Microfinance: Worth the Hype?
A Case Study of Bosnia and Herzegovina and Opportunities with the European Bank for Reconstruction and Development

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I. Introduction

The entire global community continuously struggles to eliminate poverty and increase access to markets. From small national organizations to the United Nations, extreme poverty is widely recognized as a grave issue, and over the past few years, various forms of aid and aid distribution programs have been implemented, with some experiencing greater success than others. However, the overall quality of previous aid programs was severely lacking, and today there are still millions of people living well below the World Bank’s lowest poverty line of one dollar per day. Their extreme poverty not only denies them access to things like healthcare, clean water, food, and education, but also to economic opportunities and a way out of their dire situation. The inability to obtain any sort of economic start-up traps the poor in a vicious cycle. They cannot help themselves because they lack credit, they cannot obtain money because they lack collateral, and therefore they fall further and further into poverty.

Nevertheless, a new approach to implementing poverty assistance may hold some solutions to this ongoing problem. Microfinance, or the provision of small-scale financial products like loans and savings to the extremely poor, has quickly gained popularity in recent years. Instead of requiring collateral or other monetary pressures, microfinance targets those who are rejected by the standards of conventional banks. By providing services to the extremely poor and excluded, microfinance takes a hands-on, bottoms-up approach to this global dilemma.

There are both supporters and opponents to microfinance and its effects on the international community. Supporters assert that it can build a sustainable economic foundation for places and people that are severely marginalized. Opponents argue that
although microfinance may be able to provide financial support for some, it is only causing cosmetic changes and not truly influencing society. Even so, large institutions such as the European Bank for Reconstruction and Development (EBRD) believe in the prospects of microfinance and have supported and helped establish microfinance institutions (MFIs) in its countries of operation. By examining the general microfinancial approach and societal issues in a specific country, as well as the use of microfinance by the EBRD to promote its mandate, the role that microfinance plays and should play in both the economic and social empowerment of its clientele is clear. Microfinance is a valuable resource that helps to pull the extremely poor out of their poverty and empower them, and the international community should continue to support such MFIs and the use of microfinance.

II. What is Microfinance?

a. Definition

Microfinance can be defined in many different ways. Generally it is described as the supply of loans, savings, and other basic financial services to the poor. Since microfinance was introduced in 1980, it has come to include a broader range of services, as the poor and very poor lack access to traditional formal financial institutions.

Microfinance and MFIs are typically introduced in developing countries, and their clients often include the self-employed and household based entrepreneurs. In rural areas this can represent farmers, and in urban areas with more diverse activities it could include shopkeepers, street vendors, artisans, etc.¹ Generally microfinance targets the poor and vulnerable that have no access to conventional formal financial institutions, and therefore

no motives or measures to pull themselves out of their extreme state of poverty. The microfinance process differs depending on institution and location, but essentially it provides these people small loans and insists on repayment as well as charges interest rates that could cover the costs of credit delivery. According to the MBB (The Micro Banking Bulletin), a semi-annual publication containing financial data of reporting MFIs, over 704 global MFIs reported a loss loan rate of only 0.9% in 2006. This statistic reflects the excellent repayment rates of microfinance loans, and shows that the public responds positively to the prospects of self-sufficiency. As well as empowering individuals, microfinance focuses on building up local, sustainable institutions to serve the poor.

b. Recent Popularity

Microfinance has gained recent popularity in the past few years for a number of reasons. In September 2000, the World Bank declared the eradication of extreme poverty and hunger the first priority in the Millennium Development Goals. Microfinance has been pushed into the forefront of global politics because it offers a new way to reach the poor and impoverished instead of the traditional approaches to the problem. The extreme poor cannot go to formal financial institutions for help as access is inversely related to income: the poorer you are, the less likely that you have access. Therefore they are usually forced to use the informal economic market, such as loan sharks and

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moneylenders, because they lack access to credit and/or banking services. MFIs offer these people an alternative with a low risk and micro-service related access to the financial markets, which should allow greater access to education, healthcare, social services and more. This is a unique approach to aid because MFIs rely on market principles, rather than political policies. Once a MFI is set up, it is expected to be economically self-sufficient within an approximate ten-year period, after which it should be able to operate on its own profits. By practicing self-sufficiency themselves, MFIs promote self-sufficiency to the extreme poor they are assisting, in an attempt to reduce the cycle of dependency that is typically created with modern aid.

