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THE ROLE OF MICROFINANCE IN ECONOMIC DEVELOPMENT

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Tara Mitchell shows the importance of credit and financial-sector stability for macroeconomic success and the symbiotic relationship between the two. With this in mind, she explores innovative techniques of credit creation and distribution and questions the aptness of the assumptions that underpin the finance industry. Finally she analyses the results of microfinance.

Introduction

Economists have been searching for centuries for the recipe containing that magical mix of ingredients that can ensure economic growth and prosperity. With such a large proportion of the world's population living in poverty, finding ways to reduce poverty and encourage economic growth should be a key focus of economic research. One relatively new approach to achieving this is the use of microfinance. The validity of this approach is based on the belief that a well-developed financial system, that provides a medium of exchange and the mechanism for saving and investment, is an essential ingredient for economic growth. As Hulme and Mosley (1996;1) have made clear, "capital investment is a key factor in determining economic growth and raising incomes".

Most of us in the developed world take for granted the fact that we have access to financial intermediaries. Children can open savings accounts, students can take out loans in order to travel during the summer months and credit transactions are a part of everyday life. For many in the developing world however, although greatly desired, this access to financial services is not possible. According to the Virtual Library on Microcredit "under 10 million of the 500 million people who run micro and small enterprises have access to financial support for their businesses."[1]

The demand for financial services in developing countries is huge and microfinance institutions are slowly starting to meet that demand. "The World Bank estimates that there are now over seven thousand microfinance institutions serving

[1] http://www.gdrc.org

some sixteen million poor people in developing countries. The total cash turnover is estimated at $2.5 billion and the potential for new growth is outstanding."[2]

The main focus of this essay will be on microfinance, how effective it is at reducing poverty and its possible effect on growth. It will begin by looking at the role that financial development plays in promoting growth and it will go on to discuss the lack of financial services available in developing countries. It will examine microfinance in terms of what it actually does and its impact at both an individual and a macro level. It will conclude by looking at what the future holds for the world of microfinance.

The impact of financial development on economic growth

Idealistic people sometimes like to say that money does not matter, but if you are without any then it suddenly takes on a whole new importance. Every day we in the developed world take advantage of financial services that are available to us without even thinking about it, but how would our daily lives change if we did not have access to those services? How would it affect the working of our economy? John Kenneth Galbraith defined economic growth as an increase in the quantity or quality of a country's capital stock, adding that,

> "The increase in quantity is capital formation. The increase in quality is technological advance… In the earliest stages of economic development… the simple and sufficient way of getting more growth was to have more saving and therefore more material capital."
>
> (Galbraith, 1985; 205).

Schumpeter also recognised the important role of credit in enabling entrepreneurs to create new products and thus stimulate economic growth. (Schumpeter, 1983; 102).

Berthelemy and Varoudakis (1996) highlight a number of different ways in which a developed financial system contributes to the efficiency of the economy. Firstly, it provides an efficient and adaptable system of payments, which is essential for any growing economy. Secondly, the existence of financial intermediaries can result in a better mobilisation of savings. By bringing individuals' savings together, they can finance investment in more efficient technologies that require a higher level of initial investment. In addition, financial intermediaries can improve the allocation of resources. The return on investment projects is subject to risks. Financial intermediaries can help to reduce these risks for individual investors. They can

[2] http://www.gdrc.org

provide the possibility of risk diversification, help to manage liquidity risks and spread the costs of finding information on potential investments over a large number of individuals. By managing these risks, financial intermediaries encourage investment in riskier but more productive technologies, which can help to promote economic growth.

Furthermore, Berthelemy and Varoudakis support the conclusion that the development of the financial system can have a causal effect on economic growth. This relationship is not one-way however, and it can prove difficult to separate one from the other. They put forward the possibility of multiple equilibria in financial and economic development. One possibility is a 'low equilibrium' where "the underdevelopment of the financial system leads to an inefficient productive structure which in turn justifies the absence of financial development" (Berthelemy and Varoudakis, 1996; 19). Alternatively, the case may prevail where

> "the existence of a developed financial system encourages the selection of more specialised and also more productive technologies. The resulting increase in risk justifies the existence of a developed financial system despite the cost involved."
>
> (Berthelemy and Varoudakis, 1996; 19)

The conclusion is that a well-developed financial system will not in itself guarantee economic growth but it can contribute to it. The lack of it, however, will almost certainly be a severe obstacle to growth.

