Micro-finance and the Poverty Question: 
A Historical Perspective

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ABSTRACT
The pivotal emergence of micro-finance is a function of gross insensitivity of conventional finance sector to reach the overwhelming population of the poor and to assist in the drive to manage poverty. Micro-finance movement has captured the imagination of academics, policymakers, and practitioners in terms of provision of financial means to access credit, and start small businesses, with the potential to enhance community, local and national development. When micro-finance is adequately harnessed and supported, it could scale-up beyond the micro-level as a sustainable part of the process of economic empowerment by which the poor could lift themselves out of poverty. Poverty is a multi-dimensional problem, embedded in a complex and interconnected political, economic, cultural, and ecological system. Owing to poverty's large scope and multiplicity of actors, there is no single guaranteed approach to its management. As a result, solutions are as multifaceted as the causes. Problems and solutions are not isolated phenomena, but occur within an interconnected system in which actors and actions have reciprocal consequences. The greatest contribution of micro-finance is that it empowers people, by providing them with confidence, self-esteem, and the financial means to play a larger role in their development. The potential of micro-finance far exceeds the micro-level, scaling-up to address macro-problems associated with management of poverty.

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1. Introduction

Micro-finance refers to small-scale financial services primarily credit, savings and insurance which aids poor people’s access to basic financial services, such as loans, savings, money transfer services, and micro-insurance. Savings services allow savers to store excess liquidity for future use and to obtain returns on their investments. Credit services enable the use of anticipated income for current investment or consumption. Robinson (2001) observes that micro-finance services could help low-income people reduce risk, improve management, raise productivity, obtain higher returns on investments, increase their incomes, and improve the quality of their lives and those of their dependents. Such services are rarely accessible through conventional financial sector creating a financing gap attractive to arbitrageurs but costly to non-collateralized non-banked in society. The successful development of large-scale-savings and credit services for economically active low-income people in different occupations is too complex a task for tools and models of any one discipline to manage. Nevertheless, gradually a financial systems approach emerged encompassing principles of commercial finance with the growing knowledge of the demand for financial services among poor people in developing countries. This initiative ushered in a model for financing the economically active poor through sustainable and profitable financial institutions.

1.1 Historical Development of Micro-finance.

The institution of rotating savings is ancient, dating back at least to the 16th century, when Yoruba slaves carried it to the Caribbean, as part of their institutional luggage or social capital. Both the term `esusu` and the practice have persisted to this day, as esu in the Bahamas, susu in Tobago or sou in Trinidad. The institution exists all over West Africa as well as in many other parts of the world, where it is an integral part of the local micro-economy and referred to with its own vernacular term (arisan in Indonesia, paluwagan in the Philippines, gameya in Egypt, ekub in Ethiopia, and cuchubal in Guatemala (Seibel & Damachi 1982).

Micro-finance is not a recent development, and neither is the development of regulation and supervision of micro-finance institutions (MFIs). Every developed country has its own history of micro-finance. Attributing the origin of micro-finance to recent initiatives misses not only the historical depth and scale of micro-finance, but also centuries of experience. The beginnings in Europe were all informal and small-scale, including informal savings clubs, among them the box clubs in England during the 18th century.
The case of Ireland, 1720-1950: How self-help and legal backing created a mass microfinance movement, until a cap on interest rates brought it down.

The birth of micro-finance in Europe dates back to tremendous increases in poverty since the 16th century. In Ireland, loan funds emerged in the 1720s, using peer monitoring to enforce the repayment in weekly instalments of initially interest-free loans from donated resources. After a century of slow growth, two events initiated a boom: (a) a special law in 1823, which turned the charities into financial intermediaries by allowing them to charge interests on loans, enabling them at the same time to collect interest-bearing deposits (b) the establishment of a Loan Fund Board in 1836 for their regulation and supervision. By 1840, approximately 300 funds emerged as self-reliant and sustainable institutions, generating their own resources through deposit collection and providing small loans to the poor.

Financing their expansion from profits and deposits, their outreach eventually covered 20% of households in Ireland. The funds offered three times higher deposit rates than commercial banks and started cutting into their core business. This brought conventional commercial banks onto the barricades forcing them to petition the government to legislate on interest rate capping in 1843. The Loan Funds lost their competitive advantage leading to a gradual decline during the second half of the 19th century and final disappearance in the 1950s. The Irish Loan Funds therefore passed through three phases in their lifespan: (a) a century of gradual growth as informal institutions (b) a few decades of rapid expansion as formal institutions in a conducive regulatory environment; (c) a century of decline due to financial repression.

The case of Germany, 1778 to date: How self-help, regulation and supervision created the world’s largest micro-finance system.

