

# **The Microfinance Promise in Financial Inclusion: Evidence from Pacific Region**

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## **Abstract**

Finance is one of the most effective tools not only for growth but also poverty reduction. Increased access to adequate and timely finance improves the welfare status of both producers and consumers. In addition to the relationship between financial sector development and growth, an inclusive financial sector has both indirect and direct impact on poverty alleviation, firstly because of the linkages between financial sector development and more equitable growth and secondly, because of the impact of broadening access to finance – especially to the poor, rural communities and women. Due to failure of formal financial institutions to fully align their services and products to low income and disadvantage groups of people, the microcredit or more broadly microfinance approach was innovated and institutionalized in the Pacific region rural credit system. It was aimed at overcoming the failure of the formal credit system and hence poverty reduction through income and employment generation. As a result microfinance institution has made inroads into the rural areas to improve and extend timely, easy and adequate access to financial services. The present paper examines the nature and the type of the new institutions that imaged in the Pacific region financial system hence making it more responsive and inclusive. The study finds that the micro banking model and Microfinance Institution models are the two dominating microfinance approaches in the post-financial reform in pacific region. The study also find that the microfinance sector in the Pacific region is growing with the government assisted National Microfinance Unit and Cooperative on the one hand and on the other hand, the Non-government organizations are transforming themselves into financial institutions and entering the business of microfinance.

## **1.0 Introduction**

Developing countries attach great importance to finance in the pursuit of an effective means in realizing economic opportunities and addressing poverty. Improving access to financial resources enhances the welfare of both producers and consumers. Access to the financial services allows individuals to apply their skills in engaging in small entrepreneurial activities and thereby providing them enhanced opportunities to improve their income. Access to the finance reduces poverty through increased income and hence positively reduces the income inequality. As many studies have shown that providing low-income households with access to financial services improve their productivity and management skills, create jobs, smooth income and consumption flows, enlarge and diversify their businesses, and improve their incomes and has positive spillover effects on other intangibles such as health care and education (Morduch, 1995; Gulli, 1998; Khandker, 1998; Pitt and Khandker, 1998; Zeller, 2000; ADB,2000a; Parker and Nagarajan, 2001; Robinson, 2001; Khandker, 2001; Khandker , Faruque, 2001; Coleman, 2002; Morduch and Haley, 2002; Pitt and Khandker, 2002; Khandker, 2003).

In the South Pacific, the state development banks were established since 1960s to provide loans to agriculture and small enterprises. The state banks were given the responsibility to transform the farmers and small enterprises from the traditional subsistence economy into a more commercialised agriculture to integrate into a formal market economy. However, it is evident that banks have not been successful in achieving these objectives as they served primarily the needs of the relatively well-to-do rural borrower in contrast to marginal/landless farmers who were initially the target of such schemes. Access to other financial services like insurance are even more limited for the rural poor. Difficulties experienced with access to development finance from formal financial institutions and the seemingly extortionary credit conditions of informal finance sector provide a strong need and ample space for innovative approaches to serve the financial needs of poor households in the Pacific region. Over a past decade, governments in partnership with financial institutions and NGOs have made efforts to develop novel approaches for financial delivery to the poor. These microfinance approaches have been designed to integrate the credit conditions of credit worthiness, the safety and reliability of

formal sector financial loans with the convenience and flexibility that are typically associated with informal sector loans.

Against this backdrop, the present study makes an attempt to examine critically the nature and type of new institutions that have emerged in the Pacific Islands and to critically analyze the role of governments to facilitate measures to address the financial needs of poor and small businesses. The study also analyses the success of such schemes over the years, possible drawbacks and makes recommendations. The analyses is limited to MFIs listed in Mix Market and Microfinance model in Fiji.

## **2.0 Microfinance: Innovation and Revolution**

Formal financial institutions have failed to provide adequate sustained credit services to certain sectors of the economy. The key factors for such market failure are associated with uncertainty, information asymmetries and moral hazard that generate high risk for financiers and high cost to borrowers. The problem becomes increasingly more profound when the borrowers are poor and lack of adequate collateral that makes it difficult for lenders to enforce contracts. Thus, microfinance with its package of savings, credit and insurance provisioning has revolutionized credit facilitation and has demonstrated its efficacy for social and economic empowerment through financial intermediation where markets are ‘missing’.