Financial systems in developing countries.

Seeing as financial development and economic growth often move together and can have positive effects on each other, it is not surprising to find that financial systems are not highly advanced in the poorer regions of the world. According to Hulme and Mosley (1996; 1), "The further one proceeds down the income spectrum, the harder it becomes to finance investment through borrowing from private banks, and the enterprises of the poor – both in rural areas and in the shanty towns on the edge of the cities – generally have no access to them at all." They highlight two main problems that prevent the poor from having access to formal financial services. The first is the 'screening problem'. Most low-income households are seen as being 'too poor' to save. Lenders may be discouraged from providing loans to the poor because they are not personally known to them, have not furnished them with a business plan or wish to borrow small and uneconomical sums of money. It is easy to see why the lender considers it too risky to allow them to borrow money.

Secondly, there is the ‘enforcement problem’. Banks are unable to shield themselves from these risks. Borrowers are generally too poor to offer collateral, courts are too weak to repossess any collateral which is offered and insurance against the natural disasters which commonly affect small producers in developing countries is generally unavailable.

Even if banks were willing to make loans to poorer borrowers, the poor themselves may be unable to borrow for other reasons. For example, borrowers may face high transactions costs of seeking loans, which could include the “time, travel and paperwork involved in obtaining credit”, especially if they are located in an isolated area (Johnson and Rogaly, 1997; 6).

If the impoverished in developing countries do manage to make use of financial services, they are far more likely to be in the informal lending market, which are usually monopolistic and inefficient. This may be due to the fact that they,

> “are based on moneylending in which the lender makes advances only from his own resources, rather than deposit banking, where the lender also borrows, and can relend the funds deposited with him. Thus, there is no credit multiplier.”
>
> (Austin and Sugihara, 1993; 1)

Do the poor need financial services?

There is a common belief that the poor are ‘too poor’ to save. This is untrue. Not only are the poor able to save but they willingly go to great lengths to find ways of saving. According to Johnson and Rogaly (1997; 1), “financial services are about enabling people to amass usefully large sums of cash”. All individuals have periods in their lives when they need a larger lump sum of money, for example, to protect them from disaster or to pay for events like a wedding or a funeral. Even though it may be very difficult for them, the poor in developing countries regularly try to save money. They greatly value services which allow them to save their money in a secure environment. They even go so far as to pay local deposit-takers to keep their money for them. They often may keep savings in a clay pot in their home but the temptation to spend the savings and the fear that they might be stolen mean that they place much value on services that guard their savings outside of the home, even if it means a negative rate of interest.

Despite the fact that most banks consider it too risky to lend money to the poor, research has shown that often they can be most reliable when it comes to repaying loans. According to Hulme and Mosley (1996), the Grameen Bank in Bangladesh, BancoSol in Bolivia and BKK in Indonesia, all of which target very poor borrowers, have higher repayment rates than any LDC commercial bank in those countries. They point out some possible reasons to explain why this may be the case. Firstly, the less well off do not have any political influence with which to influence loan repayments. Secondly, the poor do not have access to any other sources of finance and so need to maintain their loan repayments in order to have access to future loans. Finally, and more speculatively, these schemes are better at reaching women and generally women have better repayment rates than men.

The evidence suggests that the poor not only need and desire access to financial services but that despite their poverty, they are able to save and to reliably make repayments on loans.

What is microfinance?

"Microfinance is defined as formal schemes designed to improve the well-being of the poor through better access to saving services and loans" (Schreiner, 2000; 2) The idea behind microfinance is to provide the poor with access to those financial services which they are otherwise unable to access, with the aim of reducing poverty.

Microcredit is an aspect of microfinance. It focuses on the provision of small loans to help the poor to develop microenterprises in order to increase their income and their well-being. McKernan (2002) describes the Grameen Bank of Bangladesh, the most well-known and pioneering microcredit programme in its role of providing "credit to the poor for the purchase of capital inputs in order to promote productive self-employment. They also provide noncredit services (also referred to as social development programs) such as vocational training, information in areas of health, civil responsibilities and rights, and information sharing and monitoring among members" (McKernan, 2000; 93).

