Microfinance as a Poverty Reduction Policy

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The practices of microfinance services for the poor have grown immensely since its beginning in the 1970s. It has become one of the most popular poverty reducing strategies in the world. This essay uses poverty theory to analyse the effect that microfinance has on poverty reduction. After a short introduction on the topic this essay argues that microfinance cannot solve poverty issues alone due to the complexity of poverty, illustrated by theories on its causes. Although there are many positive outcomes as well, mainly through providing self-employment possibilities, this text presents critiques on reaching the very poor, providing education and questions its large scale impact and the commercialization of microfinance institutions. This essay concludes with a brief look into the future of development and what this might mean for the way forward of microfinance practices.

In the seventies it was noticed that a large number of poor, especially rural women, were not benefitting from anti-poverty strategies. The investments into community development and agriculture did not always reach those that needed it the most (Greeley 2003). In the sixties and seventies the informal sector and small farmers became noticed in development (Cameron 2005). This is also the time when Muhammad Yunus, Nobel Peace Prize winner, started to lend small amounts of money to the people of Jobra, a poor village in Bangladesh. Out of 'sheer frustration' and with the intention to only 'solve an immediate problem' (Yunus 1999:57) Yunus unknowingly initiated a programme that would turn into one of the most popular anti-poverty strategies throughout the world. The UN proclaimed 2005 as the year of microcredit and several world conferences have referred to it as the 'frontrunner in poverty alleviation strategies' (Lard and Barres 2007:55). In 2006 the amount of public donations in microfinance programmes was more than 1.5 billion US dollars. Private investments in that year exceeded 500 million. Practitioners are expected to use these investments to achieve the best possible outcome in changing the lives of the poor (Lard and Barres 2007). Whether these investments are truly the way to poverty reduction on a large scale can be questioned though.

After Yunus set up Grameen Bank many Microfinance Institutions (MFIs) followed his example and provided the poor with an official way to access loans. MFIs vary in legal forms, methodologies and missions, but all of them provide financial services to the poor (CGAP 2010). These services include microcredit but also saving schemes, money transfer systems (for instance through mobile phones) insurances and pensions. MFIs help the poor in setting up businesses, build up assets, consumption smoothing and risk management (CGAP 2010a). Before this development the poor depended on moneylenders with extreme high return rates and were not welcome at official banks (Yunus 1999). By introducing microfinance; self-employment and small enterprise development became possible for the poor. A variety of client targeting and those who are in fact reached through microfinance differs per programme. In most cases though, primarily women are targeted and a form of group lending or village lending is practiced (Harper 1998). According to the Consultative Group to Assist the Poor (CGAP):

> “Financial services for poor people have proven to be a powerful instrument for reducing poverty, enabling them to build assets, increase incomes, and reduce their vulnerability to economic stress.” (CGAP 2010a)

This essay attempts to critically evaluate micro financing and to analyse its effect on poverty reduction. A broader understanding of poverty is therefore helpful in order to identify how the provision of credit is related to the lives of the poor. In whichever way MFIs target, they all try to reach the living and working arena of the poor. Instead of waiting for economic growth to trickle down to the poor through other sectors, MFIs try to boost the informal markets through their borrowers. This approach is in line with Kimenyi’s (2007) principles for achieving pro-poor growth. Since not all growth is pro-poor (when growth is higher amongst the poor then the non-poor), anti-poverty policies need to be specific and be adapted to the poor. This means understanding where and how the poor operate.

