Impact of Microfinance: A Critical Survey

It is unclear whether microfinance contributes to a reduction in poverty or is the most efficient method to reduce poverty without additional measures in areas such as education, health and infrastructure. The entry of commercial banks into microfinance may increase the competition for traditional microfinance institutions and reduce lending to the core poor, even if it improves financial sustainability.

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According to the United Nations (UN), in 2002 almost one-fifth of the world population (i e, 1.3 billion people) was living in extreme poverty, earning less than one dollar a day. In recent public debates microfinance has been mentioned as an important instrument to combat poverty. Therefore, microfinance has received a lot of attention, both from policy-makers as well as in academic circles. Especially during the past 10 years, microfinance programmes have been introduced in many developing economies. Well known examples are the Grameen Bank in Bangladesh, Banco Sol in Bolivia and Bank Rakyat in Indonesia. The Grameen Bank system of group lending (established in 1976 by Muhammad Yunus, a Bangladesh banker and economist), in particular, has been copied in other developing countries. Between December 1997 and December 2005 the number of microfinance institutions increased from 618 to 3,133. The number of people who received credit from these institutions rose from 13.5 million to 113.3 million (84 per cent of them being women) during the same period [Daley-Harris 2006].

To support the view that microfinance can be an important instrument to fight poverty, the UN declared 2005 to be the international Year of Microcredit. Recently, the attention for microfinance and its role in reducing poverty was further increased when Muhammad Yunus received the Nobel Peace prize. According to the Nobel Committee, microfinance can help people to break out of poverty, which in turn is seen as an important prerequisite to establish long lasting peace [Nobel Committee 2006]. This has led to an almost euphoric attitude among policy-makers and aid organisations about potential poverty reducing effects of microcredit.

The question, however, is whether microfinance really will be able to significantly reduce worldwide poverty? In this article, we provide a critical evaluation of the discussion on the potential contribution of microfinance in reducing poverty. We do not deny that microfinance may potentially play an important role in improving the income of the poor. At the same time, however, we feel that recent discussions on microfinance have to be put into the right perspective in order to preclude overly optimistic expectations about the impact microfinance may have on reducing poverty.

The remainder of this article is organised as follows. In the next section we provide a short background to the microfinance concept. This is followed by a critical review of the arguments made by proponents of microfinance as an important instrument to combat poverty. Next, we discuss measurement problems that studies on the impact of microfinance are confronted with, which is followed by a review of available evidence from recent empirical impact studies. We conclude this article by discussing our view on the potential contribution microfinance can make in reducing global poverty.

A Short Description

Microfinance institutions aim to provide credit to the poor who have no access to commercial banks. In general, these institutions receive financial support from western donors, NGOs or commercial banks, who lend to microfinance institutions, often against below market interest rates. The microfinance institutions in turn, lend this money to domestic small companies and poor agents. The size of the loans varies, but is often small. According to MixMarket (www.mixmarket.org), the average loan size in 2005 was only about $ 470.

In addition to loans, microfinance institutions also provide a wider range of financial services, such as savings funds and insurance services. Moreover, they also play an important role in training potential borrowers how to run a firm, and deal with health provision. These non-credit services have become more important during recent years. This article, however, focuses primarily on the role of microfinance institutions in providing credit to the poor.

A recent survey among 518 microfinance institutions in Africa, Latin America, eastern Europe and Asia reveals that the majority of the microfinance borrowers are served by institutions in south and east Asia. The largest microfinance institutions are found in countries such as Bangladesh, India, Indonesia and Thailand. Bank Rakyat in Indonesia serves over 3.3 million clients; Grameen Bank, ASA and BRAC, all located in Bangladesh, have 4 to 5 million active borrowers. In India, large microfinance institutions are SHARE (8,14,000 active borrowers) and Spandana (7,72,000 borrowers) (www.mixmarket.org). Surprisingly, the extension of services of microfinance institutions to poor people (outreach) in

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the most populated countries in Asia, such as India and China, is relatively low [Weiss and Montgomery 2004].

