

Unit 3

Micro Finance: A Magic Bullet for Poverty Alleviation

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ABSTRACT

Micro Finance (MF) has gained a lot of significance as a tool for poverty alleviation in the last decade. There has been a rapid proliferation of Micro Finance Institutions (MFIs) in the recent past in the global as well as Nepalese context. It is, however, debatable whether the MF program applauded and eulogized as providing collateral free loan to the poor is really reaching the poorest of the poor. The dichotomy of reaching the core poor and making the operations financially sustainable does not seem to be reconcilable. The necessity of financial sustainability has introduced a built in bias against extending micro loans to the very poor. Moreover, the minimalist approach adopted by the MFIs that credit automatically translates into successful enterprises does not match with the reality as poor need skill, managerial ability and market outlet to start micro enterprises. Moreover, the range of micro enterprises that a poor can undertake is quite limited in a rural society. So loan alone strategy may not be an effective tool for poverty alleviation. The MFIs seem to boast of high repayment status, but the question is whether this has been from additional income or from borrowing from the village moneylenders. MF alone, if not integrated with the overall development strategy and supplemented by supportive activities, facilities can hardly be effective in helping the poor to get out of poverty.

MF is increasingly being taken as a magic bullet for poverty reduction. Planners and policy makers in the developing countries entrenched in widespread poverty of the mass have become euphoric about the potential poverty reducing effects of MF. Not only the individual poor countries, but also the international aid agencies which hold the reins of development of the developing countries have found MF a new vista for channeling aid in the name of the poor. To give boost to the MF as a potent scheme to fight poverty, the UN declared 2005 as the International Year of Micro Credit. The MF scheme has sky rocketed

when Muhammad Yunus, the Grameen Bank founder, was awarded the 2006 Nobel Peace Prize. The Nobel Committee cited 'micro finance can help people to break out of poverty, which in turn is seen as an important prerequisite to establish long lasting peace'.

In the last 10 years, MF has grown so much both in terms scale of operation and institutional structure that it has come to be termed as MF industry. The Asian Development Bank 2004 Annual Report says, "Once almost exclusively the domain of donors and experimental credit projects, institutional micro finance has evolved over the years into an industry with prospects for sustainable services and significant opportunities for expansion."¹ Between December 1997 and December 2005 the number of micro finance institutions proliferated from 618 to 3133 and the number of people who received credit from these institutions increased from 13.5 million to 113.3 million.² Nepal has also witnessed a large growth of micro credit over the last one and half a decade. Although micro credit has been around in various forms for hundreds of years, its modern incarnation took place in 1992 when the Bangladesh Grameen model was replicated in the public sector in the form of Grameen Bikas Bank one each in five Development Regions.

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The players of MF have also increased significantly consisting of governments, non-governmental organizations, cooperatives and development banks. As of mid-July 2006, the players of MF in Nepal consisted of 5 Grameen Bikas Banks, 4 private sector replicating banks, 3 wholesale lending organizations/programs, 51 NGOs, 199 small farmers cooperatives limited and 6 donor funded micro credit programs.

Poor are said to be not creditworthy because they do not have steady income, they have no or little collateral and the small size of loan makes the transaction costs too high. So the formal financial institutions driven by animal spirit are least interested in providing credit to the poor. On closer examination the accusation that the poor are untrustworthy clients is questionable, because the richer clients have been the big loan defaulters. The defaulter issue in Nepal is a glaring example of by borrowers resulting repayment of loans by mobilizing political influences. On the other hand, there are examples of poor debtors repaying back the loan even if that entailed selling of whatever property they own. Likewise, the lack of collateral does not seem to be a binding constraint for the middle and high class families have borrowed large sums with very little collateral. On the other hand the poor are unsophisticated clients and do not have connections with the politically high and mighty, which seem to be the eligibility criteria. It is true that the poor may not be readymade customers to be demanding the credit and they generally do not go to the institutional lenders.

The emphasis on MF for reducing poverty presumes that the credit to the poor promotes self-employment income generating activities. This leads to an increase in income and contributes to an accumulation of assets, which in turn reduces vulnerability due to illness, crop failures, and enables better education, nutrition, health and housing of the borrowers. In addition, MF can contribute to empower women by providing them the basis for earning of income, social mobilization and political awakening.

The effectiveness of MF in reaching the poor and contributing to lift them out of poverty is, however, a matter of controversy. Many critics argue that MF program suffers from Type I and Type II Errors which mean failure to reach the target population and reaching the non-target population respectively. Clearly more people have access to credit but what is less clear is that whether the deserving poor are the ones among those having access. There is high likelihood of MF program not reaching the poorest of the poor, or the poorest being deliberately excluded from the program. There are reasons for this. First, the extreme poor lack confidence to participate in the program or they consider the loan too risky for investment. Second, the core poor are often not accepted by other members in the group because of low status and high credit unworthiness. Third, the staffs of MF organizations may prefer not to include the core poor because lending to them is seen as involving high risk. Despite the enormous growth in micro credit program, the outreach and coverage of the poor have been abysmally low. In 2004, only 6 percent of borrowers meeting the World Bank criteria of \$1 a day were able to borrow from MFIs.³ Cross country empirical research shows large variation between different programs in different countries in targeting the poor with poor to non-poor ratio ranging between 0 and over 90 percent⁴. The exclusion problem has been reported even in the case of Grameen Bank which is cited as the success example and emulated by many developing countries.⁵ Studies carried out by the Consultative Group to Assist the Poor (CGAP) in a number of countries showed that 30 percent of the households that had joined the MF organizations were not the poorest of the poor. In Nepal, the performance of MFIs in targeting the poor is found to be strikingly poor. A study by the National Planning Commission estimated that on an average 31.4 percent of the clients benefited by the MF program were ineligible borrowers.⁶ Another study by the Nepal Rastra