Over the last few years in particular, microfinance has grown in popularity and in importance. According to Wright (2000; 4), "There is scarcely a multilateral, bilateral or private development donor organisation not involved in the promotion (in one form or another) of a Microfinance Programme." Other examples of microcredit institutions include Bank Rakyet Indonesia, Bangladesh Rural Advancement Committee (BRAC), Federation of Thrift and Credit Co-Operative Societies (SANASA) in Sri Lanka and the Malawi Mudzi Fund.

Being a successful microcredit organisation involves adapting new and innovative methods to designing programmes which fit the needs of the less fortunate sections of society. The majority of the poor cannot supply physical collateral so some institutions substitute methods such as character references or locally-recruited lending agents who know the potential borrowers, in an attempt to screen borrowers. Institutions which follow the Grameen Bank model use peer-group monitoring to aid the selection process and to give an incentive for repayment. Groups are self-selected and contain five members with a similar economic background. The group is responsible for the repayment of the loan and no member of the group may borrow in the future if one member of the group defaults. This aspect of peer pressure is reinforced by public meetings to collect savings and loan repayments where everyone notices if someone does not make a payment and the shame that this would cause is very strong. Many microcredit institutions insist on compulsory weekly savings as security against default. These restrictions help to ensure that only the poor take out loans, as the rich will be put off by the ideas of group lending and weekly public meetings. Also, many institutions specifically target the poor by placing a limit on wealth, measured by income, land or state of housing, above which loans will not be granted. (Johnson and Rogaly, 1997)

It is clear that microcredit institutions have been successful in giving loans to the poor and achieving repayment (Grameen borrowers keep up repayment at a rate of around 98%. The Bank lends US$30 million a month to 1.8 million needy borrowers[3]). That is not, however, their goal in itself. Remenyi and Quinones (2000; 7) state that "central to the concept of microfinance is the idea that poverty can be effectively and permanently reduced or eliminated within a reasonable period of time by providing the poor with access to such financial services." A question mark remains as to whether or not this has been truly achieved.

The impact of microfinance

Although the theory of microfinance is a simple one, theories often yield unexpected results, when put in to practice. This section will look at the practical effects of microfinance: whether it has resulted in a significant change in income for its beneficiaries, its impact on production and the general effect it has on the well-being of the poor. It will also look at the macro level to see if there has been an overall reduction in poverty.

Has microfinance reached the poorest?

While many microfinance institutions have been able to profitably lend money to the poor in developing countries, the poorest of the poor, generally, have not been reached. Hulme and Mosley (1996) suggest a number of reasons for this. First of all, the emphasis of many institutions is on providing credit to finance self-employment opportunities. For the most destitute people, however, these

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[3] http://www.gdrc.org

opportunities are limited and the risks are too high so that they choose not to take loans because they do not see them as the solution to their problems. Secondly, in the case of group schemes, groups are self-selected and so some members may decide that others are 'too poor' to take part, either for economic or for social reasons. Lastly, as credit programmes expand, it seems that the incentives for staff favour a focus on those who are not the poorest, due to the set-up of performance targets (Hulme and Mosley, 1996; 32).

There is much debate over whether or not the goals of outreach to the poorest and financial sustainability are incompatible. Some believe that if a microfinance institution wishes to be financially viable then it must expand its members. This will often result in a movement away from the poorest in order to gain a broader more profitable range of clients (Sharif, 1997). In practice, most microfinance providers have not achieved financial viability. According to Hulme and Mosley (1996; 12), "Not more than one in five microfinance providers function on a basis that covers all their operating costs. The remaining four in five are dependent on continuing access to donor grants and/or subsidized loans to remain in operation". For microfinance providers to remain operational in the long run, they must try to achieve financial viability. In Hulme and Mosley's study (1996), they made a distinction between 'successful' and 'unsuccessful' schemes in terms of financial performance. They concluded that there was no significant difference in poverty impact between these different schemes and that improved financial performance was not a conflicting goal with outreach to the poor. The main differences were in aspects of design: greater incentives to repay, intensive loan collection and positive real interest rates. They discovered that there was not a strong relationship between default and the interest rate charged but that there was a strong inverse relationship between the level of costs on administration and the default rate. The poor are willing to pay the interest rate necessary to cover the costs in order to have access to credit. According to Gibbons and Meehan (2000; 4), "it is not the clientele served that determines an MFI's potential for IFS (Institutional Financial Self-Sufficiency), but the degree to which its financial services program is well-designed and managed."