Another reason that may account for the recent increase in popularity of these programs is the wide range and variety of MFIs and donors. Ranging from the Bill Gates Foundation to the United States government, there is a wide spectrum of donors participating in microfinance solutions today. The funding of microfinance and MFIs can encompass a range of objectives, some are purely interested in making a profit where as others are more focused on the social benefits. Opposition to microfinance is created because these motives are hidden and therefore one cannot tell if a country is supporting a MFI for social reasons like eliminating poverty, or simply to maximize profits on their investments.

c. Locations of Implementation

Microfinance has been implemented in nearly every region of the developing, as well as developed world. Regions where microfinance is most typically used include

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7 Balkenhol, p.7.
8 Balkenhol, p.12
Africa, especially sub-Saharan regions, Asia, Europe, specifically Eastern Europe, the Middle East, and Latin America. The EBRD countries of operation encompass most of the Eastern Europe region, and the EBRD has established micro and small lending projects in Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, Macedonia, Moldova, Mongolia, Montenegro, Romania, Russia, Serbia, Tajikistan, Ukraine and Uzbekistan. This paper will focus on the Eastern Europe region and some of the projects the EBRD has established or supported.

III. **Country Case Study: Bosnia and Herzegovina**

Prior to demonstrating the past and current microfinance programs specifically with the EBRD it is important to look at the economic and social effects microfinance has had on a specific country. In Bosnia and Herzegovina (BiH), the dynamic microfinance sector and analysis of both its successes and setbacks could help microfinance donors and policy makers in other countries, especially post-transition countries, develop adequate policies to promote microfinance.  

BiH has been home to microfinance investment since 1996, and with more than 40 registered MFIs in 2004, it has one of the most competitive microfinance sectors in Central and Eastern Europe and the Newly Independent States.

*a. An Appropriate Environment for Microfinance*

The wartime and postwar history of BiH and the unique political and governmental structures that emerged out of the ashes of conflict gave way to an appropriate environment for microfinance and especially for the evolution of the legal

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and regulatory environment for microfinance over the past decade. Microfinance first became a topic of interest after the breakup of Yugoslavia, as the region suffered from massive unemployment and no functioning social welfare system. In addition to physical destruction and loss of life, there was considerable social disruption and a decline in standards of living. Something was needed to instigate people to earn a living and start rebuilding their lives, and self-employment and microenterprise were seen as important means for people to do so.

Microfinance initiatives in the BiH region began shortly after the 1996 Dayton Peace Accord, which created a complicated confederation between the “Entities” of Rupublika Srpska and the Federation of Bosnia and Herzegovina. Both were operated under a weak central government and each entity-level government could exercise all basic economic powers and have jurisdiction over substantially all matters of commercial and economic law. This became a very complicated picture; in part due to the field of NGO law. Would-be sponsors of microfinance in BiH wanted to use an NGO legal form to serve as the lending entity. When the World Bank then tried to agree with the Entity-level governments about the legal foundations of the nonprofit organizations, the two parties faced a number of possible legal forms, none of which seemed to define microfinance as the primary purpose of the lending.\(^{10}\) In addition, the banking sector of the two Entities was more focused on cleaning up the banks and closing down the insolvent ones, while building the capacity of supervisors for the task – they did not have time to monitor the behavior of new MFIs.\(^{11}\) At the same time, the BiH credit-starved population provided the necessary conditions for rapid development of microfinance in


\(^{11}\) Ibid. p.8
the region, and extreme mistrust of conventional financial institutions lead to a low savings rate and little liquidity in the banking sector.

