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Microfinance as a Poverty Reduction Tool—A Critical Assessment

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Abstract

This paper attempts to provide a critical appraisal of the debate on the effectiveness of microfinance as a universal poverty reduction tool. It argues that while microfinance has developed some innovative management and business strategies, its impact on poverty reduction remains in doubt. Microfinance, however, certainly plays an important role in providing safety-net and consumption smoothening. The borrowers of microfinance possibly also benefit from learning-by-doing and from self-esteem. However, for any significant dent on poverty, the focus of public policy should be on growth-oriented and equity-enhancing programs, such as broad-based productive employment creation.

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Microfinance as a Poverty Reduction Tool—A Critical Assessment[1]

Anis Chowdhury

> *"There are many stories of the transformative effect of microfinance on individual borrowers but* ***until recently*** *there has been surprisingly little* ***rigorous*** *research that attempts to isolate the impact of microfinance from other factors, or to identify how different approaches to microfinance change outcomes."*
>
> [Center for Global Development, 2007; emphasis added].[2]

Professor Mohammad Yunus, the founder of Grameen Bank in Bangladesh and the originator of the concept of microfinance, believes that 5% of Grameen Bank's clients exit poverty each year.[3] However, there are surprisingly few credible estimates of the extent to which microcredit actually reduces poverty. Even the *recent* more *rigorous* research findings are not free of methodological limitations or controversies.[4] Thus, the continuing intense debate about the impact of microfinance on poverty reduction is not surprising. Despite the euphoria of the Nobel Peace Prize going to Professor Mohammad Yunus there are still many sceptics.[5]

Ideally one can ascertain the impact of microfinance if the counterfactual—what would have happened to a person who borrowed from a microlender if he/she had not done so—can be easily tested. Many early studies compared borrowers with non-borrowers. But if borrowers are more entrepreneurial than those who do not borrow, such comparisons are likely to grossly overstate the effect of microcredit. Two recent studies attempted to overcome the problem of self-selection (i.e, the likelihood of people with entrepreneurial skills borrowing) by using randomized sample selection methods.[6] That is, participation in a programme is determined essentially by chance. Contrary to the usual claims, neither study found that microcredit reduced poverty. Microcredit may not even be the most useful financial service for the majority of poor people.[7] The MIT study by Banerjee, Duflo, Glennerster and Kinnan (2009) found no impact on measures of health, education, or women's decision-making among the slum dwellers in the city of Hyderabad, India. Similarly, the study by Dean and Zinman (2009), which measured the probability of being below the poverty line and the quality of food that people ate, found no discernible effects.

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1 Microfinance and micro-credit are used interchangeably here. However, in the literature, microfinance is also used in a broader sense to cover financial services such as micro savings and micro insurance.

2 "Evaluating the Impact of Microfinance" http://www.cgdev.org/content/article/detail/12338/ accessed on Dec. 4, 2008.

3 Quoted in the *Economist's* article, "A Partial Marvel", July 16, 2009

4 See, for example, Morduch (2008) for a methodological critique of the Hulme and Mosley (1996) studies.

5 See "Debate on Microcredit", Foreign Policy in Focus, http://www.fpif.org/fipiftxt/4324 accessed on Dec. 3, 2008. Among the prominent sceptics are Thomas Dichter, Aneel Karnani, Vijay Mahajan and Robert Pollin. Salil Tripathi wrote a sceptical editorial in *The Guardian* (Tuesday October 17, 2006) a week after Professor Yunus was awarded the Nobel Peace Prize.

6 Banerjee, Duflo, Glennerster and Kinnan (2009) and Karlan and Zinman (2009).

7 The *Economist*, July 16, 2009

The state of the debate

Impacts on poverty reduction

The most-cited source of evidence on the impacts of microfinance is the early set of studies collected by David Hulme and Paul Mosley (1996). The findings of these studies are provocative: poor households do not benefit from microfinance; it is only non-poor borrowers (with incomes above poverty lines) who can do well with microfinance and enjoy sizable positive impacts. More troubling is the finding that a vast majority of those with starting incomes below the poverty line actually ended up with less incremental income after getting micro-loans, as compared to a control group which did not get such loans.

Findings of the Hulme and Mosley studies imply that credit is only one factor in the generation of income or output. There are other complementary factors, crucial for making credit more productive. Among them, the most important is recipient's entrepreneurial skills. The findings of the MIT study by Banerjee *et al* also point to this factor.[8] Most poor people do not have the basic education or experience to understand and manage even low level business activities. They are mostly risk-averse, often fearful of losing whatever little they have, and struggling to survive.[9] This does not mean that they do not want to better themselves (e.g., as suggested by the so-called backward bending labour supply curve).