Microfinance institutions use innovative and unconventional methods to reduce lending costs. The main problem with lending to the poor is that information costs are high as compared to the size of the loan. It is generally known that information costs of lending may be high since lenders are not able to distinguish projects with respect to their risk profiles when allocating credit (adverse selection problem) and borrowers may be able to apply the funds to different uses than those agreed upon with the lender (moral hazard problem). Commercial banks use several methods to reduce these costs, such as screening potential borrowers, and monitoring the progress of the project. These methods, however, are too costly if a bank would lend small amounts of money to potential poor clients in remote areas. Moreover, commercial banks often ask borrowers to pledge collateral. However, the latter solution assumes that collateral is available, which is often not the case, particularly not for the poor in many developing countries.

Microfinance institutions also use methods of screening and monitoring to reduce the costs of lending. Yet, these methods are adjusted to local circumstances, enabling them to offer small-sized loans without incurring too high costs. The most well known example is the use of group lending with joint liability. With joint liability lending, the group of borrowers is made responsible for the repayment of the loan of an individual group member, i e, all group members are jointly liable. The advocates of group lending argue that joint liability lending provides clear incentives to borrowers to monitor and screen each other. Moreover, the monitoring and screening of group members is efficient and cheap, because members usually live close to each other and/or have social ties (also referred to as social capital in the existing literature). When social ties are present, group members are supposed to be well-informed about each others' projects and that this information is almost freely available. Ideally, then, the microfinance institution does not need to take care of the monitoring and screening of group members.

Despite the focus on group lending in the academic literature on microfinance, microfinance institutions often provide individual-based lending. In fact, at the moment there is a strong movement from group based lending to individual-based lending systems. Even well known microfinance institutions, which traditionally were focusing on group lending, such as the Grameen Bank of Bangladesh, have started to use individual-based lending. With individual-based lending, the information costs are reduced by means of regular contacts between the borrower and the microfinance institution (relationship lending), and by making future loans dependent on regular repayments (so-called dynamic incentives). Nevertheless, group loans are still the most important in terms of the amount of borrowers that receive a loan. According to a study by Lapenu and Zeller (2001), based on a survey among 1,500 institutions around the world carried out in 1999, 68 per cent of borrowers of microfinance institutions receive a loan through group lending programmes. Therefore, the remainder of this article will mainly focus on group loans.

Contribution and Critique

The advocates of microcredit argue that microcredit can help to substantially reduce poverty [Littlefield et al 2003; Dunford 2006]. Access to credit can contribute to a long-lasting increase in income by means of a rise in investments in income generating activities and to a possible diversification of sources of income; it can contribute to an accumulation of assets; it can reduce the vulnerability due to illness, drought and crop failures, and it can contribute to a better education, health and housing of the borrower. In addition, microcredit can contribute to an improvement of the social and economic situation of women. Finally, microfinance may have positive spillover effects such that its impact surpasses the economic and social improvement of the borrower.

Notwithstanding the predominantly positive view on microcredit, several authors doubt that microcredit can contribute to a substantial reduction in poverty. Many critics show that microfinance does not reach the poorest of the poor [Scully 2004], or that the poorest are deliberately excluded from microfinance programmes [Simanowitz 2002]. First, the extreme poor often decide not to participate in microfinance programmes since they lack confidence or they value the loans to be too risky [Ciravegna 2005]. The poorest of the poor, the so-called core poor, are generally too risk averse to borrow for investment in the future. They will therefore benefit only to a very limited extent from microfinance schemes. Second, the core poor are often not accepted in group lending programmes by other group members because they are seen as a bad credit risk [Hulme and Mosley 1996; Marr 2004]. Third, staff members of microfinance institutions may prefer to exclude the core poor since lending to them is seen as extremely risky [Hulme and Mosley 1996]. Finally, the way microfinance programmes are organised and set up may lead to the exclusion of the core poor. Examples for this exclusion are the requirement to save before a loan can be granted, the minimum amount of the loan that needs to be accepted and the requirement that a firm is registered before the loan can be granted [Kirkpatrick and Maimbo 2002; Mosley 2001].