Microfinance has been widely accepted to minimize risk in the credit market through group lending contracts with joint liability. Group lending contract has been regarded as a potential solution for bridging the gap between the supply and demand for rural finance. Borrowers under this scheme organize themselves into groups of five and approach the Banks. After formally agreeing to the rules and regulations set up by the banks, first two members of the group will receive the loan. After the loan has been re-paid by the first two borrowers, the next two members receive the loan and similarly the fifth member accesses to the loan after the second two re-pay theirs. As long as the loan is re-paid successfully by all the members, future loan is guaranteed. However if any of the members default with repayment all the members of the group will be denied loan in future. Thus group loan or joint-liability provides incentives for each member of the group to provide a ‘safety net’ to others to prevent defaults on loan repayments. Thus repayments are made in cost effective manner and results in minimizing

transaction costs associated with loan defaults, increased volume of loan transactions and improved facilitation of credit to poor. Group lending with joint-liability is the most important and successful aspect of the microfinance scheme.

Since the inception of the Grameen bank, the microfinance as a poverty alleviating tool has spread across the world like wild-fire. Such popularity of the scheme is a self testimony of its efficacy. Advocates of poverty alleviation, women empowerment and NGOs have strongly shown support for microfinance as a poverty alleviating tool. The microfinance models has been duplicated in countries such as Bolivia, Chile, China, Ethiopia, Honduras, India, Malaysia, Mali, the Philippines, Sri Lanka, Tanzania, Thailand, the United States, Vietnam and many small Pacific Island countries.

There are many forms of MFIs institution that provide financial services to the poor, these includes NGO's and regulated financial institutions. They play a complementary role to formal financial institutions. Many MFIs have earned legal status and are non-profit institutions, cooperatives, registered banking institutions, and government organizations.

Failure of government and donor supported rural credit programs have led to inception of MFIs with the aim of reaching out to the very poor in rural areas.

As MFIs institutions have become more efficient and increased their client base, they have begun to expand their services through different product offering such as micro-saving, flexible loan repayment and insurance. Development in the microfinance has influenced saving behavior amongst the clients. Some of the MFIs encourage daily savings, and hired field workers from local areas to collect the savings from the client on daily basis at a minimum cost. This is something that commercial banks may not find feasible. The MFIs are also able to encourage saving among the members by allowing them unlimited withdrawal at low interest rate. Experience has shown that many clients prefer higher liquidity than higher interest rates, a practice quite consistent with the notion that the poor consume a higher proportion of their incomes.

Many MFIs have adopted flexible loan repayment. While the MFIs maintain the solidarity group model, however the clients are provided with the option of repaying loan on an individual basis. This releases the unnecessary pressure on the group. The individual repayment is allowed on the

assumption that the client is credit-worthy. Flexible loan allows the client to re-schedule their loan during a difficult period without defaulting.

The third facility offered by MFIs is the insurance. The most basic of the insurance service provided is the debt relief on the death of the borrower. Others like health insurance and natural disaster insurance are been explored.

However, the modern MFIs are trying to enhance their operational, intermediation and dynamic efficiencies by using market based funds to achieve financial self-sufficiency. Thus, for longer term sustainability many microfinance institutions are now making transition to profit orientation. Some MFIs, such as, Grameem bank, BRAC (Bangladesh), MMF( Malawi), SANASA (Sri Lanka) are NGOs, but some have become NGO-MFIs as they have transformed into banks, now operating on much larger scale. According to IFPRI survey 1999, the unregulated NGO-MFIs account for 61.4% in the world of microfinance (Shetty and Veerashekharappa, 2009).

### **3.0 Why Microfinance in the Pacific?**

Generally the growth rate for most of the Pacific Island countries are likely to decline in the foreseeable future, implying that the economically vulnerable would need alternative means of livelihood. Unattended this may lead to unemployment, poverty, greater income inequality, crime and other vices that are likely to increase. Political and rising ethnic tensions in most of the Pacific Island Nations amongst others have resulted in a sluggish economic performance. Many have lost jobs. School drop outs and new tertiary graduates are failing to secure employment. Expiry of land leases particularly in Fiji, have pushed many people out of their farms or the traditional sources of income. The specificity rule prods us to tackle the problem at source or as close to it as possible. Microfinance cannot only induce clients to generate economic activity themselves but can also provide basic training to up-skill the target group. Hence the answer may be microfinance.

Furthermore, Microfinance is likely to provide valuable information to clients on various impacts of the climate change and global warming and better prepare them for the future. It is likely to encourage saving behavior amongst the clients and possibly insurance. It can further encourage and provide finance to clients to acquire environment friendly goods.