Aneel Karnani (2007: 37) summarizes this point as follows: "Most people do not have the skills, vision, creativity, and persistence to be entrepreneurial. Even in developed countries with high levels of education and access to financial services, about 90 percent of the labor force is employees, not entrepreneurs." According to Vijay Mahajan (2005), a social entrepreneur and chairman of BASIX, "Microcredit is a necessary but not a sufficient condition for micro-enterprise promotion. Other inputs are required, such as identification of livelihood opportunities, selection and motivation of the micro-entrepreneurs, business and technical training, establishing of market linkages for inputs and outputs, common infrastructure and some times regulatory approvals. In the absence of these, micro-credit by itself, works only for a limited familiar set of activities – small farming, livestock rearing and petty trading, and even those where market linkages are in place." Robert Pollin (2007: 2) has a similar view, and puts it in the following words: "micro enterprises run by poor people cannot be broadly successful simply because they have increased opportunities to borrow money. For large numbers of micro enterprises to be successful, they also need access to decent roads and affordable means of moving their products to markets. They need marketing support to reach customers."

As a matter of fact, most promoters of microfinance do not wholly disagree that microfinance alone cannot do the job. For example, Sam Daley-Harris, Director of the Microcredit Summit Campaign, writes, "Microfinance is not the solution to global poverty, but neither is health, or education, or economic growth. There is no one single solution to global poverty. The solution must include a broad array of empowering interventions and microfinance, when targeted to the very poor and effectively run, is one powerful tool." (2007: 1). In the words of Professor Yunus (2003: 171; emphasis added), "Micro-credit is not a miracle cure that can eliminate poverty in one fell swoop. But it can end poverty for many and reduce its severity for others. *Combined with other innovative programs* that unleash people's potential, micro-credit is an essential tool in our search for a poverty-free world".

8 Households with an existing business at the time of the program invest in durable goods, and their profits increase. Households with high propensity to become business owners see a decrease in nondurable consumption, consistent with the need to pay a fixed cost to enter entrepreneurship. Households with low propensity to become business owners see nondurable spending increase.

9 They are unlike Marx's proletariat who feel they do not have anything to lose, but their chains. Instead, they are "protective".

Thus, there is broad agreement about the need for complementary factors for microfinance to have some positive impact on poverty reduction. The supply of microcredit does not necessarily ensure the availability of complementary factors in adequate quantities and quality. Some microfinance institutions and non-government organizations (NGOs) seem to have understood the need for such factors and, therefore, also offer training to build management and entrepreneurial skills. There are also NGOs (such as BRAC in Bangladesh) which provide basic education in rural areas using innovative methods. These are all potentially positive developments for poverty reduction efforts.

But the focus has been generally on supply side factors which complement one another to make micro investment productive. Very little attention has been paid to the demand side, except perhaps for Pollin (2007: 2) who notes that micro-enterprises “need a vibrant, well-functioning domestic market itself that encompasses enough people with enough money to buy what these enterprises have to sell. Finally, micro businesses benefit greatly from an expanding supply of decent wage-paying jobs in their local economies. This is the single best way of maintaining a vibrant domestic market.” Moreover, as pointed out in a recent paper by Milford Batemen and Ha-Joon Chang (2009), microfinance ignores the crucial role of scale economies. Instead, microfinance produces an over-supply of inefficient micro-enterprises that undermines the development of more efficient small and medium enterprises (SMEs). In the absence of an expanding economy, “microenterprises are forced to survive by drastic cost-cutting strategies, which in the short run can take crucial market share away from local SMEs that might otherwise be able to reduce unit costs and register productivity growth in the long run” (Bateman and Chang, 2009, p. 7).[10]

Too many micro-enterprises due to a constant inflow of new MFI financed entrants cause ‘market saturation’, and a hyper-competitive situation. This results in very low, and declining, rewards for such simple micro-enterprise activities. As pointed out by Siddiqur Osmani (1989) very early on, the constant new entry pushes down the returns in incumbent micro-enterprises to below the cost of borrowing. The situation becomes much more difficult when MFIs charge very high effective interest rates (Huq 2004)—more on high interest rates later.

Without an expanding domestic market, new entrants into a landscape of too many micro-enterprises will be like a moral tale. Two partners jointly set up a grocery shop. They are very excited about their prospects for becoming rich. But their enthusiasm gradually wanes as they wait for their first customer who never shows up. One of them finds a solution. She borrows some extra money and buys from the shop. This generates some income for her partner, who uses this to buy from the shop. This buying and selling from each other continues until the stock finishes. In the process they may smooth their consumption, but end up with a larger debt!