Several critics also argue that group loans lead to high transaction costs. The main advantage of group loans according to the advocates of microfinance is that group loans drastically reduce monitoring costs, since group members live in the same village and know each other well. Therefore, they are able to assess the riskiness of a project against low costs (some even believe that in group lending programmes monitoring is almost costless). Additionally, group members can prevent any moral hazard behaviour without costs by using social sanctions. This, however, ignores the fact that group members sometimes live far away from each other, and need to spend time and energy to assess each other's projects [Marr 2004]. Moreover, most microfinance schemes have regular group meetings. During these meetings, information about the projects is exchanged and repayment problems are discussed. These group meetings often imply high transaction costs [Armendáriz De Aghion and Morduch 2000; Murray and Lynch 2003]. Obviously, then, these costs may reduce the positive income generating effects from access to credit.

In addition, it has been argued that sometimes the size of the needed loan exceeds the maximum amount that can be borrowed in terms of a group loan. This especially hampers the future growth of those agents who have invested in successful and growing projects [Khawari 2004; Madajewitcz 2003]. Group loans are rigid, and often it is very difficult to adapt the loan to the desired credit needs of individual borrowers within the group.

Finally, some authors criticise the impact of microcredit on women. Many microfinance schemes have a clear focus on women. Research shows that women are more reliable and have higher payback ratios. Moreover, women use a more substantial part of their income for health and education of their children [Pitt and Khadker 1998]. Thus, women play a very important role in reducing poverty within households. However, the critics argue that often women are forced to hand over the loan to men, who subsequently use the loan for their own purposes. This may lead to an additional burden for women if they are held responsible for the repayment [Goetz and Gupta 1996].

Microcredit and Poverty

The theoretical discussion about the impact of microfinance on poverty reduction calls for thorough empirical research. Therefore, it is surprising that there are only a few solid empirical studies available on the possible poverty reducing effects of microcredit. A major problem is how to measure the contribution of microcredit. Three issues are of importance: first, which contribution is seen as the most important (improvement of income, accumulation of assets, empowerment of women, etc); second, does microcredit reach the core of the poor or does it predominantly improve income of the better-off poor; and third, do the benefits outweigh the costs of microfinance schemes [Dunford 2006]? The latter issue deals with the question of the extent to which subsidies to microfinance organisations are justified.

Most studies measure the impact of microcredit by comparing recipients of microfinance with a control group that has no access to microcredit. This approach may be problematic, however. First, changes of the social and/or economic situation of the recipients of microcredit may not be the result of microfinance. For instance, it is well known that relatively rich agents are less risk averse than relatively poor agents. This may induce rich agents to apply for microcredit whereas poor agents do not apply. In this situation, an ex post comparison of income of the two groups may lead to the incorrect conclusion that microfinance has stimulated income. Second, in order to improve the probability of microfinance being successful, microfinance organisations may decide to develop their activities in relatively more wealthy regions. Obviously, this biases any comparison between recipients of microcredit and the control group [Karlan 2001; Armendáriz De Aghion and Morduch 2005].

Results

The empirical literature on the outreach of microfinance, in terms of the number (breadth) and socio-economic level (depth) of clients who are served by microfinance institutions is vast. However, most of these studies suffer from being anecdotal and case study driven. Moreover, only some of the outreach studies are published in established refereed international scientific journals, so that it is difficult to value their quality. Nevertheless, some conclusions can be drawn based on the existing literature.

Most studies conclude that microcredit positively contributes to poverty reduction. Microcredit, therefore, may help to solve the poverty problem. This seems to be good news. However, there is much discussion about the question of the extent to which microfinance reaches the core poor. Here, a new measurement problem arises, i e, how to identify the core poor [Dunford 2006]. Nevertheless, Khandker (2005) and Eda Rural Systems (2004) find that the extremely poor benefit more from microfinance than the moderately poor. On the other hand, several other studies indicate that it is the "better off" poor rather than the core poor who stand to benefit most. Evidence for this is given in, for e g, Hulme and Mosley (1996) and Copestake et al (2005).

It is also important to know what costs are involved in making microfinance a successful instrument to combat poverty. Even if microcredit positively contributes to a reduction in poverty, it is unclear to what extent these results cannot be reached by other more cost-efficient instruments. Providing microfinance is a costly business due to high transaction and information costs. Recent research shows that most microfinance programmes are still depending on donor subsidies to meet the high costs, i e, they are not financially sustainable [Cull et al 2007]. A controversial question is whether these subsidies are justified. Unfortunately, this question cannot as yet be answered due to a lack of solid empirical research.