Within the enormous amount of poor in the world, a distinction amongst them is necessary in order to address poverty reduction in the most efficient way (Hulme 2003). Since there are different indicators of poverty and measuring the deprivation of the poor (the dollar-a-day poverty line, the Human Poverty Index), there is not one definition for what constitutes deprivation (Thomas 2000). Chambers (2006) in fact names a total of twelve interlinked elements contributing to poverty in areas that go beyond income and material wellbeing. Poverty is caused by context-specific and core elements. Context-specific causes include a political, economic and socio-cultural context which for instance translates to inequality (in income, gender or political participation) and vulnerability (HIV infection rates). Core causes are direct (nutrition deprivation) or indirect (poor access to food), but are almost always linked to consumption (Sumner and Tiwari 2009). With the realization of all these interlinking influences on the life of a poor person, it makes it rather unrealistic to think that providing loans can be the answer to poverty. When analyzing the complexity of this ‘poverty web’ (see Chambers 2006) one can argue that only in a fairytale microfinance can address all these issues. The multi-dimensional character of poverty and the set of different indicators necessary, make it in addition incredibly hard to observe and measure poverty (Cameron 2005). MFIs have shown to struggle with assessments as well and although Copestake (2007) has initiated a proposition, a global agreement on measuring strategies of the impact of microfinance programs has not been reached yet. It is one of the challenges we are faced with when trying to analyse the contribution of this anti-poverty policy.

Stewart et al. (2007) define four approaches to poverty. One of these is the participatory approach with a focus on empowerment of the poor through groups. These elements seem to mostly fit the missions of MFIs which predominantly work through group lending. In addition most programmes have borrowers choose their own group members and members have full responsibility for each other’s depts (see Harper 1998). So when Yunus introduced lending to the poor, a movement of participation in rural development started. The microcredit provision was based on a basic needs strategy and focused on grassroots self-reliance. Although the participatory approach has changed and is still evolving in development, there are complications in mainstreaming it into policy. The participatory techniques tend to stick to the practical, project level and are hard to integrate into policy processes. Participatory methods for poverty reduction also tend to be hard to measure and analyse (Laderchi 2007). This practical character described by Stewart et al. and Laderchi (2007) might complicate integration of microfinance programmes within other development strategies and policies which seems necessary to handle the complexity of the ‘poverty-web’. In addition this theory could be another explanation for why MFIs (both governmental and NGOs) struggle with finding ways to measure its impacts.

When analysing the actions of microfinance programmes employment forms a main element in helping the poor. Through the provision of credit, MFIs want to stimulate and create opportunities for the poor to set up small businesses. Since the poor largely depend on employment (Kimenyi 2007), this is an important aspect in which microfinance contributes to poverty reduction. To rely simply on economic growth for decreasing unemployment rates in a country is unrealistic and even with higher employment rates it might not reach the poor or improve their conditions (Khan 2007). In order to get people out of poverty a country needs more than economic growth, pro-poor growth is necessary (Kimenyi 2007). The basis of microfinance; improving and offering self employment possibilities, is definitely an approach based on the knowledge that “[s]low employment growth has been a major correlate of slow poverty reduction in developing countries” (Khan 2007:14). This fact, supported by the International Labour Organization (ILO) and UNDP research (Khan 2007), illustrates that employment has an important role in achieving pro-poor growth. Often the problem lies not necessarily in unemployment but in extremely hard work at levels of low productivity. In addition there is very little financial compensation for labour (Wield and Chataway 2000). Since poor wage employment but also a decline in agricultural trade due to state policies may cause complications, the poor are more likely to benefit from self employment opportunities (Khan 2007). This is exactly what microcredit brings to poor regions where people tend to be stuck in unhealthy, unequal, insecure labour conditions or rely on the impossible conditions of moneylenders.

As stated above, to achieve pro-poor growth more productivity is needed. According to Khan (2007) this means investing in human capital and capabilities. This is based however on the believe that the poor are not well equipped with skills, which can be a point of debate. Yunus’ belief is, opposed to Khan’s, that the poor indeed have the skills and knowledge to perform trade and market their goods. All they need is the opportunity to do so (Yunus 1997). Microfinance is based on the belief that:

> “Poor people have skills and a capacity to produce for the market but have lacked access to financial services. They have faced usurious interest rates and have had to deal with interlinked markets in ways which reduce their earnings.” (Greeley 2003:12)