This may be a tragic-comic story, but does have an important lesson.[11] That is, without a vibrant domestic market, micro-financed businesses will most likely replicate a barter economy. But with credit

10 In Bosnia, for example, many poor individuals signed up to receive microfinance in order to purchase a cow in order to generate a little additional income from the sale of raw milk. While this was widely seen as a very sensible and compassionate intervention by the international donor and NGO community, the development outcome was extremely problematic. The local over-supply of raw milk in many communities led to a general price decline. It also had a negative longer run effect by undercutting the day-to-day operations of potentially sustainable larger dairy farms. It was, for example, made more difficult for them to generate sufficient internal finance in order to reinvest in new stock and equipment (see Agripolicy, 2006).

11 This story is not very different from the real life examples that Thomas Dichter gives where the micro-enterprises collapse or go nowhere due to the lack of an expanding market.

coming in between to facilitate transactions, the parties can even become worse off in extreme cases of a stagnant market.[12] Therefore, it is not surprising that a World Bank sponsored study, involving 1,800 households in Bangladesh, found only very marginal improvements for borrowers of microcredit.[13] For example, the incomes of women who received micro-credit increased by only 8 *taka* for each 100 borrowed. Commenting on this finding, David Roodman and Uzma Qureshi (2006: 38) write, "Thus a $250 one-year loan would raise a borrower's income by $12.50/year, or about $0.03/day. For someone living on $2/day, that is a 1.5 per cent increase. This does not live up to the microfinance hype."[14]

This modest income gain happened in the context of rapidly expanding garments production in Bangladesh. The World Bank study compared households in the sample between 1991–1992 and 1998–1999. Then it would have been an interesting counter-factual to see what would have happened in the absence of the fast expanding garments industry in Bangladesh.

Consideration of demand side factors highlights the importance of pro-growth macroeconomic, trade and industry policies. Bangladesh was at the height of pursuing neo-liberal policies during the period the World Bank study covered. Following the renewal of IMF's structural adjustment loans in the early 1980s, Bangladesh followed contractionary macroeconomic policies aimed at reducing the budget deficit and inflation.[15] The policy framework did not change with the democratically elected governments in the 1990s. Although the inflation rate fell from around 9 per cent in the latter half of the 1980s to around 4 per cent in the first half of the 1990s, GDP growth remained at around 4 per cent.[16] The average real lending interest rate during the 1990s was over 8 per cent, compared to about 4.5 per cent in the previous decade.[17] Thus, private investment in real terms declined from 12.1 per cent of GDP during 1980–85 to 11.3 per cent during 1991–95. It is quite easy to understand why the overall investment rate can stagnate under a monetary policy regime with a conservative ceiling on overall credit growth, as the expansion of micro-credit must be matched by the contraction of credit to others (e.g. SMEs) to meet the overall credit growth limit.

Policy contraction was also applied on the fiscal side, which saw a reduction in the government budget deficit from around 6 per cent of GDP in the latter half of 1980s to around 4.5 per cent in the first half of 1990s. The result was stagnation of public investment which remained around 6.5 per cent of GDP from the mid-1980s through the 1990s. Thus, not only was demand constrained, but also the stagnation of public investment meant supply side factors – such as roads, electricity and other essential infrastructure—crumbled. Fortunately, the garments sector still managed to grow, thanks to the resilience and ingenuity of the entrepreneurs in Bangladesh, and to the buoyant world economy.

In response to the modest findings in terms of monetary measures of poverty (head-count ratios of people living under the poverty line), advocates of microfinance – for example, Sam Daley-Harris and Felicia Montgomery—cite impressive social progress (reduced infant and maternal mortality, fall in the fertility rate and increased school enrolment ratios, especially of females) in Bangladesh. But can these achievements

12 For example, the findings of the Hulme and Mosley studies and those cited by Mahajan and Karnani.

13 See Khandker (2006).

14 Roughly 81 per cent of the population of Bangladesh lives below the $2 a day poverty line. The corresponding shares in Pakistan and Sri Lanka are about 70 per cent and 40 per cent respectively.

15 See Mahmud (2008).

16 The Bangladesh economy grew at an average annual rate of 5.5 per cent between 1975/76 and 1980/81 when the average annual inflation rate was 9.5 per cent.

17 See Ahmed and Islam (2006).

be attributed to microfinance? Sri Lanka was a star performer in social progress long before the microfinance movement started. In recent times, Andhra Pradesh in India has also performed much better than the rest of India in terms of social indicators of development. Microfinance does not seem to have played a big role there either.

In sum, microfinance is not a panacea for poverty reduction, which needs both complementary supply-side and demand-side factors. Supply-side factors—such as good infrastructure, entrepreneurial skills, etc.—are needed to make micro-enterprises more productive. But the potential for increased productivity will remain mostly unrealized in the absence of demand-side factors. In other words, without a supportive macroeconomic, trade and industry policy framework, micro-enterprises will remain micro, with no backward or forward linkages or employment creation possibilities. This is the crux of the so-called graduation problem of micro-borrowers, as highlighted in a recent editorial in the *Daily Star* (Dhaka, Dec. 12, 2008): "so long as this is not complemented by the government's facilitating growth of marketing network, reliable energy supplies and a dose of fiscal incentives to the small exporters, the full potential of the micro-credit sector would remain untapped."

