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# The Contribution of Micro-enterprises to Economic Recovery and Poverty Alleviation in East Asia

Charles Harvie

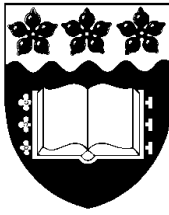
*University of Wollongong*, [charvie@uow.edu.au](mailto:charvie@uow.edu.au)

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## Publication Details

Harvie, C, The Contribution of Micro-enterprises to Economic Recovery and Poverty Alleviation in East Asia, Working Paper 03-07, Department of Economics, University of Wollongong, 2003.

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**University of Wollongong  
Economics Working Paper Series  
2003**

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WP 03-07

*May 2003*

# **The Contribution of Micro-enterprises to Economic Recovery and Poverty Alleviation in East Asia**

**Charles Harvie**

## **Abstract**

The economic and social crisis that afflicted East Asia from mid 1997 produced the biggest setback to poverty reduction in the region for several decades, as well as aggravating social vulnerabilities. There were many dimensions to this, including: falling incomes; rising absolute poverty and malnutrition; declining public services; threats to educational and health status; increased pressure on women and children; and increased crime and violence.

The objective of this paper is to analyse the potential contribution of one subset of small and medium sized enterprises, micro-enterprises and the role of micro-finance more generally, to regional economic recovery and poverty alleviation.

## 1. Introduction

The economic and social crisis that afflicted East Asia<sup>1</sup> from mid 1997 produced the biggest setback to poverty reduction in the region for several decades. Prior to the crisis East Asian countries had achieved spectacular welfare gains. Consistently high rates of economic growth were translated into quantifiable welfare improvements, primarily because growth was largely inclusive – the poor shared in the benefits of development. Public provisioning of social services was widespread, and the productivity of the poor and their employment opportunities increased enormously. The absolute number of poor people fell and the severity of poverty declined. Between 1975 and 1995 poverty in East Asia<sup>2</sup> dropped by two-thirds, and the pace of poverty reduction was faster than in any other developing region. In 1975, six out of ten East Asians lived in absolute poverty according to this standard; by 1995, the ratio had dropped to two out of ten. This meant that the number of poor in the region more than halved, from 720 million to 345 million (World Bank (1997)). Further, the rate of decline accelerated after 1985. The number of people in poverty fell by 27 percent in 1975-85; in 1985-95 the decline was 34 percent (World Bank (1998)). Over the past 25 years the region also achieved substantial gains in life expectancy, infant mortality, and literacy rates. These are even more impressive when compared with social developments in other regions, or, indeed, developed countries during their comparable decades of development.

The onset of the economic crisis, however, adversely affected the lives of millions, and aggravated social vulnerabilities. There were many dimensions to this, including: falling incomes; rising absolute poverty and malnutrition; declining public services; threats to educational and health status; increased pressure on women and children; and increased crime and violence. While the effects of the crisis were particularly acute in Indonesia, where there was a radical breakdown in social order in May 1998, they were also severe in Thailand, Korea and Malaysia. The Philippines was less affected but also suffered a worsening of social conditions. Trade, capital flows and migration linkages amongst these countries exacerbated, and hastened, the transmission of economic and social effects across the region.

While economic recovery of the region after the crisis of 1997-98 is well underway, there is a general recognition of the important role that small and medium-sized enterprises (SMEs) can play in this process from a number of perspectives (see Harvie and Lee (2002)). The objective of this paper is to analyse the contribution of one subset of SMEs, micro-enterprises and of micro-finance more generally, to regional economic recovery and poverty alleviation. In doing so it proceeds as follows. Section two identifies the contribution of micro-enterprises to regional development and poverty alleviation, and the constraints inhibiting their future development. Section three provides a picture of the diversity of micro-level enterprises, and highlights two general types of micro-enterprises: livelihood enterprises which provide livelihood to

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<sup>1</sup> For the purposes of this paper East Asia is defined to include East and South East Asian nations (Cambodia, China, Hong Kong, Indonesia, Korea, Laos, Malaysia, Mongolia, Myanmar, Philippines, Singapore, Taiwan, Thailand, and Vietnam) as distinct from those nations in South Asia (Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka).

<sup>2</sup> As measured by the region's head count index (the proportion (%) of the population with a standard of living below the poverty line) on the basis of US\$1 a day (in 1985 purchasing power parity terms).

the entrepreneur and micro-enterprises which have the potential for growth and the generation of employment opportunities. Section four examines the contribution of micro-enterprises and the related issue of micro-finance to the attainment of development objectives. Section five discusses alternative approaches to promoting livelihood and growth-oriented micro-enterprises. Section six discusses the increased recognition of the role and contribution of micro-finance to poverty alleviation, economic participation and regional development. Finally, section seven provides a summary of the major conclusions from this paper.

## **2. The contribution of micro-enterprises and constraints upon their growth and development**

Most of East Asia's poor live in rural areas, although urban poverty is also a growing problem in virtually all developing regional economies. Most rural poor are engaged in agricultural or related activities as labourers or small-scale farmers in the informal sector. Although the definitions vary according to the country context, it is generally agreed that the informal sector, whether rural or urban, comprises small scale and micro-enterprises producing and distributing goods and services in unregulated but competitive markets. These enterprises are generally independent, largely family owned, employ low levels of skills and technology, and are highly labour intensive. These micro-enterprises are concentrated largely in low-income low productivity activities, especially in petty trades and services. In many countries, women, who are a significant proportion of the poor and suffer disproportionately from poverty, operate many of these enterprises.

Micro-enterprises provide income and employment for significant proportions of workers in rural and urban areas by producing basic goods and services for rapidly growing populations. They account for more than 60 percent of all regional enterprises and up to 50 percent of paid employment. With increasing labour force participation among women in developing countries in the region, a greater number of women depend on micro-enterprises in the informal sector for survival. Hence micro-enterprise development is increasingly being seen as an essential ingredient in the promotion of broad based growth, in improving the well being of the poor and women by providing significant income and employment generating opportunities, and by encouraging indigenous investment. Consequently, there is an increasing policy focus on the need to strengthen entrepreneurship and the contribution of micro-enterprises to attain economic growth with equity, as well as in addressing gender and poverty reduction issues. Pressure to attain such outcomes has been further increased in the wake of the regional economic and social crises.