It was not until a Local Initiative Project funded by the World Bank implemented a unified strategy, that the microfinance sector began to develop, and the measures intended to move the country in direction of a market economy commenced. This Local Initiative Project identified and trained about 25 organizations of which 17 potentially viable programs received funding and the most viable received further support through 2001. The Project also strived to create an appropriate legal framework for microfinance, which helped many MFIs to become more integrated in the financial sector. Some MFIs successfully obtained commercial loans from local banks, while others transformed into financial companies, which also improved their access to funds as well as their ability to provide more financial services. By 2001, there were a number of MFIs established in BiH, for example Prizma, Mikrofin, EKI-World Vision, Mi-Bospo, Partner and Sunrise, and such programs disbursed over 20,000 microloans in the region since they were established. Among the Central and Eastern European region’s top 20 MFIs by number of clients, 25% are in BiH and Bosnian MFIs have also achieved some of the highest levels of MFI profitability throughout the world.

b. Analyzing the Effects of Microfinance in BiH

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Some argue that the great economic success of microfinance is simply measured by the high repayment rate of loans.\textsuperscript{15} As previously mentioned, as of 2006, the global loan loss rate of MFIs reporting to the MBB was a miniscule 0.9\%, with BiH posting a similar rate.\textsuperscript{16} This high repayment rate is certainly one indication of the economic success, and allows borrowers to benefit in a few ways. Good repayments allow for the acquiring of new, larger loans in many cases. They also indicate good financial standing and that the borrower now has enough assets to post collateral for a conventional loan.

However, there are more statistical figures that point to the success of microfinance in BiH. First and foremost, in the two years following the signing of the Dayton Peace Accords, per capita Gross Domestic Product (GDP) doubled, demonstrating that there had been measurable economic recovery following the war, in part due to microfinance in the region.\textsuperscript{17} A variety of studies have been performed to measure the specific impact of microfinance on clients in BiH. One such impact assessment, performed by Elizabeth Dunn and published in May 2005, used regression analysis to compare clients and non-clients of microfinance who were similar on several baseline variables, such as income, gender, education, and displaced or returnee status from the war. A total of 2,561 client and non-client entrepreneurs were interviewed in 2002 and again in 2004. Among this total, 1,385 were clients, 289 were new clients, and 630 were non-clients who were screened to ensure that they were similar to clients. Additionally, 257 non-clients took loans between survey rounds and thus provide insight to the early impact of microfinance. Clients had been members of MFIs for an average of


\textsuperscript{16} Goldberg, p.7

\textsuperscript{17} Goldberg, p.4
3.6 years, while new clients had been members for an average of 2 years, and those who became members between survey rounds had been members for 1 year. Results demonstrated that client households increased their income by about 900KM (equivalent to ~US$540 in 2004) per capita more than non-client households. In addition, new clients earned 1100KM per capita more than non-client households who had similar income in 2002. In her study, Dunn emphasized that these numbers were especially impressive in relation to the poverty line of 2200KM per capita. Overall, the study shows that microfinance contributed to the strengthening of the BiH economy as clients of MFIs experienced significant increases in income.\(^{18}\)

MFIs in BiH became very successful because their lending techniques were culturally appropriate. In comparison to poverty in some countries in Africa and Asia, BiH poverty differed, as the new poor were highly educated and usually good with physical assets base. Before the war, the clientele may have been private business owners or factory workers who became unemployed after the industry collapsed. Post-war unemployment in BiH reached as high as 85% and the population had the motivation but lacked the credit to rebuild their lives, making them perfect clients for MFIs.\(^{19}\) It is difficult to agree upon a single measure for the unemployment rate due to an active “gray market” for labor where no hard information on unemployment is available. This “gray market” arose principally to circumvent prohibitive tax and labor laws. Nevertheless, a survey conducted by the Statistics Agency of BiH and the entity statistics institutes

\(^{18}\) Dunn, Elizabeth. Impacts of Microcredit on Clients in Bosnia and Herzegovina. Impact LLC. 2005. p.21
provide an estimate based on a three-year survey of representative households. The results indicate a gradual decline in unemployment rate from 39% in 2001, to 37% in 2002, and to the lowest rate of 32% in 2003. Although these unemployment rates are relatively high, it shows a significant decrease from the extreme post-war rate of 85%.

