DEPARTMENT FOR INTERNATIONAL DEVELOPMENT

The Department for International Development (DFID) is the UK Government department responsible for promoting development and the reduction of poverty. DFID seeks to work in partnership with governments committed to these targets, with business, civil society and the research community. DFID also works with multilateral institutions such as the World Bank, United Nations agencies and the European Community.

The central focus of the Government's policy, set out in the 1997 White Paper on International Development, is a commitment to the International Development Targets, to halve the proportion of people living in extreme poverty by 2015. Associated targets include basic health care provision and universal access to primary education by the same date.

A second White Paper on International Development, published in December 2000, reaffirmed this commitment, while focusing specifically on how to manage the process of globalisation to benefit poor people. This paper, "Eliminating World Poverty: Making Globalisation Work for the Poor" argues that to conquer poverty requires sustained *economic growth* in developing countries; and this cannot be achieved without the *private sector*.

- A concise description of the objectives of your rural finance strategy.

Within DFID rural finance falls into the overall Financial Service Development Strategy.

Within this framework the main objectives are twofold:

1) To address ***market failures*** that prevent the financial sector from raising (rural) economic growth and helping the (rural) poor;
2) To address ***public failures*** that prevent the financial sector from raising (rural) economic growth and helping the (rural) poor.

As the developmental approach to the rural sector has increasingly become influenced by policies seeking to create a conducive enabling environment for private sector investment and growth it has become necessary to consider approaches to facilitate this process.

Evidence suggests that market liberalisation reforms and deregulation have failed to make a significantly impact on reducing rural poverty. This is compounded by the fact that the number of donor supported rural finance programmes that could facilitate private sector investment and growth, are in decline. In light of this evidence DFID along with other donor agencies is in the process of reassessing its approaches to rural development and finance.

DFID experiences from the field suggest that current conditions still reflect outdated approaches with less than optimal coordination between service providers leading to a confused mix of schemes provided by different donors attempting to achieve different goals. The continued supply of government and donor driven heavily subsidised credit and targeted lending leads to *crowding out* commercially viable alternatives and compromises the establishment of sustainable solutions.

An encouraging trend during the 1980s and 1990s has been a growth in the diversity among intermediaries, notably specialised financial institutions serving low-income clients and supporting community level action, and non-bank financial institutions. This thriving micro finance industry has developed a growing range of services and technologies for market oriented trading, manufacturing and service businesses in peri-urban and urban areas.

DFID's strategy particularly encourages support for the provision of suitable savings and insurance services alongside credit, to provide economic security, maximise the mobilisation of local financial resources and hence reduce the micro finance institution's dependence upon external capital. This approach stresses the importance of financial intermediation and seeks to enhance the efficiency of resource allocation by operating at non-subsidised market rates. The focus on creating an infrastructure for the provision of effective financial intermediation services and simultaneously creating efficient and viable financial instruments both for farming and non-farming activities will seek to establish forward and backward linkages to other market sectors and reduce transaction costs.

DFID will continue to strengthen the retail capacity of micro finance institutions. The focus will be on further development of financially sustainable financial service instruments and provide technical and financial support services to rural micro finance institutions to extend their scale, outreach and most important, their commercial viability. In its micro finance work, a market pricing strategy will be applied wherever possible on capitalisation of loan funds and the setting of interest rates.

Consequently DFID recognises that the financial sector continues to have an important role to play in reducing poverty by raising rural economic growth and directly helping the poor. DFID therefore also supports the deepening of capital flows and technology to fill the "missing middle" between international markets and commercial banks, or between international markets and financial institutions or small and medium scale enterprises.

However, in order to make the financial sector play its role and work for the poor the underlying problems in terms of market failure, public failure have to be clearly identified and responses prepared to tackle each problem where possible. For instance, considering the marginal viability of much farming activity in the developing world for smallholders, recent research conducted by DFID highlighted that facilitating technology transfer to rural areas is essential to achieve necessary productivity growth in rural areas.

Hence DFID believes that it is essential that the market and governance failures have to be addressed especially in the agricultural technology supply chain. The existence of these drives a wedge between social and commercial rates of return on investment. The failures also reduce effective demand for new technologies by farmers and raise supply costs and risks for producers and suppliers of new technology. As a result the production and marketing of new technologies and their subsequent impact on productivity are deterred and diminished. Without substantial gains in rural productivity, it will be difficult to achieve sustainable rural growth and any significant reduction in rural poverty. DFID focus is on trying to bridge the gaps between markets, extending rural finance but using new technologies to make it more viable.

Research into rural finance will continue and be considered in light of current discussions and developments at national, and multilateral level. The outcome of this process will contribute to improving the framework for rural support in general and the financial sector in particular. DFID believes it can be effective by showing leadership, building coalitions, assembling appropriate information and co-ordinating donor efforts towards clearly specified goals. These goals include a special focus on reducing transaction costs, accelerating rural deposit mobilisation, increasing he number of people who have access to rural financial services, building viable and durable rural financial intermediaries and reducing risks that effect their performance.