Many constraints to micro-enterprise development exist, however, due to: a lack of relevant laws and administrative procedures that undermines their legal standing and ability to receive assistance from state agencies; a policy bias toward large firms and capital-intensive import substituting industries; a lack of, or limited access to, institutional credit; exclusion from participatory processes; imperfect market information; and a lack of opportunities for skills development. Of these hurdles the most formidable is a lack of access to credit. Inadequate collateral, insufficient legal status, high transaction costs, and the inability of micro-entrepreneurs to cope with the complexities of dealing with formal financial institutions are among the reasons why

such enterprises have difficulty in growing. Most formal financial institutions do not serve the poor because of perceived high risks of default, high costs involved in small transactions, perceived low relative profitability, and inability of the poor to provide the physical collateral usually required by such institutions. The business culture in many economies is also not geared to serve poor and low-income households. Lacking access to institutional sources of finance, most poor and low-income households continue to rely on meagre self-finance or informal sources of micro-finance. However, these sources limit their ability to actively participate in, contribute to, and benefit from the development process. Thus a segment of the poor population that has viable investment opportunities persists in poverty for lack of access to credit at reasonable costs. The poor also lack access to institutional credit for consumption smoothing and to other services such as payments, money transfers, and insurance. Most of the poor households also find it difficult to accumulate financial savings without easy access to safe institutions that provide deposit services.

In response to this need for finance and credit, innovative and successful approaches have been applied in Asian developing countries in the development of micro-finance and its related institutions. An excellent example of this was the development of group lending schemes for landless people emphasising long-term sustainability. This scheme led to the development of the Grameen Bank in Bangladesh, which now serves more than 2.4 million clients (94 percent of them women) and is a model for other countries<sup>3</sup>. Micro-finance refers to the provision of financial services to low-income clients, including the self-employed. Improved access to, and efficient provision of, savings, credit, and insurance facilities, in particular, can enable the poor to smooth their consumption, manage their risks better, build their assets gradually, develop micro-enterprises, enhance income capacity, and enjoy an improved quality of life. Micro-finance services can also contribute to the improvement of resource allocation, the promotion of markets, and the adoption of better technology. Without permanent access to institutional micro finance, most poor households continue to rely on meagre self-finance or internal sources of micro-finance, which limits their ability to actively participate in, and benefit from, the development opportunities. Micro-finance can provide an effective way to assist and empower poor women, who make up a significant proportion of the poor and suffer disproportionately from poverty. Micro-finance can also contribute to the development of the overall financial system through integration of financial markets. Hence the development of micro-enterprises and micro-finance are intertwined.

### **3. Types of micro-enterprises and alternative policies for their development**

Micro-enterprises are highly heterogenous. Some aspects of this diversity relate to: size, gender of owner, location, and sector of activity. Most micro-enterprises, however, are single person, owner operated enterprises or slightly larger units engaging one or more family members. Enterprises that hire wage employees tend to be the exception.

Three approaches to the classification of micro-enterprises in developing economies can be gleaned from the literature. From a policy formulation point of view, relating

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<sup>3</sup> The Grameen Bank is discussed in more detail in Section 6.

specifically to their contribution to poverty alleviation and development, the first two are particularly useful approaches:

1. distinguishing between **livelihood** (or survival) activities and **growth oriented** (or viable) enterprises (see ADB (1997))
2. a fourfold classification, based on past growth performance in terms of numbers of workers (Liedholm and Mead (1995)): new enterprises in the start-up phase (**new starts**); existing enterprises that had survived the perils of start-up but which have not grown (**no-growth firms**); existing enterprises that show small growth (**small growth firms**); and existing enterprises that have graduated and become “small” enterprises with ten or more workers (**graduates**).

A third approach, emphasising the type of micro-enterprise customer and services to be provided from a micro-finance perspective, identifies the following classification of micro-enterprises:

3. micro-enterprises distinguished on the basis of: whether they are already in existence or are start up enterprises (**existing or start-up**); their **level of business development** (stable, unstable or growing); and their **type of business activity** (agriculture, production or services) (see Ledgerwood (2000)).

### *3.1 The livelihood-growth enterprise dichotomy (first approach)*

The first approach to micro-enterprise classification emphasises their needs and the constraints they face. A livelihood (survival or subsistence) activity is one into which an entrepreneur is pushed for want of more profitable alternatives, whereas one is attracted, or pulled, into a growth (viable) activity by considerations of profitability and out of choice by the entrepreneur. In the former case the activity is often just one of many part-time or seasonal activities undertaken to support family income, whereas in the latter case it is usually the main source of family income. In the case of livelihood activities usually no skills, or very rudimentary skills, are involved, so there are very low-entry barriers to the activity, and are consequently overcrowded. In the case of growth activities, considerable experience and skills are often involved which restrict entry. In the former case net earnings tend to be used for survival purposes, whereas in the latter part of the surplus is reinvested in the expansion and growth of the enterprise. Consequently, the former type of micro-enterprise can play an important role in poverty alleviation, while the latter type have the potential to make an important contribution to sustainable growth and development. Such a distinction is important for the identification of appropriate policies, and requirements, for these alternative types of micro-enterprise.

A number of observations can be made in terms of livelihood enterprises. First, while it is true that many persons are “pushed” into livelihood (survival) activities, once in them, they often stay in them, but for a variety of psychological reasons that are not easy to quantify. Second, livelihood activities are often among several secondary sources of income of the household, while growth activities are more often the primary source. Livelihood activities tend to grow rapidly during times of macroeconomic stress, such as that of the financial and economic crisis in Asia during

1997-98. Third, most livelihood enterprises earn small surpluses. While such surpluses tend not to be reinvested for expansion it is not an inherent characteristic of livelihood enterprises, but, rather, it is a reflection of the poverty of the entrepreneurs who operate them. Fourth, the potential of livelihood enterprises for growth is usually limited by a host of factors relating to both the environment, and to the lack of skills of the entrepreneurs themselves. The absence of skill requirements in livelihood activities contributes to low entry barriers and to overcrowding. Very few livelihood activities have the potential for growth beyond a certain size and level of income yielded, and this is the crucial distinction between them and growth enterprises. These livelihood enterprises can act as an important buffer during periods of economic downturn. A useful summary characterisation of the key differences between livelihood and growth enterprises, compiled by the Asian Development Bank (1997), is contained in Table 1.