Returns to investment and interest rates

More than anything else, the interest rates charged by microfinance institutions (MFIs) draws most vigorous criticisms. There are claims of interest rates ranging from 30 per cent to 100 per cent on an annualized basis. Jonathan Morduch (2008) reports a survey of 350 leading microfinance institutions which charged between 20 per cent and 40 per cent per year after taking inflation into account. Some (e.g., Nimal Fernando of the Asian Development Bank, Armendariz Achion and Jonathan Morduch) defend the high rates on grounds of sustainability. According to them, anything less will not attract profit seeking bankers into this market. However, this argument weakens the claim that microfinance is more cost effective compared to commercial banking loans because of: (*a*) lower information gathering and processing costs, and (*b*) higher repayment rates requiring less provisioning for bad loans.

Where the interest rate is at the lower end, it is often due to implicit subsidies. Based on in-depth case studies, Pankaj Jain and Mick Moore (2003, p. 10), observe, "all five programmes we studied obtained subsidized funds for initial capitalization and, in many cases, for meeting part of the operating costs". Jonathan Morduch's (2000) panel discussion with senior and experienced donors and NGO representatives in Colombia suggests that not more than 5 per cent of microcredit programmes world-wide could become financially viable without subsidy. Despite growing interest from private investors, 53% of the $11.7 billion that was committed to the microfinance industry in 2008 still came at below-market rates from aid agencies, multilateral banks and other donors.[18] This, then, raises the issue of the social opportunity cost of subsidies. Vijay Mahajan (2005) puts this argument forcefully: "If the implicit subsidies to microcredit institutions are made explicit, then subsidizing microcredit programmes versus subsidizing social sector programmes can become an informed policy choice, rather than be carried out under the mistaken notion that the former will require only temporary and diminishing subsidies. But the implicit subsidies to microcredit, legitimate as they may be, are not being described or analysed."

Thus, some proponents defend this by arguing that it is still less onerous than the alternatives. For example, according to Karol Boudreaux and Tyler Cowen (2008), "That's not as scandalous as it sounds—local moneylenders demand much higher rates". Others defend the high interest rates by claiming that the

18 The Economist, July 16, 2009

returns to capital are, indeed, high in micro enterprises. But Jonathan Morduch (2008: 1), an advocate of microfinance, makes an important, but moot acknowledgement: "The microfinance movement rests largely on one basic *assertion*: that poor households have high economic returns to capital." [emphasis added].

Morduch also reports some recent research findings of high returns to capital ranging from 20 per cent to 33 per cent per month for small, male-owned retail businesses with no employees other than the owner. Estimated returns to capital for the financially constrained businesses, according to these researchers, are even higher, ranging from 70 per cent to 79 per cent per month. Based on these findings, Morduch (2008) concludes that even an interest rate of 10 per cent per month would be reasonable.

However, these findings have their own limitations, which Morduch himself admits. First, they do not say anything about female owned businesses and hence, do not corroborate the popular claim that microfinance is particularly better for female borrowers. Second, and more importantly, one is not sure how these studies impute the cost of own labour. In an economy characterized by surplus labour, as in Bangladesh, where disguised unemployment in rural areas can be widespread, one can impute a zero shadow price for own labour.[19] In that case, the entire surplus over and above the cost of capital can be regarded as profit or returns to capital. This can be the most plausible explanation for the findings of high returns to microenterprises, such as from selling milks or eggs. The valuation of own labour at a zero shadow wage, coupled with high interest rates, essentially means that free labour accrues to capital.

Ideally, own labour should be priced at a "decent" or legislated minimum wage to enhance poverty reduction. Employment (self or otherwise) at a wage below a decent rate only adds to the pool of "working poor". Earning a few extra cents may be a "big step forward" for a person living on less than $2 a day, as claimed by Karol Boudreaux and Tyler Cowen, but does not generate enough profit for reinvestment to grow his/her business. He/she still remains part of working poor, and perhaps even more vulnerable to shocks due to the debt burden. Thus, this can be another explanation for the so-called graduation problem of micro-enterprises, or why so many loans need to be rescheduled or refinanced as reported by the *Wall Street Journal*.[20]

Explaining the expansion of microfinance

> *"The UN's 2005 'Year of Microcredit' marked the long journey of microcredit from an obscure experiment in the mid-1970s to the status of a worldwide movement. Microcredit has captivated not just the entire development aid industry, but journalists, editorial writers, policy makers and much of the general public in both the North and the South. Virtually every development project I see these days, from maternal and child health, to women's education, to soil conservation, to social forestry, to old fashioned integrated rural development, has a 'microcredit component', and everyone from camel herders in Mauritania to peasants in rural China can speak the lingo."*
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> [Dichter, 2006].