Micro-finance with the poor in Germany has three roots, informal at origin: community based savings funds; and two movements of savings and credit cooperatives, one rural and one urban. The community-owned financial institutions started during the latter part of the 18th century. Having learned from the early Irish charities that charity is not sustainable, the first thrift society was established in Hamburg in 1778 and the first communal savings fund (Sparkasse) in 1801. As the movement spread, the influx of savings forced the savings funds (referred to as savings banks in English) to expand their credit business, including agricultural lending. The Prussian state responded with regulation, passing the first Prussian Savings Banks Decree in 1838. After the hunger year of 1846/47, Raiffeisen and Schulze-Delitzsch reinvented the wheel of microfinance: the former in rural areas, creating rural savings and credit cooperatives,
originally called credit associations (Darlehnsvereine), later known as Raiffeisenkassen and now Raiffeisenbanken; the latter establishing urban savings and credit cooperatives, referred to as Volksbanken (people’s banks).

1.2 Recent History in Micro-Finance

Modern microfinance has its origins in Bangladesh in the 1970s, in the aftermath of the country’s war of independence, when Muhammad Yunus, an economics professor at the University of Chittagong, began an experimental research project providing credit to the rural poor (Weiss 2005). That experiment, driven by a strong sense of developmental idealism, developed into what is now the world’s most famous microfinance institution, the Grameen Bank, and institutions that replicate its pioneering methodology worldwide. Microfinance in Latin America developed under quite different conditions. In Bolivia, a collapsing populist regime led to widespread unemployment. Banco Sol, a pioneering microfinance institution in the region, developed to address the problem of urban unemployment and provide credit to the cash-strapped informal sector. The notion of commercial profitability was embraced relatively early in this approach.

The precedence for micro-finance lies in the many traditional and informal systems of credit that have existed in developing economies for centuries. Many of the current practices derive from community-based mutual credit transactions based on trust, peer based, non-collateral borrowing and repayment. Transactional, mutual, or personal credit suppliers, such as moneylenders, rotating savings and credit associations, or friends and neighbors have always lent to the poor, providing the right quality and quantity of credit, at the right time and place to low income households. However, the adoption of traditional financial systems and its integration in modern banking and financial systems is a direct response to the failure of past attempts by governments and donor funded rural credit programs to reach the poor in rural areas (Remenyi, 1991).

With the help of contributions of some wealthy people, Raiffeisen started by establishing a rural charity association in Weyerbusch in 1847, bringing in grain from non-affected areas. Within a few months, this brought down the price of bread by 50%. This was paralleled by Schulze-Delitzsch’s first urban credit association in 1850, who insisted on self-help without charity from the beginning. Raiffeisen realized that charity does not lead to sustainable institutions. In response, he established the first rural credit association (Darlehnskassen-Verein) in Heddesdorf in 1864, following Schulze-Delitzsch’s example. For the next twenty
years, the initiative turned into a movement, but growth was slow, reaching not more than 245 rural cooperatives in the mid-1880s. The turn-around came in 1989, when both the rural and the urban networks of credit associations gained legal status through the Cooperative Act of the German Reich, the first cooperative law in the world. Rural co-operatives blossomed in Germany to more than 15,000 and spread to other countries just before the start of First World War.

Integrating micro-finance systems into the larger macro-systems in developing countries has not been smooth with other institutions such as donor agencies, international NGOs, universities and research institutions playing an important role in mainstreaming of micro-finance programs and institutions. These institutions have supported micro-finance initiatives financially, and have assisted in creating capacity building and good governance practices in micro-finance programs. The most famous of the MFOs are the Grameen Bank and the Bangladesh Rural Advancement Committee (BRAC) established in the late 1970s as pilot projects. Both were later formalized in the early 1980s, with the Grameen Bank becoming a private sector bank with a limited license, and the BRAC becoming a non-governmental organization (Zaman 1999).

2. Micro-finance Models

2.1 Grameen Model

The most commonly known model is the Grameen model, which emerged from the practices of the Grameen Bank, a project of Mohammed Yunus in Bangladesh. The model consists of a bank unit under a Field Manager and a number of bank staff, covering an area of about 15 to 22 villages. The manager and staff start by visiting villages to familiarize themselves with the local culture in which they will operate and identify prospective clients, as well as explain the purpose, functions, and operations of the bank to the local population.

Five prospective borrowers come together in the first stage, with only two out of the five members eligible for a loan. This initial group of five is piloted for a month for conformity to bank rules. Other group members only qualify for loans when the initial two have serviced their loans over a period of fifty-two weeks. These restrictions provide substantial group pressure to keep individual records clear. Therefore, the collective responsibility of the group serves as collateral on the loan creating joint liability of all members (Hassan et al., 1997, Hassan, 2002, Hashemi et al. 1996).
2.2 Cooperative model

The Cooperative model has emerged from the practices of credit cooperatives and credit unions operating in developing countries. The model is based on three principles: 1) owner-managed firms, where all members have an equity interest in the MFO; 2) distribution of benefits through lower-cost member services and higher returns on member deposits; and 3) savings mobilization. Membership is targeted at below poverty line households that cannot access financial services from the banking sector.