**Table 1. Major differences between livelihood enterprises and growth oriented micro-enterprises**

	<b>Livelihood enterprises</b>	<b>Growth oriented micro-enterprises</b>
1. Capitalisation	Relatively low	Higher, but initial capitalisation is often similar
2. Education - (entrepreneur)	Little formal education	Usually at least secondary schooling
3. Skills and experience	Relatively low, except for skills acquired traditionally, as in handicrafts; trading often a fertile training ground for later manufacturing of the same product.	Higher, more often acquired through vocational training and/or previous wage employment.
4. Gender	High (often majority) participation of women.	Lower participation of women, but still high in many cultures.
5. Sector	Higher proportion in livestock, backyard poultry, food processing and petty trading.	Higher proportion in manufacturing and services requiring skills.
6. Competition	Usually function in perfectly competitive markets with low barriers to entry and little scope for cutting costs by intensive use of family labour and even by offering credit.	Often occupy “niche” markets with more scope for specialisation and product differentiation.
7. Seasonality	Often seasonal and tied to crop cycle, school year, major festivals.	Less affected by seasonality and function throughout the year, even if at varying levels.



8. Contribution to household income	Usually a secondary source (although vital)	Often primary
9. Whether only enterprise	Usually one of several “multiple” enterprises (to compensate for seasonality and low returns)	Usually the only enterprise.
10. Use of hired labour	Infrequent, mostly use family labour.	More common, often relatives or children.
11. Surpluses and reinvestment	Surpluses limited and often ploughed back into household expenditure.	Reinvestment of surpluses the norm.
12. Use of credit	Trading activities often started on a consignment basis, livestock required on a profit sharing basis, boats and rickshaws on lease; however, in order to compete, often become net lenders, especially in trading and restaurants.	Credit available from a wider range (informal and semi-formal) and a greater two-way flow of credit so that micro-enterprises are more often net lenders than livelihood enterprises.
13. Potential for growth	Limited in terms of new employment generation, but offer scope for increases in sales, productivity, profitability, and income; growth blocked often by demand constraints, resource constraints, and physical constraints (space in home and yard).	Have growth potential; number of workers higher, with more paid employees; employment usually of “higher quality”.

Source: Asian Development Bank (1997)

### 3.2 *Liedholm and Mead (second approach)*

Liedholm and Mead (1995) adopt a fourfold classification of micro-enterprises using past growth performance as measured in terms of numbers of workers added. In doing so they identify the following classifications: new enterprises in the start-up phase (new starts); existing enterprises that had survived the perils of start-up but had not grown (no-growth firms); existing enterprises that had shown small growth (small growth firms); and existing enterprises that had graduated and become “small” enterprises with ten or more workers (graduates). While their results pertain to a number of African economies, they are likely to be applicable to the situation in East Asia, where a similar study remains to be conducted.

Liedholm and Mead’s work provides valuable insights into designing policy interventions that take into account the different needs of the four types of enterprises identified. For example, they point out that high-enterprise birth rates (usually over 20 percent) as well as high attrition rates, suggest caution in engendering new starts.

They conclude that it would be more useful, from a policy perspective, in order to ensure a higher proportion of survivals to: restrict new starts to those with prior experience; and to encourage on the job and other skill training programs for those without the requisite skills.

In the case of non-growing enterprises they suggest that focus should be given to increasing incomes through efforts to reduce costs, increase sales, or switch product lines. Both financial and non-financial assistance could contribute to each of these objectives. A second goal would be to increase the number of such enterprises that succeed in growing. However, as they point out, the most serious problems non-growing enterprises face, the availability of markets and inputs, are not amenable to credit based solutions. Effective programs to address these non-credit needs require operating primarily at a systems level.

### 3.3 *Micro-enterprises from a micro-finance perspective*

The micro-finance literature distinguishes enterprises by whether they are existing or start-up businesses; by their level of business development (unstable, stable or growing); and their area of business activity (production, commercial or service). The level of business development is important when identifying the different types of micro-enterprise to which a micro-finance institution (MFI)<sup>4</sup> wishes to provide financial services. This is closely linked with the level of poverty existing in a potential target market. There are typically three levels of business development of micro-enterprises that benefit from access to financial services: unstable survivors, business operators who have not found other employment and tend to have very unstable enterprises for a limited time; stable survivors, with operators for whom the micro-enterprise provides a modest but decent living while rarely growing; growth enterprises, or businesses that have the potential to grow and become genuinely dynamic small enterprises.

**Unstable survivors** comprise the group most difficult to provide financial services to in a sustainable fashion, because loan sizes tend to remain small and the risk of business failure is high. Focusing on unstable survivors as a target market can result in a great deal of time spent by MFIs with clients just to ensure that their businesses survive and that they continue to be able to make loan repayments. Some technical assistance may also be required, resulting in further time and cost increases. Also, unstable survivors often need credit for consumption smoothing rather than income generating activities. Depending on the objectives of the MFI, these stopgap loans may or may not be appropriate.

Generally, the debt capacity of unstable survivors does not increase. Accordingly, the MFI is limited in its attempts to reduce costs or increase revenue, because loan sizes remain small. While not all MFIs have the immediate goal of reaching financial self-sufficiency, over the long term the choice to focus on unstable survivors will likely be a time bound strategy because access to donor funding may be limited.

**Stable survivors** comprise the group that many MFIs focus on and for which access to a permanent credit supply is vital. This is the group that benefits from access to

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<sup>4</sup> A MFI is an institution that aims to provide, in a sustainable way, financial products and services to the poor.

financial services to meet both production and consumption needs, while not necessarily requiring other inputs from the MFI. Stable survivors are targeted by micro-finance providers who have as a priority poverty reduction objectives. Stable survivors are often women who simultaneously maintain family-related activities (providing food, water, cooking, medicine and child care) while engaging in income generating activities. Generally, profits remain low, leading to low re-investment, low output, and a high level of vulnerability. Profits remain low due to: the unspecialised nature of the product; the lack of timely and complete market information (beyond the local market); underdeveloped infrastructure facilities; the lack of value added services (such as packaging); and the number of producers with similar products.