If the poverty reduction impact of microfinance is so doubtful, how can one explain the movement's phenomenal expansion over a short period of three decades? The microfinance movement is enjoying tremendous support from both bilateral and multilateral donors. The movement climaxed with the Microcredit Summit, held

19 This is what the Lewisian model of surplus labour would dictate.

20 Two of its correspondents, Michael Philips and the late Daniel Pearl, suggested that Grameen was often rolling over unpaid loans and its non-performing loans were actually higher than investors were being told.

in Washington, DC, on February 2–4, 1997, when 2900 delegates from 137 countries attended. According to the estimate of Microfinance Summit Campaign, there are now more than 3000 microfinance institutions, serving more than 100 million people in developing countries. The total cash turnover of these institutions world-wide is estimated at $2.5 billion. The success of microfinance has now even attracted big mainstream commercial financial institutions, such as Morgan Stanley, Deutsche Bank and Citigroup.

Pankaj Jain and Mick Moore of the Institute of Development Studies (UK) and David Roodman and Uzma Qureshi of the Center for Global Development (USA) have attempted to explain the microcredit movement's rapid growth and international support. Based on an extensive survey of the literature and interviews with its leading players, Roodman and Qureshi (2005) claim that the success of microfinance is due to innovative business practices involving product design and management, and enabling environments. Roodman and Qureshi (2006: iv) conclude, "Microcredit, like all credit, helps some people—one hopes, the majority of clients. And like all credit, especially when *pushed hard by suppliers*, microcredit must hurt some clients too.…[T]he historical emphasis among MFIs on credit rather than savings appears to have arisen for practical business reasons rather than because it has been shown that credit helps clients more… Microfinance investors should therefore work to understand how MFIs succeed on both bottom lines—as businesses and as agents of development." [emphasis added].

Roodman and Qureshi's findings are similar to those of Jain and Moore (2003) who undertook extensive case studies of four leading microfinance institutions in Bangladesh (ASA, BRAC, Grameen and Proshika) and CARD in the Philippines. Jain and Moore found little evidence to support three core claims of microfinance movements: strong social bonds among small borrowers, substantial borrower participation in management and unsubsidized interest rates. According to them, the real explanation for their success lay in careful attention to managerial and strategic 'fundamentals'. These include keeping transactions costs low, matching loan payment schedules to borrowers' income and savings potentials, finding ways of obtaining good work performance from large and widely dispersed field staff, etc.

In addition to a business model explanation, Jain and Moore give a political economy explanation for the success of the microfinance movement. According to them, microfinance campaigners successfully projected the image of the movement, such as empowerment of women, which resonates well with the donor community. The birth of the movement roughly coincided with the rise of neo-liberal ideas in the US and the UK, and within the Bretton Woods institutions in the late 1970s and early 1980s. Thus, the notion that microfinance programs are primarily engaged in the promotion of small scale enterprises appealed to major donors. While donors were wary of subsidized credit through state-owned specialized financial institutions, they were quite happy to subsidize microfinance institutions as they appeared to promote a market economy, and more importantly, they helped to diminish the role of the government. Jain and Moore (2003: 29) end their paper with a paradoxical note, "To properly appreciate the great achievements of the micro-credit movement, one has to be more sceptical of its self image than normally considered polite or respectful."

In liquidity constrained societies, there is always demand for credit. So, when donor supported MFIs pushed the supply of credit, there was no shortage of takers. As a result, microfinance expanded exponentially. This seems to have created a mistaken belief among advocates of microfinance that supply creates its own demand *a la* Say's law. The reality is that the supply of credit and other complementary supply-side factors cannot drive the growth of viable businesses if the market itself does not expand rapidly. This can only create debt-burden or underutilization of credit and a downward pressure on the returns to investment.

There is a clear parallel in the labour market. In the early days, after independence, many countries invested heavily in higher and technical education. But as their overall policy framework failed to generate employment intensive growth, the supply oriented human resource policy only contributed to swelling educated or graduate unemployment. This not only amounted to wasteful under-utilization of graduates, but also contributed to the decline in returns to higher education due to over supply.