Greeley (2003) therefore describes credits as a core need for the poor because the markets have failed them. He does add that microfinance can only be effective when it is supported by other forms of services. Even if there are the necessary skills available in a poor region, specific knowledge regarding finance but also health care and social relations might not be. This is a fair point to make; poor borrowers still need to find a way to transform their loans into profit making businesses. However small this business can be, not everybody has entrepreneurial skills. Some claim that microfinance is therefore not for everyone and especially the very poor can encounter complications due to their lack of skills (CIDA 2001). This believe complements Sen's theory that poverty "must be seen as the deprivation of basic capabilities rather than merely as lowness of incomes" (Sen 1999:87) Although it is a main cause of poverty, a lack of income can worsen capability deprivation which in return influences employment possibilities (Sen 1999). Even though some MFIs pay a significant amount of attention to education and capacity building, by offering graduation programmes where borrowers are obliged to have training before taking out loans, microfinance is in its essence not aiming at education. Those that do provide education can usually account for better results. It can also help limiting abuse of loans by borrowers (for example using one loan to pay off another or pay for dowry) (Harper 1998). One cannot claim that credit will automatically be transformed into a profit making business. Education should therefore be integrated in all MFIs practices and complementing credit programmes.

This does not mean that microfinance has no significant impact on poverty reduction at all. In Bangladesh every year five per cent of microfinance borrowers can lift themselves and their family out of poverty. Microfinance has a positive impact on income generation but even more on the social development of clients. Not only does it provide consumption smoothing and improve nutritional health of families (Khandker 1998), the borrowing rules set by Grameen Bank, BRAC and other MFIs have contributed a great deal in decreasing the fertility rates in heavily overpopulated Bangladesh and having smaller families means fewer mouths to feed.[1] There is evidence that show a positive effect on "health, nutritional status and primary schooling attendance" (CIDA 2001:2) as well as the empowerment of women (Coleman 2005). Mostly the outcomes are positive for increasing income and reducing the vulnerability of the poor (CIDA 2001). Borrowers of the Uganda Women's Finance Trust (UWFT) for instance place an extremely high value on having access to UWFTs credit and saving facilities since it is helping them in becoming less vulnerable to shocks and crises such as theft, fires and chronic illness

[1] Rules can be along the lines of health care (drinking pure water, clean housing, and use of latrines) helping the community, dowry and marriage laws, education and family planning (see Khandker 1998 table 2.3).

(Wright et al. 1999). Thereby hardly any other development programmes are so cost-effective (Coleman 2005).

There are doubts however about the large scale impact microfinance can have. The long term, widespread impact does seem limited. Due to the petty nature of its investments Hulme and Mosly (1996) believe that in order to achieve structural economic growth and pull people out of poverty, more is needed than credit. The types of enterprises that are inspired by microfinance are mostly executed within a household and borrowers usually don't hire employees. Therefore the wider impact on a larger economic scale and on the lives of non-borrowers is questionable (Hulme and Mosley 1996). When analysing the impact of microfinance, the outreach towards the extreme poor and the chronic poor indicate questionable results as well. As discussed by Kimenyi and Yunus, skills to produce and market goods are important, but also human capital plays a major role in the achievements of MFIs in reaching the poor. Since many programmes handle group or village lending structures, social capital is necessary for one to be able to join a programme. Especially the chronically poor are often located in desolated areas (CPRC 2009). Isolated poor or individuals amongst the bottom poor that lack human and social capital tend not to become members of MFIs (Khandker 1998). Microfinance can therefore never achieve a large enough outreach.

> "[M]icrocredit programs...should not be the sole instrument for poverty reduction. The ultrapoor may not join such programs even if they are eligible because they lack human capital. Other targeted programs... as well as broad-based economic growth are required for the left-out groups to become productive and able to escape poverty." (Khandker 1998:11)

Khandker (1998) agrees with Hulme and Mosley and Kimenyi that the petty nature of the businesses and the low skilled levels of performance and knowledge of the borrowers are harming the sustainability of the growth that is achieved. In order for the poverty alleviation to be sustainable, an increase should be seen in productivity and income rather than in consumption. Khandker (1998) argues for more activities with high growth potential to initiate long term poverty reduction. In order to do this, an increase in loan size will be necessary.