**Growth enterprises** are often the focus of MFIs whose objective is job creation and whose desire is to move micro-entrepreneurs from the informal sector to a progressively more formal environment. These MFIs often establish linkages with the formal sector and provide additional products and services. Growth enterprises represent the upper end of the poverty scale: they usually pose the least risk to the MFI. While generally a heterogeneous collection of enterprises, they tend to share some characteristics and face similar problems. Most have both production and risk taking experience, keep minimal accounting records, and usually do not pay taxes. In addition, they often have little or no formal management experience. These enterprises tend to produce a single product or line of products serving a narrow range of market outlets and clients, and use labour intensive production techniques that rely on family and apprentice labour. These firms build their asset base slowly, in an ad hoc manner, and depend largely on family credit for initial investment capital and on informal sector loans for working capital. Cash flow is a perennial problem, and they are very sensitive to output and raw material price changes. They often use second-hand equipment. Growth oriented micro-enterprises are an attractive target group for MFIs, because they offer potential for job creation and vocational training within the community. They can resemble formal sector enterprises in terms of fixed assets, permanence, and planning, which offer the potential for physical collateral and more thorough business analysis. All these offset risk for the MFI.

#### **4 Micro-enterprise, and micro-finance contribution to development objectives**

Micro-enterprise development, in conjunction with appropriate micro-finance support, can contribute to the attainment of four major economic and social development objectives: poverty reduction; empowerment of women; employment generation; and private sector enterprise development. In particular, micro-enterprise development contributes to a widening of the pool of entrepreneurship available to society, increases the number of direct participants in the development process, and broadens the base of the private sector. Most micro-enterprise development projects have combinations of the first two, or first three, as their explicit objectives. In order to make such projects successful a supportive role for micro-finance is also crucial.

##### *4.1. Poverty reduction*

Reducing poverty and enhancing the role of women in development are the most frequently stated objectives of micro-enterprise development projects. There is an

abundance of evidence to suggest that properly designed micro finance projects have an impact on poverty, and manage to reach the poor (although not always the poorest of the poor) on a scale large enough to cover their costs, meeting the twin tests of outreach and sustainability. Successful poverty-oriented micro-finance projects aimed at micro-enterprise development need to contain two essential design features. First, the poor cannot offer collateral and projects must rely instead on group collateral, or the joint and several liability of group members. Organising groups and training them in the norms of repayment discipline entails what is sometimes referred to as “social intermediation”. Second, poverty oriented micro-credit projects usually exhibit a set of loan characteristics: small initial loan size, increasing gradually as the borrower builds up an absorptive capacity and creditworthiness; weekly or at least frequent repayment instalments to keep each repayment small and manageable, and to maintain repayment discipline; and a short maturity period of usually up to one year. The last feature is not as important as the first two, and is a function of the need to ensure quick turnaround so that the borrower can be extended a larger loan as soon as possible.

There are three reasons for these typical loan features. First, they conform to the needs of poor micro-entrepreneurs, who are mostly looking for a working capital loan to expand an existing livelihood enterprise rather than set up a new one. Even when the intention is to start a new enterprise, it is often a simple processing or trading activity or service yielding a regular cash flow from which repayments can be made, and with little fixed capital requiring a larger, longer term investment loan. The impact of poverty-oriented micro-finance projects usually takes the form of increasing the productivity of a large number of existing enterprises, many of which are: operated by women; constitute a supplementary source of household income; and are seasonal and part-time. Although some new enterprises are created, the benefit of poverty-oriented micro-finance is primarily an income augmenting and not an employment generating benefit. Second, small initial loan size and repayment in small frequent instalments contribute to ease of repayment and are largely responsible for the impressive repayment record of a large number of micro-enterprise projects. Third, and perhaps most important of all, poverty-oriented micro-finance is the most effective way of targeting the poor and especially women, who self-select themselves in response to loan terms and a lending technology that is not of interest to the non-poor.

One effect of this combination of loan features, however, is that each loan typically has only an incremental impact on enterprise and household income, or only a short term impact, and a series of loans is needed if the household is to raise its income above the poverty line let alone graduate to bank financing.

#### *Limitations of micro-enterprise projects for poverty alleviation*

Despite the potential benefits for poverty alleviation arising from micro-enterprise development projects, it should be recognised that there are limitations in the usage of such projects as instruments of poverty reduction. First, available evidence suggests that micro-finance projects often do not reach the poorest of the poor, particularly the old, sick and disabled. Outright transfers for the destitute under social security programs may be more cost effective than attempting to reach everyone through micro-enterprises. Apart from the destitute, there are usually just not enough micro-enterprise opportunities available to cover all the poor, given demand constraints and

the lack of skills to produce products for which there is a demand. Second, from a longer-term perspective, micro-enterprise promotion can never be a substitute for a variety of social sector programs such as primary health care, environmental sanitation, education, nutrition, and family planning and child-care or structural changes, such as land reform. The many causes of poverty constitute a vast and complex subject and cannot be dealt with by micro-enterprise programs alone. Hence there is also a need to focus on anti poverty approaches and projects that could complement micro-enterprise development.

#### *4.2 Empowerment of women*

The empowerment of women is an objective that goes beyond increasing the income of low-income women. Micro-enterprise programs can lead to empowerment in its social as well as economic dimensions. The mobility of women and their access to information is strengthened by the process of participation in micro-enterprise program activities, including attendance at weekly meetings and other interactions in the public sphere that come about as a result of economic activities. Empowerment leads, in turn, to such social benefits as more education and lower fertility rates for girls.

Women constitute by far the largest share of borrowers of several major micro enterprise programs in South Asia, both rural and urban, as they do in other developing regional economies. Many of these programs are exclusively for women, and include a strong component of building up self reliant women's organisations through which women can develop leadership skills and lobby to remove some of the policy biases, market distortions and legal and regulatory constraints in the working environment facing them. Interestingly, because women have built up their creditworthiness as reliable borrowers over a number of years, they are now accessing much larger and longer-term loans for their families. This aspect of empowerment contributes to the role of women in decision-making in the family, and to their status outside it. It is true, however, that in some societies many loans made to women are either fully or partially controlled by men, while the responsibility for repayment remains with the women.

