to note, however, that the expansion of savings services by the MDIs is significantly less than originally projected in the planning for the MDI Act. This is because the MDI regulations imposed huge additional costs on the transforming NGOs which stopped expansion. These costs included meeting bank standards for security and IT etc. and also prohibited intermediation of savings which imposed huge financing costs.

²⁶⁹ Pelrine & Kabatalya (2005) also found these three were the main reasons people gave for saving.

²⁷⁰ The Ugandan Labour Force Survey used by the ILO and by Ugandan Government publications was dated 2003, so there are not accurate numbers for 2007. Its estimate of for 2003 was that 38% of the population was economically active, which, assuming approximately consistent percentages, would equate to 11.529 million in 2007.

²⁷¹ To improve the quality of data on financial access Finscope has been undertaking household surveys in selected African countries to assess the extent of financial service usage. In Uganda the 2006 Finscope found: 18% use formal services; 3% use semi-formal and 17% informal. (Johnson and Nino-Zarazua 2009) The 5.6% of the population as micro-savers estimated here would include the 3% semi-formal plus some of the formal service that focus on low income clients.

Table 10 Key indicators for Ugandan microfinance, 31 December 2007

2007	Number of Borrowers	Avg. Loan size % of GNI/ Capita	Number of Savers	% Women	PAR > 30 days	Yield on Portfolio	ROA	Portfolio USD '000
Centenary Rural Developmt. Bank	81,346	378%	391,577	<20%	1.72	39%	5.4%	113,855
PRIDE MDI 2008 numbers	60,589	89%	148,634	41%	1.9%	50%	n/a	22,739
FINCA Uganda MDI	45,313	59%	36,019	74%	3.6%	68.6%	4.7%	9,939
BRAC Uganda NGO	37,543	34%	37,543 ²⁷²	100%	0%	47.4%	3.4%	4,717
UML / Equity Bank	29,604	221.5%	54,679	48%	3.4%	53.3%	5.4%	24,263
Finance Trust MDI	16,908	148.6%	86,185	70%	4.17%	56.7%	2.8%	9,298
Opportunity Uganda NBFi	16,885	88.4%	18,370	38%	1.6%	54.7%	3.2%	5,519
Hofokam	12,202	41.8%	0	n/a	n/a	49.1%	-0.4%	1,887
MED-Net NGO	3,771	66%	3,771	73%	7.2%	22.5%	-85.1%	921
Ugafode NGO	7,670	96.2%	0	51%	7.3%	n/a	n/a	2,730
Total	311,831		776,778					
UCSCU estimate			806,000					
Est. Savers			1,582,778					
CARE VSLA estimate.			127,000	70%				
Total Estimated Savers			1,709,778					

Key: Highlighted cells indicate the best performers in that category for reaching low income
Sources: MIX Market, 2011, Werikhe 2008, CARE Uganda 2007

MDIs, Centenary and BRAC have strong financial performance with positive ROAs ranging from 2.8% to 55.4% showing that the leading providers are sustainably serving poor clients. In microfinance the PAR is the best indicator of whether a lender knows how to make good loans that get paid back. PARs after 30 days higher than 5% indicate serious problems. The difference in performance between the few top MFIs and others is best indicated in their PARs. Furthermore, high yields on portfolios but not high ROA (as is the case for the struggling MFIs) typically indicates that efficiency needs improving. Wholesale lending funds are available from funders like Stromme, SUFFICE and AfDB – but there are now few strong MF NGOs and SACCOs able to

²⁷² BRAC did not report savers to the Mix Market (2011) for 2007 but did report amount of deposits in 2007 and number of savers in 2006 and 2008. In both 2006 and 2008 the number of depositors was exactly the same as borrowers so I assumed it was the same for 2007.

manage it (MSCL 2007). As one long-time practitioner noted “microfinance has become a banking business for the poor” as previously soft-hearted donors have become hard headed investors (Okaulo 2006). BRAC NGO is now the largest of any NGO in Uganda and it has differentiated itself by using a low cost approach to microfinance, (using local transport not 4WDs) and focusing on rural women who have showed a significant unmet demand for financial services.

Like the performance indicators, the average loan sizes in Table 10 above also show a wide range from BRAC’s 34% of GNI to UMU’s 222% of GNI. This reflects the different niches each operates in from rural women to urban micro and small businesses – although all clients are excluded from the formal sector banks. As discussed above, for those living in rural poverty, access to a safe place to save and small loans has enhanced the mechanisms they have traditionally used to smooth consumption.

But, looking at the lists of top MFIs over the past ten years there are some notable ones missing from this 2007 list due to fraud. FOCCAS is no longer there – it was liquidated due to a network of corrupt Chief Executive Officer (CEO), loan officers and even bank clerk. MED-Net’s numbers of clients have plummeted due to the removal of fraudulent “ghost” clients which corrupt loan officers had fabricated. The Support Organisation for Micro Enterprise Development (SOMED) has also collapsed due to the CEO leaving, taking substantial funds out of the NGO and not being found. In addition Wright and Rippey (2003) report that SACCOs (under UCUSCU) were frequently losing members’ money and the smaller MF NGOs were struggling with adequate information systems and fraud was not uncommon (Goodwin-Groen 2007). Transparency is not the norm in Ugandan microfinance which has left the sector open to fraud.. Nearly all MF NGOS and MDIs are members of AMFIU, whose goal is to serve its members (AMFIU 2008) It played an important role in getting the MDI Act passed but it has proved ineffective in improving transparency in the sector.

The BoU had responsibility for supervising the four MDIs along with the banks. But as of December 2007 there was no effective supervision of Tier 4 NGOs even though the parliament had asked for Tier 4 regulation in 2004 when it passed the MDI Act. The MDIs were each successfully managing portfolios of between USD 9 million and USD 24 million. The loans are from socially responsible microfinance and investment funds and include Hivos – Triodos and Triodos – Doen, Overseas Private Investment Corporation (OPIC), Netherlands Organization for International Assistance (NOVIB), AfriCap and Kiva. With the MDIs having similar regulations to banks, and the BoU recently licensing several new banks, there is increasing competition between MDIs and Banks. This has put added pressure on MDIs costs since they are not allowed to intermediate savings and have to borrow more expensive funds to lend. Partly to respond to this competition UML looked for a bank partner and was glad to merge with Equity Bank of Kenya which is also committed to low income, formerly excluded, clients. However, the banks’ high interest margins mean that competition has not yet brought down those interest rates margins (Okidi *et al* 2007) and there is still limited access to credit especially in rural areas.

8.10 Conclusion

This chapter started as the influx of donor funding for NGO microfinance was beginning in 1997. Ten years later the types of microfinance organizations had changed significantly, but their services were still in great demand. By 2007 two new forms of microfinance providers were dominating Ugandan microfinance, Micro-Deposit taking Institutions (MDIs) and VSLAs, and the number of SACCOs was also increasing. There were four regulated and supervised MDIs which, together with a regulated commercial bank, were the leading formal sector providers of safe places for poor people to save, together reaching over 700,000 clients. The sustainability of microfinance as a business had been proved to a sceptical financial sector. At the opposite end of the poverty spectrum VSLAs, village based (mostly) women's savings groups, were not even registered, but were meeting the financial service needs of over a hundred thousand of the rural poor. The Government's major effort was underway to provide rural Ugandans with access to financial services under its "Prosperity for All" programme, so SACCOs were being rapidly set up across the country. The growth and diversity of microfinance service providers in Uganda from formal to semi-formal to informal, is a very positive story.

This positive story is important to draw attention to in a context where it is easy to focus on the fraud in NGO and SACCO microfinance, corruption more generally in the political sphere and how much more the sector could have grown. Furthermore as Tier 4 organizations are still not supervised there remains the danger of low-income clients continuing to lose their savings in semi-formal organizations. The next and final chapter of the Ugandan trilogy will explicate the micro-ethnographic findings about the institutional functions which provided the foundation for this expansion of the microfinance market.

Chapter 9: Uganda: Institutional Analysis of the Microfinance Market 1997- 2007

This chapter provides an institutional analysis of the development of the microcredit market in Uganda based on the micro-ethnographic research findings. It is the third in the set of Uganda chapters and builds on Chapter 7 and 8. Chapter 7 presented the political and economic context for the institutional development of the Ugandan microfinance market and particularly its social norms, prior to Museveni's Presidency. Chapter 8 reported on the milestones in the development of the financial and microfinance markets, as Uganda tried to bring rigor to the formal sector and respond to the strong demand for microfinance. The new Micro Deposit-taking Institutions were profitable, had performed well and gained the trust of international lenders. They had not expanded as fast as hoped, but still dominated the sector. VSLAs numbers were growing, as were SACCOS with the support of the Government, and there were many small microfinance NGOs too. This diversity of providers was an achievement. However, without Tier 4 regulation there was a lack of transparency and accountability for the non-MDIs, and there had been cases of fraud. Chapter 9 now provides the findings of the micro-ethnographic research with microfinance stakeholders on the institutional foundations of the microfinance market, including the social norms, to answer the research questions: How have rules and norms in the Ugandan financial market changed between 1997 and 2007 to enable increased delivery of financial services to poor people? What has the role of development agents been in catalyzing this change?

This chapter starts with the constitutional institutional functions in Williamson's (2000) framework, because that is where respondents started. It moves on to the operational institutional functions for the expansion of microcredit and then the social norms which provided the foundation for all the others. The social norms then, in turn, became embedded in the new institutional functions. Finally, the chapter concludes with a deeper examination of the institutional changes that took place during this time.

9.1 Constitutional institutions - building blocks for microfinance market²⁷³

Institutional development for microfinance in Uganda was in a state of flux between 1997 and 2007 and respondents did not differentiate between types of building blocks for the sector. However, it was these constitutional or formal rules that respondents typically thought of first when asked about the building blocks for financial market expansion to the poor and how they have changed. Table 11 below outlines the form and enforcement mechanism, and its intended functions as understood by respondents, which are then subsequently discussed in detail, including the relationship with the social norms and the effectiveness of the enforcement.

²⁷³ These are Williamson's Level 2 institutions

Table 11 Constitutional institutions - building blocks of Ugandan microfinance market

Form	Functions	Comments
1. The MDI Act (2003) of Parliament – enforced by law and the BoU	<ul style="list-style-type: none"> officially include poor people in the formal sector; provide safe access to savings services for poor people due to BoU oversight; give MF NGOs that transformed into MDIs access to commercial financing. 	<ul style="list-style-type: none"> All these functions were fulfilled by the Act
2. Stable Liberalized Policies and Rule of Law - enforced by legal and political system	<ul style="list-style-type: none"> stability for investors – stable inflation & stable policies freedom on interest rate setting; security in rural areas provision of basic infrastructure 	<ul style="list-style-type: none"> Stability for investors compromised by some corrupt officials
3. An Independent Central Bank and Bank Supervisor - the BoU	<ul style="list-style-type: none"> provide financial sector stability and confidence to investors risk based supervision and clear management guidelines enforcement of banking standards 	<ul style="list-style-type: none"> BoU perceived to be rigorous and fulfilling functions effectively
4. Kampala commercial court	<ul style="list-style-type: none"> contract enforcement for commercial contracts in Kampala (not for criminal cases) 	<ul style="list-style-type: none"> perceived to be quick and effective enforcement
5. Land Registry - not effectively enforced	<ul style="list-style-type: none"> register of land owners and land users for specific purposes including as collateral for loans functional exchange of title – this is most easily undertaken for condominiums 	<ul style="list-style-type: none"> functions of land registry - missing function of condominium title exchange fulfilled

9.1.1 Micro Finance Deposit-taking Institutions (MDI) Act

By far the most important formal building block within this timeframe to every type of respondent was the Micro Finance Deposit-Taking Institutions (MDI) Act, known as the MDI Bill passed by Parliament in 2003. It formalized microfinance as part of the financial system. The MDI Bill was the key formal building block that all types of respondents identified as contributing to the building the sector. Recognition of the importance of the bill was unanimous, even though there was ambivalence about the subsequent regulations which enforced the Bill. It would take Parliament to change this act which was gazetted on 2 May 2003. According to respondents, the MDI bill fulfilled several functions. It:

- officially included poor people in the formal sector;
- provided safe access to savings services for poor people due to BoU oversight and;
- gave MFNGOs that transformed into MDIs access to commercial financing.²⁷⁴

²⁷⁴ This focus on the MDI Act must be seen in the context of a legal framework that did not enable the expansion of microfinance. The options were either NGO or Coop or Company. There was no option for something like VSLAs which are a semi-legal hybrid. The SACCO law was designed for producer coops not financial coops and was not indigenous either. The producer coops failed because of lack of accountability and lack of skills and this was the law that was supposed to work for FIs. (PS3)

Respondents agreed that in addition to the MDI Bill formalizing poor people's savings, it also recognized that microfinance needs to be prudently managed and controlled and that formalization and regulation is a good thing. The Bill (and the subsequent regulation) forced the leading NGOs to make changes to improve their strength. There is much more transparency in MDI operations and they are financially stronger than the other Tier 4 NGOs. It improved their ability to serve their customers and their financial viability (F5). From an MDI's perspective "becoming an MDI showed we were a more serious organization to our clients. We have been able to intermedicate our clients savings and provide money transfers since 2004" (MDI2). Banks also understood the role of the MDI to 'mop up' the savings where they cannot go and they get more out of the relationship (MDI4). The conclusion was that everyone benefited from the MDI Bill: the BoU had oversight; the clients had better products and; the MDIs had more capital (PS2)

The passing of the MDI bill was underpinned by the social norm of the importance of saving in Ugandan community life as identified in the previous two chapters and discussed below. Three other of the social norms identified by respondents that undergirded the importance given to supervision of poor people's savings was the recognition of pervasive corruption, the agreed role of the government to regulate financial services, as well as a lack of trust in banking sector. MFNGOs were managing millions of shillings of poor people's savings and they needed to have rigorous oversight. These are a powerful set of norms as the foundation for this formal institution. But this is a static analysis – it needs to be complemented by an understanding of the dynamic processes that also led to these rules which will be discussed under change processes below.

9.1.2 Stable, liberalized policies and rule of law²⁷⁵

Those respondents who remembered Uganda's political instability before Museveni and the NRM Government were keen to point out that the building blocks of the financial market in Uganda were dependent on a stable government, liberalized policies on interest rates and the rule of law – meaning that the country was safe for investors both financially and physically. They understood that instability resulted in high inflation and high risks, and had seriously detrimentally affected investment in Uganda in the past. Due to the government's policies the economy is stable and growing, which gives investors confidence to enter the market. (B1, MDI3) 'Investors need stability to be able to invest' (GO1) 'The Private Sector Investment Promotion Authority has conducted a significant marketing campaign to show Uganda has minimal risk for investors and the government is trying to cut red tape for investors. This is important for banks that are very conservative' (F6).

For the MDIs and MFNGOs the most important general functions of the stable government and liberal policies were: freedom on interest rate setting; provision of basic infrastructure and ensuring security in rural areas. On interest rates, "we were able to charge within acceptable norms. As we increase efficiency the rates go down. If rates were controlled in any way then MFIs would not have been able to grow. (MDI2). On infrastructure, 'the physical infrastructure

²⁷⁵ As one funder commented – the government may be fundamentally corrupt but it is stable and that is what matters more to investors in the financial sector. (F5)

including roads, electricity and mobile phones are all important to expansion of services' (PS2, MDI2). On security, 'security has been very good. Even though we had money going to the banks and being paid, in seven years there was only one incident of our van being attacked (MDI3). This physical security is enforced by the power of the armed forces and is welcomed by the older generation who remember the violence of the past.

There is a close connection between the importance of the government providing stability and basic infrastructure services, with the norm of the role of government to support expansion of financial access discussed below.

9.1.3 Central bank and competent supervision

There was also a general recognition that for the banking sector to effectively perform its functions within the Ugandan economy it needs a strong and independent central bank – the Bank of Uganda. Even MFNGOs that work with the lowest income groups identified the importance of the strong Independent Central Bank which provided oversight of the banking sector. The most important function it performed for microfinance was to provide confidence to investors in the sector in the way it regulated the sector (MDI3). There is risk based supervision and clear management guidelines which are enforced and leads to confidence in the sector. (GO1). There was respect for the Governor - 'The Governor is strong and set the standards and everyone follows, without him there would be a problem' (F6). But there were divergent opinions in the banking sector about whether the BoU had been too strict in the overarching 2004 FIA (B6, PS3, B3, B2). Even this debate however, indicates that the BoU effectively enforces its power. There appears to be a close connection between this recognition of the need for a strong, independent central bank and the norms discussed below of lack of trust in the banking system due to the history of banks and the prevalence of corruption in the government.

9.1.4. Commercial court and land registry

Those banks, MDIs, MFNGOs and money lenders that take some form of collateral, considered the Kampala commercial court an important building block because it effectively performs the function of contract enforcement. It can settle financial and smaller cases quickly and transparently' (GO5). 'It has a lot of flexibility to interpret the rules', 'they look for ways to solve problems and in most cases that is out of court' (PS7) 'It is possible to get a judgment in 60 days.' in the commercial court, whereas the criminal court can take forever (PS10) It is very important – but it is overwhelmed with hundreds of cases and only 3 – 4 judges (B6). However, the MDIs, MFNGOs and banks that operate in rural areas, do not use the Kampala commercial court, so did not consider it important. With the prevalence of corruption, to have this court as much more effective enforcer of rules than the rest of the judicial system, was important to respondents

The Land Registry is considered a "museum" (B6), however land title was still the best security available. The registry only minimally performed the function of collateral registration. Although

it has legal status, banks and MDIs acknowledged that when it is community or hereditary land they cannot liquidate the collateral²⁷⁶ so there is no effective enforcement. But for clients to give the bank title, even if it is community held land it indicates their willingness to pay back the loan and there is a potential of taking them to court to attempt to enforce the collateral. Even money lenders take land title (MDI4) which shows that it has some real enforcement effect. But MF NGOs did not consider this important.