Finally a highly debated aspect of microfinance today which cannot go unmentioned in this essay is the commercialization of MFIs and the question whether this harms the poor. There seems to be a split between MFIs that are poverty focused and may always rely on donations and those that are commercializing. Greeley (2003) describes the two main pathways of MFIs as on the one hand attempting to reduce poverty; on the other hand trying to establish financial markets that function. Trade-offs between humanitarian work and commercialization are a concern for many MFIs. In order to manage a large enough outreach organisational growth and financial self-sustainability is needed, which means relying on commercial funds instead of donations. By focussing on commercialization, MFIs are bound to loose in the area of social development (Greeley 2003). Greeley takes it as far as saying that:

> “[T]he poverty reduction agenda has been taken over...by the excessive focus on financial sustainability. Many... MF[I]s have prioritised microfinance operations and have suffered from mission drift, from compassion to capitalism.” (Greeley 1997 cited in Greeley 2003:12)

Von Pischke (1996:227) names a ‘fender-bender assistance strategy’ which he translates to the following: “to make a dent in poverty, specific microenterprise lending programmes are worth considering seriously only if they can grow very fast.” Especially western donors want to see rapid progress and growth, which is not a natural course for the organisations and can cause an unstable situation. At least three to five years into existing trade-off situations occur for MFIs in terms of outreach and their self-sustainability. Good management, efficient use of knowledge and monitoring are necessary to manage these trade-offs (Von Pischke 1996). There are successes booked in commercialization of MFIs though. In the case of Compartamos Bank in Mexico that introduced the first Initial Public Offering for an MFI, the action has not disadvantaged its borrowers in any way according to research (Rosenberg 2007). For some scholars (Drake and Rhyne 2002 cited in Greeley 2003) it is the only way forward and gaining an understanding of what this means for the field of microfinance will need to shape our future thinking. Even with success stories of MFIs entering the trade market we must not forget the initial reason for Yunus to give out those loans in Jobra; to help the poor. A trade-off is understandable but whether the poor can and should suffer from this is a question we need to address.

What is the way forward then? When the Millennium Development Goals (MDGs) results will be counted in 2015 there will be a significant decline in the number of people living under the poverty line of a dollar a day (Sumner and Tiwari 2009), undoubtedly with help of microfinance programmes. But even if the first MDG (to halve extreme poverty in the world) will be met, still one fifth of the world's population will live in extreme poverty (Sumner and Tiwari 2009). Most of them will fall under the group of chronically poor, which tend to be hard to reach for MFIs (CPRC 2008). Sumner and Tiwari (2009) recognize several issues likely to arise after the 2015 deadline of the MDGs. An increasing inter-dependence between wealthy and developing countries is already seen in several processes. The main global and regional Emerging Processes and Issues Clusters (EPICs) show a development in areas of economics and markets, employment, natural resources and technology (Sumner and Tiwari 2009). In order to maintain and gain positive effects on poverty reduction through microfinance these EPICs can provide an indication on how programmes might need to adapt to future changes. To have a sustainable effect on the poor, labour market expansions, a decrease in natural resources and agricultural activities, changing global value chains and rapid urbanisation (Sumner and Tiwari 2009) need to be taken into account. This illustrates that MFIs have a lot of work ahead of them; finding better ways to measure poverty reduction impact, increase educational and capability enhancing activities, reaching the bottom and chronically poor, deciding on trade-offs to become self-sustainable and focus on the MDGs and beyond. Considering the hardship of the lives of the poor, it cannot be anything else but worth the trouble.

This essay has illustrated the practices of microfinance programmes and some of the debates that have arisen in relation to effects on poverty reduction. Through the use of theories on poverty an insight in MFIs achievements in reaching the poor was gained. What from this brief description and the provided arguments can be concluded is that microfinance can definitely contribute in a positive way to the lives of the poor in the areas of income, social development and vulnerability, but it cannot be an isolated solution and will need integration within overall development in a region or country. Questions were raised in terms of reaching the bottom poor, large scale impact, the provision of education and the commercialization of MFIs. These areas therefore need attention from MFIs as well as looking towards the future and finding more exact ways to measure the true effects of microfinance on poverty reduction.

Resources

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