The cases of the Grameen Bank and BRAC in Bangladesh are excellent examples where participation in micro-finance and the development of micro-enterprises is positively associated with a woman's level of empowerment, defined as a function of relative physical mobility, economic security, ability to make various purchases on her own, freedom from domination and violence within the family, political and legal awareness, and participation in public protests and political campaigning. A positive effect on contraceptive use was also discernible.

#### *Characteristics of women's enterprises*

Women's enterprises tend to be home-based because of their family responsibilities, and in South Asia because of traditions of female seclusion as well. Another characteristic of women's enterprises is the high degree of concentration in activities with the lowest capital and skill entry barriers, which makes them overcrowded, with low return, and subject to short term volatility (high birth and closure rates). Due to the burden of domestic work, such enterprises tend also to be part time, to constitute a

secondary source of household income (the main source being the husband's wage labour), to be seasonal, and to be one of several multiple activities. Because women's enterprises are concentrated in sectors with particular ease of entry and low returns, new starts and closures tend to be higher for enterprises run by women, and to be particularly sensitive to changes in the overall level of the economy. However, when personal reasons are taken into account, female enterprise closure rates are no higher (Liedholm and Mead (1995)).

In addition, women's enterprises tend to be more concentrated in livelihood enterprises which is why the two objectives of poverty reduction and women's empowerment largely overlap, and why it is all the more important that development projects serving those objectives reflect a thorough understanding of livelihood activities.

#### *4.3. Employment generation*

Available evidence suggests that most micro-enterprises do not grow in terms of the number of people employed. For example, in a study of micro enterprises in a number of African countries by Liedholm and Mead (1995), a similar survey has not been conducted for Asia, over three quarters of all enterprises that started with less than five workers had not added even one worker since start up (see Table 2).

Liedholm and Mead (1995), as mentioned previously, adopted a fourfold classification of micro-enterprises, for policy purposes, based on their past growth performance in terms of numbers of additional workers employed:

1. new enterprises in the start-up phase (new starts);
2. existing enterprises that had survived the perils of start-up but had not grown (no-growth firms);
3. existing enterprises that had shown small growth (small growth firms); and
4. existing enterprises that had graduated and become "small" enterprises with ten or more workers (graduates).

Their study, based upon data from six core countries (Botswana, Kenya, Malawi, Swaziland, Zimbabwe and the Dominican Republic), found that new starts (firms less than one year old) accounted for 28 percent of all small and micro-enterprises (SMEs) (Table 3). They found that new starts were typically higher than 20 percent a year, but closure rates were also high. Thus, not surprisingly, they found considerable churning and turbulence in the micro-enterprise population. Net new starts (new starts less closures) contributed over 80 percent of SME employment in the long run, with the remainder coming from net enterprise expansion (enterprise expansion less contraction). Hence about 80 percent of people working in small and micro-enterprises were in jobs that were created when the micro-enterprise was formed.

Non-growing firms constituted the largest share of the universe of firms (43 percent) (Table 3) and three quarters of all micro-enterprises that had been in existence for more than one year (Table 2). The bulk of new starts, and by definition all the no-growth firms, corresponded to the livelihood enterprises category. Non-growing enterprises were very small (averaging only about 1.2 workers, smaller even than the average new start with 1.8 workers), and relied almost exclusively on family labour.

A significant proportion of the owners of such enterprises are female (60.4 percent), as is the proportion of the workforce that is female (55.1 percent). As indicated in Table 2 most female owned enterprises were no growth enterprises.

Small growth firms constituted only 12 percent of all small and micro-enterprise firms (Table 3), and a little over one fifth of all enterprises over one year old (Table 2). They accounted for about one half of all new jobs created by the expansion of existing enterprises, excluding new starts (Table 3). The proportion of small growth firms owned by women as a proportion of the total number of female owned enterprises was much lower than for men (Table 2). While the majority of these firms relied exclusively on family labour, nearly 40 percent had one paid employee. The share of women as owners of small growth firms was only 38.5 percent, and females only contributed 35.9 percent of the total employment in such enterprises.

**Table 2 Growth characteristics of micro-enterprises (percent distribution of all enterprises more than one year old that started with 1-4 workers)**

	No Growth	Small Growth	Graduates	Total
All micro-enterprises	77.2	21.7	1.1	100.0
Female-owned enterprises	84.7	15.2	0.2	100.0
Male-owned enterprises	75.1	23.3	1.6	100.0
Manufacturing enterprises	88.5	10.7	0.8	100.0
Trade and commerce enterprises	76.2	23.5	0.4	100.0
Enterprises in urban areas	77.3	21.8	0.8	100.0
Enterprises in secondary towns	73.5	26.2	0.5	100.0
Enterprises in rural areas	77.5	21.3	1.2	100.0

Note. This table refers to all enterprises that had been in existence for more than one year, and that started with less than five workers. Those with missing data, those whose employment declined or grew by intermediate amounts are excluded from these statistics. These exclusions account for less than 5 percent of those covered by the surveys that started with less than five workers.

Source: Liedholm and Mead (1995), Table 6.2.

Less than 1 percent of all small and micro-enterprises were graduates (Table 3), but they accounted for about one quarter of all new jobs created by the expansion of existing enterprises, excluding new starts (Table 3). Jobs arising from the expansion of both small growth firms and graduates were more likely to reflect profitable business opportunities based on the experience of the entrepreneurs. Their share of employment among existing small and micro enterprises was only 5 percent. A very small percentage of them were female owned and a similarly smaller proportion of the workforce being female.