Assessing the contributions of microfinance

Even the vocal critic Thomas Dichter admits that microfinance can help the poor smooth consumption over periods of cyclical downturns or unexpected crises. This positive role of microfinance should not be dismissed altogether. If this consumption smoothing means parents can send their children to school, or buy essential medications, and maintain nutritional in-takes of their children then microfinance is likely to have positive long-term impacts on productivity. As noted by Partha Dasgupta (1995: 247), "At low levels of nutrition and health care, increase in current consumption improves future labour productivity: if nothing else, morbidity is reduced. For example, Pitt and Rozenweig (1985) observed from Indonesian data that an increase in the consumption of fish, fruit, or vegetables by 10 percent reduces the chances of illness there by 9, 3 and 6 percent respectively."

Microfinance, thus, fulfils an important safety-net task, especially in countries where there is no state-sponsored social security system. In difficult times, the poor can first turn to family and neighbours. But in a situation of generalized poverty or economy-wide crisis, the poor will have to go to money lenders or to the employer/landlord for whom she or he works. If MFIs extend lending to the very poor in these circumstances then they can help break the power and hold of such creditors who operate in the inter-locking credit and factor markets.[21] Although high, the interest rates charged by the MFIs are lower than the rates charged by informal creditors (money lenders/employers/landlords).

Unfortunately, however, most MFIs have been found lacking when it comes to lending to the very poor. Nonetheless, it seems that microfinance has significantly dented the informal credit markets by undermining debt-bondage and usury in some agrarian societies. Thus, microfinance is having a modernizing impact, even if inadvertent, unacknowledged and unsung.

More importantly, by "democratizing" the credit market the microfinance movement has not only curtailed the power of money lenders, but also constrained MFIs' own behaviour. Some abuses of employees of MFIs, as reported by Anisur Rahman (1999), cannot be hidden under the carpet for too long. For example, when some MFIs officials went to collect repayments as part of their regular job immediately following the devastating cyclone Sidr in Bangladesh, this was widely reported in the national newspapers. As a result, the MFIs acted quickly to suspend loan recovery and to offer softer loan conditions.

In other words, the rapid expansion of microfinance has empowered not just women, but all small borrowers. Even if they do not participate effectively in MFIs' decision making or management (as found by Jain and Moore), the ability of the MFIs to foreclose on any tangible property of loan defaulters seems to have shrunk significantly. So, one should not be surprised by the findings of the *Wall Street Journal*'s reporters that Grameen was often rolling over unpaid loans.[22] Whether Grameen was driven by any humanitarian consideration or forced to do so to avoid bad publicity is, of course, moot.

21 Inter-locking credit and factor markets is a feature of the semi-feudal agrarian relationship where farmers depend on their landlords for work (share-cropping) and credit. See Bhaduri (1973).

22 Jain and Moore (2003) also found the same with another large micro-credit organization, Proshika, in Bangladesh.

There is also the learning-by-doing effect. Even when own labour in micro-enterprises is given a zero shadow price, the people who are involved benefit. They learn some basic principles of business, and with luck, and perhaps some help, may be able to become more viable and even expand. This is akin to apprenticeship where the apprentice gets a low wage, but in exchange, gets training in a trade. So, with their support and training programs, many MFIs are making some useful contributions.

Microfinance, thus, gives the unemployed and the poor some opportunities, hope and self-esteem. Being employed (whether self-employed or by an employer) gives a person a significant boost to his/her sense of self-respect and dignity. Furthermore, microcredit allows people to signal their creditworthiness. If their success makes banks more willing to lend them larger sums and leads to even more economic activity, then that should help reduce poverty in the long run.

Finally, being successful business ventures, microfinance institutions themselves have also created a large number of good paying jobs. In the words of Roodman and Qureshi (2006: 39) "We should not lose sight of the fact that commercially successful microfinance institutions are remarkable organizations, employing hundreds or thousands of people at tasks once thought impossible". Good jobs created by successful MFIs should have considerable multiplier effects.

Thus, beyond the "hype", microfinance is making some important positive contributions of microfinance. However, many of these effects cannot be measured in monetary terms, and hence will remain largely unacknowledged in the literature focused on the traditional income or expenditure measures of poverty. The question, nevertheless, remains as to how long microfinance can continue to provide consumption-smoothing support or extending the payments schedule. To be able to serve as a viable poverty reduction strategy, micro-credit financed enterprises must expand and create decent jobs for the growing labour force.

Concluding Remarks

It is often claimed that the greatest discovery of the Grameen-led microfinance movement has been the credit worthiness of the poor. Related to this has been the discovery of the dynamism of micro-enterprises. In reality, however, neither is new. The poor have been borrowing from money lenders (landlords) from time immemorial. Micro-enterprises have been operating for a long time in many poor societies, and form the vast informal sector associated with developing countries. However, the real discovery is the concept of "group lending" which effectively overcomes the problems of collateral and adverse selection due to information asymmetry through peer monitoring.[23]

Impact analysis of microfinance suggests that the majority of borrowers who already have some assets (or business skills and education) are more likely to succeed. Therefore, when William Easterly (2006) refers to MFIs as "searchers", the search should instead be for existing small enterprises in the informal sector, not the very poor without any assets or entrepreneurial skills. The danger of the hype over microfinance is that the needs of micro-enterprises in the informal sector may not get due attention. The owner operators of these micro-enterprises have already proven their entrepreneurial acumen, but they face numerous constraints ranging from inability to access the formal credit market to marketing their products. These enterprises should be supported with easy access to credit and other financial services (e.g., insurance).