Bank aimed at assessing the impact of micro credit program carried out under its Rural Self-Reliance Fund revealed that 22.5 percent of the sampled beneficiaries were not eligible for the assistance.⁷

The MF organizations are caught in the Scylla of focusing on the poor and Charybdis of making the operations financially sustainable. The question is how the organizations can avail the credit to the poor that too in remote and sparsely populated areas in a sustained manner so that both the poor and the providers benefit from the program. Sustainability would require higher interest rate close to the market rate but encouraging poor to take loan would require lower rate. In the trade off between the financial sustainability and the depth of reaching the poor, it is but natural that the MF organizations give priority to the first. This mostly explains why MF is reaching not the poorest of the poor but only those near and above the poverty line. This also explains why micro finance programs have not expanded in remote and neglected areas where no financial service is available and no self-help group exists. Most of the micro credit programs are being operated with interest subsidy in order to make credit available to the poor borrowers at lower than market rate. This subsidy is borne by the government in the case of state led program and by the donor agencies in the case of NGO operated programs. The dependence on subsidies to meet the cost implies that MF programs are not financially sustainable. The issue is how long the program should be continued on subsidy and whether these subsidies are justified when the program excludes the poorest of the poor?

On the impact of MF program to get the poor out of poverty, there is little evidence of a conclusive result. Various studies show that the economic impact has varied with larger impact for those closer to the poverty line than those further away⁸ and that the extreme poor will not benefit from access to financial services.⁹ Credit extended to the poor through the micro finance program presumes ample profitable opportunities within the reach of the poor and it is the lack of capital that is hindering their utilization by the poor. This is the familiar minimalist approach which assumes that credit automatically translates into successful micro-enterprises. The reality is, however, something different. What the poor actually need is not only credit but other inputs as well, such as business and technical training, establishing of market linkages for inputs and outputs and some infrastructure. The absence of these could be the reason for the virtual confinement of microcredit to a limited set of traditional activities, such as small vegetable farming, livestock rearing and petty trading, and these too in places with market linkages. For the first two activities, the poor ought to have some land of their own, or capable of renting in land, and homestead with kitchen yard. Obviously, for the landless and those having only a hut this option does not exist. For the last activity there may not be scope for many within the limited boundary of the hamlet. Regarding other nontraditional activities, such as tailoring, weaving, processing, etc skill is needed which the poor may not have. So the single intervention of small loan given for short duration with repayment beginning as quickly and as frequently (weekly), has very little impact on poverty reduction. The short repayment cycle has, no doubt, resulted in high repayment rate but the question is at what cost? Instances from Nepal and Bangladesh show women having to borrow money from the village money lenders at high interest rates in order to keep up with the repayment schedule of micro credit. There are also cases of re-lending of micro credit to professional investors at a higher interest rate earning margin as easy income. Although a few successful cases are elaborated here and there for emulation by those lagging behind, there are many cases of failure, which remain buried.

The conclusion to be derived from the above discussion is that MF provides no magic bullet, and no panacea for poverty reduction. There are several dilemmas and challenges which need to be well addressed, if the MF is to serve the poorest of the poor. For one thing it is clear that MF in isolation can do no good. There is a need to place the program in the larger context of development and growth, integrated with other mutually reinforcing and supportive activities.

ENDNOTE:

- ¹ Asian Development Bank, *Annual Report, 2004*, Manila, Philippines.
- ² S. Daley-Harris, *State of the Microcredit Summit Campaign Report 2006*, Washington DC.
- ³ S. Daley-Harris, *ibid.*
- ⁴ Paul Mosely and David Hulme, 'Microenterprise Finance: Is there a Conflict between Growth and Poverty Alleviation?,' *World Development* 26 (5), 1998.
- ⁵ S R Osmani, 'Limits to Alleviation of Poverty through Non-Farm Credit', *Bangladesh Development Studies*, 17 (4), 1989.
- ⁶ National Planning Commission, Government of Nepal, 'Impact Evaluation of Micro-Finance Programs on Poverty Reduction', Study Report submitted by the Centre for Policy Studies and Rural Development, 2004.
- ⁷ Nepal Rastra Bank, 'Impact Study of Rural Self- Reliance Fund Credit Program', Study Report submitted by the Centre for Policy Studies and Rural Development, 2007.
- ⁸ D. Hulme and P. Mosely, *Finance Against Poverty*, ,1996, Routledge, London.
- ⁹ M. Robinson, 'The Microfinance Revolution: Sustainable Finance for the Poor' World Bank, Washington.