The findings from Liedholm and Mead's study are consistent with the observation that the means through which poverty-reducing micro-enterprise programs make an impact is by increasing income rather than generating new jobs. However, given the fact that there is a minority, but still considerable number in absolute terms, of enterprises that do grow, there is also scope for micro-enterprise programs that focus more narrowly on growth oriented micro-enterprises. Such enterprises tend to have a

more complex set of requirements for growth other than simply credit, and the need to meet those multiple

**Table 3 Characteristics of Micro-enterprises: contributions to income and welfare (percentage)**

	New Starts	Non-growing enterprises	Enterprises experiencing small growth	Enterprises that had graduated	Total of all enterprises
Contribution to employment					
Share of all existing enterprises	28.1	42.8	12.0	0.6	100
Share of employment among existing enterprises	26.0	27.7	18.4	5.1	100
Source of new employment over the long haul	80.0	0.0	10.0	5.0	100.0
Part time or full time activities					
Average number of months worked per year	10.6	10.9	11.2	10.7	10.9
Average number of days worked per month	23.3	24.2	25.4	24.8	24.3
Contribution of SME to Household Income (percent of respondents in category)					
100 Percent of Household Income	30.7	35.6	34.0	21.7	33.7
50-99 Percent of Household Income	33.3	35.5	41.9	59.5	35.3
Less than 50 Percent of Household Income	36.0	28.9	24.2	18.7	31.0
Contribution of Distributional objectives					
Percent of Female owners	26.9	60.4	38.5	8.4	54.2
Percent of Female Workers	47.0	55.1	35.9	8.9	42.2
Percent of Employment in Rural Areas	71.6	74.1	70.4	79.5	72.7

Note. All data are from six core countries (Botswana, Kenya, Malawi, Swaziland, Zimbabwe and the Dominican Republic).

Source: Liedholm and Mead (1995), Table 6.1

requirements simultaneously makes it all the more important to provide them with cost-effective delivery of non-financial as well as financial services.



#### 4.4 Private sector enterprise development

Liedholm and Mead note that while only 1 percent of micro-enterprises succeed in graduating to a size of ten or more workers, graduates contributed about one quarter of all new jobs created from the expansion of existing enterprises in the countries studied because each enterprise added substantial numbers to its work force. Moreover, although only a miniscule proportion of micro-enterprises graduated, the share of existing enterprises with ten or more employees that started as micro-enterprises was much larger, about half. Proponents of private sector development see micro-enterprises as a fertile source of entrepreneurs for the future, a sort of seedbed for the universe of enterprises. In countries where the number of medium and large-scale enterprises is sparse, especially in the private sector, the importance of micro-enterprises as an incubator of new enterprises becomes even more important

### 5. Promoting livelihood and growth-oriented micro-enterprises – alternative approaches

The promotion of livelihood and growth oriented micro-enterprises suggest two quite different sets of development objectives, which themselves correspond to two major types of promotional programs (see Figure 1). As will be suggested in this section, there is a trade-off in micro-enterprise development programs between making a short-term impact on poverty, mostly through livelihood enterprises and self-employment on the one hand, and longer-term growth oriented enterprise development and expanded employment on the other, but for a much smaller number of direct beneficiaries.

**Figure 1 Two types of micro-enterprise programs**

<b>Micro-enterprise classification</b>	<b>Livelihood Activities</b>	<b>Growth oriented Activities</b>
Program objectives	Poverty reduction, women's empowerment	Employment generation, enterprise development
Program assistance	Livelihood Programs	Micro-enterprise programs
Entailing	Enterprise "expansion" but usually only one step up	Enterprise "transformation" ("Escalator")

Programs aimed at livelihood activities have poverty reduction as their main objective, and the vast majority of micro-enterprises are livelihood enterprises (about

71 percent for the countries analysed in the Liedholm and Mead (1995) study (see Table 2)). The main benefit of such programs for existing livelihood enterprises is likely to be higher turnover and an upgrading of productivity, resulting in increased income earned but not new employment although underemployment of the main operator and the family will decrease. In addition, livelihood programs can reach previously unemployed persons by helping set up some new livelihood enterprises that will result in both income and employment benefits. Such programs entail bringing about small improvements for many enterprises, often providing only credit, which is why they are sometimes characterised as being 'minimalist'. Credit alone, unaccompanied by other inputs, tends to be more relevant for the "middle" poor operating livelihood enterprises, especially nonmanufacturing livelihood enterprises such as those in agro-processing, transportation services, retail and wholesale trade where working capital requirements are high, skills demand is low, and where backward and forward linkages are not problematic. Credit alone, however, is less relevant for the poorest of the poor starting new livelihood enterprises for whom skills training and social preparation are as important, or for borderline poor for whom training, technology upgrading, marketing assistance, and the availability of inputs may be more important than stand alone credit. Non-credit inputs such as design, product development, market information, and marketing assistance are usually much more important for a large number of manufacturing activities such as handicrafts. Appropriate technology development and the provision of common facility centres also often have an important role to play in assisting manufacturing enterprises.

After credit, the importance of training is universally acknowledged, but its effectiveness remains little understood. The most common types of training in small and medium size micro-enterprise programs are: (1) management oriented or business training (in such skills as cost accounting, bookkeeping, business plan preparation etc.); (2) production oriented technical skills training and (3) entrepreneurial development training. Two other categories of training sometimes identified are: (4) credit oriented training; and (5) general community development or pre-entrepreneurship training which targets potential entrepreneurs rather than borrowers who have already been selected for programs, and which focuses on more general skills such as literacy or leadership. Business-skills-training is relevant to a large number of diverse activities so that micro-entrepreneurs from a variety of sub-sectors can be brought together conveniently to receive the training. Business training is probably more relevant to growth oriented micro enterprises than to livelihood enterprises. Some agencies make business training a condition for credit assistance and integrate it also with post start-up consultancy and counselling. Technical skills training is just as important, especially for manufacturing, food processing, handicrafts, livestock, and some service sector activities of both the livelihood and growth oriented micro enterprise type, as well as for micro-enterprises generally, the main barriers to which are the lack of skills and at least secondary education. Skills-training is at least as important for ensuring the survival, if not growth of, existing enterprises as it is for generating new starts. Entrepreneurship development training (focusing upon the motivational, attitudinal, and behavioural aspects of entrepreneurship) is particularly evident in certain countries such as India.