Many cooperatives have their beginnings as informal saving clubs or rotating savings and credit associations (RoSCA) where groups of individuals come together for regular contributions to a common fund, which is then disbursed as a lump sum to one member in each cycle (Remenyi, 1991).

2.3 Intermediary model

The Intermediary model of credit lending positions a go-between organization between the lenders and borrowers. The intermediary plays the role of generating credit awareness and education among the borrowers with the aim of raising their credit worthiness and making them attractive to potential lenders. The intermediary links borrowers to lenders through training, education and research. Intermediaries could be individual lenders, NGOs, Micro-enterprise/ Micro-credit programs, and commercial banks. Lenders could be government agencies, commercial banks, and international donors.

NGOs have been active in starting and participating in microcredit programs by creating awareness of the importance of microcredit within the community, as well as to various national and international donor agencies. They have developed resources and tools for communities and microcredit organizations to monitor progress and identify good practices. They have also created opportunities to learn about the principles and practices of micro-credit through publications, workshops, seminars, and training programs. Examples of some larger NGOs include Save the Children, World Vision, and CARE (Remenyi, 1991).

2.4 Village Bank model

The Village Bank model tends to serve poor, predominantly female clientele, similar to the Grameen Bank. Morduch (1999) postulates that the sponsoring agency makes an initial loan to the village bank and its 30 to50 members. Loans extended to members are as low as from $50 with a four-month term, with subsequent loan sizes tied to the amount of deposits with the bank. The initial loan from the sponsoring agency is recorded in a suspense account with
interest income covering costs operational costs. This ensures a build-up of internal accounts and a staggered withdrawal of external funding within three years. The Bank Kredit Desa (BKD) system in rural Indonesia is an example of a successful village bank that has harnessed local information and peer dynamics. Most village banks require subsidies to cover costs because most have been set up in areas that are difficult to serve (Morduch, 1999).

3. Modalities of Micro-Finance Delivery

3.1 The Credit Union Approach

One of the oldest modalities of micro-finance delivery is the credit union, or financial cooperative. In the informal sector, Rotating Savings and Credit Associations (ROSCA) have always been an important way for poor households to fill the gap left by formal financial institutions. Credit unions are semi-formal, registered entities, subject to commercial law, but not regulated or supervised under banking law, although in some countries specific regulations for credit unions exist. These institutions are member-owned and provide financial services such as savings and loan services and insurance to members. Traditionally, membership in a credit union is some common bond among the members such as employment or membership in the same community. Closed bond credit unions exist at the workplace and membership is open only to employees. Open bond credit unions operate in a given community and membership is open to any member of the community. Where available, financial co-operatives often choose to affiliate with a national apex institution, which will provide training and technical assistance and channel resources from external donors to the national financial cooperative system. These national institutions might in turn affiliate with one of the international credit union apex agencies.

3.2 The Non-Governmental Organization Approach

To many outside the micro-finance sector, a natural delivery mechanism is a non-profit making non-governmental organization (NGO). This modality ushered in micro-credit revolution in both Asia and Latin America. For example, the Grameen Bank in Bangladesh, founded on small loans to groups of female micro-entrepreneurs, and Prodem, the successful Bolivian micro-finance institution (MFI) that later became the first micro-finance NGO to transform into a commercial bank, both started as NGOs. The breadth of outreach of NGOs varies greatly between countries.
In South Asia, NGOs have much greater outreach in Bangladesh, for example, than in India or Pakistan. In Latin America, outreach is far greater in the smaller economies of Bolivia and Central America than in the larger economies of Brazil, Mexico and Argentina. Limits on the NGO modality are mostly regulatory. NGOs cannot access domestic or international capital markets.

In most countries, NGOs cannot legally offer savings services and, therefore, cannot mobilize deposits, using client deposits as a way to finance other parts of the organizations operations such as lending. Both of these restrictions in effect limit the scale of most NGO operations. In countries where microfinance NGOs have achieved significant scale, regulators have either come up with a regulatory framework suitable for MFIs separate from banks (Bolivia), or have allowed the sector to flourish unregulated (Bangladesh), what some in the industry have referred to as benign neglect.

3.3 The Banking Approach

The most recent entrants to the micro-finance industry are commercial banks. This modality includes many variants: transformed micro-finance NGOs, government owned development banks, reformed state banks and diversification into microfinance by existing commercial banks. The Khushhali Bank in Pakistan is an established retail commercial bank specializing in micro-finance. The transformation of NGOs into commercial banks is still a relatively new phenomenon, but they seem to be performing well in terms of profits and have been able to expand the scale of their operations significantly (Fernando, 2004). In comparison, state banks have generally under performed. In the heyday of directed Micro-finance delivery in China credit in the 1970s, subsidized loans often went to politically inclined wealthy landowners rather than to poor farmers.