23 As a matter of fact, many leading microeconomic texts (e.g. Hal Varian, *Microeconomic Analysis*) cite this innovation in their discussion of asymmetric information and agency problem.

Recognizing this, the United Nations has advanced the idea of "inclusive" finance as an integral part of financial sector development. To quote,

> *"There needs to be a continuum of financial services available to households as they increase their standards of living and for enterprises as they grow into the business mainstream. This is a critical issue for the development of financial sectors. It involves adequate financial services for small and medium-sized enterprises (SMEs) often called the 'missing middle', as well as the smallest microentrepreneurs."* (United Nations, 2006: 6)

Unfortunately, SMEs found themselves disadvantaged by neo-liberal financial sector reforms which have sought to promote profit-seeking financial institutions by eliminating state-run specialized financial institutions which catered for the needs of SMEs and the agricultural sector. As the UN (2006: 7) notes, "mainstream for-profit financial institutions have largely ignored the lower segment of the market. This includes SMEs, microentrepreneurs ….Instead, these mainstream institutions have sought mainly high-value clients." These high-value clients usually reside in urban areas while the majority of the poor people live in rural areas in developing countries.

The inefficiencies of many state-run specialized financial institutions have provided a strong rationale for market-based financial sector reforms. It is now realized that these reforms had their own limitations, while SMEs and the agricultural sector, especially food production, need state support. Therefore, instead of focusing solely on microfinance, designing efficient state-run specialized financial institutions as part of developing an inclusive financial sector should also be integral to the poverty reduction efforts. Management and operational lessons learnt from successful MFIs can provide valuable inputs into the design of specialized financial institutions for SMEs and the agricultural sector.

Access to financial services is but, one aspect of the support needed by entrepreneurs running SMEs and micro-enterprises. They also need training in business skills and access to marketing information so that they can expand to take advantage of both domestic and international markets and thereby create decent jobs. Here too, the state has an important role to play as the majority of SMEs and micro-entrepreneurs will not be able to afford the market-determined fees for such training or marketing information.

In sum, while non-government organizations (NGOs) are making valuable contributions to safety-net by providing micro-credit to the poor and vulnerable, the state cannot abrogate its role in the area of social provision. The state also has to be a major player in the design and operation of an inclusive financial sector to cater for the needs of the "missing" middle in the informal and agricultural sectors. This is crucial to ensure that growth is employment-intensive to maximize its impact on poverty reduction.

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Appendix:
Employment generation as a poverty reduction strategy: lessons of history

> *"if we take a closer look, we see something else – something alarming. In developing countries, excluding China, at least 100 million more people are living in poverty today than a decade ago. And the gap between rich and poor yawns wider"* [James Wolfensohn, 2000].[24]

Ironically, this sombre acknowledgement from the former President of the World Bank comes after two decades of experiment with conservative macroeconomic policies and microfinance. With an unwavering faith in Say's law, the orthodox macroeconomic policy framework of the so-called Washington Consensus relegated the responsibility for growth and employment to supply side policies of microeconomic reforms. The rapid expansion of microfinance was expected to generate enough self-employment to compensate for job losses due to reforms, especially the roll-back of subsidized credit schemes to support SMEs and the agricultural sector. Income growth from microeconomic reforms and micro-financed enterprises was presumed to be sufficient to generate demand as long as governments maintained budget surpluses or zero deficits and low inflation (generally at less than 5 per cent). Trade liberalization was supposed to fill any shortfall in (or add to) demand as long as the government followed a flexible exchange rate regime with an open capital account. Hence, in this framework, there is no effective demand problem.

Interestingly, China, which according to Wolfensohn contributed most to the reduction of global poverty in recent decades, is not significant for microfinance. Nor did it follow the orthodox policy framework of the Bretton Woods institutions. During 1985–1997, the average rate of inflation in China was around 11 per cent and domestic credit grew at an average rate close to 25 per cent (average money supply growth was over 28 per cent). The average real lending rate was less than 1 per cent. It also followed a policy of an under-valued real exchange rate to support exports and to discourage imports. This mix of pro-growth monetary and exchange rate policies produced very rapid GDP growth of about 10 per cent for almost three decades which has helped reduce poverty despite growing inequality.[25] Furthermore, its restricted capital account shielded it from the 1997–98 East Asian financial crisis.