Growth oriented micro-enterprise programs, on the other hand, have enterprise development as their immediate objective, aiming to lift micro-enterprises to a qualitatively higher level of sustainability by setting them on the path to long term

growth and seeking to provide a comprehensive range of services, including credit, training, technical assistance, and the inculcation of business skills. Being more staff intensive and entailing forms of assistance that, with the exception of credit, take a longer time to deliver, growth oriented micro-enterprise programs reach a much smaller number of enterprises. Business skills training and entrepreneur development training are particularly important for growth-oriented micro-enterprises. Generally speaking non-credit inputs and support services are particularly important for growth oriented micro-enterprises, and activities with relatively numerous backward and forward linkages such as manufacturing.

Business Development Service Delivery mechanisms can be identified as being: networks (associations of entrepreneurs which provide mutual support); subcontracting and franchising; technology transfer; counselling (or business advice or mentoring on a range of topics, usually delivered through one on one interaction); consultancies (often conducted on-site and related to solving a specific problem); business incubators; and referral centres. Creating business linkages with services provided by the private sector is another aspect of this role. Encouraging linkages of small micro-enterprises with larger firms has been a long standing objective in micro-enterprise development as through the encouragement of franchising and subcontracting. One possible way to encourage micro-enterprise development being discussed in Indonesia is tax incentives for procurement from micro-enterprises, and tax write-offs for investment in training micro-enterprise suppliers.

## **6 The role and contribution of micro-finance**

It has been estimated that there are 500 million economically active poor people in the world operating small and micro-enterprises (Women's World Banking (1995)). Most of them do not have access to adequate financial services. Micro-finance, operating through MFIs, refers to the provision of financial services to such low-income clients, including the self-employed. Activities usually involve: small loans, typically for working capital; informal appraisal of borrowers and investments; collateral substitutes, such as group guarantees or compulsory saving; access to repeat and larger loans, based on repayment performance; streamlined loan disbursement and monitoring; and secure savings products. Although some MFIs provide enterprise development services, such as skills training and marketing, and social services, such as literacy training and health care, these are not generally included in the definition of micro-finance.

### **6.1 Background**

Micro-finance arose in the 1980s as a response to concerns about the effectiveness of state delivered subsidised credit to poor farmers. In the 1970s government agencies were the predominant method of providing productive credit to those with no previous access to credit facilities. Governments and international donors assumed that the poor required cheap credit and saw this as a way of promoting agricultural production by small landholders. In addition to providing subsidised agricultural credit, donors set up credit unions that focused upon savings mobilisation in rural areas in an attempt to "teach poor farmers how to save".

This subsidised, targeted credit, model supported by many donors was the object of steady criticism in the 1990s, because most programs accumulated large loan losses and required frequent recapitalisation to continue operating. This led to a new approach, emphasising market based solutions, that considered micro-finance as an integral part of the overall financial system. Emphasis shifted from the rapid disbursement of subsidised loans to target populations, toward the building of local sustainable institutions to serve the poor. Today the focus is on providing financial services only, whereas the 1970s and much of the 1980s were characterised by integrated packages of credit and training – which required subsidies.

In Asia, initiatives by non-governmental organisations, such as that by Dr Mohammed Yunus of Bangladesh, established pilot group lending schemes for landless people emphasising long-term sustainability. The Yanus scheme later became the Grameen Bank, serving more than 2.4 million clients (94 percent of them women) and has become, as mentioned previously, a model for other countries. Changes have also been occurring in the formal financial sector. For example, Bank Rakyat Indonesia, a state owned rural bank, moved away from providing subsidised credit and took an institutional approach that operated on market principles. In particular, the bank developed a transparent set of incentives for its borrowers (small farmers) and staff, rewarding on-time loan repayment and relying on voluntary savings mobilisation as a source of funds.

## *6.2 The goal of micro-finance and MFIs*

In a World Bank study of lending for small and micro-enterprise projects, three objectives of micro-finance were most frequently cited (see Webster, Riopelle, and Chidzero (1996)): the creation of employment and income opportunities through the creation and expansion of micro-enterprises; increased productivity and incomes of vulnerable groups, especially women and the poor; and reduced rural families' dependence on drought prone crops through diversification of their income generating activities. Micro-finance, in collaboration with micro-enterprise development programs, is, therefore, perceived as being a critical element of an effective poverty reduction strategy. Improved access and efficient provision of savings, credit, and insurance facilities, in particular, can enable the poor to smooth their consumption, manage their risks better, build their assets gradually, develop their micro-enterprises, enhance their income capacity, and enjoy an improved quality of life. Micro-finance services can also contribute to the improvement of resource allocation, the promotion of markets, and adoption of better technology; thus promoting economic growth and development. Micro-finance can also contribute to the development of the overall financial system through integration of financial markets. Most formal financial institutions do not serve the poor because of perceived high risks, high costs involved in small transactions, perceived low relative profitability, and inability of the poor to provide the physical collateral usually required by such institutions. The business culture in many regional economies is also not geared to serve poor and low-income households. MFIs, as development organisations, aim, therefore, to service the financial needs of unserved or underserved markets as a means of meeting development objectives.

Micro-credit can have a significant impact upon the standard of living of families and social development. Studies have shown that micro-finance services have a positive

impact on specific socio-economic variables such as children's schooling, household nutrition status, and women's empowerment. MFIs have also brought the poor, particularly poor women, into the formal financial system and enabled them to access credit and accumulate small savings and financial assets, reducing household poverty. However, researchers and practitioners generally agree that the poorest of the poor are yet to benefit from micro-finance programs in most countries partly because most MFIs do not offer products and services that are attractive to this category. Specific programs are required to meet their particular needs

### *Remaining challenges*

While the achievement of micro-finance in the Asian region, and in particular South Asia, has been impressive relative to that in the 1970s, a number of problems remain. First, despite a general improvement in the policy environment for financial sector programs, the policy environment for micro-finance in many countries remains unfavourable for the sustainable growth in micro-finance operations. For example, in countries such as China, Thailand and Vietnam the ceilings on interest rates limit the ability of MFIs to provide permanent access to an increasing segment of excluded households. Furthermore, developing country governments extensively intervene in micro-finance to address perceived market failure through channelling micro-credit to target groups that are considered to have been underserved, or not served, by existing financial institutions. With subsidised interest rates and poor loan collection rates, these interventions undermine sustainable development of micro-finance. As a result, most developing countries are crowded with poorly performing government micro-finance programs that distort the market and discourage private sector institutions from entering the industry.