What has been the impact of microfinance on incomes, production and employment?

The main idea behind microcredit programmes is to provide loans to those on low-incomes, and to invest in self-employment opportunities with the aim of raising their living standards. Hulme and Mosley (1996; 87) assert that, "there is every likelihood that the receipt of credit did directly increase the income of assisted enterprises". However the effect varied greatly from individual to individual. The income earning opportunities available to enterprises depends on a number of factors. Their access to financial services *is* an important factor. However, there are other influences such as the state of technologies available to the borrower and the relative prices of capital, labour and other inputs. Factors which influence the impact of different schemes in different countries include the rate of growth in the local economy, the rate at which credit is being invested in new technology and the extent to which credit creates employment within the assisted family.

The use to which loans are put varies between borrowers and can be related to borrowers' initial level of income. Credit can perform two roles- a protectional role and a promotional role. Poorer clients are likely to use loans for protectional purposes. For example they may use credit for capital widening which does not involve an increase in risks or they may even use credit to reduce their risks and vulnerability but leave their incomes unchanged. Wealthier clients are more likely to use their credit for promotional purposes. For example, for capital deepening, which increases their expectations of income and risk at the same time. Borrowers often face a trade-off between expected value and variance of income. Poorer borrowers cannot afford to take risks even if it means an expected increase in income. Even though credit used for promotional purposes is more likely to increase productivity, this does not mean that loans for protectional purposes do not perform an important function. Hulme and Mosley's findings show that there is a correlation between the borrower's initial income and the likelihood of investing in new technology. They also show that those who have taken a series of loans are more likely to adopt new technology but that in general, the use of loans for the purpose of capital deepening is the exception rather than the rule.

The impact that loans will have on employment depends on the technology that the loan is invested in. As the majority of loans have not had a huge impact in terms of technological change, the effect on employment outside the family has not been dramatic (Hulme and Mosley, 1996). Despite the fact that most microfinance institutions issue loans to be spent on investment, Wright (2000) claims that his research shows that many loans are in fact being spent on consumption. He states that this is not necessarily a bad thing. This consumption can help to create the security necessary before the poor can begin to invest in income-creating opportunities.

What has been the impact of microfinance on vulnerability?

One of the consequences of poverty is the feeling of vulnerability and helplessness. If this is seen as being important, then microfinance institutions need not only to provide credit for income *generation* but also to try and reduce *fluctuations* in income. One way of doing this is through voluntary savings schemes and the availability of emergency consumption loans. According to Hulme and Mosley (1996; 115), "the evidence available from our case studies reveals their relatively limited contribution to reducing the vulnerability of the poor households to a sudden dramatic decline in income and consumption levels.”

In a minority of cases it has been shown that borrowers’ vulnerability has actually been *increased* by loans from microfinance institutions. Evidence from Hulme and Mosley’s (1996) case studies shows that BancoSol staff report that 10-15% of borrowers’ enterprises go bankrupt. Also, BRAC borrowers reported cases of the seizure of defaulters’ assets and their sale in order to cover the costs of loans that were not repaid. There have also been several reports in the Bangladeshi media of ‘Grameen bank suicides’ as a result of peer-group pressure to repay loans.

For the majority of cases however, by increasing incomes loans from microfinance institutions, can help towards reducing the vulnerability of the poor. In order to really reduce this vulnerability however, more emphasis needs to be placed on the savings side of microfinance.

What has been the impact of microfinance at a macro level?

If microfinance institutions are successfully reaching large numbers of poor households and increasing their incomes by giving them access to credit to fund private enterprises, then one would expect to see some kind of change at the macro level. Sobhan illustrates this point,

> “One would assume that with twenty-five years of micro-credit going into a particular area certain transformatory effects on the macro-economy should have been felt. I am not merely referring to the village economy, a macro-entity in itself, but also to the national economy, where the poverty alleviating impact at a macro level of credit interventions and the social transformatory effect of this particular process should be felt.”
>
> Sobhan (1997; 134)

Can it be that so many individuals can benefit from microcredit yet the impact at a macro level be so small? This does indeed seem to be the case, as studies such as that of BIDS/The World Bank have revealed. There has been no wholesale reduction in poverty across a significant area (Sobhan, 1997; 134).