Further due to high labour mobility from the Pacific Island countries large inflow of remittances need to be channeled to productive use. Microfinance can provide guidance and initiative to better utilize this funds through financial literacy education, intermediation and creating awareness for various viable economic projects.

#### **4.0 Microfinance industry in Pacific region**

In Pacific Region microfinance has continued to grow rapidly for financial inclusion to a growing share of poor households and to approximately 80% of the population that is yet to be reached directly by formal institutions. Various methods of microfinance financing exist in Pacific region. These includes state commercial and commercial banks, Solidarity groups, a Grameen bank adopted model, individual direct lending model, cooperatives and private microfinance industry.

At macro level, increased efforts have been made to enhance accessibility of credit to poorest of the poor. For instance, in PNG, two microfinance institutions are registered by the Central Bank as registered financial institutions (Aube, 2010). Similar efforts have been made by reserve bank of Fiji. Following the directive of the Reserve bank of Fiji in May 2009, there is in the delivery of microfinance services in Fiji (Reddy 2009). All commercial banks including the Fiji Development bank have facilitated Microfinance Units in 2010.

There are total of 53 MFI operating in Pacific region, 40 in PNG, 9 in Fiji, 2 in Samoa, 1 in Vanuatu and more lately 1 in Tonga (see table 1) with a total outreach of about 375,360 clients. The initial example of the commercial bank model that existed in Pacific region providing microfinance service include; PNG microfinance Limited, Nationwide Microfinance Bank, National Bank of Vanuatu and 'aPex' remittance services in Samoa. In PNG there are two commercial banks which are making inroads to rural finance. PNG Microfinance Limited which was set up in 2004 with the assistance of International Finance Corporation assistance has about 116,000 accounts according to IFC report. The other bank which made commitment to rural finance is Nationwide Microfinance Bank which has about 60, 000 accounts. Similarly in Vanuatu, after being close to facing liquidation in 1990s, National bank of Vanuatu restructured between 1999 - 2001. Part of the restructure initiative was to make a concerted commitment to rural banking services, including making modest micro lending to rural clients. Technical

assistance was provided by ADB to facilitate the bank's commitment of micro-lending. While the bank has made some inroads in assisting rural clients with micro finance, however, it only makes up a very small percentage of total loans of the bank, which was approximated to be around 2% in 2006. Under the microfinance facility the bank provides collateral free loans to clients, which is totally based on the character references of clients. The village chiefs are usually consulted to provide the character references of clients, and who also agree to apply pressure to clients to fulfill their commitments. However with gradual weakening of the traditional authority and migration, this system is becoming less and less effective.

There are a number of cooperative microfinance models in the Pacific. The cooperative model shows promise. Statistics indicate there is a steady market for microfinance services provided through such models. For instance, 'Hebridean' savings and Loan (S& L) Cooperative Ltd, Vanuatu. Though registered under the cooperative act and reporting to government ministry responsible it operates more like a private institution. It provides loan to rural clients, however it requires 100% cash deposits as collateral. Clients still to borrow from the institutions as they not willing to use their accumulated cash. There are also two prominent government cooperatives providing services in Fiji; Northern Microfinance cooperative which started in 2003 and Central eastern cooperative which started in 2008.

Microfinance Institution model (solidarity group) is also very promising, for instance, in Fiji there are eight Microfinance Institutions. While the solidarity maintains its traditional structure in terms of collection and distribution centers for loans, it has evolved to a more individual banking for savings and that has improved the efficiency of the institutions. There twenty one savings and loans societies in PNG. In Samoa and Tonga there is one major charitable organization providing microfinance services basically to women. (*see table 1*)

**Table 1: MFIs outreach in the Pacific**

PIC	No. of MFIs	No of Clients	Country Population
Fiji	10	24, 700	834,639
Papua New Guinea	40	336,000	5,900,000
Samoa	2	7,800	220,000
Vanuatu	1	5,060	219,000
Total	52	373,560	7,173,560

*Source: Microfinance Pacific*

#### **4.1 The MIX market**

The microfinance information exchange (MIX) established in 2002, as a non profit body, with the view to provide information in microfinance sector. It is a Web based, microfinance information platform. The three broad objective of MIX are: (1) to collect, validate and standardize financial performance data, (2) to enhance the performance of MFIs and promote financial transparency and (3) to build information infrastructure and provide better understanding of the function of MFIs. It provides information to various stake holders of MFIs and interested parties such as policy makers, practitioners, funders and academia.