9.2 Operational Institutions – building blocks for the microfinance market ²⁷⁷

Ostrom (1990) and Williamson (2000) theorize that in addition to the constitutional or formal ‘rules of the game’, there are more specific operational institutions for different sectors which determine ‘how the game is played’. For example, the MDI Act is clearly a formal rule which needs an Act of Parliament to change, whereas the MDI Regulations are about how the MDI ‘game’ is played and after an appropriate process, these rules can be changed by the BoU.. However, institutional development for microfinance in Uganda was in a state of flux between 1997 and 2007 and respondents did not differentiate between types of rules that applied to the sector which is not surprising since institutions are “nested” (Ostrom 2005a). So it was the task of the researcher to analyze the data to see if any common categories or patterns were revealed using an inductive iterative process. Table 12 below summarizes the institutional forms respondents identified which focused on the operations of the microfinance sector.

The MDI regulations generally were noted by all respondents, whereas the specific rules were discussed by MDIs, banks and the private sector that operated under the regulations. The respondents from NGOs or government were more aware of the challenges of Tier 4 providers and tended to provide more detailed comments on what was missing in terms of specific incentives for the development of the microfinance sector as described below. During the iterative process of categorizing respondents’ observations, it became obvious respondents had also differentiated between the form and function so this is also outlined below. The frameworks for government action, such as the Microfinance Outreach Plan (MoFPED 2003) and “Bona Bagagawale” (Akandwanaho, 2006) are not included because there were no rules with enforcement mechanisms, so did not fit North’s definition of institutions. Those building blocks with ineffective enforcement mechanisms and the “missing” building blocks were, however, included because respondents identified their significance.

²⁷⁶ There is a World Bank sponsored project to ‘rationalize’ land title but because there are complex norms about different types of rights to community owned land it is a volatile political process.

²⁷⁷ These are Williamson’s Level 3 institutions.

Table 12 Operational Institutions – building blocks of Ugandan microfinance market

Forms	Intended Functions for the Form	Comments
<p>1. MDI Regulations - enforced by the Competent Banking Supervisor - the BoU</p> <p>IAS Compliant Financial Statements required for Banks, MDIs</p>	<ul style="list-style-type: none"> • To manage the risk of bringing low income people’s savings into the formal sector • To bring significant numbers of more low income people’s savings into the formal sector • Setting standards for governance, performance and public financial reporting (transparency), high enough to encourage equity investors to the country bringing more capital and technical capacity • Registering financial institutions that meet standards • Enforcing performance standards, including sanctioning non-performers. • Ensuring competition in the market to improve client services. • Internationally standardized independent information about financial performance • Transparent and comparable information • Consistent reports on financial performance over time to track trends 	<ul style="list-style-type: none"> • Five of the six functions have been achieved. • The one that has not been achieved is bringing significant numbers of low-income people’s savings into the formal sector. • All these functions were achieved
<p>2. Foreign investors and smaller banks allowed enforced by BoU</p>	<ul style="list-style-type: none"> • encourage expansion of the sector (by increasing competition) 	<ul style="list-style-type: none"> • competition between banks is increasing but MDIs are unable to compete effectively
<p>3. Car registry – enforced by courts</p>	<ul style="list-style-type: none"> • Non-land collateral for loans • Standard information about collateral taken by lenders • Public information about to whom collateral has been pledged e.g. cars/trucks 	<ul style="list-style-type: none"> • Functions achieved but only relevant for clients who have cars
<p>4. Microfinance Funders’ standards – no enforcement mechanism</p>	<ul style="list-style-type: none"> • To ensure MF NGO’s met performance standards by making funding performance based. (The funders did not act as a group for the benefit of the sector so this function was not achieved.) 	<ul style="list-style-type: none"> • Most funders goals were spending money, not building a sustainable sector.
<p>5. Rating agency – no enforcement mechanism</p>	<ul style="list-style-type: none"> • Independent high quality assessor of the governance and financial performance of MFI / Bank/ NGO for a fee • Results respected by investors and funders 	<ul style="list-style-type: none"> • Without enforcement it could not achieve its function.
<p>Missing - effective Tier 4 regulation and support for the development of the sector</p>	<ul style="list-style-type: none"> • None of the functions needed for the prudent development of Tier 4 were in place. Including: no formal performance standards for registering or maintaining registration, only transparency required is submitting financial statements (unlike for MDIs they are not IAS compliant, not public etc.) and no effective accountability to members or the boards. • No govt. organization had a clear mandate and resources for capacity building for the sector. 	<ul style="list-style-type: none"> • Without effective Tier 4 regulation it leaves the sector open to mismanagement of funds and fraud • Without any support for the sector it will not grow

Missing – a formal credit registry until 2007 (or informal sharing of bad clients)	<ul style="list-style-type: none"> • no standardize information about borrowers, from a complete range of lenders, • no information about bill paying from a complete range of utility companies, • no way to identify and share information about bad clients 	
Missing - a national ID system	<ul style="list-style-type: none"> • no standardized information about all clients, • no government verification of identity, • no ability to use ID number to cross check information with other data sources 	<ul style="list-style-type: none"> • In 2008 the BoU started giving each new client an individual ID and to set up a credit registry

9.2.1 MDI regulations

The MDI regulations are very similar to the bank regulations in the 2004 Financial Institutions Act and, apply to all MDIs and banks making small loans and (B5). There was considerable division regarding the effectiveness of the regulations in building the microfinance sector. According to respondents who participated in the preparation of both the MDI Bill and regulations, the original functions intended for the MDI regulations were to:

- a. register MDIs that meet appropriate performance standards and ensure they keep those standards (and keep the number of MDIs to a manageable level for the BoU (MFNGO6) because they cannot regulate what they cannot supervise (F2)
- b. safely manage low income people’s savings (MFNGO2)
- c. safely bring significant numbers of low income people’s savings into the formal sector (GO5)
- d. enforce standards that would encourage equity investors to the country bringing more capital and technical capacity (GO1).
- e. ensure competition in the market to improve client services, without saturation (GO5)

There was recognition by many of the importance of the MDI Regulations in providing financial accountability to the government and professionalizing the sector. It provided a stark contrast to the accountability of SACCOs and NGOs. In particular, requiring IAS compliant financial statements which should be published in the newspaper was seen as very important. They provided internationally standardized financial performance information, which is transparent and comparable, conducted by an independent and recognized auditor, and provides consistent reports over time to track trends.

But - there were also many negative comments about the regulations not being appropriate for building the market for financial services for the poor. Examples noted by respondents included: (MDI3, GO5)

- Requirement to treat client deposits required for access to loans as ‘cash collateral’ which cannot be intermediated. Only voluntary deposits can be intermediated. Respondents considered this not only a breach of promise made by the BoU, not only denying them access to funds for growth but doing so in the name of risk management when the SACCOs could lend savings with no oversight.

- High provisioning for micro loans – 100% after 90 days (which is much higher than was common practice) Even Centenary Bank found this very strict because their experience is that small loans do get paid back, even if they are late. This regulation originated in other countries and cultures and is not appropriate for Uganda.
- Requirement to have guards for cash in transit. Before they became MDIs, NGOs had moved a lot of cash from rural branches and never had guards and never had trouble. This was appropriate for banks in cities not NGOs in rural areas.
- Requirement to have offices on the ground floor like banks. Many NGOs before becoming MDIs has offices in much less expensive locations such as the third floor which was not a problem for clients. In addition, mobile branches are not permitted unless all the formal transactions savings and deposits are recorded at the branch.
- Requirement to buy generators for every office so that when there is no power we can open every day! Again for MDIs with many branches in rural areas this is very expensive and not necessary.
- Requirement to report every Monday on the Friday closing. This means that MDIs have to send people from up country with zip disks over the W/E to get to the city for Monday!
- Requirement to have a dedicated customer care officer and dedicated cashier at every branch. This is clearly not necessary for the small rural branches and increases costs.

The BoU chose to be risk averse by treating client deposits required for access to loans as ‘cash collateral’ which cannot be intermediated and many of the other MDI regulations are almost the same as banking regulations and are strictly enforced. “The BoU is very tough” (MDI1) Respondent across the market from government officials to MDIs to NGOs agreed that by making the regulations very tight they achieved all of the intended functions but one – to bring hundreds of thousands more low income people’s savings into the formal sector (GO1, MDI1, MDI3 MFNGO2 MFNGO6, PS 3, PS 5). By not allowing the best providers of microfinance to intermediate their savings and forcing compliance with the regulations above MDIs costs rapidly increased. These increased costs have meant that MDIs have not been able to expand as projected. Furthermore, they are structured like banks so compete directly with the banks and report having their good staff poached by banks (MDI3, PS5). “[T]he key lesson from Uganda’s experience with microfinance regulation is that prudential regulation should not be expected to automatically result in greater outreach and more advantages for poor people” is what a DFID study found (Friends Consult 2007b. p.46). Many respondents had reflected a similar opinion. By 2008, two of the original MDIs, CMF and UMU, have merged with banks. They could see no future as MDIs which is why some respondents said the regulations have ‘killed’ microfinance in Uganda. (PS5, MDI3)

Respondents recognized that the BoU was reacting to the earlier banking collapses and wanted a “no risk” approach to regulation (PS3, B5). The BoU would have gone against common mistrust of banks and concern over corruption discussed below, if they had allowed this new form of quasi-bank greater leniency compared to the rest of the banking sector; they would have gone against the commonly recognized mandate of the government to carefully regulate the sector. Finally, there was also the issue of what the BoU could effectively supervise using its current approach. Supervising microfinance was a totally new exercise and they had to keep the number of MDIs

low to learn about the sector if they were to have effective supervision (GO1). If many MFNGOs were able to transform to MDIs then the BoU would not have had the capacity to supervise them effectively and enforce the regulations, thus jeopardizing the credibility of the sector.

9.2.2 Foreign banks

Respondents noted two other BoU operational rules and enforcement mechanisms that have resulted in the expansion of the sector. First, liberalization in the 1990s allowed smaller banks into the market such as Nile, Orient, Allied and Crane Bank' (MDI4). Nile Bank in particular was noted as an exceptional local bank that made a difference to the sector because it was prepared to lend money to MFNGOs. Second, the lifting of the moratorium on new foreign banks entering the market in 2006. As of 2007, seven new banks have been licensed and entered the market with lots of capital to establish branches, do marketing and pay staff. With the sudden influx of new banks in addition to the MDIs, the established banks also expanded fast to beat the competition. All are pushing further into the formerly unbanked market with new branches and new products being offered (B6, GO5). The MFNGOs are moving further into rural areas where the MDIs and banks cannot compete (F3). For example, in 2008 'the banks were competing with loans as low as \$15,000 – because they have learnt that the 'unbanked' are not 'unbankable' any more (N1) 'Their focus was to get a return for international shareholders, so expanding access is happening, but is not their primary goal (N3). This was great for clients who need better services– e.g. an ATM close by (B1). (See Annex 3 for a discussion of this competition)

9.2.3 Car registry

A car registry provides the function of registering cars and trucks as mobile collateral, so they can be taken as collateral by lenders. Standard information about the collateral is taken by lenders and it is public information to whom collateral has been pledged e.g. cars/trucks. Respondents with clients who could afford cars or trucks found this to be a useful form that enabled the function of recognizing transferable collateral. For the microfinance market this was unusual.

9.2.4 Funders' failure to set performance standards

In the late 90s "there was a "torrential rain of donor funding" (PS2) for MFNGOs. There were few incentives to improve performance or get commercial financing (PS7). Each funder had a pot of money that they had to spend, but they did not understand microfinance and were not focused on building viable MFNGOs (PS3). As a result, during this time, many funders gave money to MFNGOS for lending and paid all their costs, and typically did not require that they meet performance indicators for sustainability. They did not hold people to account for the funds (PS6). The focus was on numbers of loans disbursed (particularly to women) and sometimes repayment rates. Donors were giving capacity building for things that looked good, like motor bikes, but which did not build sustainability (PS3). Donors even gave grants to MFIs that were already

receiving grants from other donors for the same activity (F3)²⁷⁸. Eventually, a few funders started to maintain close financial oversight and provided technical capacity building for a few top tier MF NGOs e.g. USAID's SPEED project in 2001.²⁷⁹ But a focus on sustainability was hard for MF NGOs that had been awash with funds" (PS3),

In 2001 the microfinance funders group recognized that some MFNGOs were not transparent about their multiple sources of funding (F3). So the funders developed the Donor Principles for Support to Uganda's Microfinance Sector (Uganda Donors 2001). Donors had quarterly meetings to coordinate their actions, but there was no enforcement mechanism for the donor principles. The donor culture in Uganda was to spend money so any action that might prevent spending targets would not be embraced, so they failed to improve performance. Furthermore, there was no standard reporting, with each funder requiring individual reporting in its own reporting format that was no consistent with good practice in microfinance . In March 2003 the PMT was agreed by the funders to be managed by AMFIU (Duval 2003) but, because the data was self-reported and accuracy was never enforced, it again did nothing to improve the performance of the sector. In the worst cases, it gave a veneer of credibility to reports that were falsified.

Furthermore, the establishment of an independent high quality rating agency which can assess the governance and financial performance of MDI or Microfinance NGO (MFNGO) for a fee was thought by donors to be an important building block for the sector as it is in more developed financial markets. So a microfinance rating agency was supported by funders and their rating reports were respected by investors and funders. But, unlike the reports of rating agencies in developed financial markets, there was no enforcement mechanism. Rating agencies could report a negative rating and the MFNGO would still get funding. Funders were not prepared to make decisions based on the rating agency's assessment, so without that enforcement, it was unable to fulfil its function.

9.2.5 Credit Registry and Tier 4 regulation.

It was not until 2007 that the BoU initially approved the establishment of a credit registry using biometric data, because there is no national ID system for lenders of any kind to ascertain if people are who they say they are. The functions a credit registry will perform include: standardized information about each individual or company borrower; information about payment performance of borrowers from a complete range of lenders and utility companies; and sharing information about bad clients. Because there is no national ID system a credit registry is all the

²⁷⁸ For example, the first USAID project, PRESTO, just gave funding to people who had completed training – they did not require them to meet performance standards. NORAD required performance of PRIDE in maximizing outreach – so they expanded very quickly but not cost-effectively. NOVIB provided a long term consultant to UWFT but her fees were not accounted for on UWFT's books and there were no performance standards that UWFT was required to reach using her input. EC SUFFICE I and II gave grants with simply a report on expenditure required.

²⁷⁹ SPEED provided substantial training and international technical inputs in the areas including liquidity management, asset and liability management, market research and product development, ownership and governance, internal controls, and information systems (Goodwin-Groen *et al* 2004 p. 15)

more important, as lenders reported borrowers establishing multiple identities and not being able to cross check potential clients' identity with any government authority.

Respondents contrasted the tight regulation of MDIs with the lack of serious regulation for SACCOs and MFNGOs, but which, in total, served many more people and their savings. The Parliament had asked to be sent a Tier 4 Bill within six months of the MDI Bill but by 2008 this had still not happened.(GO6). The functions and enforcement mechanisms, which respondents considered missing for SACCOs and NGOs included:

- registering only those SACCOs and NGOs that meet appropriate performance standards
- enforcing performance standards by de-registering those that do not perform so there is clear accountability
- in particular, safely managing low income people's savings (i.e. not allowing them to be mismanaged) and
- ensuring competition in the market to improve client services, without saturation.

With no standards being enforced, the SACCOs' and MFNGOs' lack of capacity did not become apparent to the rest of the sector until there were severe problems. In 2004 the 'strongest' MFNGOs attempted to transform themselves into MDIs but needed massive amounts of technical assistance. It cost a astonishing USD 4.7 million to convert four MF NGOs to MDIs (GO1, MFNGO10). The lack of skilled capacity also became apparent in the cases of fraud discussed above which happened in 2006 and 2007 and there were regular unconfirmed reports of SACCO mismanagement. Lack of skilled human resources at the Board and Management level was the most frequently mentioned need for capacity building (F4, N5, N1, MFNGO6, PS5, PS3 etc.). There was a Capacity Building Committee under the Microfinance Outreach Plan but there it was not clear who was responsible for building the capacity of the whole sector and reducing fraud. (One of the lead funders had a large capacity building fund but it only supplied hardware, such as motorcycles, not technical rigor, and the manager was found to be corrupt.) It was apparent that (after PRESTO closed), neither funders nor the government were taking effective steps to set up and enforce performance standards or build the capacity of the sector.

9.3 Social norms – building blocks for the microfinance market

This section will explore the (until now), largely unexplored (Granovetter 2005) social norms which were the building blocks for microfinance in Uganda. Respondents referred to traditions, or common attitudes across communities which supported the provision of financial services or that hindered or undermined market development. The researcher followed up by asking how each of these norms worked and if they had changed at all over the past ten years. These issues arose much more in discussion with practitioners (MFNGOs, MDIs, and Banks) who work closely with clients, than government officials. The term 'everyday life' norms will be used, (as in the Bosnia chapter), because they were described as part of everyday life regardless of background or status, as long as people can remember. No value judgments were being made about the culture or society; this was simply an analysis of the development of the sector. The NVivo analysis of the

respondents' descriptions clustered around six 'everyday life' norms²⁸⁰ which are part of the way people behave, regardless of community background or status. To represent particular voices I have also included a quote or incident that typifies the discussion of the norm. It is important to note that many of these social norms are directly reflected in the characteristics of the sector in 2007 as described at the end of the previous chapter and also that several of them are foundational for every one of the constitutional and operational institutions. Five of these norms were specifically identified as underpinning formal and operational 'building blocks' and the first provides more general support for the development of microfinance in Uganda.