A Panacea?

After having reviewed the debate on microfinance and poverty, the conclusion must be that it is still unclear whether microfinance substantially contributes to a reduction of world poverty. Nor is it clear whether microfinance is the most efficient method to reduce poverty. Much more solid empirical research is needed.

In addition, it should be noted that the outreach of microcredit is still small. Despite the enormous increase in microcredit to poor borrowers, in 2004 only 6 per cent of borrowers with an income below $ 365 were able to borrow from microfinance institutions [Daley-Harris 2006]. It is not to be expected that microfinance, without additional measures in the area of education, health, and infrastructure, is able to substantially reduce poverty.

Moreover, recently we observe a trend towards a further commercialisation of the microfinance sector. Among other things, this has led microfinance organisations to decide on providing a wider range of financial services. We also see a move from traditional group lending to individual loans. This move seems to be bad news for the poor, since the fraction of poor borrowers and female borrowers in the loan portfolio of individual-based institutions is lower than for group-based institutions. At the same time, individual-based microfinance institutions seem to perform better in terms of profitability, as has recently been shown in a study by Cull et al (2007). Due to the trend of commercialisation of the sector, financial sustainability of microfinance institutions is becoming more and more important at the expense of using credit to help overcome poverty.

To some extent, the trend towards financial sustainability is counteracted by establishing special programmes for the core poor. Especially in Bangladesh, programmes have been initiated to specifically support the core poor, for instance, by the well known institutions of BRAC and ASA. These programmes not only focus on credit, but also aim to provide a broad range of services for the poor, such as training, health provision and more in terms of the general social development of this category of poor. Yet, the impact of these programmes is still unclear, and the outreach is small, at least for the moment.

Fortunately, there is another, potentially hopeful, development. The involvement of traditional commercial banks in microfinance is growing rapidly around the world. In several developing countries large state banks and private banks have started to provide microfinance services. In Pakistan, for instance, a number of

private commercial banks have moved into microfinance. In Malaysia, Nepal and Thailand there are programmes stimulating commercial banks to become involved in microfinance. In India the National Bank for Agriculture and Rural Development (NABARD) recently initiated a programme to involve private banks in microfinance. According to recent studies the growth of microfinance in India is led by a number of commercial banks such as ICICI, HSBC and ABN AMRO, together with private venture capital funds and social venture capitalists [Lakshman 2006; Iyer 2006].

A possible advantage of the move of commercial banks into microfinance may be that these banks can provide credit to the poor, without being dependent on donor subsidies. Commercial banks have diversified portfolios, and are able to use profits from lending to wealthy clients to finance (subsidised) loans to the poor, i e, cross-subsidisation would take place. At the same time, however, one may question why commercial banks would do this. To some extent, this trend can perhaps be explained by the increased attention to socially responsible entrepreneurship, at least among the large western commercial banks. Probably more importantly, however, will be the fact that these commercial banks will try to use subsidised loans to the poor as an instrument to enlarge their future profit-making portfolio, based on the assumption that lending to them will make them more wealthy clients in the future, who can afford to pay market-based interest rates.

A potential disadvantage of the increased involvement of commercial banks is that traditional microfinance institutions are confronted with increased competition in the market for micro loans. While increased competition may lead to increased efficiency and stimulate financial sustainability, it may also reduce the scope for lending to the core poor, an argument we already highlighted above. Moreover, increased competition and increased supply of loans may result in higher levels of indebtedness of the clients as they may take up multiple loans from different sources at the same time [Ciravegna 2005]. This may lead to lower repayment rates, endangering the long-term sustainability of the programme [Vogelgesang 2003]. Lower repayment rates, in turn, may lead to less favourable credit contracts for the poorest borrowers, for instance because interest rates are raised, which may lead them to drop out from the loan portfolio of microfinance institutions. Research shows that whereas wealthier borrowers are likely to benefit from increasing competition among microfinance institutions, it also leads to lower levels of welfare for the poorer borrowers [McIntosh et al 2005].

The trend of commercial banks entering the market for microfinance appears to be one of the most important challenges for the microfinance business in the near future. The potential of this trend in terms of reducing poverty is still unclear, however. Further research into this important issue is therefore highly desirable. EPW

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