Perhaps the socio-economic performances of Indonesia and Nigeria offer the best historical comparisons for poverty reduction. Both are large, populous developing countries with similar ethnic mixes of Muslims and Christians; they were largely governed by military rulers from the mid-1960s until very recently. In 1973, both were roughly at the same level of development, measured in PPP$; Indonesia's per capita GDP was PPP$1504 compared with Nigeria's PPP$1442.[26] Despite both enjoying windfalls from the oil price booms in the 1970s, their economic performances have diverged. By 1998 Indonesia's GDP per capita was three times that of Nigeria (PPP$3070 vs. PPP$1232). The result was a rapid reduction in poverty in Indonesia. $1-a-day poverty in Indonesia dropped from 59 per cent in 1975 to 14 per cent in 1997, while economic stagnation in Nigeria meant an increase in 1-a-day poverty from 35 per cent to 70 per cent over the same period.[27]

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24 Foreword to Thomas, V., M. Dailami, A. Dhareshwar, D. Kaufmann, N. Kishor, R. López, and Yan Wang (2000). *The Quality of Growth*. Oxford University Press, New York, for the World Bank.

25 China followed a combination of expansionary and restrictive fiscal policy during this period; the overall budget deficit was only -1.7 per cent of GDP. Since the Asian crisis in 1997–98, China has switched to a combination of restrictive monetary policy and expansionary fiscal policy; the overall budget deficit during 1998–2006 was slightly over 3 per cent of GDP, while growth of money supply (M2) and domestic credit slowed to around 16 per cent. The average inflation rate during the later period was 1 per cent and the average real lending rate was around 5 per cent.

26 See Maddison (2001).

27 See World Bank (2008).

There are several explanations for Indonesia's impressive performance in the literature. While there are some disagreements about the role of liberalization and market reforms, all agree on the role played by the state in promoting labour (employment) intensive industrialization and agriculture with a variety of schemes. These included:

» massive investment in infrastructure, especially in rural areas and the outer islands, and in irrigation projects
» supply of subsidized agricultural inputs (in particular fertilizers)
» price support for rice farmers (through BULOG–a marketing board)
» rural savings and credit programs (Bank Rakyat Indonesia–BRI)
» competitive real exchange rate through successive devaluations and managed depreciations.

In contrast to the microfinance movement, the rural credit scheme of Indonesia through the Bank Rakyat Indonesia (BRI) emphasized savings, not credit. Thus, by the end of 2005, BRI had 32.3 million deposit accounts and only 3 million loan accounts. The success of Indonesia highlights the role of domestic savings mobilization vis-à-vis credit. An expanding economy opens up the scope for productive investment, by small savers in a less risky environment. On the other hand, in a stagnant or slow growing economy, pushing credit can be quite risky for unsuspecting small borrowers.

One might argue that some other developing countries, notably India, also had some of the schemes (such as subsidized agricultural inputs and price support programs) but still could not achieve the same success as Indonesia. But India largely succeeded with its agricultural policies to attain self-sufficiency in food as Indonesia; their performance varied in the industrial sector.

India, in following an import substituting industrialization (ISI) policy, was influenced by the Soviet model of heavy industrialization, which the celebrated Indian planner, P.C. Mahalanobis, described as "machine to produce machine". Thus, the capital intensive ISI failed to create enough employment; the domestic market did not grow rapidly to absorb the growing labour force while the industrial sector suffered from over-capacity. As such it was not the fault of ISI, but the capital-intensive nature of industrialization that failed. ISI can be followed equally for labour-intensive industries, and this is the lesson we learn form the experience of successful East and Southeast Asian economies.[28]

The labour-intensive industrialization strategy has another advantage; it helps reduce income inequality. This is evident from Indonesia's experience. It did not undertake significant land reforms as Taiwan or South Korea, yet inequality in Indonesia declined remarkably; its Gini ratio declined from 0.41 in 1971 to 0.32 in 1990. The decline in inequality during the phase of rapid economic growth increased the growth elasticity of poverty reduction.[29]

The industrial strategy based on a model, "machine to produce machine" required an over-valued exchange rate to reduce cost of imports of industrial inputs. This, in turn, not only disadvantaged the agricultural sector, but also the industrial sector. Industries could not get rid of their excess capacity by exporting. India was one of the leading exporters among the developing countries of technologies (machinery) in the 1950s and early 1960s, but fell way behind other emerging countries in Asia by the 1980s.[30]

28 See Chowdhury and Islam (1993) and Jomo K. S. [ed.] (2001).

29 Since the adoption of liberalization programs in the late 1980s and early 1990s, the Gini measure of inequality has registered an increase. According to World Bank estimates, it was 0.363 in 2005. This phase (since 1993–94) was also characterized by slow employment growth.

30 See Lall (1982).