Despite this, repayment rates were low and many programs operated at a loss. However, many state-owned banks have extensive branch networks, enabling them to achieve significant outreach. There are an increasing number of examples of commercial banks diversifying into microfinance, either directly or through partnerships with financial NGOs. Even big multinational banks such as ABN Amro, Citibank and Deutsche Bank are now involved in microfinance.

4. Select Microfinance Experiences around the World

4.1 Grameen Bank and Bangladesh Rural Advancement Committee (BRAC) Bangladesh.
The most famous of the MFOs are the Grameen Bank and the Bangladesh Rural Advancement Committee (BRAC), both established in the late 1970s as pilot projects. They were later formalized in the early 1980s, with the Grameen Bank becoming a private sector bank with a limited license, and the BRAC becoming a non-government organization (Khandker 1998).

These two institutions have had successful global replication in other developing countries (Remenyi, 1991). Garson (1998) postulates that there are approximately seven guidelines that provide good practices for micro-finance management.

First, the development and implementation of a micro-finance program facilitates organizational and operational systems that are set up as a part of the program. This includes community-based organizations, peer groups, as well as systems of operation to manage the micro-finance program. A good organizational/operational system leads to better financial sustainability of the program.

Second, the success of a micro-finance program greatly depends on the degree of networking incorporated into the program, both within the community in which it operates and the external agencies and institutions that can help its development. Good networking and information gathering systems result in better-informed decisions and understanding of market operations.

Third, micro-finance programs bring the community together and facilitates the development of kinship among the residents. Networks of kinship and community organizations greatly facilitate the implementation and success of MFO’s activities. In the long term, micro-finance leads to a better quality of life and well-being for the community.

Fourth, micro-finance programs provide residents with appropriate skills and vocational resources in order to aid residents in better utilization of their credit. This strengthens the existing skills that borrowers possess which leads to more equitable economic development.

Fifth, leadership-training programs are in-built in many micro-finance programs. Identification and the nurturing of good community leaders helps in bringing the community together and in providing a representative voice for the community. Good leaders instill discipline among the borrowers, resulting in better financial management.

Sixth, building trust among the community leaders, borrowers, NGOs, and other stakeholders is an important aspect of microfinance programs as it enhances prompt loan servicing and recovery schedules.
Seventh, a good micro-finance program provides small business management training. Good management of a business ensures that credit is invested properly and profitably, resulting in long-term financial independence of a community. Indirect benefits occur when the borrowers invest their financial resources to ensure that education and health needs of their households are catered for, leading to better overall development of the community.

4.2 Bolivia Banco Solidario (BancoSol) of urban Bolivia lends to groups but differs in many ways from Grameen. BancoSol focuses mainly on banking, not on social service. Loans at BancoSol are advanced to all group members simultaneously, and the solidarity groups can be made up of between 3 and 7 members. In Bolivia, borrowers are better off than in Bangladesh and loans are larger, with average loan balances exceeding $900, roughly nine times larger than Grameen. Thus, while BancoSol serves poor clients, the typical clients are among the richest of the poor and are clustered just above the poverty line (Morduch, 1999). Banco Solidario has been highly successful in scaling up its micro-finance activities and serving Bolivia’s underclass through increased access to financial services. However, there are a number of important issues, which the institution would be wise to confront.

The first issue relates to the restrictive financial sector regulatory environment in which BancoSol operates. Since the regulations limit the amount of personal guaranteed loans at twice the value of the institution’s equity capital, leverage is difficult to obtain. By prioritizing collateral considerations over repayment patterns in valuing the quality of a loan portfolio, the regulatory authorities in Bolivia have made it difficult for BancoSol to lower its capital to risk-weighted assets ratio and have restricted the institution’s capacity for growth.

The second issue deals with target population. One of the only eligibility criteria for BancoSol loan is that the client be unable to access financial services from any other formal financial institution. In Bolivia, not only is the informal sector under-served by the Bolivian financial system, but the middle-class of the economy is frequently denied access as well. In the past, while the bank was able to successfully maintain its orientation as a financial institution for the poor, more economically sophisticated proprietors have taken up an increasing percentage of BancoSol’s customers. Not only are BancoSol customers graduating to higher levels of business activity, but it also appears as though the bank is starting to attract new clients from the informal business sector who are not poor but who are unable to obtain financial
accommodation from traditional banks. Whether or not BancoSol opts to serve a more heterogeneous clientele is one of the future challenges of the institution.