Second, inadequate financial infrastructure is another major problem in the region. Financial infrastructure includes legal, information, and regulatory and supervisory systems for financial institutions and markets. Most developing country governments have focused on creating institutions or special programs to disburse funds to the poor with little attention to building financial infrastructure that supports, strengthens and ensures the sustainability of such institutions or programs and promotes participation of private sector institutions in micro-finance. Other major financial infrastructure-related problems include a lack of (i) a legal framework conducive for the emergence and sustainable growth of small-scale financial institutions, (ii) regulatory and supervisory systems for micro-finance in countries where the micro-finance sub-sector is approaching a level of maturity, and (iii) emphasis on development of accounting and auditing practices and professions. These are important for the development and expansion of market based micro-finance services, since, in order to serve clients who are outside the frontier of formal and semi-formal finance, MFIs must have access to funding far beyond what external agencies and governments can provide. MFIs and micro-credit portfolios cannot be safely funded with commercial sources in the long term, especially public deposits, unless appropriate performance standards and regulation and supervision regimes are developed and enforced and measures are introduced to protect public deposits. In most developing countries, formal and semi-formal micro-finance service providers are not supervised and regulated. While this may not be necessary for all types of MFIs, the lack of a system for supervision and regulation, as well as a lack of adequate measures to protect

public deposits, can impede the development, and integration, of formal micro-finance within the broader financial system.

Third, most retail level institutions do not have adequate capacity to expand the scope and outreach of services on a sustainable basis to most of their potential clients. Many institutions (i) lack capacity to leverage funds, including public deposits, in commercial markets; (ii) are unable to provide a range of products and services compatible with the potential client's characteristics; (iii) do not have adequate network and delivery mechanisms to cost effectively reach the poorest of the poor, particularly those concentrated in resource-poor areas and areas with low population densities; (iv) do not show a vision and a commitment to ensure their financial soundness and sustainability within a reasonable period, and become subsidy independent; and (v) do not have the capacity to manage growth prudently.

Most of the state-sector institutions or programs that provide micro-finance services have been created within, and nurtured by, a distorted policy environment characterised by various degrees of financial repression. They do not have a business culture. Even new institutions created by governments in most developing countries are unable to provide good quality services, let alone expand their services on a sustainable basis.

Most non-government organisations (NGOs) are also characterised by a high level of operational inefficiency, and have a very limited capacity to serve an increasing segment of the market on a continuing and sustainable basis. They suffer from governance problems mainly because they lack "owners" in the traditional sense of the term, and their management assumes a great deal of power. Heavy reliance on the relatively easy access to donor funds has aggravated the governance problems of some NGOs.

Inadequate emphasis on financial viability is the most serious problem of MFIs in the region. This prevails among many NGOs, government directed micro-credit programs, state owned banks, and cooperatives providing micro-finance services. As a result only a few MFIs are sustainable. Viability is also important from an equity perspective because only viable institutions can leverage funds in the market to serve a significant number of clients and contribute to broad based development. Viability is fundamental to reach a larger number of the poor which, in turn, is essential to have a significant impact on poverty reduction.

Fourth, agricultural growth, which underpins much of the growth in the rural non-farm sub-sector, significantly influences rural financial market development. Thus, agricultural growth must be accelerated in much of Asia. However, many developing economies are not making adequate investment for agricultural growth and rural development. This is a major constraint on the development of sustainable micro-finance services. The insufficient investments in physical infrastructure (especially irrigation, roads, electricity, and support services for marketing, business development, and extension) continue to increase the risk and cost of micro-finance, and particularly discourage private investment in the provision of micro-finance services on a significant scale. Also, in the absence of economic opportunities created by growth-inducing processes, micro-finance cannot be expected to play a significant role in poverty reduction.

Fifth, the low level of social development, a distinctive characteristic of the poor in the region, is a major constraint on the expansion of micro-finance services on a sustainable basis. This is particularly true with respect to the poorest of the poor, women in poor households, poor in resource poor and remote areas, and ethnic minorities. A vast amount of financial and human resources is required to address this issue. Private sector MFIs are not likely to invest in social intermediation given the externalities associated with such investments. The development of sustainable micro-finance to reach a large segment of the potential market requires supporting social intermediation on a large scale.

Finally, the financial crisis of 1997-98 had a number of adverse effects on micro-financing in crisis-affected countries. First, the credit crunch experienced by commercial banks affected MFIs that were formally integrated into the financial system more than those institutions that relied more heavily on donor support. Second, MFIs with a larger share of clients who are small business owners experienced more severe impacts than MFIs that targeted the poor. Third, increased inflation and higher interest rates (from both banks and traditional money lenders) drove many poor and middle-class people to seek MFI loans to support consumption, school fees, and other necessities. Fourth, currency devaluations and price hikes rapidly drove up the average loan size sought by borrowers. While the impact on MFIs varied widely across the region, the financial crisis greatly affected micro-finance institutions; and, hence, the informal sector and SMEs that rely on such institutions.

## **7. Summary and conclusions**

This paper has analysed the various types of micro-enterprises that are in existence in East Asia. It is important to differentiate between these various types in the formulation of policy. In very broad terms two major types of micro-enterprise can be identified. First, there are those that can be described as livelihood enterprises, which represent an important source of income for poor families and entrepreneurs. Such enterprises do not generate much employment and are unlikely to grow. However, their development and growth as a whole can generate more employment as well as alleviate poverty. For many of the economies of East Asia, adversely affected by the regional crisis, focus upon these can assist in the alleviation of poverty. The other major type of micro-enterprise is that of the growth oriented micro-enterprise. These have the potential to grow into small and medium enterprises, and to be sustainable in terms of income and employment generation. They represent a much smaller proportion of micro-enterprises, and consequently their development will affect a much smaller number of the population, but they do represent a better prospect for the longer-term development of the regional economies.

It is important that these two types of enterprises are recognised and their own particular requirements identified. For livelihood enterprises access to finance can play an important role in their development, and in this regard micro-finance institutions can play an important role. In the case of growth-oriented enterprises, access to finance can also be important as well as the need to gain access to skills upgrading as well as technology.

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