- **Which office or offices in you organization are responsible for implementing the strategy. Contact information would be helpful.**

Both at local and international level DFID works across different departments to foster an enabling environment for broad-based and sustainable rural growth. The relevant departments involved include the Enterprise Development Department (EDD), Private Sector Policy Department (PSPD), Rural Livelihoods Department (RLD) and the Natural Resources Department (NR) at From 1st April 2003 the Financial Services Team within DFID's Policy Department in London will take the lead on defining and formulating the rural finance strategy, collaborating and coordinating with other international donors on improving approaches to rural finance within the context of overall financial service development.

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At local level DFID regional and country offices will be responsible for implementing the strategy. Since DFID operations have been decentralised, the exact nature and focus of work in-country is dependent on the specific country situation identified in Poverty reduction Strategy Papers (PRSPs) and Financial Sector Assessment Programmes (FSAPs). An assessment of DFID's comparative advantage vis-à-vis other donors active in the field helps to formulate DFID in-country priorities that are listed in the Country Assistance Plans (CAPs) and form the basis for DFID interventions.

DFID interventions at country level can be summarised into three main areas:

i. The macro approach seeks to improve the legal and regulatory framework to facilitate rural enterprise development and growth. It works with local and national government, legal bodies and other development institutions to promote the development of sound policies that take into account the constraints faced in rural areas.

ii. At a meso level, DFID works with institutions, such as local bodies, existing micro finance institutions and NGOs to expand outreach on a commercial and sustainable basis. Initiatives in this area will continue to be carried out in close partnership with international financial institutions and specialist consultants to provide leveraged funding and expertise.

iii. At a micro level, DFID will work with existing organisations to target improved efficiency amongst small and medium-scale enterprises by raising export performance standards and to help them compete in export and domestic markets thereby creating the demand for sustainable and improved financial services at local level by fostering innovation and market development.

- **What level of funding are you providing annually to implement the strategy**.

DFID employs some 35 enterprise advisors and field managers both in London and overseas, with a current (2001/ 2002) portfolio of project commitments totalling over £ 200 million.

- **What is the geographical and/or country focus of your programs (e.g. worldwide, regional - South East Asia, and/or country - Zambia, Angola, etc.).**

Programmes DFID is supporting are global in nature focussing extensively on developing and least developed countries. Specific emphasis is on Africa, Asia, the Caribbean and Central and Eastern Europe. See www.dfid.gov.uk

- **What type of interventions is your program is championing?**

SOME EXAMPLES OF DFID SUPPORTED PROGRAMMES

International Community (Multilateral)

Consultative Group to Assist the Poorest (CGAP)
What: a consortium of 29 bilateral and multilateral donor agencies working in micro finance, of which DFID is an active member.
Why: in terms of our analytical framework, this is concerned with helping the poor directly, and is designed to tackle both market and government failures. The market failures are in arms-length transactions of 'knowledge' and economies of scale, which mean that there is under-provision of information on micro finance. CGAP provides a solution to this is as a clearing house on best practice in micro finance. There is also a public failure in lack of mainstreaming of best practice among donors and coordination between them. CGAP tries to improve this through donor training, the development of common donor standards, and co-ordination in-country.
Assessment: it has been most successful in its information dissemination role, developing since its establishment into the most important global resource base for the micro finance industry. However, its work on donor mainstreaming and coordination has been less successful, due largely to a lack of will on the part of the donors. This is of course the main constraint with using any international body as an instrument: it is only as effective as its member countries allow it be. Which brings one back to the influencing tools. Our Secretary of State has therefore become personally involved in this area, discussing with CGAP how to ensure aid effectiveness in micro finance. As a result CGAP will be co-ordinating a series of donor peer reviews to help them identify and act on internal success factors and constraints that influence the effectiveness of their microfinance operations. Ten donor agencies will participate in the first round, the preliminary findings of which will be discussed during a meeting in Morocco in September 2002 hosted by the Secretary of State and CGAP.

Financial Sector Reform and Strengthening (FIRST) Initiative
What: a multilateral initiative to provide technical assistance to help countries address financial system weaknesses identified in FSAPs and ROSCs and to implement the new international financial standards and codes. It will also act as an information exchange for donors on the delivery of financial sector technical assistance. DFID has been a prime mover in its creation.
Why: this may also be justified in terms of both market and public failures, but is concerned with reducing poverty by improving the financial sector's capacity to raise economic growth. The formulation and implementation of international financial standards and codes (S&C) is important in overcoming asymmetric information of domestic investors and savers as well as of international investors about the credit-worthiness of domestic governments, firms and financial institutions, improving the access of developing countries to resident and international capital by signalling financial prudence and stability. S&Cs and FSAPs also overcome the information constraints faced by developing country governments about international best practice for financial sector development and in understanding the key problems and solutions with respect to their domestic financial systems. However, there is a public failure in terms of a lack of capacity to implement key S&Cs and FSAP recommendations. Furthermore, the magnitude of technical assistance required goes beyond the resources and expertise that any single institution can provide. There is therefore a need for a mechanism to co-ordinate the efforts of the international community in providing technical assistance and capacity building to LDCs in this areas, that draws from both public and private providers of technical assistance. FIRST is such a mechanism.