9.3.1 Economically active women

MF NGOs reported that across Uganda women are involved in economic activity outside the home, they have some mobility and some control over their own limited resources. However, even though women are economically active, they are still expected by the husbands and community to balance their economic life with social and family commitments. There are social practices which 'enforce' women to balance economic activity and family commitments. In rural communities, it is typically women who make the money and men who spend it (B6, PS5). But even though women do much of the farming²⁸¹ they rarely have land title which they could use as collateral and the majority are poor and/or illiterate, so they are not able to access credit from formal providers, even MDIs. An irony was noted – that although women find it very hard to get loans from the formal sector because of collateral and poverty issues, they pay back their loans better than men (GO1, B1) and that because they also typically take smaller loans there is less risk if one defaults. Women's economic activity and the need to balance family commitments together with their exclusion from formal finance has meant that there was a natural fit for financial services targeted at these excluded women. But only one of the leading MF NGOs, BRAC maintains a policy of 100% women clients because they want to specifically serve these women. (BRAC, has the lowest portfolio at risk of all the NGOs as shown in the previous chapter.) Other MF NGOs and MDIs are finding their percentage of women clients is decreasing as they become more formal and increase their average loan size in a bid to increase efficiency (MDI4, PS5). In contrast, VSLAs target rural women and design their product to meet rural women's schedules (F3). VSLA meetings are local and are finished within 45 minutes so they are not away from their work/children for a long time, they gain both economic status and social capital. When they pay their children's school fees they are recognized by their husbands. (MFNGO5)

This norm provides an important understanding of why there is only one large NGO that focuses exclusively on women and none of the MDIs focus on women. The former Uganda Women's Finance Trust has dropped its focus on women and is now just Finance Trust (FT). (There are small women led and women focused NGOs like the renamed "Success" MFNGO but they are too small and unsustainable to be significant to the sector.). As the MDIs have had to focus on

²⁸⁰ I am sending this chapter to key respondents who offered to give feedback, to address the validity of the findings.

²⁸¹ The Board of the Iganga General Farmers Assembly has 11 people of whom 30% are women.

meeting banking regulations they have less ability to reach out to poorer and more excluded clients – namely women.

9.3.2 Saving as a Ugandan tradition

Respondents discussed the many different ways people in Uganda have traditionally saved together for a range of purposes, including burial societies, ROSCAs and gift societies (as discussed in the previous two Uganda chapters.) Typically, each member of a group commits to pay a fixed amount each week or month to the group and because of the groups' social importance and the inbuilt enforcement characteristics they keep this commitment²⁸² (PS6). Many are women's groups but men also have versions of the same group based approach to saving, such as drinking groups. One respondent told of how he and a group of his friends allocate USD 10 per week to both drinking and saving. They give it to a different leader each week who spends USD 6 of it on their drinking together and the remainder is for his family (PS2). The Governor of the Central Bank estimates that three quarters of the cash is in circulation and is being saved in ways other than the formal sector banks (MFNGO1). The culture of savings with a purpose also shows itself in a common preference for saving in chickens, cows and land. (B3) It was evident to many respondents that the importance placed on savings in Ugandan culture was one of the norms which facilitated the passage of the MDI Bill through parliament. Since everyone saves in some way for specific purposes such as school fees or larger expenditures, there was a basic understanding by politicians of the importance of saving and an awareness of the importance of protecting savers.

The importance of savings for a purpose can be seen in the performance of the microfinance market as a whole with at least double the number of savers to borrowers. Savings-based local microfinance providers built on this culture, such as the PRIDE, Uganda Women's Finance Trust, FINCA etc. which originally used a women's savings group approach and Centenary Bank which has many more savers than borrowers (B2). Many expatriate microfinance providers were not aware of the Ugandan culture of group based savings, but benefited from it when they replicated Grameen methodology using a 'forced' savings methodology (PS3, PS6). Some consider that there has been too much of a focus on credit instead of saving in Ugandan microfinance not recognizing this tradition (F2). Others argue that MF NGOs did not do enough to more closely adapt international microfinance methodologies to rural Ugandan savings practices which is what has hampered growth (PS3) and that the process to regulate savings in MDIs and SACCOs has also not properly recognized this tradition. However, the VSLAs are tapping into this culture of saving together for a purpose and saving to ensure access to lump sums in an emergency, to give them confidence to learn to manage their savings (MFNGO5).

²⁸² One participant commented that the social pressure to conform was greatest at the time of the Kabaka. There was much greater enforcement of cultural norms at that time because of the power of the Kabaka, but now there are fewer effective social enforcement mechanisms (PS10)

9.3.3 Loan repayment

Consistent with the community focus of savings, when people borrowed from each other within a community, there was a commitment to pay back, but there was not often a time frame given when the loan would be paid back. The borrower would pay when they could – there was not a schedule or deadline. Within the savings groups if people borrowed, there was a “social norm of willingness to pay” because of the cohesiveness of the group (PS6). For example, in Iganga “the norm of on-time payment in the villages is very tough to establish. Usually they will pay when they are ready and not before.” (MFNGO7). Historically, when the Kingdoms were strong, the Kabaka had a hierarchy to keep control. He appointed the village heads and if people did not keep their social commitments they were in big trouble with the village head. The social structure ostracized people who did not follow social norms (PS10).

Several respondents noted with frustration that since the rule of President Amin the norms that constrained people in financial transactions started to erode. Amin took away shops from the owners without paying and gave them to his followers. People started to expect free things without working for them. As one older former banker noted, in 1971 there was looting, then there was plenty of looting, finally there was more looting. The government removed thousands from our money in the 80s and a 30% surcharge was imposed overnight. The Ugandan people have been consistently looted and then their money made worthless by their leaders, why should they keep the social norm of paying back what you owe? (PS10) When Entandikwa and most recently Bona Bagagawale came – people thought the loans were a “thank you” for supporting the politicians– they had no intention of paying back. And the government had little ability to enforce repayment (PS10). The culture of repayment was not easy to build up, but was quickly knocked down (F2).

Since many stakeholders were aware of the erosion in the culture of paying back loans, this contributed to the desire to regulate a growing microfinance sector and was part of the BoU's desire to impose stringent regulations on MDIs to ensure that there was no opportunity for poor performance. This changing norm can be seen in that the portfolio quality of leading MFIs in Uganda is not as high as in Bosnia. To have such well established MFIs still experiencing repayment problems may reflect these changes in the society and they are having difficulty managing them.

9.3.4 Honesty and corruption

The increasing prevalence and acceptance of corruption was one of the most frequently mentioned norms that affected the development of financial services for poor people in Uganda. It is included as a norm because four well established MF NGOs have serious corruption problems that in three cases closed the organizations, as well as a regulated bank. This is not a minor trend.²⁸³

²⁸³ ADD this is how respondents saw it not: A particular concept of rationality is assumed and real societies are analysed by reference to it. Thus we develop a series of derived concepts like corruption....nepotism...secrecy and so on through which to conduct a critique\ with the implication that

Participants discussed it with a combination of sadness and resignation but also anger. Many participants explained that the existence of fraud in banking and microfinance is symptomatic of broader changes in the culture such as: cheating is OK (MDI3); prevalence of corruption in government and business (MFNGO10); an attitude of grab what you can and you won't get caught, comes from the top and has permeated the whole society. (F5)²⁸⁴. A retired banker commented that 'We have become a nation of thieves'. (PS10) According to one of the raters (PS1), corruption is able to occur because there is no culture of transparency in the Ugandan financial sector as a whole. For example, banks have resisted the Credit Reference Bureau because it will require them to disclose their customers to other banks. It will then be obvious that a person has multiple loans and is not credit worthy and so they have probably bribed loan officers to get their loans. Respondents could not identify general social enforcement mechanisms which ensure honesty (only individual values). In the words of one respondent: "There is no man that God has created that is not tempted in the face of temptation and does not need supervision" (N1); meaning that fraud is not surprising unless there are strict controls to check honesty – and those controls are rarely in place.

In the previous chapter fraud was identified as a characteristic of the microfinance market in between 1997 and 2007. The following five specific examples given by respondents of how MFNGOs have been affected by fraud, were reported as symptoms of the systemic wider social practices.

- SOMED collapsed due to the CEO's fraud. The CEO took money from the MF NGO and disappeared. He controlled too much, the board could not provide effective oversight and he could not resist the temptation (N1).
- MED-Net nearly collapsed due to loan officers' fraud, when it found it had thousands of ghost clients (N1).
- Cowe microfinance was specifically formed in 2006 to deprive clients of money. They asked people to save and then deliberately took their money. (PS2)
- FOCCAS was sent into receivership due to fraud. The Board members and Freedom from Hunger believed the CEO's reports, despite evidence to the contrary. He was a CPA and managed the auditors to report only the information he gave them. FOCCAS was well funded and the staff knew it and took a 'let's get it' attitude. They set up fictitious groups to meet the projected targets without oversight and disbursed the money to themselves. The CEO had three people from his family working in the organization, which was another form of corruption. There were also allegations that one of the bank officers colluded in the fraud by preparing false bank statements about payments received from clients. (MFNGO4).
- Likewise Development Finance Company of Uganda (DFCU) had to sack staff members because of misappropriation of Global Fund monies and Greenland Bank and the Coop Bank were all ethical failures. (MFNGO10) As one disillusioned former banker and microfinance lender said 'in Uganda, banking is an industry of fraudsters' (PS10)

they are all bad things which must be overcome as a precondition for achieving good or better governance Wood 2000 p. 222

²⁸⁴ For example it is the norm for SMEs to have three sets of books: Books for the Tax authorities; Books for Banks and Management Books. They often undertake multi-banking deliberately so no bank can see their full transactions - as well as keep cash under the mattress. (B3)

This social norm of corruption and fraud has clearly undermined the growth of the microfinance sector, both in the collapse of the MFNGOs and in the seed of the lack of trust it has sown. It was one of the broad-based underlying motivations to regulate a fast-growing microfinance sector that was clearly open to corruption. It was also behind the BoU's desire to impose stringent regulations on MDIs to ensure that there was no opportunity for corruption.

9.3.5 Limited trust in the banking system

Corruption and a litany of bank failures would have given rise to the norm of limited trust in formal banks. In addition respondents noted that low income people will not put their money in banks because it 'disappears' (MFNGO1). They think the bank "takes away our money". (MFNGO8.)²⁸⁵ Bank fees were perceived as high - with a minimum charge just to hold savings and an account admin fee and if you have no account activity for three months they close the account! (MFNGO1). These fees are the main characteristic that enforces this norm and low income clients are entirely justified in not wanting to save in formal sector banks (MFNGO5). Other reasons include:

- In the '80s the Building Societies were unregulated, had massive losses and collapsed (PS10, PS7)
- In the 90s Tefe Bank associated with the Buganda Kingdom was very popular but failed. (PS5)
- In 1999 the Coop Bank failed and it had a lot of branches up country. It left a huge clientele without services. (Centenary purchased six of its branches in the north and east and took over those clients.) (B2)
- UCB was failing and closed several of its branches before it was bought out by Stanbic in 2001 (B2).

This mistrust however does not extend to clients who have stayed with the MDIs they have known since they were struggling NGOs. They trust those institutions which are committed to serving them. The strict regulations of the 2004 Financial Institutions Act may have prevented more bank failures, but they have not resulted in reduced costs for poor clients. It will take more than short term strict regulations to gain their trust again.

9.3.6 The Government role in regulation and expanding financial access

Respondents largely believed that the Government is responsible for regulating financial services, especially in preventing further banking collapses and to take action when unscrupulous people take poor people's savings (B5). This would be consistent with the history of the banking sector discussed in the last two chapters whose foundation was a flawed colonial banking system that had serious collapses both as a result of its own ineptitude and lack of government action. It is recognized that there were weaknesses in the banking system before 2004 FIA which were mitigated by the 2004 Act (N2). Many financial sector respondents thought the BoU erred on the

²⁸⁵ This is one of the reasons for a key VSLA principle: members' money is never taken away – it is either in the box or lent out.

side of too tight regulation (PS10, PS3, B3, B2 etc.) suggesting that they should have given guides to risk management and how to prevent fraud in the banks instead of only very tight restrictions (B5). However, the social norm which appeared in these discussions is that is it the government's role to regulate the financial sector, not the banks themselves or the general population.

But, there was also an increasing belief amongst respondents, that the government should also support the expansion of access to financial services. Respondents explained that this attitude has been stimulated by a series of government initiatives in financial services outreach, which in turn has been based on the conviction within government and the society that access to finance is a 'public good' (F1). Starting in 1994 with the "Entandikwa" government loan scheme, then the Microfinance Outreach Plan in 2002 and most recently the "Bona Bagagawale" scheme in 2006 discussed in the previous chapter, the government has consistently engaged in promoting outreach of financial services. The people are saying to parliamentarians "where are the benefits of voting for you, we do not see it here?" (F2) Effectively the enforcement of this norm would be the removal of the government through democratic means, as access to finance had become part of the government's social contract with the people. The (former) Minister for Microfinance Salim Saleh put it this way: "Our people need all forms of infrastructure, roads and electricity and financial infrastructure too." He went on to say that private sector led MF has become too profit oriented and not socially oriented enough and current avenues are not reaching the poor so it is up to the government to step in (GO3)²⁸⁶.

The subtext is that the large MDIs which were NGOs serving low income clients, now look like banks and have not expanded rapidly into rural areas as expected. (The MDIs would probably agree, but it is the government's own regulations which have caused the MDIs to move in this direction.) This illustrates the tension between the government's role to both regulate and expand financial services. So the government has responded in the manner consistent with its previous efforts and as now expected. It will establish a SACCO in every sub county and each of these government sponsored SACCOs has been promised a line of credit from the government but with no regulatory oversight as yet. As a result, the rural majority now think that the government has promised to give them money (N1).^{287 288}

These six social norms were identified by respondents as providing the building blocks for the constitutional and operational institutions and are also the key to unlocking an understanding of the characteristics of the microfinance sector in Uganda. But this has been a static analysis or rather social norms change only slowly over time. So what I also examined was the processes of institutional change to find out how they built on these norms to contribute to the characteristics of the market.

²⁸⁶The commercial banks have largely been left to themselves and the BoU because they do not affect the large number of voters.

²⁸⁷ Government ministers do not like to be publicly criticized but will often change their mind if spoken to privately. However, in this context there is a very public dilemma (N1).

²⁸⁸ The inconsistency in tight regulation for the commercial financial sector and no regulation for government sponsored SACCOs is being addressed by pending Tier 4 regulation. The Parliament had asked to be sent a Tier 4 Bill within six months of the MDI Bill but by 2008, four years later, this had still not happened

9.4 Institutional change processes - MDI Bill and MDI Regulations

As discussed in chapter one Chang (2011) and others have identified that the dominant method of trying to change institutions has been institutional transfers. In Uganda there were two different processes of institutional change which led to the MDI Bill and MDI regulations. We will analyze these processes, as described by respondents, to try to understand whether either of the two frameworks is useful.

9.4.1 Institutional change process for the MDI Act

To improve the enabling environment for microfinance, there was an intense collaborative effort by microfinance stakeholders in the GoU, under the leadership of the Microfinance Forum (chaired by MoFPED). All types of microfinance funders and MFNGOs between 2001 and 2003, focused on introducing a bill in Parliament to provide oversight for poor people's savings. These groups were united in the goal of providing safe (i.e. supervised) deposit services for poor people and integrating them into the formal financial system. It came to be called the Micro Finance Deposit-Taking Institutions (MDI) Bill. The main functions of the 2003 legislation were: including poor people in the formal sector; providing safe access to savings services for poor people and access to commercial financing for MFNGOs that transformed into MDIs. The Act was a win for everyone: BoU would have oversight; clients would have better products; MDIs would have more capital (PS2)

Over those years between 2001 and 2003 there were long technical consultations between AMFIU (for the MFNGOs), donors and the BoU (managed by GTZ staff who were providing technical assistance to the BoU) as well as negotiations with parliamentarians. In 2004, participants in the process analyzed why this change process was considered highly successful by all involved (Goodwin-Groen *et al* 2004). Their conclusions were:

- A clear agreed goal shared by all microfinance stakeholders to draft a good practice MDI Act and get it passed into law. The goal was the main concern, not the timeline.
- Wide stakeholder participation with government leadership gave shared ownership: MFNGO practitioner involvement, both directly and through AMFIU was considered to be important because direct MFNGO involvement led to a broader acceptance of the final outcome. Local funder representation - DFID, EC, USAID and GTZ all had separate, independently managed projects dedicated (in part) to microfinance. The Ministry of Finance's chairmanship of the MFF gave that forum an official standing as a place for discussion and feedback where MoFPED shared its power with the stakeholders. The GoU was represented at a senior level in the MFF. The GoU was also remarkable for its level of accessibility to MFNGOs and donor agencies in this process and vice-versa. The MFF gave the BoU the authority to draft the legislation consistent with the agreed purposes (i.e. institutional functions).
- Qualified and committed participation, with champions. Stakeholders of all types had qualified staff that made collaboration a high priority. In Uganda, several donors explicitly

incorporated collaboration into the TORs of their staff and/or project staff and funds were also allocated. Key individuals were identified early on as champions of certain issues and play a key role in moving the issue forward. For example AMFIU was the champion of getting political support for the MDI Act.

- Open transparent process, without time pressure. The MFF as a collaboration mechanism had clearly understood rules of operation and decision making which was a key to success. Participants defined how the group made decisions, monitored progress and held each other accountable for results. “Donor-only” or “government-only” discussions often result in misunderstanding or miscommunication by other respondents.

Translating this process into the terminology used in the participatory development literature explored in Hickey and Mohan (eds) (2004a), the GoU, through the MFF, shared power with microfinance stakeholders, the MFNGOs and microfinance funders, so that the unjust exclusion of poor people from the formal financial sector could be addressed. Both the open structure of the GoUs consultative MFF and the agency of the MFF Chair, AMFIU President and leading funder representatives were essential to the achieve a consensus position. This participatory process was “beyond the individual and local” and “encompassed the institutional and the structural” (Hickey and Mohan 2004b, p.12). Therefore, this process overcame common critiques of participatory processes, that had become “mainstreamed” into development practice (Tandon, 2008).²⁸⁹

To use Boettke’s framework to analyze this process requires identifying how the institution was introduced and who was responsible for the content of the institution (the design). It was introduced to Parliament by Ugandan microfinance stakeholders so was indigenously introduced. The design of the Act appears to have been primarily by Ugandans (with international technical advisers) because it was clearly owned by the parliament and microfinance stakeholders. Therefore it was endogenously designed. It appears to be an example of an Indigenous Endogenous (IEN) process and so it has ‘stuck’. One respondent who had worked with donors, bankers and MF NGOs over the years put this analysis in his own words: ‘The MFF mechanism was very successful. Everyone who was involved contributed to the development of the sector. The partnership between the private sector and the government was in itself a critical building block for the sector. (PS2).