The last issue deals with managing growth. Several dangers of growth exist. First, arrears and losses can become more prevalent as the risk composition of the portfolio changes. In addition, monitoring and evaluation costs may rise, as a relatively unknown clientele comprises most of the portfolio. Another challenge arises from the changing corporate culture that necessarily accompanies a rapidly growing institution. Finally, the possibility of drifting away from the objective of serving low-income clients may occur. Each of these problems associated with growth can affect the future path of BancoSol.

4.3 Indonesia Bank Rakyat

Indonesia unit desa system is financially self-sufficient and lends to better off poor and non-poor households. Unlike BancoSol and Grameen, however, Bank Rakyat Indonesia does not use group lending. Instead, unlike nearly all other programs, the bank requires the individual borrowers to put up collateral on their loans. The bank focuses on cost reductions through setting up networks of branches and posts to serve borrowers and depositors. Borrowers receive graduated loans subject to servicing ability. Lastly, like BancoSol, Bank Rakyat Indonesia does not see itself as a social service organization and therefore does not provide clients with training or guidance on financial management.

4.4 Bank Kredit Desa System

The Bank Kredit Desa system in rural Indonesia (a sister institution to Bank Rakyat Indonesia) is much less well known. Replicating Grameen bank, Bank Kredit Desas extends non-collateralized small loans to the poorest households with a loan term of between 10 to 12 weeks serviced weekly (Morduch, 1999). Successful Bank Kredit Desa borrowers can graduate naturally to large scale lending from Bank Rakyat Indonesia units.

4.5 Fundacion Integral Campensina (FINCA), Costa Rica.

This Costa Rican NGO initiated revolving loan programs of Grameen-type in isolated rural communities. The FINCA program has a two-stage design. It organizes and trains joint liability groups who receive a series of graduated loans ranging from approximately $50 to $400 per person in the first stage and up to $2000 in the second stage at subsidized interest rates. Loan terms are usually a year in the first stage and up to five years in the second stage.
During the first stage, FINCA promoters present the village-banking model to all interested parties in a particular community. Those interested in forming a credit group democratically elect a leadership committee (who is usually male, literate, and agriculturally based), contact FINCA, and receive training. These groups meet monthly and members are required to save twenty percent of their total loan amount on a regular basis to insure against loan defaults or to finance group activities. FINCA promoters continue to visit the group periodically to instruct the group leadership in basic bookkeeping and group management techniques.

Successful aspects of the program include the transfer of organizational skills, promotion of community action, and development of collective marketing strategies as an outgrowth of credit and savings mobilization. Strong credit groups have used accumulated savings to finance playground construction, restore cemeteries, and to improve roads (Paxton, 1998). He continues to state that the major lingering weakness FINCA suffers in Costa Rica is its adverse environmental impact. Cattle production is the second most profitable activity available to the typical FINCA participant in Costa Rica. As traditional cattle production is increasingly financed through micro enterprise programs, tracts of forestland are cleared for pasture, resulting in soil degradation and deforestation.

4.6 Le Projet de Promotion du Petit Credit Rural—Burkina Faso

Le Projet du Petit Credit Rural (PPPCR) has been particularly innovative in adapting the Grameen style of group lending to the conditions in West Africa. The combination of failed previous efforts, low population density, poverty and illiteracy make the Sahelian region one of the most challenging environments for microfinance. In preparation for these obstacles, the PPPCR has separated from a pure Grameen replication and has adapted its financial services and organization to its environment. The PPPCR experience highlights the importance of extensive knowledge of the regional context before any type of replication is attempted. The PPPCR’s primary reason for group lending is that it reduces costs by a hierarchical structure. In addition, the use of peer pressure and group solidarity have led to favorable repayment rates. In some villages, most groups have been successful in terms of group dynamics. There are groups in some villages, however, where these group dynamics have led to a domino effect of widespread default, highlighting a potential source of instability in the future.

Loan recipients have come to accept the group structure of the project, but would rather have individual liability than group liability due to the strain that joint liability imposes on the groups and the village (Paxton, 1998). In spite of all the careful and meticulous modifications of the Grameen model to the Burkina Faso context, the provision of micro-finance services has
proven to be quite costly in the Sahelian region. The high costs are linked more to the environment (low population density, poor infrastructure, poverty, illiteracy) than to the style of group lending itself. By using hierarchical group structure, Burkina Faso has created a way for one loan officer to serve a large number of clients. As clients are sensitized on group dynamics, the program will fine-tune its organization and training of groups than before. Future viability of this program depends on Burkina Faso’s legal environment that dictates institutional reforms, interest rate ceilings, and deposit insurance. The PPPCR has experienced greater efficiency in the past couple of years as it continues to learn from its early experience and achieves economies of scale. The extent to which this improvement can continue will determine whether this approach will become viable and sustainable in the future or not (Paxton, 1998).