Due to the devastating state of BiH after the war, much impact analysis of microfinance is focused on the social aspects of the population. Access to credit for clients of microfinance leads to substantial improvements in education and health. Preliminary reports from an ongoing assessment of Education Development Projects Quality Fund suggest that useful innovations in teaching and learning are being introduced in many schools. In addition, the number of young adults in schools increased as available credit for their families allowed them to attend school rather than working to support the family. The health status also improved as the infant mortality rate (IMR) decreased steadily from 14 per 1000 in 1996 to 7.6 per 1000 in 2001, only slightly above the 7.4 pre-conflict levels. Overall, microfinance credit on BiH stimulated household reconstruction as it provided an efficient and long lasting coping mechanism for households after the war.

The war in former Yugoslavia left BiH in a dire situation as shows by unemployment rates, poverty, etc. Microfinance helped to improve the situation and also instigated a goal held by BiH prior to the war. Since 1989, Central and Eastern European countries, including BiH, have been in the process of transition from planned economies to market economies. The war in Yugoslavia generated a setback in the transition

process, as in a post-war environment this transition was not of utmost importance. The new government has made considerable effort to launch a comprehensive reform agenda despite the chronic economic problems. Due to the impacts of microfinance, per capita GDP doubled in the two years following the war, and economic activity has remained relatively high. MFIs have contributed significantly to the transition to a market economy and will continue to do so in the future as they acquire more clients and disburse larger loans.

IV. Microfinance and the European Bank for Reconstruction and Development

a. Introduction to the European Bank for Reconstruction and Development

The European Bank for Reconstruction and Development (EBRD) uses tools of investment to help build market economies and democracies from central Europe to central Asia. Founded in 1991 to help ex-soviet countries transition from communism to democracy, the EBRD has now expanded and operates in 29 countries and 10 business sectors. The EBRD is the single largest investor in the region and is owned by 61 countries and two intergovernmental institutions. It mainly invests in private enterprises, usually together with commercial partners, even though public sector shareholders own it. The EBRD’s mandate is that it only works in countries that are dedicated to democratic principles. In these countries, the EBRD provides project financing for banks, industries and businesses, and also works with publically owned companies to support privatization, restructuring state-owned firms and improvement of municipal services.22

b. Microfinance with the EBRD

Although the situation in postwar BiH is different from many of the EBRD countries of operation, the underlying reasons for the EBRD to support microfinance and establish MFIs remains the same – transition to market economy. BiH provided the perfect environment for microfinance, as the clientele were unemployed and lacked access to credit. This is often the same, but perhaps not as extreme, in many of the transition countries the EBRD operates in. The success of microfinance in BiH and in other regions has caused the EBRD to create such lending programs throughout many countries. The EBRD’s micro and small business finance sector has already established programs such as the US/EBRD SME Finance Facility, the Russia Small Business Fund, and most recently, the Romania Micro Credit Facility. In addition to these programs, the EBRD also provides loans to already established MFIs in its countries of operation. Microfinance with the EBRD is a fairly new phenomenon and has had some success thus far, but as the current programs expand and as more are implemented, the EBRD hopes that it can use this tool of investment to help build market economies.

c. **Micro and Small Business Finance Sector**

The EBRD has continuously supported micro and small enterprises because they contribute fundamentally to the bank’s mandate of promoting market economies and democracies.23 Due to the escalating use of microfinance as aid distribution in the international community, the EBRD has put microfinance into the forefront of its investments. Since the bank was established in 1991, it has provided over €14.8 billion

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through its small business lending programs to support micro, small and medium-sized enterprises.\textsuperscript{24}

These lending programs provide individuals and firms, who have been denied access to formal financial institutions, access to finance by making credit available to local banks and MFIs. Instead of acting directly with the people receiving the loans, the EBRD cooperates with existing commercial banks and non-bank MFIs, and also sets up brand new, specialized microfinance banks based on the location. EBRD financing is provided by 103 local banks and specialized microfinance organizations, which in turn disburse loans through almost 2,000 branches.\textsuperscript{25} This cooperation strategy is important because institutions already established in the area are familiar with the clientele and the clientele is more likely to trust a small organization rather than the bank itself. If there is no sufficient stable banking sector, the bank cooperates with partner institutions to establish a new MFI suitable for the region. The EBRD takes a hands-on approach by making credit readily available, and also by organizing technical cooperation donor funds to confirm that the loan funds are used efficiently and reach the intended clients.\textsuperscript{26} By taking a strong regional approach, the EBRD is able to support economic development and social stability in its countries of operation.