However, Mahoney and Thelen’s (2010) framework does not appear to hold for this process. A large number of stakeholders supported the Bill passing Parliament including the government, the BoU and microfinance practitioners – so in the end there was only a weak veto possibility. There was a high level of enforcement discretion by both the Parliament who passed the law and the BoU who would implement. Mahoney and Thelen therefore predict, understandably, that the outcome would be “conversion” where there is a “change in function of existing rules”. Instead

²⁸⁹ Another critique of participatory processes by Robins, Cornwall and von Lieres (2008 p. 1078) is that “the idea of participatory or deliberative democracy is profoundly middle-class in its overall conception and aspiration” thus rendering it inappropriate in many development contexts. However, in this particular context in Uganda that critique is not applicable because the participants were all educated middle-class bureaucrats or leaders of civil society organizations, who shared aspirations, they were not illiterate rural farmers.

the result was a new law with which stakeholders were largely satisfied. This raises several questions which will be explored further in the next chapter including, what is an appropriate scale and timeframe for applying Mahoney and Thelen's (2010) framework. (Perhaps this is too minor an issue and too short a timeframe?) As they referring to institutional forms not functions how does that change their analysis? Or, is it that a new law is not appropriate to use a theory that focuses on gradual change?

9.4.2 Institutional change process for the MDI Regulations

After the euphoria of the MDI Bill, there was a loss of momentum. It was not until a year later that the BoU focused on the regulations and there was a new Executive Director of Supervision. By then, the MFF was no longer functioning effectively and was not a place for engagement by stakeholders. There were new staff at MOFPED, a new head of AMFIU (who did not have the same types of relationships and skills as the previous incumbent) and many new donor representatives, (typically less skilled and not so collaborative). There was also time pressure with the major donors (GTZ/SIDA and USAID) wanting the BoU to move quickly (MFNGO9, GO1, PS1, MFNGO2). For example, USAID had a project target to hit of getting an NGO formally registered before the end of their project, so needed the regulations passed quickly (PS5). In other words, almost all of the major elements respondents identified as key to the success of the participatory and indigenously designed MDI Act (above), were not in place.

According to those close to the process (MFNGO 2, PS 3, PS 5, GO1) there were just two meetings between the BoU and a few non-representative stakeholders before the regulations were promulgated. The BoU did not appear to be willing to share power in this regulatory design process. At the second meeting it was agreed that clients' savings taken by MDIs as part of the requirement for access to loans would *not* be at risk if they were intermediated, so they would simply be regarded as typical deposits and not "cash collateral". When the regulations were promulgated the agreement on clients' savings "had not been kept" (MFNGO2). There were no draft regulations circulated for discussions and no opportunity to question the BoU's decision. The MDIs would NOT be allowed to intermediate their clients savings – they would have to hold them as cash collateral. The other regulations applied the tools of banking to microfinance (PS5). GTZ/SIDA were advising the BoU (MFNGO9) and assured other donors that these were global best practice regulations, so the donors did not grasp the implications of the banking regulations for Ugandan microfinance²⁹⁰. AMFIU did not pay attention to the details in the regulations (PS1) or was unable to understand them – they wanted them passed quickly too and did not challenge the process. No-one appears to have grasped the implications of the regulations for microfinance before they came out. (PS5). The focus was simply on getting the regulations quickly, not on the

²⁹⁰ In 2004 discussions with many of the donors who were subsequently involved in pushing for the MDI regulations – they acknowledged that 'they had an insufficiently broad vision of financial system development' in Uganda. (Goodwin-Groen *et al* 2004). Birdsall's (2007) observation seem entirely accurate: "outsiders are unlikely to help if they try to push institutional forms and norms that have worked for them, in one place and time, as the solution for others at another place and time". (ibid p.7)

process or even the content of the regulations. Immediately the regulations were out, the donors formed a Transformation Committee and created a basket of funds to provide support to the MF NGOs able to transform into MDIs. Power had not been shared. It had not been a transparent broad-based collaborative discussion process in operation, there were not qualified people from all stakeholder groups engaged, and there were no champions and no time.

The contrast between these two processes is radical. The first had power sharing to address an injustice using an open, transparent process involving major stakeholders, with the key representatives having the technical capacity and time to debate the issues with colleagues and arrive at a result that all stakeholders were happy with. These seem to be the key factors which allowed the creation of an innovative MDI Bill. Whereas, for the second, the power was in the hands of the BoU, without a clear justice goal, without a transparent, inclusive participatory process, so the regulations were little different from the BoU's other bank regulations.

Using Mahoney and Thelen (2010), the process to agree the MDI Regulations was one with a weak political veto possibility, because the Bill had already been passed and everyone was anxiously waiting for the regulations, and a high level of enforcement discretion on the part of the BoU. This meant that “the changed enactment of existing rules due to their strategic redeployment” which (Mahoney and Thelen 2010 p. 16) define a “conversion” was the most likely outcome. There could not be a better description of the MDI regulations – they were effectively a modification to the function of the existing Banking regulations.

To use Boettke's language, the design of the regulations was a combination of BoU and external advice but the primary effort in the design was exogenous. The regulations were introduced indigenously by the BoU although there was not an inclusive process, unlike the MDI Bill. Other indigenous stakeholders such as the parliament, the private sector and NGOs were not involved at all. So with this analysis it should be classified as an Indigenously introduced, Exogenously designed (IEX) process although it is closer to a foreign introduced exogenously designed process. This helps explain why the regulations have been enforced but are not considered to have achieved their goals.

The analysis of this Ugandan case using Boettke *et al*'s (2008) framework indicates that an indigenous process is more important than whether the institution is endogenous or exogenously designed. This appears to support Boettke *et al*'s conclusion that “any path to progress with a reasonable probability of success must ultimately be rooted in indigenous institutional order.” (Boettke *et al* 2008 p. 354) But this analysis goes further by showing that for institutional change to be rooted in the indigenous institutional order, the process of the change must include all major stakeholders. Indeed, it appears that an inclusive indigenous introduction process is the means by which exogenous institutional forms are negotiated to become endogenous. In Uganda where the lengthy process of designing and introducing the MDI Bill included all major stakeholders, this process was effectively a negotiation so that the final institution was indeed endogenous and indigenous. Logically then, an inclusive indigenous introduction process, would be consistent with social norms and as a result, would enable the functions of the institutional form to be fulfilled as designed. Since all key stakeholders were involved in the design process

they would have agreed on both the new institution's form and function and would be working to support them, not against them. These issues will be explored further in the following chapter.

9.5 Conclusion

This chapter has provided the findings of the ethnographic research with microfinance stakeholders to answer the research questions about how rules and norms in the Uganda microfinance market changed between 1997 and 2007 and the role of development agents in catalyzing this change. At the level of social norms the findings showed how everyday norms such as: saving in groups; women's economic activity; increasing corruption; and the loss of trust in banks; were foundations for the microfinance market. In turn they then also became embedded in the constitutional and operational institutions critical to the expansion of the microfinance market.

The constitutional and operational institutions which changed in this market in the study period were the MDI Act and the MDI regulations respectively. The MDI Act fulfilled the functions of bringing poor people and their savings into the formal sector, making them safe and providing MDIs access to commercial financing. The MDI regulations fulfilled all of the functions there were designed for except perhaps the most important – bringing significant numbers of poor people's savings into the formal sector. This highlights another important finding: that it is not the *form* of the institution but the *functions* it plays and the enforcement characteristics which are critical for market development. The right form for a particular context is one that enables the key functions required in the financial market to be carried out. Two other operational institutions which have changed and which function to support the expansion of the microfinance market is the licensing of foreign banks in the market and the establishment of a car and truck registry.

For institutional change to occur the process by which new rules or institutional forms are developed requires both that they are close enough to the underlying norms to be accepted but also different enough to offer a break with path dependence so do not just repeat existing rules and norms. In the Ugandan case, this process occurred for the MDI Bill when Government shared power with a broad cross-section of stakeholders in a transparent, inclusive participatory process. Support from a wide range of Ugandan stakeholders meant that the new institution was close enough to underlying norms so it was accepted. Using Boettke's language the process was indigenously introduced and endogenously designed so it "stuck". But, in the case of the MDI Regulations, just two donors (development agents) and the BoU made the decision, so the process was not transparent and inclusive. There was no process of adapting the exogenous regulations promoted by the donors to fulfil the intended functions. The MDI regulations have therefore achieved all but the most important intended function of including significantly more poor people in the formal sector. The regulations have so far "stuck" but there are now only three MDIs left and no more expected. Looking back, respondents are questioning the development agents' decisions. The next chapter compares and contrasts both Bosnia and Uganda case studies and draws out the common findings.

Chapter 10: Comparative institutional analysis

Financial sector reforms that promote inclusive access to financial services need to be at the core of the development agenda (Demirgüç-Kunt *et al* 2008 p.2) but research has not yet systematically examined the institutional functions critical for the financial market to include poor clients. Institutional change is also at the core of the development agenda but current theories are either “simplistic” or “extremist” (Chang 2011 p.495) and need to be more richly informed by real world experiences. Furthermore, the place of social norms in inclusive financial market institution building has also not been systematically explored. This chapter now comparatively reviews the findings from both the Bosnian and Ugandan microfinance markets to identify which institutions matter most for increasing financial inclusion; how the rules and norms in the Bosnian and Ugandan microfinance markets changed between 1997 and 2007 and what the role of development agents has been in catalyzing this change. A study of institutions in two comparable microfinance markets is not an adequate basis to make definitive statements about theory or policy. However, it is a sufficient basis to identify promising avenues for further endeavour.

A careful historical analysis of each of these financial markets including relevant political, economic and social factors to 1997 was undertaken in Chapters 4 and 7. The growth of the microfinance market between 1997 and 2007 was then detailed in Chapters 5 and 8. Clients of self-defined microfinance providers grew from very few clients to approximately 360,000 borrowers in Bosnia or about 11% of the economically active adult population, and approximately 1.7 million savers in Uganda or about 13% of the economically active adult population. Corresponding changes in the rules and norms were carefully researched through micro-ethnographic methods, as explained in Chapter 3. The empirical findings of the institutional analysis of the Bosnia and Ugandan microfinance markets have been carefully set out in Chapters 6 and 9 respectively. This Chapter 10 now discusses the significance of these findings in the context of current empirical and theoretical debates in financial market development and institutional theory.

The structure of this chapter follows a similar logic to Chapter 2. The Williamson (2000) framework is used as a heuristic tool to compare the common empirical findings from both markets on what institutions matter most for financial inclusion and to relate them to the pertinent financial market literature. The contribution of these research findings to the theoretical debates about institutional form and institutional function, the characterization and significance of social institutions and institutional change processes, are subsequently discussed. Specifically, the institutional change theories of Mahoney and Thelen (2010) and Boettke *et al* (2008) are interrogated based on the institutional change processes revealed using micro-ethnographic methods, as is the role of development agents in those processes. The chapter concludes with a brief assessment of whether the post – 2007 developments in the Bosnian and Ugandan microfinance markets appear to support or contradict these findings.

10.1 Institutions that promote financial inclusion

Amongst microfinance practitioners there is an increasing understanding of the importance of “rules” made by governments including both laws and regulations (CGAP 2011). Williamson’s (2000) framework identifies four different related levels of institutions, laws and regulations are given separate levels, as have the informal institutions which are identified as the foundation. The names given to the different levels of institutions are: Level 1 - Social Norms, Level 2 - Constitutional Institutions (which include both constitutions and laws, Level 3 - Operational Institution (which determine how the ‘game’ is played) and Level 4 – Pricing (Joskow, 2003). Joskow (2003) observed that Williamson’s division was somewhat arbitrary. None the less it has proved a useful framework for analyzing institutions in financial and microfinance markets. The detailed breakdown of institutions for financial market development according to Williamson’s framework in Chapter 2 was useful to start to show how the multiple layers are nested (Ostrom 2005a) and then the complexity of the relationships between levels became more evident in the comparative case studies. Therefore, in addition to using this tool to present the literature on what institutions mattered for financial market development, it is also used to frame the empirical findings on what institutions matter most for financial inclusion in Table 13 below.

Table 13 identifies the institutional *functions* common to both cases and reflects the precision in terminology advocated by Chang (2006, 2007), Rodrik (2004) Tebaldi and Mohan (2010). The respondents distinguished them from the institutional *forms*, which has have often, mistakenly, been assumed as the meaning of *institution* in financial market development. (The differences are discussed subsequently.) It is also worth noting that there was more than one institutional function for each of the institutional forms discussed, which supports Chang’s (2006 p. 2) statement that “no institution performs only one function”. Each of the levels will be discussed in the same order that respondents discussed the building blocks of the sector (a different order to Table 13).

Table 13 Institutional functions which matter most for microfinance market development – those common to both markets

Levels	Institutional functions found to matter for microfinance market development and increasing financial inclusion
Level 1: The Social Norms Informal foundations	Social norms embedded in the microfinance markets included: <ul style="list-style-type: none"> • Women’s economic role • Local financial practices e.g. saving or paying back loans • Lack of trust in the banking system
Level 2 Constitutional Rules. Laws which set the rules of ‘the game’	<ul style="list-style-type: none"> • The inclusion of poor people in the formal financial system. • The constitutional level institutional functions which the rest of the financial market needs to operate efficiently also support microfinance.
Level 3 Operational Rules. Regulations about how ‘the game’ is played	<ul style="list-style-type: none"> • Appropriate supervision of the microfinance market • Support for the development of the microfinance market • Foreign banks encouraged to increase competition

10.1.1 Constitutional rules which matter for increasing financial inclusion

The inclusion of poor people in the formal financial system at a ‘constitutional’ level i.e. a law was an essential institutional foundation for the development of financial inclusion. The institutional functions which the rest of the financial market needs to operate efficiently are also essential for financial inclusion. There was also consistency between markets on the importance of the functions of competent supervision of the financial sector, a stable independent central bank, working courts for basic contract enforcement (although in both cases they were not frequently used), enough security for daily operations, a payment infrastructure and flexible interest rate policy²⁹¹. These institutional functions are widely regarded as important for the whole of the financial market to work effectively as detailed in Table 1 (Demirgüç-Kunt *et al* 2008, Honohan and Beck 2007, Fergusson 2006, Platteau 2000). It is, perhaps, a mark of the maturity of the microfinance markets in Bosnia and Uganda that most respondents recognized that the institutions which the rest of the financial system needs to operate efficiently also support microfinance. Property rights are not on this list because the land registry was not used by microfinance

²⁹¹ These comparative findings are consistent with the Kaufmann, Kraay and Mastruzzi (2008) Governance Indicators on the Rule of Law and Regulatory Quality which rank both Uganda and Bosnia around the 40% percentile and 45% percentile respectively. These are not high, but indicate that both countries have the basics in place.

providers in either market (and did not effectively perform its function) so was not considered a critical institution for financial inclusion. (This is also consistent with recent research that has found effective contract enforcement more important than property rights (Guirkinger 2008, Demirgüç-Kunt *et al* 2008)) discussed in Chapter 2.)

Respondents in both markets recognized that the law, with the function of recognizing poor people's access to financial services, was decisive in the development of the sector. The laws in both markets were typically the first building block that respondents identified and the most frequently identified building blocks, because without them poor people's exclusion from the formal sector would have continued. In Bosnia it was the MCO Law and in Uganda it was the MDI Law. Respondents in Bosnia saw huge flaws in the law but still acknowledged its importance, whereas respondents in Uganda were satisfied with the law (but saw huge flaws in the regulations). It is essential to note here that in each market these constitutional institutional functions both had underlying social norms embedded in them and were dependent on those norms for their effectiveness (see section 10.3 below).

Such a law has not been previously identified as critical to financial market development and is not present on the list in Table 1 in Chapter 2, so this finding is breaking new ground. Also, as discussed in Chapter 1, a law has not generally been considered critical by microfinance practitioners, as the focus initially was on how to ensure microfinance was financially sustainable. However, the G20 Principles of Innovative Financial Inclusion in 2010 highlighted both the importance of national leadership and rules that promote financial inclusion (Goodwin-Groen 2010), generating changes in priorities by microfinance global leadership such as CGAP and the Alliance for Financial Inclusion (Ndungu 2012)²⁹². It is worthwhile noting that the function of "support for the development of the microfinance market" was categorized as an operational function, similar to regulation. However, the importance given to that function by participants in both markets appears to suggest that it should be a constitutional function written into the laws.

10.1.2 Operational rules which matter for increasing financial inclusion

Appropriate supervision of the microfinance market, together with support for the development of the microfinance sector were found to be essential institutional functions at the regulatory level. Both were essential. The supervision function was to hold microfinance providers accountable to meet standards, perform transparently and to honestly serve poor clients. In addition, the development function (including capacity building and advocacy) was to ensure the expansion of appropriate financial services for poor and excluded people. Both were of equal importance.

The importance of the supervision function is shown in Uganda by the difference between the MDIs that were supervised by the BoU, which attracted international funding and could be trusted

²⁹² As a result of my work with the Australian Co-Chair of the G20 Financial Inclusion Experts Group (FIEG) in 2010, I was able to influence the report and G20 FIEG implementing partners, CGAP and AFI, so my research findings are being implemented.

by clients²⁹³ and the unsupervised Tier 4 NGOs which were not supervised, did not attract funding and several collapsed due to fraud. The microfinance sector development function (which included supporting NGOs transformation into MDIs) lapsed after the MDI Bill and was not effectively picked up again until 2006 when the government launched its 'Bona Bagagawale' program promoting SACCOs. This lapse was noted by respondents as a major problem for the development of microfinance. In Bosnia both operational functions of supervision and development of the sector were established at the outset of microfinance and according to respondents were critically important, but did not continue after 2005 when the LIP stopped. The LIP supervised the MCOs they funded and trained all MCOs together to reach performance standards. The good practice of accountability and financial sustainability became the microcredit market norm. When the LIP project stopped, there was both a supervisory vacuum and a development vacuum. As a result, the microfinance sector experienced great difficulties in both managing the problems of the global financial crisis (Chen, Rasmussen and Reille, 2011) and curbing its own excesses. When the Banking Agency took over supervision functions, there was still no development function in place to help MCOs focus on the financial services which would better serve poor clients financial needs.