5. Micro-Finance Theories

There are four mainstream theories of micro-finance: Supply leading finance theory, the imperfect information paradigm, informal credit markets and the savings for the poor. These theories have helped lay the foundations for commercial micro-finance.

5.1 Supply-leading Finance Theory

This theory came from a combination of three ideas:

(1) Governments of newly emerging nations were responsible for their economic development

(2) It is crucial for economic growth, that high yielding agricultural technologies are adopted rapidly and extensively

(3) Most farmers could not afford the full costs of the credit they would need to purchase the inputs for the new technology. In this context, massive subsidized rural credit programs were established throughout much of the developing world. Poor farmers would receive below market credit, it was believed, produce higher yields and increase their incomes.

This approach, usually formulated and stated in explicit contrast to colonial policies, was a product of Keynesian economic thinking and of the post war view that developing countries must pass through a series of stages to achieve the status of developed nations. Emphasis was placed on the obligations of governments to play multiple roles including accumulating capital, planning investment, promoting industrial development and agricultural growth, developing infrastructure, and in varying degrees depending on the country thus improving income
distribution and increasing equity. It was in this context that supply-leading finance theory emerged in the 1940s and 1950s.

Supply leading finance refers to the provision of loans in advance of the demand for credit to induce economic growth. The prevailing ideas of the time were that the rural areas of developing countries were critically important for national development, and that it was essential for economic growth that high yield agricultural technologies be adopted rapidly and extensively. Such an adoption would often require substantial credit subsidies because it was believed that most farmers would need more capital than they could save, and that they could not pay the full costs of the credit, they would need (Oketch, 2003).

By the 1960s, the growing assumption of responsibility for economic development by the governments of emerging nations coincided with the rapid spread of new varieties of rice and wheat that ushered in the green revolution, and the related issue of financing inputs for the new agricultural technologies. Traditionally many rural households borrowed primarily for consumption to subsist in pre-harvest seasons, for emergencies, and for social and religious obligations. In the 1970s, however, rural households increasingly began to borrow for the growing expenses of production: initially for agriculture, and later for off-farm productive activities as well.

Supply leading finance theories assume that economic growth in rural areas could be induced through the financial system. As a result, financial incentives for the adoption of new agricultural technologies, often in the form of subsidized credit, were provided to farmers in advance of the demand for them. These theorists believed that most farmers could not save enough for the inputs they needed and could not pay the commercial cost of credit. Savings was the forgotten half of rural finance (Vogel, 1984) because it was assumed that in rural areas of developing countries there were little or no savings to be mobilized. Thus, with the emergence of the green revolution in the late 1960s and 1970s, large scale subsidized credit programs proliferated in developing countries around the world. The approach later extended to non-agricultural borrowers. Subsidized agricultural finance in the form of crop input credit stimulates agricultural growth similar to those provided for fertilizers and pesticides (Nagarajan 1995).

Government planning for intervention in rural credit markets, as formulated by many subsidized credit programs, especially in state owned institutions, often have high default rates (World Bank 2000). This shortcoming is pronounced in subsidized rural credit programs in
state-owned financial institutions. Partly because borrowers tend to be locally influential individuals (rather than the poor) and because lending is often seen as a political entitlement rather than a business transaction, lending institutions typically put little effort into collection and usually do not foreclose on collateral in case of default (Vogel 1984, 1997). The financial performance of virtually all government-owned RFIs (rural financial institutions) has usually been extremely poor. Most RFIs have remained highly subsidy.

An example from Zimbabwe provides an illustration of how a politicized micro-credit program capitalized and administered directly by the government, can rapidly fail financially although it may achieve its political objectives. In 1992, the government of Zimbabwe established the Social Development Fund, a $14 million revolving loan fund for small enterprises and microenterprises. Loans were offered at a subsidized annual effective interest of 10 percent (at a time when inflation was more than twice that). The fund was intended to help mitigate the effects of structural adjustment on the lower half of Zimbabwe’s economically active population. In reality however, these loans were close to political pay-offs than to financial instruments. While much attention and publicity was given to disbursing the loans, little effort went into collecting them. There was no mechanism to follow up on late payments, and a loan officer for the program was not hired until three years after the first disbursements. By the end of 1995, 1,500 loans had been disbursed, the repayment rate was about 3 per cent, and most of the funds allocated for the program had been lost in the three years of operation (Malhotra 1992).

While this is an extreme example, a similar pattern of low loan repayment as part of the political process exist in subsidized credit programs in many parts of the world. Argentine provincial banks routinely lost their capital due to loans provided to rural elites without expectations of repayment (most of the banks involved have now been privatized or liquidated). In India, in the fiscal year 1996, loan recovery for more than 14,000 branches of the country’s Regional Rural Banks (RRBs) was reported at 56 per cent of the amounts due. These and other rural banks in India are required to provide subsidized loans to a quota of poor people. However, banks often have little role in selecting the borrowers. Rather, influential local political committees draw up lists comprising their relatives and supporters (Rahman 1999).