Assessment: FIRST is expected to be up and running later this year, so it is too soon to make any judgements over the effectiveness of the instrument. Its comparative advantage will be its flexibility and speed and access to global public and private sector expertise. Interventions will be strategic, plugging the gaps in other donor efforts and acting as a catalyst for long-term capacity building. However, we have much to learn about the effectiveness of standards and codes, particularly with respect to developing countries.

Governments

Monitoring Private Capital Flows to Developing Countries Project

What: TA and grants to national governments, primarily in Africa, to raise their capacity to monitor private capital flows, in particular through investor surveys.
Why: international financial stability and domestic macroeconomic stability may be considered public goods that are essential for a secure financial sector. As well as international action to create an international financial architecture that limits capital flow volatility, national governments must improve their capacity to manage such flows. This will include the careful sequencing of capital account liberalisation, the ability to impose temporary capital controls, and a responsive macroeconomic policy. Good information about the size, composition and source of flows is essential for this, but in liberalising their capital accounts many developing countries have lost their monitoring capacity. There is therefore a need for innovative methods to improve the capacity of developing countries to monitor their capital flows.
Assessment: the pilot phase of the project has been successful in terms of short-term effectiveness, finding inflows to Africa to be much higher than was previously thought. For instance, in Tanzania FDI inflows were found to be 5 times higher than previous estimates. As for long-term capacity building and sustainability, efforts have been made to ensure its institutionalisation, but there will be a need for a second phase to transfer the technical assistance function to regional financial organisations.

Private Sector

AfriCap

What: DFID has provided to the Canadian NGO Calmeadow £3.4m in grants, which it has invested as equity in a new company – AfriCap Microfinance Fund. This Fund will seek an appropriate return on investment for its shareholders while promoting the growth of regulated and efficient financial intermediaries in Africa whose main target market is SMEs.
Why: the project is concerned with SMEs and so we are dealing with the financial sector's role in promoting pro-poor economic growth. The market failure is incomplete information on the part of the formal financial sector about the profitability of financial services to SMEs, which is one of the key factors limiting the access of such MFIs to private capital. The solution is therefore to demonstrate commercial viability through providing finance to MFIs on near market terms.
Assessment: although it is too soon to judge the effectiveness of AfriCap (it became operational in October 2001), the model has already been used by ProFund International in Latin America. With $18.5m invested in 10 institutions, ProFund has succeeded in attracting commercial capital to every one. However, in no case has it fully exited and sold all of its equity holdings, and so the financial sustainability of the institutions has not yet been fully tested.

Financial Deepening Challenge Fund (FDCF)

What: an £18.5m challenge fund to provide grants to commercial private sector associations, or such associations in partnership with civil society or government, to improve access to financial services for the poor and previously excluded groups in Africa and South Asia. The focus is on innovative projects

that address weaknesses in financial services that are unlikely to be solved by the private sector alone, and which can be replicated or scaled-up reasonably quickly, particularly by country programmes.
Why: there are various market failures that may lead to under-investment in R&D in providing financial services to the poor, including externalities in R&D, incomplete information about the profitability of banking on the poor, and merit good considerations. The fund is also trying to tackle a government failure in encouraging public-private partnerships.
Assessment*:* in the two bidding rounds to date, seven projects have been approved, with £3.7m provided by the fund and £4.8m by private sector partners. The transparency and speed of the process have been welcomed. However, few proposals have been received to improve the enabling environment for financial services for the poor, since individual companies are unwilling to invest in initiatives from which their competitors will also derive benefit. Businesses have also been discouraged by DFID's standard policy of having the right over any intellectual property generated by the projects. This policy will need to be reviewed. It would appear to be less suitable for public bodies, whose budget processes are less able to take advantage of competitive funding opportunities.

Other

Ugandan Financial Sector Deepening Project:
Takes a sectoral approach to supporting the Government of Uganda's policy for financial sector development, providing a series of strategically focused interventions to address critical constraints to the development of Uganda's micro-finance sector, namely: investment capital; institutional capacity-building; product development; financial market integration; micro-finance support service providers; research and innovation; and improving the institutional framework. Works with a wide range of agents and uses a wide range of different instruments as appropriate.

Emerging Africa Infrastructure Fund (EAIF):
Provides long-term loan finance to infrastructure projects in sub-Saharan Africa. DFID and other donors are providing grants of more than US$100m to a specially created trust that in turn has invested in EAIF as equity. This 'equity cushion' provides a degree of security to leverage in US$205m of loans from a consortium of banks led by Standard Bank Africa.