One other operational institutional function was identified in both markets as a building block for microfinance, and that was allowing new or foreign banks to enter the financial market. In Bosnia, new banks entered the market and brought much needed credibility to the financial sector but also brought new skills to the market, such as cash-flow lending and so proved to be the financial life-blood of MCOs who could not collect savings. In Uganda new banks entering the market also financed the MFIs. Opening up the market to new players looking for new opportunities has contributed to increasing financial inclusion.

The finding that both appropriate supervision of the microfinance market and support for the development of the microfinance sector were both essential operational institutional functions at the regulatory level, breaks new ground. As discussed in Chapter 2, the importance of a regulatory framework with adequate enforcement for sound financial sector development has been extensively researched. However, in microfinance, following the lead of Christen and Rosenberg (2000) there was initially a hands-off approach to regulation, and subsequently there was a focus on commercialization. Karnani (2009) and Bateman and Chang (2009) argue that microfinance was too focused on commercialization and insufficient emphasis was given to the duty of the legal and regulatory environment to protect and serve clients²⁹⁴. The MDI and MCO regulations and lack of ongoing investment in the development of both sectors seem to reflect this bias. The appeal of microfinance, that it was financially self-sustaining and did not need ongoing subsidy (see Chapter 1), appears to have distracted both donors and governments in these markets from keeping focused on the original goal, which was overcoming financial exclusion. These findings

²⁹³ For example, the Finance Trust in Uganda has grown consistently after it became a regulated MDI as shown in its audited financial statements (Uganda Finance Trust, 2011). Furthermore, as of Dec 2010 it provides a range of savings and other financial services to over 116,408 low income clients (MIX Market, 2012).

²⁹⁴ Bateman (2011 p. 4) has recently advocated that that microfinance regulation should ensure "local financial institutions act in a manner conducive to sustainable local economic development" which is entirely consistent with these findings.

bring back the focus on challenging governments to both set up appropriate supervision of microfinance markets and to ensure continued support for the development of the sector in pursuit of financial inclusion.

10.1.3 Social norms which matter for increasing financial inclusion

Social norms consistent across both markets for the development of microfinance market included norms about women's economic role; saving and / or paying back loans and a lack of trust in the banking system. Notwithstanding the recognition that there is ambiguity in social institutions and gaps between a rule and its enforcement (Mahoney and Thelen 2010 p.14), there were three clearly identifiable similarities in the social norms in both markets which provided positive incentives for the development of the microfinance markets and for increasing financial inclusion.

²⁹⁵ As described in Chapters 4 and 7, these social institutional functions had a different origin in each market, but during the 1997 – 2007 study period, the functions were similar. One was the economic role of women. In Chapter 5 it was discussed how Bosnian women were typically literate and in urban areas had completed secondary education, expected to work outside the home and participate actively in the formal sector, but there were few jobs and many female headed households post war. As a result, many women became micro-entrepreneurs to earn an income. But the banks were typically focused on serving international relief agencies and the government, so women (and other poor people) effectively had no access to finance. Serving poor women and other excluded groups was a major incentive for the development of microfinance. In contrast, in Uganda the majority of women were barely literate and worked in agriculture although they often had farm based micro-businesses. They too had no access to finance, (although more for cultural than economic reasons as discussed in Chapters 7 and 8); so again, there was a major incentive for development of microfinance. In both cases, respondents reported it was the economic activity of women which drove their engagement with MFNGOs as the only providers reaching poor women. It would appear, then, that the common issue for the development of microfinance in these markets is women's exclusion from access to financial services. This is consistent with Johnson's (2005a) research on gender norms in the Kenyan microfinance markets. However, to get a more complete understanding of women's exclusion, more research would be needed on why for example, in Bosnia women had to rely on microcredit and could not get government jobs (Pupavac 2006 p.92) and why, in Uganda, women do not have equal ownership of the family residence (Waring 2010 p.8).

Another common norm was the loss of trust in the banking sector. In Bosnia many people had trusted the banks before the war and lost their life savings. Their savings had been taken by corrupt politicians, by inflation and an economic system that failed. In Uganda, the history of banks being used for political ends, being nationalized and others closed for fraud and mismanagement had also left many with deep suspicion of banks. In both markets this provided an incentive for the growth of financial services providers that were not banks. The importance of

²⁹⁵ It is important to emphasize that these norms are not neatly defined catechisms of practices and that there was a degree of messiness surrounding the labelling of these norms which is discussed under the assessment of methodology in the following chapter.

trust in financial contracts cannot be underestimated in both the formal sector (Fergusson 2006) and in the informal (Woolcock 1999, Van Bastelaer and Leathers 2006).

There were significant differences in the social norms around financial practices between the two microfinance markets but the point of commonality is that the norms provided clients a basis for engaging with microfinance services. In Bosnia there was the norm of paying back on time with strong enforcement characteristics and in Uganda the norm of saving in groups. Although they had different expressions, social norms about financial practices were critical to the development of the microfinance sector. In Table 1 some examples of other social financial practices are noted such as “loyalty” (Wood 2003 p. 455) and “ethics” (Argandoña 2004 p. 200). In Bosnia and Uganda, financial practice norms became embedded in the laws and regulations of each market through processes of institutional change, which will be discussed in 10.4 below.

These norms have had a positive effect on increasing financial inclusion in the view of respondents. But, in contrast, the norm of corruption common to both markets has had a negative effect. In Bosnia the government and leaders were seen to be corrupt and in Uganda it was also at the leadership level, but appeared to have become more pervasive with the collapse of several microfinance NGOs. The application of these findings to development agents undertaking institutional change is discussed in section 10.5 below. In addition, these findings also contribute to the theoretical discussion about the form and function of institutions and the understanding of social norms as rules with enforcement characteristics which are discussed respectively in sections 10.2 and 10.3 below.

10.2 Institutional function and form

There are several findings about the relationship between institutional functions and forms, common to both the Bosnian and Ugandan microfinance markets that could contribute to institutional theory. These include that institutional forms had more than one function, that there is no unique mapping from institutional function to form across markets, and that effective institutional functions are what matters, and the form has to be fit for that function. These findings also appear to address several of the weaknesses in North’s definition of institutions discussed in Chapter 2. These included that it was a vague concept, (Sachs 2003, Portes and Smith 2009), without clear differentiation between the rules and the players, and there was a preoccupation with defining “best practice” institutions, which are, by definition, non-contextual (Rodrik 2008a, Bardhan 2005, Evans 2004).

First, Table 13 shows one function common to the microfinance laws in both markets - the inclusion of poor people in the formal financial system, but each law also had at least one other function. In Bosnia the MCO Law’s second (more prosaic) function was to provide a legal basis for NGOs to lend. In Uganda the MDI Act’s two other functions were: to provide safe access to savings services for poor people due to BoU oversight and to give MF NGOs that transformed into MDIs access to commercial financing. Therefore the laws in both markets had multiple

functions, supporting Chang's (2006 p.2) assertion that "no institution performs only one function".

Second, the function of developing the sector, including capacity building for microfinance service providers, has been undertaken by different institutional forms, *de facto* and *de jure*, sequentially and in parallel, in both markets so there was no unique mapping from institutional function to form across markets. In Uganda, USAID's PRESTO project had *de facto* responsibility for the development of the sector from 1997 (and also supported the drafting process for the MDI law) together with the government's Microfinance Forum which provided guidance to the sector. The government's Microfinance Outreach Plan started in 2002 and then in 2006 the government launched its 'Bona Bagagawale' effort, and a Minister for Microfinance was appointed. Finally IFAD funded the Rural Financial Services Project under the Bona Bagagawale effort and UCSCU was contracted to implement the national development of SACCOs in 2007. So there have been several forms - donor projects and at least four different government agencies - with responsibility for the function of developing the microfinance sector between 1997 and 2007, with varying degrees of success. The supervisory function was also undertaken by more than one form in Bosnia. In Bosnia, the two different entity Local Initiative Departments were *de facto* supervisors with either the Ministry of Finance or the Ministry of Social Services in each entity having *de jure* accountability, over MCOs which worked in both entities. These are not described as good practice examples, but simply real world examples (as Chang 2011 stated was needed) which provide evidence that one function does not map onto one form and nor does one form have only one function.

Demirgüç-Kunt and Levine (2008a p.2) note that "it does not matter who provides these functions" i.e. the functions necessary for financial development; what matters is that they are being performed. But clearly in the Bosnian and Ugandan microfinance markets that was not always the case. The forms have to perform the institutional functions effectively, the form has to be fit for that function. So an overall conclusion is that developing appropriate financial market institutional forms to fulfil critical financial inclusion functions is more art than science and so more cases are needed explore this challenge (Recent theories around institutional change processes will be discussed in section 10.4 below.)

These findings on the importance of institutional functions challenge the weakness in North's definition of institutions. With respect to the "vague concept", a focus on assessing an institutional form or organization such as the Central Bank or Banking Agency could indeed be vague, but it is difficult to have a vague assessment about whether an institutional function is being achieved or not. In fact, identifying discrete institutional functions as undertaken in Chapters 6 and 9 and addressed in this chapter requires a specificity which can then be assessed. Moving towards such precision in defining institutional functions has enabled me to start to make generalizations across markets. Indeed, without attempting such precision it is hard to envisage any meaningful cross market comparisons. Regarding the "best practice" issue, given that a similar institutional form may have multiple different functions in different contexts, attempts to define global best practice institutional forms become redundant (another critique of North). It may not be too great a step to assert that defining precise institutional functions better represents North's recognition that

institutions provide the incentive structure of economies. These examples also demonstrate the difficulty of building sustainable new institutional forms. So what has been learned about the process of institutional change will be discussed in section 10.4 below.

10.3 The embeddedness of social norms

Although social norms feature in Williamson's framework he publicly states that social institutions have been taken as "given" (Williamson, 2000, p. 596). Furthermore, as discussed in Chapter 2, Greif (2006 p.380) recognizes that they have been treated as a "black box" and other new institutional economists have taken the same approach. This is despite the earlier work of Granovetter (1985, 1992) and others who have demonstrated that markets are embedded in local cultures and that institutions in markets are "cultural embodiments" reflecting the value systems and historical antecedents of the societies (Platteau 2000, p. xvii). Also despite the ground breaking analysis of the ways social rules constrain economic opportunities in rural financial markets in Bangladesh (Wood 2003), China and India (Tsai 2004), and Kenya (Ensminger 1992²⁹⁶ and Johnson 2004b, 2005a), one major barrier to a greater focus on understanding how social norms provide incentive structures for economies has been the methodological challenge of operationalizing research into informal institutions and discerning causality. In this study a micro-ethnographic methodology allowed market participants themselves to identify social institutions which they experienced as having provided the incentives for market expansion and, furthermore, allowed comparison of significant social institutions across two microfinance markets, addressing a *sui generis* critique (Shirley 2005).

The first finding on social norms from the microfinance markets of Bosnia and Uganda is that they provide the foundation for other institutional functions. This substantiates the way in which social norms underpin the development of markets as theories of social embeddedness suggest. However, these findings also go further than the rather static approach such analysis often uses, to highlight how this happens in a dynamic way through the social norms becoming embedded in new constitutional institutions for financial inclusion. It becomes clear that this happens most clearly when the change process is itself embedded in processes which engage local stakeholders and not solely by external actors (see Eversol 2010). This finding also relates to the institutional change processes discussed in section 10.4 below but it is important to include it here because it shows that social norms have been integrated into constitutional and operational institutional functions.

A discussion of the different social norms in each market will better illustrate the ways they are foundational and have become embedded in other institutions. As described in Chapters 7 and 8, saving was part of everyday Ugandan culture and was integrated into the ways that both genders

²⁹⁶ For example, Ensminger (1992) describes changes to economic and social institutions occurring between 1981 and 1987, including institutions that decrease transaction costs such as "the simple notarizing of legitimate traders and property rights by third party agencies, security forces that reduce banditry, banking facilities that extend credit and reduce the dangers of travel with cash...courts that enforce contracts and property rights" (*ibid* p. 27); as well as the changes to "gerontocracy, clan, lineage, patron-client relations, and, marriage." (*ibid* p.169).

interacted in both urban and rural communities. So when the Ugandan microfinance network, AMFIU, started working with the Microfinance Forum, and members started lobbying for the MDI Bill there was a broad-based understanding of the importance of saving across all sets of stakeholders from politicians and senior officials to rural voters. When the MDI Bill was being drafted, therefore, the provision of a safe place for poor people to save in the formal sector was accepted as an important function of the Bill.

In contrast, savings was not an informal norm in Bosnia. As described in Chapters 4 and 5, paying back loans on time was important to the way people interacted socially, as they did not want to lose status within their communities. Another difference was that as Bosnia had been part of the former-Yugoslavia, there was still a residual fear of the financial police and norm that governments regulated all financial services, including those delivered by NGOs. Therefore, when the LID was lobbying for a law on microfinance, the only function accepted by politicians and bureaucrats for the Micro-Credit Law was to make lending legal for MCOs (NGOs or Foundations) in amounts less than 10,000KMs. So there was no recognition of the importance of saving in the Bosnian law, consistent with the social norms. These two examples in very different markets show how the prevailing social norms provided the foundation for and became embedded in new constitutional institutions²⁹⁷.

These findings are a challenge to many donors (like myself now with the G20) and even practitioners who want to be able to follow ‘best practices’ in microfinance because they mean there is no such thing as global best practice financial inclusion institutions, only local good practice financial inclusion institutional functions. Only institutions which are built on the foundation of social norms and have social norms embedded in them will last. These findings are consistent with the findings of researchers like Crook and Booth (2011 p.101) who have identified the importance of a “much more encompassing role to social embeddedness” in the development of effective institutions. In conclusion, what now matters is building institutional functions for financial inclusion which have congruence with social norms.

10.4 Assessing institutional change theories

The dominant method of aid donors trying to build institutions in developing economies has been institutional transfers (Moore 2001), transplants (Gibson and Woolcock, 2008), or the imposition of uniform institutional blueprints on the countries of the global South without recognition of the role of underlying social norms (Evans 2004 p. 30 – 31). In financial markets the story is no different. “Much of what is held to be good practice for the development of financial markets still amounts to a transplant of models that have been successful in advanced economies” (Demirgüç-Kunt *et al* 2008 p.147) without regard for local norms. (In microfinance there has also been transplanting of supposedly successful models such as the Grameen Bank model into other markets (Grameen Trust, 1989). This is largely because of the predominance of a “best-practice” mindset at the World Bank and International Monetary Fund which presumes it is possible to

²⁹⁷ At the time, working as an expert, I was very disappointed that no savings option had been agreed since at the time it was regarded as “best practice” – this analysis has offered new insight! .

determine a unique set of appropriate institutional arrangements *ex ante*, and those arrangements are inherently desirable (Rodrik 2008a p. 100)²⁹⁸ But according to Bräutigam and Knack (2004) and Djankov *et al* (2008) this approach to institutional change has failed, as foreign aid had resulted in institutional weakening and had a negative impact on institutions. Conyers and Mellors (2005), Collier (2006a) and Birdsall (2007) are in general agreement with these findings that the donor approach to institutional change needs to change. Chang (2011) has aptly identified two “absurd extremes” in donors’ approach to institutional change with most assuming that institutions can be easily changed (like the transplant approach above) and others that it takes generations to change. But there does not yet appear to be a robust theoretical debate about the temporal perspective of institutional change to inform the global development agenda.

The historical, sociological and rational-choice institutional theorists’ approach to institutional change have, in the past, depended on a combination of path dependency, punctuated by exogenous shocks (Hall and Taylor, 1996). Clearly as more research is undertaken about the role of institutions in economic and financial market development these theories need revision. The institutional change theories of Mahoney and Thelen (2010) and Boettke *et al* (2008) take elements of all three approaches and address incremental institutional change. The two theories, however, have very different purposes. Mahoney and Thelen aim to predict the type of change that can be expected, and Boettke *et al* at predicts whether the change will “stick”. So each set of researchers have pared down the variables they focus on to two very different key drivers of change: Mahoney and Thelen on veto possibilities and enforcement characteristics; and Boettke *et al* on where the change is designed and how it is introduced.

However, consistent with the findings above about the foundational role of social norms, they both specifically include social norms as critical to the institutional change process, but Mahoney and Thelen do this rather less directly. Boettke *et al* include the *metis* or culture directly in their theorem, recognizing that unless the institutional change is close to the *metis* it will not ‘stick’. In contrast, Mahoney and Thelen take time to identify the attributes of institutions which create the spaces for change all of which apply to both informal norms as well as formal rules. Furthermore, they state that the two major variables which affect change apply to both “formal or informal” (*ibid* p.19) rules. So although there is less overt reference to social norms they are integrated into the theory. However, Mahoney and Thelen and Boettke *et al* substantially differ on addressing the role of external agents. Boettke *et al* recognize that institutional change can be foreign designed and exogenously introduced, but Mahoney and Thelen are silent on whether change agents are internal or external. (Although their discussion about agents’ “short-run behaviours” and “long-run strategies” (*ibid* p.22) appears to refer to internal agents.) Conveniently, they have also both provided diagrammatic representations of the key elements of their theories. When the institutional change theories of Mahoney and Thelen (2010) and Boettke *et al* (2008) (discussed in Chapter 2) are assessed against the two real world case studies, to find points of commonality, there are some surprising results.

²⁹⁸ This mindset presumes the primary role of institutional arrangements is to minimize transaction costs without paying attention to potential interactions with institutional features elsewhere in the system.

10.4.1 Mahoney and Thelen’s theory of incremental change

This theory identifies the result of incremental institutional change as being in relation to the existing or old rules as summarized in Table 14 below. The drivers of institutional change are the effect of political veto and the enforcement characteristics of the target institution on the establishment of new institutions²⁹⁹.