Currently there are some 1800 MFIs listed with MIX, with 43.8 US dollars of gross loan portfolio, 23.7 billion US dollars in deposit and 593.1 US dollars in average loan per borrower. In total 3 MFIs institutions are listed with the MIX, namely Nationwide Microbank, South Pacific Business Development (Samoa and more recently Tonga) and PNG Microfinance Ltd.

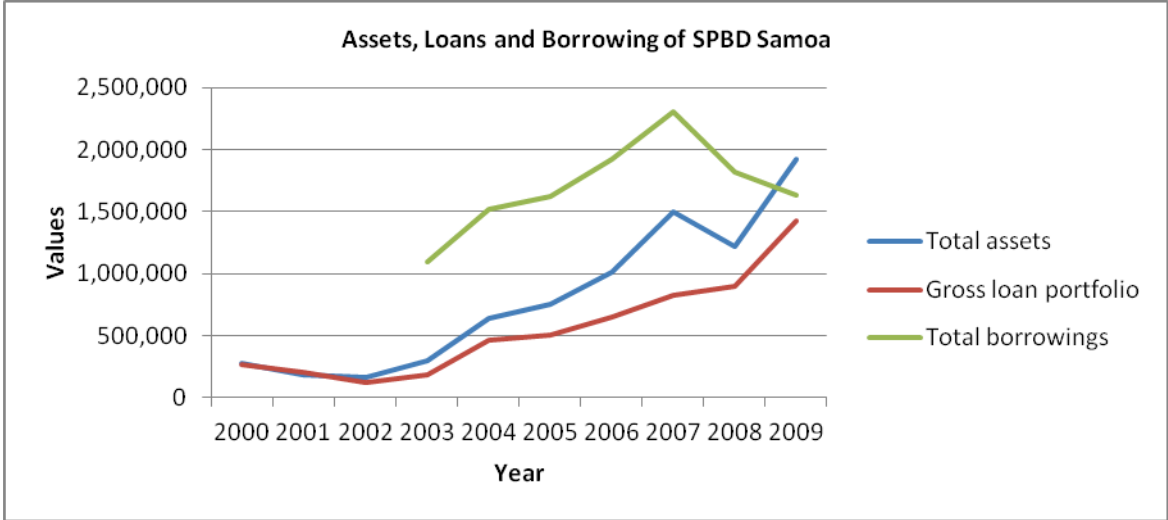
##### **4.1.1 SPBD Samoa**

SPBD Company was established in Samoa in 2000 with the motive to assist women with credit and business development. The money is only lent to women because the company believes women were more likely to reinvest their profits back into their business and families. Men were more likely to spend part of the profits on unproductive activities such as cigarettes and alcohol.



Evidence show that the rate of return to money lent to women is more compared to men. Women were more likely to invest in children’s education, health care and on home improvements. Since the company started microfinancing in 2000, more than 29,000 loans, worth \$30m, have helped 12000 Samoan families become more financially viable and economically active. According to the Samoan government, for every dollar the company lends, \$7 is created for countries gross domestic product through multiplier effects.