The EBRD’s microfinance approach differs depending on country of operation and size of enterprise. In micro and small enterprise lending, the EBRD focuses on delivering finance quickly with small loans and also provides an example to the banking

\textsuperscript{24} Ibid.
\textsuperscript{25} Annual Report. European Bank for Reconstruction and Development. 2007. 36-37.
sector in the region of “best practice” in such lending. The micro and small enterprise lending programs have been established in 19 countries of operation, usually countries that are in the early phase of transition to a market economy. The EBRD targets regions where businesses and people have little or no access to finance, and historically this approach has been very successful in these regions. In comparison, with regards to small and medium-sized enterprise lending, support from the EBRD usually comes in the form of credit lines, equity funds and technical cooperation. The EBRD strives to reach small business by targeting less advanced economies dominated by the state sector. Countries with better-developed private sectors are impacted more by credit lines targeting larger borrowers, because they have higher prospective returns and require longer-term capital. The EBRD endeavors to provide financial support to these small businesses to help them grow into major enterprises, which in turn can provide jobs, poverty alleviation and economic growth.

Many donors, such as the United States, European Commission, and a number of private institutions, support the EBRD’s microfinance programme. These donors have worked together with the EBRD to establish a number of facilities and funds that use microfinance techniques to finance the poor and promote private sector growth. For example, the US/EBRD SME Finance Facility, one of the most successful initiatives thus far, was established by the United States and EBRD in July 2000 to promote economic development in southeastern Europe and other transition countries. The Facility assists lending schemes in 15 countries and also trains staff in local banks and non-bank financial institutions to reduce legal and regulatory obstacles to small business finance. It

28 Ibid.
has also assisted in transforming non-bank financial institutions into full commercial microfinance banks in countries such as Kosovo and FYR Macedonia. In addition, an example of how EBRD supports small and medium-sized enterprises is through the EU/EBRD SME programme, established in 1999 for financing small businesses in the new EU member states and EU candidate countries. Funding amounting to €1.4 billion is available through this facility, which has proven to be extremely effective in encouraging local intermediaries to lend to small enterprises. Since the programme was implemented, 90,000 transactions worth over €1.9 billion have been undertaken with small businesses in the region. Support from these donors has been crucial to the success of microfinance programs with the EBRD so far, and without their cooperation, many of the facilities today would not have been implemented.

V. Conclusion

In an ideal world, opportunities would exist for everybody to better their lives. Unfortunately, this is not the case, and today the World Bank estimates that there are nearly a billion people living below the poverty line. The old, top-down approaches to aid have not been successful in alleviating this global problem. Today, microfinance has begun to fill the gap, and many international institutions such as the EBRD, are beginning to believe in the prospects of microfinance. By targeting the impoverished and marginalized, microfinance has become extremely popular. From an economic perspective, MFIs are experiencing large profits and high repayment rates. Simply providing these marginalized clients and businesses with small amounts of start-up money gives them the opportunity they could never obtain from conventional banking.

29 Annual Report, European Bank for Reconstruction and Development. 2007. 36-37.
Microfinance has also contributed to transitioning to a market economy by providing more economic opportunity for the country. This is particularly important for Central and Eastern European countries that strive to join the European Union. Institutions such as the EBRD have taken the initiative to introduce and support MFIs and have been quite successful thus far.

On its own, microfinance cannot function to lift up a billion people from below the poverty line. Increased cooperation between governments, international institutions, NGOs, and MFIs will increase the cohesiveness of global aid policies to further help the impoverished. Additionally, it is important to understand that what works in one area or country cannot necessarily be implemented in another. Nevertheless, as the microfinance industry continues to mature, it will be interesting to see the direction that the programs take. More research in the coming years will expose the true long-term effects and benefits, both economically and socially, of microfinance. For now, however, microfinance seems to be working and should not be ignored. The world of microfinance is able to reach millions of poor that were previously shunned from the free market, giving them the opportunity to better themselves, their families, and their community.
VI. Bibliography