Table 14 Applying Mahoney and Thelen’s typology of institutional change

	Characteristics of the Targeted Institution		
		Low level of interpretation/ enforcement discretion	High level of interpretation/ enforcement discretion
Characteristics of the Political Context	Strong Veto possibilities	<i>Introduction of new rules on top of old ones – Layering e.g. MCO laws in Bosnia</i>	<i>Neglect of existing / old rules - Drift</i>
	Weak Veto possibilities	<i>Removal of old rules and introduction of new ones - Displacement</i>	<i>Change in functions of existing rules – Conversion e.g. MDI regulations in Uganda</i>

Applying Mahoney and Thelen (2010) to the introduction of the MCO Laws in Bosnia, there was a strong political veto possibility (because of the dysfunction of the government) and a low level of enforcement discretion by the Departments of Social Welfare / Finance and the Banking Agencies as the target institutions. So “Layering” of the MCO law on top of the banking law was the result as Mahoney and Thelen (2010) would have predicted. Applying it to the introduction of the new MDI Bill in Uganda, there was a weak veto possibility (because of the consensus building process that had been undertaken by AMFIU and the MFF) and high level of enforcement discretion by both the Parliament who will pass the law and the BoU that would implement the law. So according to the theory the result should be “Conversion” when there is a “change in function of existing rules”. But it was a totally new law, which raises the question about whether the theory is limited to situations where there is change in *existing* institutions, but perhaps does not apply to totally new institutions. In fact, Mahoney and Thelen’s (2010) theory does apply in this case because they are referring to institutional *forms*, not institutional functions. There was “Conversion” because there was “a change in functions” of existing form of the Parliament and the BoU, reinforcing the empirical power of their theory. However, it also usefully highlights the need to explore whether Mahoney and Thelen’s (2010) theory could usefully be adapted to be address changes in institutional functions.

These examples raise a further question about what is an appropriate time-frame within which to apply Mahoney and Thelen’s (2010) theory. If the time frame for this research considering the

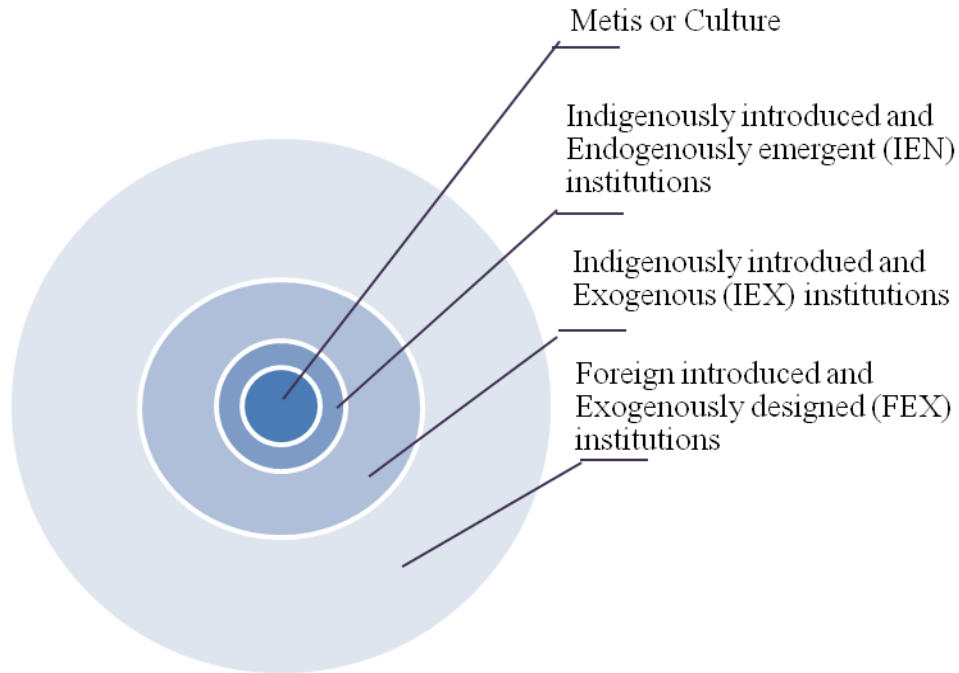
²⁹⁹ In addition they identify four different types of change agents who either seek to preserve the institutional rules or abide by the institutional rules. As discussed in Chapter 2, although useful to identify different types of change agents, this part of their theory only “calls attention” to the different types of change agents, in contrast to the “crucially important” (ibid p. 31) focus given to the two other aspects described above. Therefore, the change agent aspect of their theory will not be used in this discussion.

MDI Bill had started in the early to mid 1990s, instead of 1997, then there would have been strong veto possibilities as this was before awareness had been raised of the importance of microfinance for poor clients, and particularly savings in the Ugandan context. It identifies what appears to be missing from their chapter, a discussion of time frames within which their theory operates. This study used a ten year time frame but that may not be long enough to identify changes in social norms or to effect changes in laws. Furthermore, the discussion about change agents is clearly too limited to be useful in these cases as it does not address the multiple different stakeholders involved in institutional change, nor any process for them to be engaged which would translate into changed institutions and nor does it identify what role external development agents could usefully play.

10.4.2 Boettke *et al* 's theorem of institutional stickiness

This theorem has social norms (the “metis”) at the centre and has the design and introduction of the institution as the drivers of institutional change. Either the institution is designed endogenously or exogenously and it is introduced either through an indigenous process or by a foreign agent. The theorem explains whether the institutional change will “stick” or not depending on how close it is to the local culture. This theory appears to embody Chang’s (2007) and Woolcock’s (2009b) views that the effectiveness of ‘institutions’ depends crucially on their legitimacy in the eyes of those living under them (Woolcock 2009b p.13). In order to gain legitimacy, “the new institution has to have some resonance with the existing culture/institutions,” (Chang 2007 p.30) Chang sees this as limiting the possible scope of institutional innovation, but it still gives room for innovation within these parameters.

Figure 3 Applying Boettke, Coyne and Leeson’s theorem of institutional stickiness



Source: Boettke *et al* 2008 p. 344

Applying Boettke *et al* 's (2008) theorem, both the performance standards the Bosnian MCOs followed and the Ugandan MDI law were both endogenously emergent (from the MCOs and MFIs) and indigenously introduced (i.e. an IEN process); so according to the theorem the changes would “stick”, which indeed they have done. In contrast, both the MCO Law which was indigenously introduced by the LID and exogenously designed by World Bank experts and the MDI regulations which were indigenously introduced by the BoU but exogenously designed by donor experts (IEX) were more likely to ‘stick’ than not stick, but not as well as one that was endogenously designed, as it was not expected to be close to the *metis*. But there is not such a simple dichotomy between the two Bosnian examples as there appears to be. In practice, to get to standards being set by the Bosnian MCO’s, the World Bank project experts had to teach the MCO leaders first raising the issue of whether it was really an endogenous or an exogenous design process. The theory appears to be unable to problematize the complex nature of the relationship between the endogenous and exogenous design (nor between indigenous and foreign introduction). Furthermore, it is clear from these cases that institutional change closest to the *metis* will “stick” and that change furthest away is unlikely to “stick” but it is not clear what will happen to the majority of institutional changes which result from processes between these two extremes. Unlike Mahoney and Thelen (2010), Boettke *et al* (2008) do include an element of process in their theorem and have differentiated the roles of internal and external agents, but there is still no discussion of what process will result in an institutional change closer to the *metis*, what the time-frames are for such change nor recognition of how power relations affect outcomes; so much more work is needed on these issues.

10.4.3 Assessing the usefulness of institutional change theories

Evidence from the institutional change processes in the two microfinance markets indicates the usefulness of both Mahoney and Thelen's and Boettke *et al*'s institutional change theories. They both accurately predicted the institutional change outcomes according to their parameters. By showing ways in which institutions change, these findings challenges the theoretical position of path dependency and exogenous shocks and the primary way institutions change (discussed in Chapter 2). These findings also seriously question the basis for the blue print approach commonly practiced (discussed in Chapter 1). However, as noted above, neither theory appears to be complex enough to theorize multiple sets of stakeholders / agents or multiple institutional functions of an change process that has the potential to "stick" (as identified in the Bosnian and Ugandan cases). Grindle (2007) has recommended that the *process* of institutional reform (or change) be understood as the "process is a complex one that unfolds over time" (*ibid* p. 569) and Bebbington (2004) recommends that "theory workers and practice workers ought never to lose touch" (*ibid* p.281). So perhaps a deeper engagement between theorists and participatory practitioners (some of whom are trying to theorize their experience e.g. Crook and Booth, 2011)³⁰⁰, could provide useful input to both Mahoney and Thelen (2010) and Boettke, Coyne and Leeson's (2008) theories.³⁰¹ Such engagement, however, might need to be facilitated to enable communication between two the different languages.

In addition, both theories would benefit from the insights of the other theory to arrive at a three-dimensional approach. Boettke *et al* (2008) has the potential to predict whether an institutional change will "stick" and therefore challenges change agents to modify their approach accordingly, but it does not help change agents prepare for a particular change option as Mahoney and Thelen's theory does. This theory has the potential to predict what type of change option can be expected given the political context and enforcement characteristics, but it cannot anticipate whether a change process will stick or not, as it is designed to frame incremental institutional change, and the multiple agents and institutional functions in the new microfinance markets overwhelm the theory. Together, this would enable them to move them from being theories which have shaken off the limitations of both path dependency and blueprint approaches to institutional change, to being theories which can usefully frame analysis of complex institutional change processes.

³⁰⁰ For example, Crook and Booth (2011 p. 101) state their "research is suggesting that the institutions most likely to contribute to development in low-income Africa are 'practical hybrids', combining the authoritative coordination which can come from a developmental neo-patrimonial state with an enabling environment for local problem-solving and a constructive use of culturally legitimate ways of working." This is consistent with both Mahoney and Thelen (2010) and Boettke *et al* (2008) and the processes arriving at these types of institutional forms and functions could very usefully be mined.

³⁰¹ Bebbington (2004) recognizes that some participatory practitioners view theoretical abstraction as "tyranny that obstructs change-oriented action" and "privileges elite form on knowledge" (in Hickey and Mohan (eds) 2004 p.278) and so engagement is not an easy process.

10.5 The role of donors as institutional change agents

Boettke *et al*'s (2008) theorem challenges the idea that any external change agent (including donors) can drive institutional changes that are endogenously designed and indigenously introduced and sufficiently close to the *metis* that it will “stick”. This is consistent with Shirley's (2005 p.631) observation that “absent a powerful local supporter [i.e. indigenously introduced]...there are few instances where aid or advice alone has made enduring improvements in another country's embedded institutions”. Birdsall (2007) also found that in Africa “outsiders are unlikely to help if they try to push institutional forms and norms that have worked for them, in one place and time, as the solution for others at another place and time” (*ibid* p.7). These and similar findings are starting to be put into practice by Kelsall (2008) and Booth (2011) in Africa. Mahoney and Thelen (2010) also provide change agents with the ability to anticipate what type of changes can be expected given the veto possibilities and enforcement characteristics so that they can prepare for the ensuing changes, but they do not address the issue of external agents. However, neither theory explicitly addresses the strengths and weaknesses that external agents, such as donors, bring to institutional change. Evidence in the Bosnian and Ugandan microfinance markets points to the importance of better theorizing the role of external agents in the process of institutional change.

The contrasting processes undertaken in Uganda (described in detail in Chapter 9) to get the MDI Bill passed and to write the MDI regulations illustrates this importance of better theorizing the role of external agents. The Microfinance Forum in Uganda deliberately gave power to a wide range of stakeholders in the microfinance sector including clients, MFNGOs, and to donors, to become engaged in the design process, and the role of external funders was to provide financial support to AMFIU to undertake an extensive consultation process with stakeholders and to provide expert opinion. This took approximately two years as the process started in 2001 and ended in 2003. The result was that all stakeholders endorsed the institutional functions of the MDI Bill, including the BoU. This participatory process overcame common critiques of mainstream participatory practices as its focus was “beyond the individual and local” and “encompassed the institutional and the structural” (Hickey and Mohan 2004, p.12) by including all the organizations with a stake in the outcome both powerful and not so. However, when ready to draft the MDI regulations the BoU had just one meeting with a small number of NGOs about the MDI regulations, and then did not keep the promise they made about permitting cash collateral savings to be lent out, instead the regulations said the savings could not be lent out. Furthermore, the external funders and experts were pressuring them to promulgate regulations not to delay any longer with a consultation process. Clearly the donors as external agents had key roles but in the later example, did not support a transparent, inclusive participatory process.

Other findings from this study also have direct application to external change agents such as donors. The findings (in section 10.3) that social norms provide the foundation for other institutional functions, is a direct challenge to change agents to invest time and resources in identifying and understanding social norms before embarking on change processes. The finding that there was no unique mapping from institutional function to form across markets (see Section

10.2 above) reinforces the position of Evans (2004) and others that to attempt to undertake change by imposing an institutional “blue print” from another market, will ultimately fail. For change agents this means there will need to be a process for deciding what the most appropriate forms should be for the desired functions. The finding that the institutional form has to be fit for that function in the particular market, together with being congruent with social norms, reinforces the need for a process in which a wide range of stakeholders are engaged.

The application of the findings for change agents creates a dilemma when it comes to timeframes. In each of the markets the withdrawal of external change agents too early, in the view of respondents, meant the institutional change process was not complete. In Bosnia the Local Initiatives Projects ended in 2005 after seven years, but it was too early because the revised MCO laws had not been passed and there was still no legal option for safe savings designed for poor people. Respondents reflecting on the change process noted that the external agent, the World Bank, had been critical to the change process until that point, so to withdraw then meant the change process as planned was never completed. In Uganda the SPEED projects needed to meet its five year deadlines for getting the regulations passed and a minimum number of NGOs upgraded and registered as MDIs, hence the pressure to pass the regulations. In both cases it was the timelines of external agents that derailed the change processes. The apparent conclusions for change agents is either only to engage in institutional change process that they are prepared to continue with until the local stakeholders can stand alone, or to ensure that there are endogenous design methods and indigenous introduction processes that will last.

10.6 Developments post 2007

Since 2007 there have been significant challenges faced by the Bosnian and Ugandan microfinance markets. For the purposes of this study what matters most, however, is whether the institutional function findings in section 10.1 are still correct. The two constitutional institutional functions found to be critical to microfinance market development - laws which included poor people in the formal financial system and laws which enabled the financial sector to work efficiently - were still in place. What is particularly interesting though is what happened to the two operational institutional functions or regulations which were found to be critical for financial inclusion.

By 2007 in Bosnia only the supervision function was being undertaken by the Banking Agency. There was no government agency *de jure* responsible or donor project *de facto* responsible for supporting the development of financial inclusion. The global financial crisis hit the country and region very badly and exposed the serious problem of client over-indebtedness. Up to 40% of clients had loans from more than one MCO, and MCOs had to aggressively write off loans (Chen, Rasmussen and Reille 2011 p. 7). When the crisis hit, the Banking Agency was focused only on the financial performance of the MCOs not on the plight of the clients or the future of financial inclusion. The MCOs were eventually able manage their balance sheets and none collapsed, but

from a high of over 360,000 clients as of December 2007 (reported in Chapter 5) five years later by December 2011, there had been a 25% reduction in clients to only 273,247 clients reported (MIX Market, 2012) So the supervision function succeeded but financial inclusion had contracted. Furthermore, there is increasing evidence of practices which, although legal, would not have been permitted under the LIP's ethical practices, such as a Christmas bonus of BMWs for Board members and the highest monthly salary in the country of KM240,000 (approx. GBP 95,000) being paid to an MFI Director (Radio Sarajevo, 2011). On a positive note, it is better that this information is transparently available than hidden. However, because there was no government focus on clients, a new donor project started in 2011, which is helping over-indebted clients and improving the regulatory options for MCOs³⁰². These results appear to reinforce the importance of the research findings that both the supervision and the developmental institutional functions are critical for increasing financial inclusion and that development agents need to be prepared to stay for the long term when engaging in institutional change processes.

By 2007 in Uganda the supervision function of MDIs was being undertaken by the BoU and the government's Rural Financial Services Programme (RFSP) had the institutional function of developing the microfinance sector - with a narrow focus on the establishment of a SACCO in every sub-county. This programme was a means to provide a national financial infrastructure under the "Bona Bagagwale" or "Prosperity for All" programme (Mbaguta 2007), launched by the President in 2007. The Rural Financial Services Programme (funded by IFAD) with UCSCU had responsibility for the capacity building of SACCOs. According to the RFSP website, as of December 2010, the total number of functional SACCOs in Uganda is 2,063. Of these, the Government has enabled the establishment of 1,085 SACCOs in the same number of sub counties (between 2008 and 2010) which represents 64% of the sub counties (Rural Finance Services Programme, 2012) This is an impressive expansion, but no financial performance information has been released, and there is no official explanation for this lack of transparency³⁰³. This shows that a development function for the microfinance market in Uganda is in place with support from the national leadership, (albeit narrowly focused for apparently political purposes). The growth of the rest of the Ugandan microfinance market has significantly slowed as major donors have withdrawn support and MDIs have not expanded as rapidly as projected. The number of savers of microfinance organizations reporting to the MIX has almost doubled in five years from 776,778 to 1.6 million, but mostly because of the growth of Centenary Rural Development Bank increasing savers from about 400,000 to over 1 million. Many microfinance NGOs have stagnated and are desperately in need of capacity building to better serve clients and manage their organizations. The MDIs have seen slow growth but have increased profitability. For example, FT MDI has only increased clients from 86,000 to just 116000 as of December 2011 (as their profit almost doubled (Uganda Finance Trust, 2012)). Stakeholders' assessment of results in Uganda since 2007 continues to support the research findings that without both appropriate supervision and sector development institutional functions, increasing financial inclusion will be compromised.

³⁰² A former colleague now working on that project reports that politicians are still mad at LID for leaving them this mess to deal with.

³⁰³ Several colleagues have reported that many SACCOs have failed but no triangulation of this evidence possible.