*Graph 1: Asset, loans and Borrowing of SPBD Samoa*



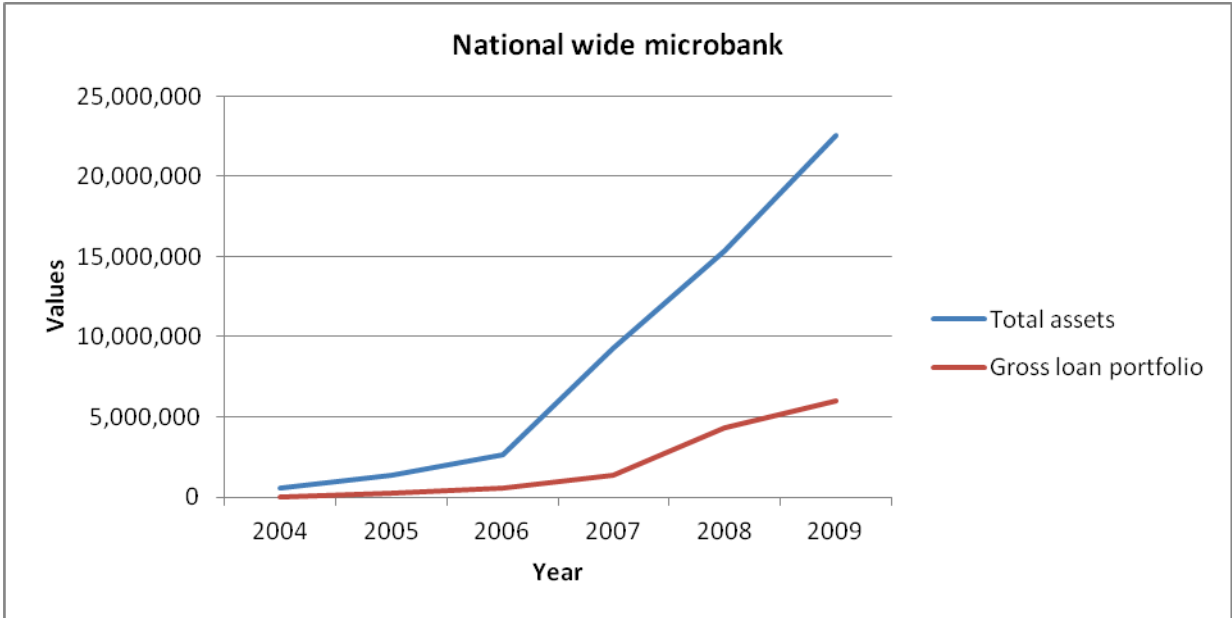
On the year to year basis, in the second and third year since the inception of the company there were some decreases in assets, loan and borrowing of the company (see graph 1). However, thereafter the company experienced steady growth, with a major growth felt in 2003 and 2004. There has been a moderate decline in the number of borrowers after 2007, with year 2008 and 2009 showing a decline of 21% and 10% respectively. Since 2002, the Portfolio at risk (PAR) has been between 1.22 to 4.08%, which is quite low. A low PAR suggests loan approval policies, loan collection practices or both are efficient.

**4.1.2 Nationwide Microbank**

Micro banking scheme in PNG started in 2004 on a commercial basis. In March 2007, it was incorporated as Wau Micro bank Limited. In 2008, it changed its name to Nationwide Microbank Limited (NML). The micro bank started with an asset cover of \$525,490 and Loan

portfolio of \$3,922 in the first year of the operations. Since the inception of the scheme there has been a sharp growth in terms of the asset and loan portfolio. In the second year of operation the asset grew at a rate of 151% while the loan increased by 63%. In the third year assets grew at 100% while the loan Portfolio increased by 130%. A significant increase of 248% and 132% in assets and loan portfolio respectively was observed in 2007, as micro finance scheme was incorporated as Wau Microbank Limited. Renaming the bank further boosted the assets and loan portfolio in 2008. Assets and loan portfolio increased by 65% and 219% respectively and it continued to grow in 2009. As of 2009, the client outreach of National wide micro bank was 3764 and loan portfolio crossed \$4,298,135 (see graph 2). It has some 60,000 accounts according IFC report. The Portfolio at risk (PAR) has been between 11 to 25%, which is quite high. A high PAR suggests poor loan approval policies, poor loan collation practices or both.