Microcredit alone is not enough to reduce poverty at a macro-level. Hulme and Mosley (1996) showed that the technological increase and the increase in the level of employment due to microcredit has been very small. The impact of microcredit depends on various factors in the macro economy, such as the demand for the goods produced by the borrowers, which will increase the return on investment and provide more opportunities for expansion.

> "While much attention gets focused upon the institutional options for the provision of financial services to the poor, there can be little doubt that the overall performance of the macro economy is the key to any micro success. Thus an element in the linkage between credit and employment creation is lobbying for the appropriate national level policies, conducive to securing the best multipliers on micro forms of investment."
>
> (Wood, 1997; 297)

Wright (2000) suggests that there has been more of an impact at a macro level than has been believed, citing the case of Grameen Bank, which has accounted for between 1.1 and 1.5% of GDP compared to agriculture and fisheries, which makes up a mere 3% of GDP (Wright, 2000; 16). He also claims that a big part of the picture is lost when looking at the macro level because policy-makers often see the poor as a homogenous group. This is not the case; there are many different levels of poverty. An individual may move from being one of the core poor to one of the upper poor, involving a significant rise in living standards from the point of view of that individual, yet still be seen as poor by an outsider.

Conclusion: The Future of Microfinance

When it comes to economic growth, access to good quality financial services plays a large role. However the relationship is complex. Financial development may help growth but a financial system develops in response to the economic environment and because of this, economies can get stuck in a poor financial services – poor growth equilibrium. Access to formal financial services is very poor in developing countries. Entrepreneurs often find themselves in situations where they have no funds to finance income–generating opportunities. Microfinance emerged in response to this need. Its goal is to provide financial services to the poor with the aim of reducing poverty.

Much research has been done on microfinance but because it is a relatively new area, many questions remain unanswered. Some believe that outreach to the very poor can be achieved simultaneously with financial self-sustainability. Others believe that these are conflicting goals. Some suggest that the focus should be placed on savings services rather than credit, while others see only credit, for use in investment, as the way forward.

However A number of clear points seem to have emerged from the literature on microfinance. Firstly, the poor are not a homogenous group. There are very many different types of poor people. Some are much poorer than others, some are more willing to take risks, some have better entrepreneurial ability and some value access to savings facilities more highly than access to loans. They should not be treated as a homogenous group. Microfinance institutions need to provide a range of opportunities that cater to the needs of the clients they are trying to serve. Particularly, when it comes to the very poor, microcredit for the purpose of investment may not be the solution. The poorest are too vulnerable to invest and are far more likely to spend loans on consumption. A focus needs to be placed on services such as providing basic healthcare and education rather than credit.

Secondly, from the point of view of both the borrowers and the microfinance institutions, a bigger emphasis needs to be placed on the role of savings, in particular voluntary, open-access savings. The poor place enormous value on the provision of these services and in turn they could play a role in helping institutions to achieve financial self-sustainability. Thirdly, great care must be taken when dealing with people who are already extremely vulnerable. Microfinance institutions must be careful to never increase the vulnerability of individuals in any way or encourage them to take loans which will be too difficult for them to repay. They must also take care to fully understand the effects of peer pressure in the situation of group lending.

Microfinance institutions have successfully reached millions of poor people all over the world. If access to finance can play an important role in economic growth then why have larger changes at the macro level not been seen? There are many more factors involved in promoting economic growth and if those factors are missing then microfinance alone cannot solve the problem. The overall structure of the macro economy is extremely influential in terms of the impact of microfinance. The level of education, the demand for goods and services and access to new technologies all play a role in determining the impact of microfinance.

> "Macroeconomic stability is an important pre-requisite for getting a scheme off the ground. Hyper-inflation and economic instability do not encourage individuals to save, and loans under such circumstances are difficult to manage"
>
> (Johnson and Rogaly, 1997; 27)

But maybe microfinance is still too young for us to judge its impact. The number of microfinance institutions and the level of funding devoted to them are growing all the time. Perhaps, with co-operation, sharing of information and a genuine devotion to the services that the poor really need, microfinance can go a long way to the alleviation of poverty in the future. In itself, microfinance is not a panacea but it certainly is a first step.

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