10.7 Conclusion

This research shows that institutional functions are more important than institutional form, and the four institutional functions found to matter most to increase financial inclusion were: a law including poor people in the formal financial system; institutions which the rest of the financial market needs to operate efficiently; appropriate and competent supervision of microfinance; and support for the prudent development of the sector. A law that specifically includes poor people in the formal financial system has not previously been identified as critical to inclusive financial market development, so this finding breaks new ground. Likewise, the finding that appropriate supervision of the microfinance market and support for the development of the microfinance sector were both essential institutional functions at the regulatory level also breaks new ground as the trend is for donors to move out and commercial financiers move in to the sector.

Perhaps more challenging to those working on financial market development is the finding that local social norms were critical to the effective functioning of these new constitutional institutions. Social norms were both the foundations for them and then became embedded within each of these laws.

The interrogation of institutional change theories in these comparative contexts shows the inadequacy of dominant theories of institutional change: either transplanting institutional blueprints from developed economies; or immutable institutions that are path dependent and will only change with exogenous shocks. Mahoney and Thelen's (2010) institutional change theory and Boettke's *et al* (2008) institutional change theorem each move beyond path dependency and provide a useful contribution to explaining the success or failure of change efforts. Each have weaknesses exposed by the other theory which, if addressed could make them more powerful and enhance their usefulness. The apparent conclusions for change agents is either: to only engage in institutional change process that they are prepared to continue with until the local stakeholders can stand alone, or, to ensure that there are endogenous design methods and indigenous introduction processes that will last. The theoretical and policy implications of each of these findings is discussed in the following final chapter.

Chapter 11: Conclusions

This study set out to understand which institutions mattered most for increasing financial inclusion, as “getting institutions right” (Rodrik 2008a p.100) has been emphasized as critical to both economic development policy and financial market development. This study also sought to understand how institutional change happened and the role of external development agents as new theories of institutional change have been called for to incorporate progress in institutional understanding (Chang 2011). Two comparable real world cases of the microfinance markets of Bosnia and Uganda, which rapidly expanded between 1997 and 2007, were studied to respond to these calls. This final chapter will summarize the empirical findings from chapter 10 and then assess the research for its contribution to theories of institutions and institutional change and to financial inclusion policy and discuss its limitations and the additional research needed. In addition, the micro-ethnographic methodology will be evaluated. The chapter concludes by discussing the potentially far-reaching implications for financial inclusion policy.

11.1 Empirical findings

Defining institutional functions rather than forms has enabled greater precision in identifying what functions matter most for financial inclusion, as well as allowing comparability across markets. The institutions which this research has found mattered most for increasing financial inclusion in the Bosnian and Ugandan microfinance markets go beyond the widely accepted emphasis on appropriate supervision and regulation, and the institutional functions which the rest of the financial market needs to operate efficiently. This research has particularly identified a constitutional level function (i.e. a law) of including poor people in the formal financial system, appropriate supervision for microfinance service providers, and a separate function of supporting the development of microfinance.

In addition to the microfinance markets being embedded in social norms, this research found that local informal norms were embedded into the microfinance laws and regulations, adding to critiques of externally imposed ‘best practice’ institutional blueprints. Examples of the local informal social norms included saving and / or paying back loans and a lack of trust in the formal banking system. Thus the different levels of institutions were nested in each other. All the constitutional and operational institutional functions for microfinance in these markets were new and either were part of new forms or had the new functions added to existing forms; so there was a lot to learn from those processes. Two of the main institutional change processes used carefully structured participatory approaches which facilitated the embedding of social norms into the constitutional and regulatory institutional functions. Two other processes were not participatory and the ensuing institutions did not reflect local social norms.

Arising out of these findings, it is most important that similar field work be undertaken in other countries where microfinance has also expanded rapidly such as Bangladesh, the Philippines or Bolivia, as well as where it has not expanded so rapidly, to test these results. If the findings about the constitutional and operational institutional functions needed for financial inclusion; the

importance of social norms; and participative change processes are not uniquely important for Bosnia and Uganda; but are found to be consistent in other markets too, this will fundamentally change the way governments and donors address financial inclusion.

These are the cross-cutting institutional findings from two microfinance markets which means that they are not *sui generis* (Shirley 2005) and can begin to contribute to the theoretical discussions below. This study chose to undertake research that had not been done before at the intersection of institutional analysis, financial market development and microfinance. This choice meant that some of the complexities in these markets could not be explored in greater depth, including some of the the historical and ethnic discourses discussed in chapter 4 and 7, nor the wider financial market and economic reforms discussed in chapters 5 and 8. So it is particularly important to be clear about the theoretical implications of this research. These findings will be assessed for their contribution to theories of institutions and institutional change, particularly two new institutional change theories, issues of timeframes and processes for institutional change.

11.2 Reflections on institutional theory

The next three sub-sections will reflect on what the findings mean for the definition of institutions and on the importance of informal institutions or social norms for market development

11.2.1 Definition of institutions and institutional functions

While North's contribution to our understanding of the role of institutions in economic development is lauded, his definition of institutions has faced criticisms. These include that it was a vague concept, (Sachs 2003, Portes and Smith 2008), there was a preoccupation with defining "best practice" institutions, (Rodrik 2008a, Bardhan 2005, Evans 2004), and that there was an unfortunate tendency to assign a single function to each institutional form (Chang 2007). Given that an institutional form may have multiple functions and different multiple functions in different economies it is not surprising that institutional forms are considered vague.

This research has shown that identifying discrete institutional functions for markets allows a specificity which can then be assessed across markets. There is little that is vague. Indeed, without attempting such functional precision it is hard to envisage any meaningful cross market comparisons. In these cases, defining institutional functions for markets meant that attempts to define global best practice institutional forms became redundant, because forms varied across markets, but the functions were consistent. There was no consistent mapping from institutional function to form across these markets. The form only mattered in that it had to be fit for the purpose of the function.

This research then supports Chang's (2006) argument that the same function or purpose can be served by different institutional forms in different societies (or in the same society at different times). But Chang also recognizes that it is a challenge to "clearly distinguish between the forms and the functions of institutions" (Chang 2006 p. 3). The 'micro' ethnographic methodology is

able to overcome this particular challenge because it was the market participants who defined the functions (not an external “objective” researcher). This is consistent with North’s (1994 p. 360) definition that institutions are “humanly devised constraints that structure human interaction”

These empirical findings show that Chang (2007) and Rodrik (2008a) are right; institutional functions are what matters, not institutional form. Further defining of institutional functions in both financial and other markets will need to be undertaken to test this further, specifically testing to see if there can be comparability in functions across countries in similar markets.

It may not be too great a step to assert that institutional functions better represent North’s definition of institutions, recognizing that institutions provide the incentive structure of economies. This assertion is clearly very preliminary but has the potential to usefully reframe institutional theory. Further research and analysis to test this assertion would enable progress to be made in arriving at a common useful definition of an institution.

11.2.2 Social norms embedded in financial markets.

New institutional economists have typically treated social norms as “given” (Williamson 2000) or in a theoretical “black box” (Greif 2006). Financial market institutionalists have also assumed that the development of international good practice required standard institutions, independent of cultures (Demirgüç-Kunt *et al* 2008, Fergusson 2006). There has been a focus on comparable and quantifiable data for institutional development (Knack and Keefer, 1995), on institutional forms, not functions as discussed above, and social norms were not addressed. This was despite Granovetter (1985, 1992) and others demonstrating that markets are embedded in local cultures and that institutions in markets are “cultural embodiments” (Platteau 2000, p. xvii) reflecting the value systems and historical antecedents of the societies. Grindle’s (2007) definition of good political economy analysis supports the importance of understanding local culture, recommending that “both context and content” be combined that analysis should be brought to bear on the process of reform (*ibid* p. 569). Such analysis would identify different levels of institutions and particularly the underlying social norms.

This research, has shown clearly that microfinance markets are embedded in the local social norms and so supports the embeddedness position. Perhaps more importantly, unpacking the social norms in that theoretical “black box” has led to a more complete understanding of why those markets have developed as they have done. For example in these markets norms about paying back loans and corruption had different local meanings and had an influence on how the market developed. It means that social norms should not be taken as given, but in any institutional analysis of markets they should be identified and explained before any attempts at institutional change are made. It is simply a lack of rigor to undertake financial market analysis without understanding relevant social norms.

However, there is clearly still a need for longitudinal anthropological research on social norms in both the Bosnian and Ugandan markets, and in particular to understand them from the client

perspective. This would provide a more detailed and nuanced understanding of those norms for future institutional analysis. This research, of necessity, did not do justice to the complexity of the social and economic systems and ways in which the major economic and social changes those countries have experienced over the last twenty years have created spaces for incremental institutional change. But as the demand for detailed institutional market analysis increases such longitudinal anthropological research will be a very useful foundation and could usefully be progressed in microfinance markets.

11.2.3 Social norms integrated in laws

There are clear commonalities between markets in the institutional functions that respondents identified as critical to financial inclusion. In each case there are additional very specific local institutional functions embedded within those institutions, based on their respective social norms. For example, microfinance laws have been newly promulgated in both countries and both laws have the function of including poor people in the formal financial system. But in Bosnia the Microcredit Organizations Law had only one additional function to provide a legal basis for NGOs to make small loans. This is in contrast to Uganda where the Micro-Deposit-taking Institutions Law had three additional functions of recognizing that poor people saved and needed safe access to savings services, as well as to give MF NGOs that transformed into MDIs access to commercial financing. The differences largely reflect the underlying social norms. In Uganda there is an informal social norm of saving in groups that is both rural and urban and is undertaken by both men and women whereas there is no such norm in Bosnia but a social norm that if loans are not paid back on time there is a loss of “face” or status within the community.

These findings show that social norms not only provided the foundation for other institutional functions, but in turn had become embedded in the constitutional and operational institutions. This additional embedding highlights the importance of understanding social norms in institutional analysis and development. This also supports the focus on institutional functions, which can be market specific and can allow for additional local functions which best practice forms do not. It was largely as a result of the institutional change processes in both markets which ensured the social norms were embedded in the constitutional institutional functions.

11.3 Theories of institutional change

Shirley (2005 p.631) observed that institutional change appeared to fall through a gap in the literature but by 2011 Chang (2011 p. 494) was able to critically examine two main theories of institutional change. He identified two “absurd extremes”. One extreme was “hopelessly optimistic” that institutions can be changed easily. It had a “simplistic, linear and static” (*ibid* p.476) theoretical basis and was fundamentally at odds with everything we know about institutions. The other extreme was “unduly fatalistic” that only external shocks (like colonization) can change path dependent institutions. It was based on theoretical views of the immutability of institutions due to climate and culture. Chang (2011) concurs that path dependence “operates at a more fundamental level than we normally think”, and that “the constitutive role of institutions, the

inherent change resistance of designed institutions and the interdependence between institutions” (*ibid* p. 490) means that institutional change does not happen easily. But he does not agree that only exogenous shocks can change institutions. Chang (2011 p. 494) concludes: “[o]nly theories that take both structural constraints and real human agencies seriously can help us”.

Two recent theories from Mahoney and Thelen (2010) and Boettke *et al* (2008) which attempt to meet this standard are critiqued in the following sections against the findings in the microfinance markets of Bosnia and Uganda. These incremental change theories were chosen although there had been civil conflict in both Bosnia and Uganda. As discussed in Chapters 3, 4 and 7, the conflicts did not appear to create significant new space for social norms to change beyond the already existing endogenous spaces. Furthermore, it would seem important to question whether civil war can be categorized as an exogenous shock when its roots are internal.

11.3.1 Mahoney and Thelen’s theory of gradual institutional change.

Mahoney and Thelen (2010) set out to design a theory for gradual institutional change and identified the key drivers of change to an institutional form (not function) as the possibility of political veto and the enforcement characteristics of the target institution as well as the role of different types of internal agents of change. They also usefully identify the many spaces for change within institutions, often around social norms. When tested in the microfinance markets of Bosnia and Uganda this theory showed some predictive power but some limitations. For example, the MDI regulations in Uganda which were operational level institutional functions, faced low veto power and a high level of enforcement discretion by the BoU, were indeed simply a change in function of existing rules. The MCO Law in Bosnia had strong possibility of veto by the parliament and low level of enforcement discretion by any agency and was indeed an introduction of new rules on top of old ones.

Mahoney and Thelen’s (2010) theory, however, has three limitations in these cases, in addition to addressing institutional forms, not functions. First is a lack of clarity around the theory’s timeframes. It is possible to define the veto possibilities and enforcement characteristics at different points in time and so generate different results and it is not clear how one makes these choices. Second the theory assumes that given these processes, the changed institution will last, but there is no discussion about the other factors that would contribute to it lasting or not. Finally, although it recognizes the power dimension in the possibility of veto, it does not address process more generally and does not incorporate a role for external change agents, or multiple internal change agents and multiple institutional functions. Such cases would appear to overwhelm the theory. These limitations could arise because Mahoney and Thelen (2010) prefer to take a longer term view of institutional change in which case timing might not matter so much. Nevertheless, the examples Mahoney and Thelen’s (2010) provide include shorter time frames similar to this study and they appear to want to apply their theory to a range of contexts, so therefore, it would be useful to address these limitations.

11.3.2 Boettke *et al*'s theorem of institutional stickiness

Boettke *et al*'s (2008) theorem also focuses on institutional forms and hypothesizes that when institutional change is endogenously designed (as distinct from exogenous design by external agents) and indigenously introduced (as distinct from a new form that is introduced by foreign partners) it will “stick” - i.e. will function effectively for the foreseeable future. Their theorem specifically includes social norms (but does not address exogenous shocks). When tested in the microfinance markets of Bosnia and Uganda this theorem showed some predictive power but also had limitations. For example, the rules (performance standards) the Bosnian MCOs first followed and the Ugandan MDI law were both endogenously emergent (from the MCOs and MFIs) and indigenously introduced; so according to the theorem the changes would “stick”, which indeed they have done.

This theorem usefully puts congruence with social norms as the focus and key to success of institutional change. There are, however, also three flaws in Boettke *et al* (2008) theorem, in addition to addressing institutional forms, not functions. First is the lack of clarity of the parameters and timeframes. For example, when local consultants working for external donors design a new institution, is this endogenous or exogenous design? Or, when a local decision maker takes a external agent's “expert” opinion without question, is that indigenously or foreign introduced? Second, it is clear that institutional change closest to the *metis* will “stick” and that change furthest away is unlikely to “stick” but it is not clear what will happen to the majority of institutional changes which result from processes between these two extremes. Are they simply ineffective institutions? Finally, the theorem only takes a one-dimensional view of the process of institutional change without recognizing the complexity of the power dynamics in institutional change processes. This theorem, however, despite its flaws, was found to be a generally useful guide for predicting whether institutional change will “stick”.

Both Mahoney and Thelen (2010), and Boettke *et al* (2008) have provided useful contributions to theories of institutional change but if they are to be used to reach a mid-level theory of institutional change then the limitations identified will need to be addressed. Further iterations of these theories are needed, with subsequent additional empirical research to test them out. In particular they need to address the two common limitations of ambiguous processes and uncertain timeframes. Therefore, the challenge to institutional researchers is to take these theories forward to reach a mid-level theory of institutional change and engaging with participatory development practitioners (as discussed below) may be a useful part of that process. Grindle (2007) recommended that the *process* of institutional reform (or change) be understood as the “process is a complex one that unfolds over time” (*ibid* p. 569). So the contribution of participatory development practitioners to this debate will be discussed and the challenge of appropriate timeframes will be discussed in the following sections.

11.3.3 Participatory development informing institutional change theory

Six years before Mahoney and Thelen (2010) identified some of the spaces for change within institutions, Cornwall (in Hickey and Mohan (eds) 2004) was reflecting on how participatory approaches to development were explicitly “creating spaces where there were previously none, about enlarging spaces where they were previously limited opportunities” (*ibid* p. 77) to create “innovations in institutional design” and “styling new institutions” (*ibid* p.85). Surely there must be value in participatory practitioners like Cornwall, whose focus is changing the “rules of the game” (*ibid* p.86) to contribute to institutional change theory? In the opinion of Chambers, participatory practitioners “do not have time always to search and see whether what we do is new or a rediscovery.” (*ibid* p. 38). Bebbington (in Hicky and Mohan (eds) 2004 p. 278) understands this “tense interface between theory and practice.... in discussions of participatory development” as between some who see the need to “theorize strategy carefully” and others who view such abstraction as “tyranny that obstructs change-oriented action” and “privileges elite form on knowledge” (*ibid* p.278). Indeed, Bebbington recognizes that “the values that dominate academic assessment push academics away from practice” (*ibid*. p. 281) but despite these challenges he states that “theory workers and practice workers ought never to lose touch” (*ibid* p.281) and particularly in the field of participatory development.

So, perhaps deeper engagement between the institutional theorists and participatory practitioners who are usefully beginning to theorize their experience could provide useful input to both Mahoney and Thelen’s (2010) and Boettke, Coyne and Leeson’s (2008) theory.³⁰⁴ For example, Crook and Booth (2001 p. 101) state their “research is suggesting that the institutions most likely to contribute to development in low-income Africa are ‘practical hybrids’, combining the authoritative coordination which can come from a developmental neo-patrimonial state with an enabling environment for local problem-solving and a constructive use of culturally legitimate ways of working.” This is consistent with both Mahoney and Thelen (2010) and Boettke *et al* (2008) and with Grindle (2007) The practices of participatory experience which have arrived at these types of institutional functions and forms, could very usefully be mined to contribute to theory development.

11.3.4. Timeframes institutional change research

There is remarkable silence on the issue of the appropriate timeframe for studying change in the literature except from Williamson (2000). His approach recognizes different time frames for different levels of institutions and puts social norms as the slowest taking from a hundred to a thousand years to change. It is not clear on what basis he made that estimation but his point is that fundamental change of social norms takes generations. Given our understanding that markets are embedded in social norms then will it take at least a generation to carefully assess institutional change – a minimum of twenty years (which is approximately a generation). The time frame in this study was ten years but given that the constitutional change processes start before the actual

³⁰⁴ Bebbington (2004) recognizes that some participatory practitioners view theoretical abstraction as “tyranny that obstructs change-oriented action” and “privileges elite form on knowledge” (in Hickey and Mohan (eds) 2004 p.278) and so engagement is not an easy process.

institutional function changes, then ten years did not allow for a complete understanding of whether the institutional change would last or not. So it would appear more than a decade is needed. However, if a study were looking at smaller scale changes then there might be an argument for a shorter timeframe such as with operational institutions like the MCO standards. But this evidence suggests that such timeframes are still somewhat longer than project based interventions and required if institutional change is what is seen as at stake which will be discussed under the policy implications below.