In rural India, as in many countries, government officials and politicians routinely announce loan forgiveness programs for micro-credit borrowers ostensibly in honour of some political event or anniversary to garner votes for themselves. Borrowers then delay their loan repayments, waiting for the next forgiveness day. Much of the credit is politically induced, and
much of it is uncollectible. These are classic examples of moral hazard, in which many or all borrowers have limited liability because lenders, in varying degrees, do not expect repayment. In Kenya, such loan forgiveness is synonymous with pre-election pledges mostly to kikuyu farmers and affiliated subtribes mostly from central Kenya and rift valley regions.

Lending institutions providing subsidized credit typically impose time consuming and cumbersome procedures that could result in high transaction costs for borrowers as well as insignificant opportunity costs of the borrower’s time spent waiting in line and in making return visits. In addition, staff members of institutions offering subsidized, below-market rate credit often require bribes from potential borrowers. This process raises transaction costs to borrowers and encourages a culture of corruption among the staff. The accommodation of officials capturing the baksheesh (or irregular payment to a bank official for authorizing loan) impoverishes the financial intermediary, adversely affects financial discipline, and undermines the repayment culture (Yaron et al. 1997).

For borrowers, corruption is just another transaction cost, though often an expensive one because multiple payments to different people may be needed. This is especially the case when extensive documentation is required for a loan because each document may require a bribe not only to the credit officer involved but also to his assistants, who act as gatekeepers to the officer. In contrast, in commercial micro-finance institutions where non-subsidized credit is available to all credit worthy borrowers, incidences of bribery decrease dramatically.

Loan products in subsidized credit programs are rigidly determined; the purpose, amounts, and terms of loans are prescribed with little or no regard to borrowers’ needs and income flows. Loans can be too small or too large. Inadequate loans may occur, for example, when a poor woman is lent $100 to purchase a cow service the loan by selling milk. Bank staff in subsidized credit programs typically spend their time in unproductive ways. For example, they may engage in futile monitoring of the end use of loans, which cannot be effectively monitored because credit is fungible. They may train borrowers in their business activities (which the borrowers already know better than the bank staff) or in new projects that neither one knows. Staff may fill out multiple, long forms and reports that contain largely useless, and unused information—instead of completing a few well-designed reports that provide information needed for good management of the institution. Bank staff may spend their time attending training sessions and meetings that reinforce assumptions that do not hold ground and promote unproductive expenditure (O’Brien 2006).
Subsidized credit curtails the development of sustainable financial institutions. Large-scale subsidized credit programs depress, in one way or the other, the development of sustainable financial intermediation at the local level. Similarly, Vogel (1984) observes that low interest rates on subsidized loan programs discourage deposit mobilization and micro lending. In contrast, sustainable micro-finance institutions with wide outreach typically offer both services and act as financial intermediaries.

Credit subsidies often depress savings because revenues are too low to cover the operating costs of effective savings mobilization. Savings mobilization in conjunction with subsidized rural credit programs, as in China and India occur at high arrears and losses. Implementing both savings and lending effectively requires relatively high operating costs to cover sufficient management, staff, personnel training, security, supervision, transportation and management information systems. Revenues needed to cover these costs are generally unavailable in programs that provide large-scale subsidized credit. Far from being sustainable, many institutions providing subsidized credit programs especially state owned agricultural credit institutions suffer from political interference, haphazard governance, and poor and often corrupt management, untrained and unmotivated staff, unwanted products, low repayments, high costs, and high losses.

Subsidized Credit Programs for Micro-enterprises

In the mid-1980s, driven by the mounting international economic crisis, increasing attention was directed not only to agricultural loans but also to the financing of small enterprises, micro-enterprises and low-income people more generally. Thus, the original concern with small farmer credit problem has become only a proxy for a pre-occupation with difficulties of access to financial services by particular groups of societies (Gonzalez 1997). Some formal institutions began to lend subsidized government or donor funds to small and micro-enterprises in urban areas at below market interest rates. Nevertheless, other micro-finance institutions, funded by low-cost credit from governments and donors, began to lend to borrowers at or near interest rates that would enable full cost recovery. While such institutions vary considerably, some have been highly successful both in reaching low-income borrowers and in recovering loans. However, Vogel (1997) observes that financial institutions funded primarily by grants and low interest loans usually cannot mobilize substantial voluntary savings, raise much equity, or leverage significant commercial investment.
The best of these institutions become operationally self-sufficient but remain perpetually dependent on outside funding; hence are inherently unstable. Even donor-funded institutions that lend at rates that cover their operating costs and maintain high repayment rates cannot raise sufficient capital to meet local demand for micro-credit (Ledgerbook 1998, 1999). Some boards and managers of non-governmental organizations (NGOs) have come to recognize that due to capital constraints, their institutions can meet only a tiny fraction of the demand for microfinance in their service areas. As a result, they have launched banks, such as BancoSol in Bolivia, Mibanco in Peru, and the Kenya Rural Enterprise Programme (K-Rep) in Kenya (Nyerere 2004, Oketch 2003, Omino 2005).