*Graph 2: Asset and Gross loan Portfolio of National wide Microbank*



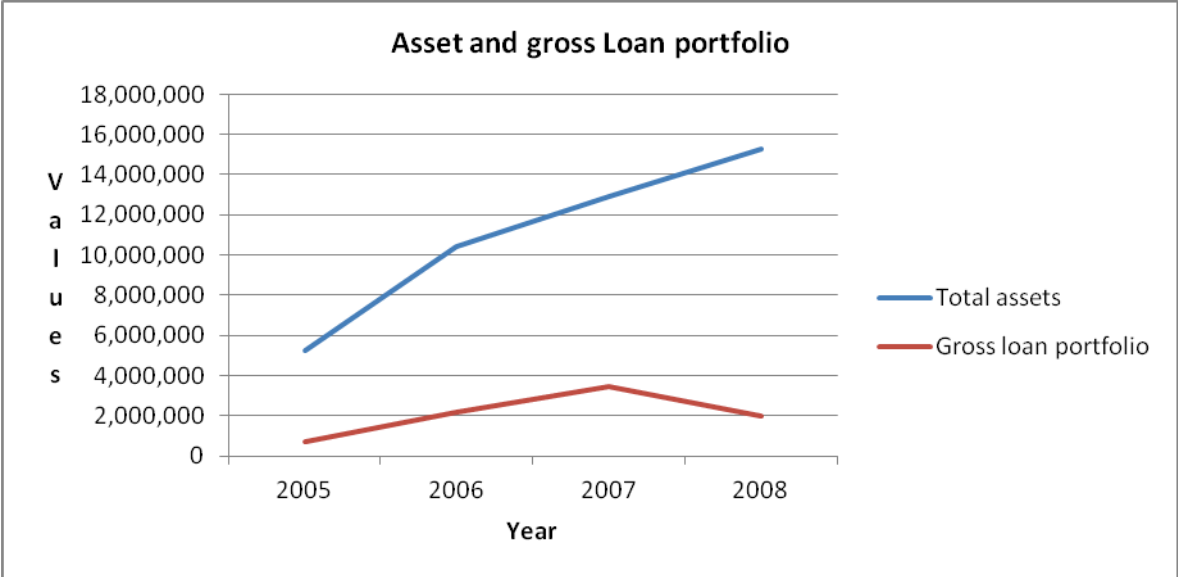
**4.1.3 PNG Microfinance Ltd**

The other microfinance institution in PNG registered in Mix Market is PNG microfinance limited. PNG microfinance Ltd was established in 2004 and is sponsored by PNG sustainable development program Ltd. It operates as a financial institution, provides credit and financial

services (including) savings to micro and small businesses in PNG, with aim of achieving long term sustainability on a commercial basis.

In 2008, the client outreach of PNG microfinance Ltd was 4227 borrowers and a gross loan portfolio of 1,961,418 k. It has some 116,000 accounts. Similar to Nationwide Microbank, The Portfolio at risk (PAR) has been between 6 to 22%, which is quite high.

**Graph 3 Asset and Gross loan Portfolio of PNG Microfinance LTD**



**4.2 Microfinance Model in Fiji**

In 1999, National microfinance Unit (NMFU) was established in Fiji under the Ministry of Finance and later transferred to the Ministry of Commerce, Business development and Investment. The NMFU was set up as government unit to enhance and promote microfinance initiative in Fiji. The NMFU began its full operation in 2000 with formation of two microfinance institutions namely the Fiji council of social services (FCOSS) and Anglow Lautoka. It has to date, established a total of eight Microfinance institutions and two cooperatives.

The microfinance sector in Fiji is witnessing a steady growth. There has been significant progress in terms of expansion across the country and outreach. As of December 2009, the client

outreach of National Microfinance Unit exceeded 24,000 and their gross loan portfolio crossed \$1,051,060.

Initially, MFIs used different business models and lending methodologies; however currently all are following a similar approach. All MFIs give individual loan products, though in some cases clients are still required to form groups. Loans are typically given for either six month or one year, but terms of loan from three months to six years are available. Repayments are made weekly or fortnightly in installments to cover both the loan principal and interest.

On a year to year basis, the coverage of 10 MFIs had an annual growth rate of 73% in 2001 and then it declined by 11% in 2002 (*see table 2*). A positive significant growth of 50%, 143%, 8.6% and 23% was felt in year 2003, 2004, 2005 and 2006 respectively, with a major increase in 2004. A slight negative growth of 6% percent was felt in 2007 before it increase by 4.5% in 2008 and it further declined by 1.7% in 2009. Till 2006, there was positive and significant growth in the outreach of microfinance. Following the 2006 coup the performance of microfinance in terms of outreach, number of loans has been somewhat negatively affected. Despite the various initiatives by the government through National Micro finance centre, the number of new loans is on decline since 2006.

The repayment rate continued to improve till 2007, with 2007 having a repayment rate of 97.3%, it declined thereafter with 2009 having a repayment rate of only 82%. This is again consistent with hardship faced by households and small enterprises following the 2006 coup. In 2009, the PAR for various MFIs in Fiji range between 14.48 to 84.69, which is very high.

Microfinance institutions in Fiji encourage progressive savings by members. Since the inception of Microfinance scheme in Fiji, members saving with MIFs showed a positive growth on year to year basis, with the highest savings of \$1,656,000 in 2007. There after it followed a downward trend. This again clearly indicates that following 2006 coup members accessed their savings to meet their day to day needs.