11.4 Reflections on methodology

The strengths and limitations of two aspects of the methodology have had a direct bearing on these results. These are the ontological and epistemological foundations and the micro-ethnographic qualitative method.

11.4.1 The social constructionist ontology and interpretivist epistemology.

Under a social constructionist ontology, culture is not an inert objective reality but “social phenomena and meanings are constructed by the perceptions and actions of social actors and are in a constant state of revision” (Bryman, 2004, p.17) A social constructionist ontology is foundational to this particular research on institutions. This ontological understanding that social norms are in a “constant state of revision” (*ibid*) is more consistent with a path dependent view of change in these institutions, assuming that revisions are constructed by social actors and happen slowly. However, at a stretch, it could also be considered consistent with the institutional blue print approach if one assumes social actors are able to integrate institutional blueprints quickly, but an objectivist ontology is more closely aligned with the blue print approach. Therefore, even from the ontological foundation there is a presumption about how social institutions change.

The interpretivist epistemology considers language to be one means of interpreting our experience of the world, so the respondents interpreted their experience of engaging in the microfinance sector to me, according to their mental models (North 1990). But this epistemology also “requires the social scientist to grasp the subjective meaning of social action” (Bryman 2004 p.13), so my role was to grasp how institutional functions including social norms, operated in practice by engaging with the meaning that the respondents gave to those functions. As discussed in Chapter 3, a positivist epistemology would have had limitations in understanding social norms, because they are less open to verification independent of human perception, (although useful in relation to formal rules). Together, a social constructionist ontology and interpretivist epistemology gave me the freedom to understand institutions from the perspectives of the participants in the microfinance markets. To be able to develop a qualitative methodology that recognized the lived experiences of those engaging with markets everyday was essential; there was no other reality.

The great challenge of this ontological and epistemological foundation, however, is that the results are framed by the respondents, they do not conform to pre-designed academic categories, or frame

their answers in support or against a particular theory; they are not looking for similarities and differences between markets. This means that the respondents' view of the market will be personal, sometimes contradictory or inconsistent, messy and framed according to their own mental models. It is dependent on me to make sense of these complex responses. So the qualitative methods used had to be robust enough to "make sense of, or interpret, phenomena [i.e. institutions] in terms of the meanings people bring to them." (Denzin and Lincoln 2005 p.3). To make sense of respondents' perceptions of the social norms that were foundations for the microfinance market, required careful rephrasing or summarizing during the conversations (using facilitation skills) so that I was sure I understood their meaning. Then once all those perceptions were collated the next step was to see how they clustered together and make choices about what was a social norm and where the boundaries lay.

For the majority of the norms, there was a clear clustering in respondent's perceptions around the key norms reported in this study. However it is the ones that did not make the list where there may be questions. For example, in Uganda I was unsure how to treat the view held by a few that the entrepreneurial spirit of Ugandans was one of the building blocks for the rapid expansion of microfinance. In their opinion Ugandans had been traders and entrepreneurs since well before the British arrived and this was critical to the success of microfinance. However interesting, there is no enforcement characteristic for this norm and only a few people mentioned it; so I decided it could not be considered an institution for this study, but I may have missed a critical mental model in their culture. Likewise in Bosnia some respondents felt that the painful loss of the quality of life for clients was a critical building block for the rapid expansion of the sector. In their opinion the desperation of clients was critical, but this desperation did not appear to be fundamental social norm across the culture with enforcement characteristics. In both cases I decided not to include these "norms" in the final list of social norms. However, another researcher might have made a different decision or might have chosen a different qualitative methodology to understand the social norms. I had chosen a 'micro'ethnography within the self-defined subculture of the microfinance markets in Bosnia and Uganda, and this had strengths but inherent limitations too.

As most institutional analysis does not take a social constructionist ontology and interpretivist epistemology, this raises the question of whether it is a useful avenue for further institutional research. The findings would appear to show that this ontology and epistemology indeed merit further exploration for institutional market analysis.

11.4.2 Micro-ethnography methodology

The strength of ethnography is its focus on the participant's perspective, seeing it through their eyes and understanding the meaning they give to it all (Spradley, 1980). Lewis and Moose (2006) state that ethnographic research can "bring fresh insights into the social processes of policy, offering a "methodological deconstructionism" that draws attention to the nature of policy language (or discourse) that reveals how particular policy ideas...work to enrol supporters, ... forge political connections and create common realities from heterogeneous networks" (*ibid* p. 15 -16). A micro-ethnography is ethnography undertaken in this manner, but with tightly focused

research questions and field-work limited to addressing those questions. This highlights one of its several limitations as a methodology, namely that the topic, time frame and respondents were restricted. With such restrictions, decisions had to be made about who would not be included in the research. My decision was to go for breadth across all types of self-defined financial service providers reaching low income clients, together with the relevant government officials, recognizing that this focus had not previously been tackled, whereas the client research had been undertaken before (Johnson 2004a, 2005a). Clients were not part of the self-defined sub-culture, and a robust survey in two markets was not possible, so clients were not included, but this potentially limited the market analysis and the findings on social norms. There was also not depth within organizations so loan officers were missed out, as were more government officials. (Less directly engaged but still potentially relevant political parties, women's groups or financial education providers were not self-defined members of the sub-culture but that is an issue in itself.) The bias towards leaders of organizations and heads of government departments meant that as a group, their views were privileged as spokespeople for the sector. This appeared fair as they were the ones making decisions about the expansion of the sector, but with greater depth and diversity within organizations or departments, different results might have been found.

Another limitation was the nature of the engagement with respondents. There had to be time for each person to tell stories, reminisce, consider, eat or drink and discuss shared experiences, as part of expressing their perceptions of the institutions in the microfinance market. The term institution, per Douglass North, was not known to respondents, so the term "building blocks" for the expansion of microfinance was used as a starting point instead. (Building blocks was the everyday term used by Grindle (2007, p. 567) and by Honohan and Beck (2007, p.7) to refer to institutions.) There were over a hundred respondents some of whom I had known for many years with whom the conversations were free flowing, many going in unexpected directions as they reflected on the past ten years, some with anger and frustration and others with gratitude and interest. But the assumption behind these conversations is that we understood each others' meanings, particularly when it came to social norms. This may not always have been the case. There may have been religious, political or other attitudes that were too sensitive to discuss with me as a foreigner, a woman, a former colleague, or issues they themselves were not even aware of. Miscommunication may also have biased the result. To help overcome this bias there was a validity check of the findings in each market with representatives who spoke both English and local languages, who had worked with both clients and with international organizations and who had some academic background to understand the research methodology and its potential flaws – but again that profile brings its own biases.

There were volumes of recorded conversations. It was incredibly arduous to transcribe and then classify these accounts into themes and then to check back before grouping them together, compare the meanings of the conversations across markets. Without N'Vivo this would have been an impossible task. However, N'Vivo itself forces an element of bias into the results in the way that each comment by a person is effectively given the same weight, which may not be their intention, and each person is also given the same weight, which also may not be their perception of their importance. So N'Vivo was simply used to grapple with the volume of data and to help reveal the institutional "bricolage", but not to provide any quantified reporting of results. Rather,

the goal in creating the ethnographic text was to write against the typifications of communities (Abu-Lughod 2000 p. 262) and instead express the “contextually bound and mutually created story” (Fontana and Frey 2005 p. 696) in ways that provided “fresh insights into the social processes of policy” (Lewis and Moose 2006 p. 15).

The benefit of using this methodology was that, once the validity checks had been undertaken, if commonalities were to exist then they would have the power of the market voice from two major microfinance markets for financial inclusion institution building; (not an independent expert’s analysis.) There were indeed commonalities, but not ones that had been expected prior to conducting the field work. My experience was similar to that of Drinkwater (in Cornwall and Pratt (eds) 2003 p.61) who reflected that “conducting extended fieldwork taught me important lessons about the limits of what we take as truths, based either on our own convictions or on existing knowledge”. When I came with an open mind to learn from the market participants as a researcher, I learned about local social norms which I had not understood before, the importance of constitutional institutions which I had dismissed before and why some processes of change had succeeded and others failed. These were revelations.

In conclusion the methodology provided an opportunity for this set of respondents at the time of the field work to describe their understanding of local social norms and other building blocks for the expansion of the microfinance market, in terms they typically used. Accordingly, they are “socially constructed” building blocks, true for the respondents during my conversation with them and are given recognition as such.

11.5 Implications for financial inclusion policy

A study of institutions in two comparable microfinance markets is not an adequate basis to make definitive financial inclusion policy recommendations. However, it is a sufficient basis to reflect on what has been learnt and to tentatively suggest ways that policy might be progressed, so that the policy implementation can become part of the process of learning.

On reflection there are four key messages for financial inclusion policy makers and microfinance practitioners from this research. First, there are basic constitutional and operational institutional functions which appear to support poor people’s participation in the financial market which deserve further examination in each country context. For example, The Alliance for Financial Inclusion (AFI) (a network of developing country Central Bank Governors and Ministers of Finance) is implementing the G20 Principles for Innovative Financial Inclusion (Goodwin-Groen 2010). AFI may want to consider the appropriateness of these institutional functions under the Leadership principle. Likewise the new Financial Inclusion Practice at the World Bank may want to engage with either their country partners or the World Bank Governance teams to consider how and whether institutional reforms might usefully consider these functions. Such an engagement approach would respond to the call for “good enough governance” (Grindle 2007) as applied to institutions in microfinance.

A constitutional institutional function of including poor people in the financial system has not been previously identified as critical to financial market development and is not present on the list in Chapter 2 Table 1 so the first step would be one of giving this evidence further consideration. This is not about a new microfinance law. Each country has its own unique mix of institutional forms but, this evidence is about where institutional functions to support poor people's inclusion in the formal financial system might be appropriately included. For example, appropriate supervision of microfinance and the function of supporting the development of the sector, if considered more important than in the markets of Bosnia and Uganda, could be undertaken at the formal constitutional level.

There are, of course, broader financial inclusion institutional issues not addressed by these findings such as consumer protection and private sector development more generally. So it is important to note that if national discussions about financial inclusion are being enjoined then questions such as what kind of institutional framework prevents profiteering from poor clients and what is the relationship between financial inclusion institutions and business development, should also be discussed.

The second and third points are closely connected. Second, there is no such thing as a "best practice" institutional form for financial inclusion. There are only institutional functions congruent with local social norms which support poor people's participation in the financial market. Third, unless the institutional change processes to arrive at these institutional functions include market participants and either clients (or the perspective of clients) then the new institutions will not be congruent with local economic social norms and will not last. If anything this research has shown that the wholesale transfer of what are considered 'best practice' institutions from either Europe or Bangladesh to any other country is a recipe for failure. The underlying norms in each country are simply not the same and will not be able to support the operational or constitutional institutional transfer. The only way that new institutional functions can be embedded in local social norms is if the change processes are carefully structured to share power with key stakeholders to allow the social norms to be worked through into the new institutions. Experience has shown that this is a time consuming process and will require commitment to see the process through, but no short cut is possible.

Fourth, there is, potentially, a role for external funders as catalysts for institutional change but it is a long term catalytic role and unless funders are prepared to commit to the lengthy process (possibly up to 20 years) and be facilitators (not leaders) then perhaps they should not start. The Bosnia and Uganda microfinance markets show that donors can play a critical catalytic role in actively supporting the local institutional change processes that are transparent and inclusive of all key stakeholders, if they stay for the long term. It is by ensuring that all stakeholders have the skills to actively participate, that the process is understood by all stakeholders and to assure other stakeholders that the inclusive process will result in institutional functions that are congruent with social norms. The catalytic role by donors in Bosnia in engaging the MCO in the design of their own performance standards, and in Uganda by facilitating the inclusive stakeholder process prior to MDI Bill were examples of such success. There is greater awareness of the importance of a long term commitment beyond typical donor projects time frame of 3-5 years, and these were two

such examples. The importance of a long-term commitment can best be summed up by Henry Mbaguta an MoFPED official in 2007 and now the Ugandan Assistant Commissioner for Microfinance who said: “financial inclusion does not come easily – it is a long term issue”.

11.6 Possible future research

Although this research has started to address the gaps in knowledge at the intersection of institutional development, financial market development and financial inclusion, there are still many theoretical and policy questions to be answered.

As discussed above, the conclusion that institutional function best represents North’s definition of an institution needs theoretical debate so that progress can be made towards a common definition. If institutional function is indeed a common useful definition, this would facilitate comparable empirical research on institutions which has been widely called for. Theoretical research and debate is also needed on the usefulness of a social constructionist ontology and interpretivist epistemology for institutional analysis. Most institutional analysis does not take such a perspective, yet the findings presented here show that this ontology and epistemology merit further exploration for institutional analysis.

The two recent theories of institutional change examined in this thesis offer valuable insights beyond simplistic theorization (Chang 2011), in identifying spaces for change and how changes will ‘stick’. Further iterations of these theories are needed to address their common limitations of ambiguous processes and uncertain timeframes. In particular, the theories need to be able to incorporate multiple sets of agents (including external development agents) and multiple institutional functions. In addressing these limitations and recognizing the complexity of institutional change processes, these two theories could be taken forward towards a mid-level theory of institutional change.

Turning to the Bosnian and Ugandan microfinance markets there is clearly still a need for robust longitudinal anthropological research on social norms, and in particular to understand them from the client perspective. This would provide a more detailed and nuanced understanding of those norms for future institutional analysis than was possible in this research.

Finally, in order to test the financial inclusion policy findings similar institutional field work needs to be undertaken in other markets where microfinance has expanded rapidly such as Bangladesh, the Philippines or Bolivia. Subsequently, this evidence could then be used to develop research questions for institutional analysis of microfinance markets that have not expanded significantly. If results are consistent, this would start to build a compelling evidence base for fundamentally changing the focus of financial inclusion policy to developing appropriate institutional functions.

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Appendix

List of Bosnian organizations for which respondents worked, date of coded interviews and code numbers.

Micro-Credit Organizations: code is “MCO” then the number below

1. Mikrofin: May 2008
2. Mikrofin: February & May 2008
3. Sinergija: May 2008
4. LOK: May 2008
5. MIKRA: May 2008
6. PRIZMA: May 2008
7. MI BOSPO Feb & May 2008
8. MIKRA Feb & May 2008
9. Women for Women: May 2008
10. Partner: May 2008
11. Sunrise: May 2008

Banks: code is “B” then the number below

1. Raiffeisen Bank: May 2008
2. Hypo Bank Group Federation: May 2008
3. ProCredit Bank (formerly Micro Enterprise Bank): May 2008
4. Volksbank: May 2008
5. Hypo Bank Group RS: Feb & May 2008

Government Agencies: code is “GO” then the number below

1. Federation Insurance Supervisor: May 2008
2. Deposit Insurance Agency of Bosnia and Hercegovina, RS Branch: May 2008
3. Office of the High Representative: May 2008
4. Central Bank of Bosnia and Hercegovina: May 2008
5. Development Bank of RS: May 2008
6. RS Ministry of Finance: May 2008
7. RS Banking Agency: May 2008
8. Federation Banking Agency: May 2008

Funders: code is “F” then the number below

1. World Bank: Feb and May 2008
2. USAID May 2008
3. USAID May 2008
4. European Fund for Southern Europe (EFSE): May 2008
5. World Bank: Feb 2008
6. World Bank consultant: Feb 2008

Private Sector: code is “PS” then the number below

1. RS Insurance Company: May 2008
2. LRC Kreditini Biro: May 2008
3. VB Leasing: May 2008
4. Price Waterhouse Coopers: Feb and May 2008
5. Faculty of Economics, University of Banja Luka: May 2008

List of Ugandan organizations for which respondents worked and coding. All respondents’ coded interviews occurred in August 2008.

Microfinance NGOs – unable to intermediate savings: code is “MFNGO” then the number below

1. Faulu Uganda Ltd. (Non-Bank Financial Institution)
2. FINCA
3. Success Microfinance Services Ltd.
4. FOCCAS
5. VSLA Program of CARE Uganda
6. MED Net
7. Three MSCL SACCOs in Iganga
8. Iganga District Farmers Association
9. BRAC Uganda
10. UGAFODE

Microf-Deposit taking Institutions: code is “MDI” followed by the number below

1. UML (now Equity Bank)
2. FINCA
3. PRIDE Microfinance
4. Finance Trust (formerly Uganda Women’s Finance Trust)

Bankers: code is “B” followed by the number below

1. Stanbic Bank
2. Centenary Bank
3. DFCU Bank
4. Barclays Bank
5. Post Bank
6. Bank of Africa

Government Officials: code is “G” followed by the number below

1. BoU
2. BoU
3. Minister of State for Microfinance
4. Henry Mbaguta, Assistant Commissioner for Microfinance – MOFPED
5. BoU
6. MOFPED

Funders: code is “F” followed by the number below

1. African Development Bank
2. Microfinance Support Centre Lts. (MSCL)
3. Stromme Foundation
4. World Bank
5. GTZ, BoU
6. European Union
7. DANIDA

Private Sector: code is “PS” followed by the number below

1. Planet Rating
2. Microfinance Consultant
3. Private Sector Consultant
4. Microcare
5. Money lender and Consultant
6. Microfinance Consultant
7. Financial Agent
8. CAPITEC Investment Company Uganda
9. AIG Uganda Insurance
10. Uganda Securities Exchange

Networks: code is “N” followed by the number below

1. Association of Micro Finance Institutions of Uganda (AMFIU)
2. Uganda Bankers Association (UBA)
3. Uganda Institute of Bankers (UIB)
4. Uganda Insurers Association (UIA)
5. AMFIU
6. Uganda Cooperative Savings and Credit Union Ltd. (UCSCU)