However, many governments and some donors continue to spend large amounts on credit subsidies, with poor results. There are far better ways to spend less money for much better results in microfinance. Supply leading finance theorists believe that subsidized credit programs stimulate economic growth and agricultural production. Their assumptions are largely uninformed about the ways that real rural credit markets work. As a result, governments and donors provide massive amounts of money for credit subsidies with very poor results serviceability.

Countries such as China, India and Vietnam continue to subsidize rural credit programs today with continuing low repayment and high defaults for ideological and political expediency. Some, however, are beginning to experiment simultaneously with commercial micro-credit programs. It is hoped that the governments of such countries will find ways to overcome the political obstacles that have prevented them from initiating on a large scale the basic credit reforms that underlie the microfinance revolution.

5.2 The Imperfect Information Paradigm Theory

Self-sufficient micro-finance institutions are rare and unnecessarily so. As noted earlier, supply leading finance theory and subsidized credit programs have been a major constraint to the development of such institutions. Yet another problem has arisen from the application of the imperfect information paradigm to developing country credit markets and in some cases specifically to rural credit markets without sufficient understanding of social, political and economic dynamics of these markets. Models of the imperfect information school of credit markets are not concerned specifically with micro-credit, but with their general nature and less developed rural credit markets economies. Imperfect information paradigm helps explain a
A number of imperfect information credit models assume that banks cannot differentiate cost-effectively between low-risk and high-risk loan applicants, among observationally distinguishable groups of potential borrowers. Five of the most common conclusions from imperfect information credit models that relate to experiences of financial institutions in micro-credit markets are; (1) Banks may raise interest rates to compensate for risks related to their inability to distinguish between high-risk and low-risk loan applicants. (2) The higher interest rates may drive low-interest borrowers out of the market, increasing the average riskiness of the loan applicant pool. (3) Borrowers with limited liability attract higher interest rates because of a bank’s assessment of its asymmetric information risk, which may induce them to choose risky projects that increase the likelihood of loan default. (4) As a response to an expected decrease in returns resulting from the higher average riskiness of loan applicants, banks may choose to keep interest rates low enough to avoid a high-risk profile and may ration available loan funds. (5) Collateral may signal borrower creditworthiness and help banks attract low risk borrowers, and this may decrease credit rationing. However, other analyses conclude that collateral requirements may have adverse selection effects, increasing the riskiness of loans and decreasing the expected returns to lenders with the possibility of entrenching credit rationing (Stiglitz 1981).

In addition, formal institutions are unlikely to compete successfully with informal commercial moneylenders because such lenders have access to better information about credit applicants than formal institutions can obtain cost effectively (Braverman and Guasch 1989). While imperfect information models of rural credit markets vary considerably, overall their conclusions suggest that it would be difficult for banks both to operate profitably in developing country credit markets and to attain extensive outreach. Because in some cases imperfect information theory has been applied to rural credit markets (Braverman and Guasch 1989, 1993; and Hoff and Stiglitz 1990).

Rural areas of developing countries tend to share some general features even though their social, political, and economic structures can vary greatly. One commonality is that many types of information do not flow freely. Much valuable information tends is segmented and circulates within different groups, factions, alliances, and networks. Informal moneylenders, like everyone else in the locality, have access to reliable information only about some people and some activities in their communities. The often-segmented social structures of rural
communities in developing countries frequently provide a significant opportunity for banks, which need not participate in the local political economy to the same degree as local residents to meet the demand of community members for financial services (Mayoux 1999).

6. Conclusion

Micro-finance institutions have come a long way since inception with their twin objectives of poverty alleviation and per capita income improvement particularly to the low-income sections of developing economies. Achieving these twin tasks has been short of expectations because targeted poor sections of society have not been keen on boosting savings as well as practicing rational borrowing mechanisms. The functionality of micro-finance institutions is not only demand driven but also to smoothen consumption, coping with emergencies, acquiring assets and paying for expenditure. Poverty persists not just because of absence of or inadequate income but also because of risk and vulnerability of that income, and these institutions are not a panacea for poverty eradication single-handedly. Conventional commercial banks need to come up with sustainable modules of income growth among low-income earners with expanded savings generation mechanism for economic development to thrive.

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