**Table 2: Performance indicator**

Performance indicator	Total loan disbursed	Total no of loan disbursed	Repayment rate(%)	Total no of savings accounts	Total no of enterprise assisted	Savings
2000	164,000	763	62.30	883	583	49014
2001	285,000	767	88.40	1102	519	89,387
2002	252,000	1,181	85.20	2041	939	179,835
2003	379,000	1,490	87.87	6,376	932	519722
2004	921,000	3179	90.30	12514	1312	1125887
2005	1001000	3,366	89.61	19533	1,380	1,544,437
2006	1,239,000	3645	94.62	21,277	1,699	1,656,00
2007	1,163,667	3166	97.31	21,479	899	1,361,378
2008	1,216,619	3,110	95	22,387	992	1,023,883
2009	1,194,774	2875	82	23,066	797	1,051,060

*Source: Microfinance Fiji*

## **5.0 Challenges of providing Microfinance In Pacific**

Geographical isolation and demographic dispersion has always been the major hurdle for progress of the microfinance. This combined with lack of trained staff has also been the major challenge of Microfinance institutions. According to latest release of PFIP (Dennis, 2010), nearly all the MFIs lack adequate staffing and the pressure has always been to expand geographically, including to distant islands. This has resulted in increased transportation costs and significant time spent in transit to destinations. Lack of vehicle, licensed drivers and irregular public transport has also been outlined as a major constraint to MFIs. This limits the

ability of the field credit officers to pay regular visits to the field. All this entails a disproportionate increase in personnel cost relative to the revenue generated.

People in the Pacific region still regard loans as ‘free money’ to be used at their own discretion. It has been a major challenge for MFIs to change this mindset. It requires continuous project monitoring and training to help break this way of thinking of the people.

Limited income generating activities are also outlined as one of the major hindrance to progress of microfinance. Small micro enterprise development is lacking in areas where microfinance has outreach. There is a need to change policies and by-laws of local councils, more skills upgrading and business training for entrepreneurs and market outlets. The Central Government through various ministries has been making various initiatives to provide relevant training for small enterprise development. For example in Fiji there are training programmes on how to make bamboo basket, bee farming and others to earn money.

Lack of funding has also led to slow progress of MFIs. For instance in Fiji, the inability of the government to release fund on time, leaves the MFIs with no other option than to use their member’s savings for to meet cash flow short-falls, placing savers money at risk.

According to August 2010 PFIP report, none of the MFIs in Fiji have managed to break even since inception, failing to reach critical mass of clients to benefit from economies of scale. The report noted that every additional client actually decreased the self sufficiency of the institution.

## **6.0 Conclusion**

This study looked at the prominence of microfinance model in the Pacific region. The study noted that no microfinance model is dominant across all Pacific Island countries and different models are used in different Pacific Island countries. Only PNG has mixed of microfinance model, including; Licenced Micro Finance Institutions, National development bank, savings and loan societies and Non-licensed MFIs. All forms of financial institutions including the microfinance institution in PNG are bound by national laws and regulation. Financial and legal frame work in PNG has been reformed over the last five years, which has immensely contributed

to rise of microfinance in PNG. This has led to the establishment of two licensed microfinance institutions in PNG.

Fiji has generally employed microfinance institution model of funding. It has got eight microfinance institutions and two cooperatives providing microfinance services. Whereas, in Samoa and Tonga we find that most of the microfinance service is provided by a charitable organization namely South Pacific Business development.

The performance of the MFIs in the Pacific region has been mixed. In Samoa PAR was low, ranging from 1.22 to 4.08 in respective years, In PNG it was between 11 -25% whereas in Fiji it was very high ranging from 14.48 – 84.49 %.

The analysis conducted in this study indicates that most of the MFIs in the Pacific are constrained by lack of funding, challenging geography and lack of technical support which makes them less competitive and aggressive in reaching the large section of the poor people. The outreach of microfinance institutions in all Pacific island countries has been slow.

More innovation is needed in the MFIs institutions to improve the performance in terms of cutting down cost and increasing revenue. The introduction of mobile phone money transfer system may offer MFIs a lower cost means for MFIs clients to access savings and reduce amount of time spent by MFIs managing savings.

The central Bank of PNG, Fiji and Samoa believes that mixed strategies are needed to provide a broad range of relevant, accessible, affordable and cost effective financial services to the poor.

So far there is no study evaluating the impact of microfinance in Pacific region and hence its impact on various household outcomes is not known. My further studies will attempt to analyze the impact of microfinance on various household outcomes using relevant economic theory and empirical methodology.

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