Microcredit in International Development

By Jeff Merchant

The institution of microcredit represents a new and effective form of developmental assistance. Microcredit succeeds by putting money directly in the hands of the poor, adapting to their unique cultures, and stimulating personal empowerment. Although not a panacea for economic disparity, microlending holds a great potential for alleviating poverty when coupled with more traditional aid programs and the forces of globalization.

INTRODUCTION

Rajamma lives in India. For years she worked as a lowly maid in an "upper-caste" household so she could feed her malnourished children the leftover scraps of food her employers left after dinner. Finally, she became so impoverished she borrowed money from one of the rich landowners in her village. When she could not repay the loan, her daughters were taken to his house to live in virtual slavery. Fortunately for Rajamma, her story does not end in tragedy. She joined the Bridge Foundation, a microcredit organization, which loaned her a milk cow for the equivalent of about $200. Through hard work and her own innovation, she purchased a half-acre of land, paid for the release of her children, and took out a larger loan to begin irrigation for groundnut production—all in one year. Now, her children are learning vocations and attending school. She has maintained her success as a businesswoman (Serageldin and Yunus 2000).

Rajamma's story is not isolated. Today, microcredit institutions are popping up throughout the world, in both developing and developed countries, serving the poorest of the poor. With over 7,000 of these organizations worldwide, loaning more than 16 million people well over $2.5 billion (Srinivas 2000), microfinance has revolutionized traditional models of international development in just a few years (New York Times 1997). As countries look for ways to decrease spending and shore up deficits (Economist 1997), this innovative concept is beginning to catch on in the United States, the European Union, and many non-governmental organizations (Sarno 1998).

Of the types of international aid, microfinance is the most promising. It is the only form of aid that empowers its beneficiaries, is customized to the culture it serves, and creates sustainability—and in some cases profit—for the organizations that provide it. Microcredit, is not a panacea for the world's developmental problems, especially in the realm of poverty eradication. While microcredit is currently a necessary element of international development, it is essential that the United States and other countries provide more traditional forms of aid to supplement the economic and social benefits of this remarkable system.

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MICROCREDIT AND INTERNATIONAL DEVELOPMENT: DEFINITIONS IN CONTEXT

It is necessary to create a workable definition of international development and microcredit/microfinance before addressing the complexities of these issues. International development is difficult to define. The *Development Dictionary* describes the process of "development" thusly: "There is nothing in modern mentality comparable to it as a force guiding thought and behavior. At the same time, very few words are as feeble, as fragile, as incapable of giving substance and meaning to thought and behavior as this one" (Esteva 1992). Of course, there are debates as to what constitutes "development," but it is true that "development defies definition" (Cowen and Shenton 1996). Although the meanings maybe complex, and diverse, for this discussion, development simply refers to the process by which the citizens of a nation-state become more economically and socially empowered. Cowen and Shenton's *Doctrines of Development* best depicts this definition by saying:

> Development can be construed as "a process of enlarging people's choices;" of enhancing "participatory democratic processes" and the "ability of people to have a say in the decisions that shape their lives;" of providing "human beings with the opportunity to develop their fullest potential;" of enabling the poor, women, and "free independent peasants" to organize for themselves and work together.

INTERNATIONAL DEVELOPMENT THEORY

Models of development have shifted dramatically over time. Originally, theories of development derived from European concepts of modernization and expanded by Western scholars; a school of thought which saw development as a linear path leading from the backwardness of "traditional society" towards a modernized "age of high mass-consumption" (Rostow 1991). This "orthodox" view of development was popular throughout most of the 1950s and 1960s, creating the rationale for international aid. Aid flowed from developed nations like the United States to the "less developed" nations throughout the world, since they were "helping" those nations that could not help themselves (Dickson 1997).

Traditional aid led many developing nations to reject notions of orthodoxy, arguing developed nations had taken advantage of them. For example, one school of theorists rejected the entire international system, which they believed forced a dichotomy between the developed and the developing. Rather than a linear path, these theorists saw development as "a world system composed of a developed center or core and an underdeveloped periphery" (Dickson 1997). The core created manufactured products from raw materials provided by the periphery. Raul Prebisch, the chair of the Economic Commission of Latin America (ECLA), argued that industrialized countries have greater economic growth than developing nations, because developed nations take cheap raw materials from poor states, and then sell expensive manufactured goods to them (Baer 1962). Eventually, this unequal exchange, leads to a wider economic gap between the core and the periphery (Dickson 1997).

Some theorists took this concept a step further, arguing that the capitalist system forced underdevelopment by its "persistence of commercial rather than industrial capitalism in the underdeveloped world" (Frank 1966). They rejected both modernization theories and the theories initially created by Prebisch and the ELCA, arguing that neither took historical factors into account nor addressed the overall economic theory used by the international system (i.e. capitalism). Additionally, these critics abandoned the notion that there was one universal theory that could apply to all cultures (Amin 1972).[1]

Currently, development debates center on new neo-liberal concepts of political economy. Today's theorists deny two mainstream concepts in development theory: first, that the developing world constitutes a "special case" and needs to have special considerations, with particular policies and economic theories; and second, that the nation-state should play a key role in economic development. Modern theorists instead embrace the notion that neo-liberal concepts of development have been affirmed by the continued dominance of globalism in the economy.

Globalism is defined as "the idea that, through a series of mechanisms, the world has become more closely interconnected, and by implication that it will continue to become more closely interconnected…Globalization [is] a qualitative change in the nature of social activities, linkages which are of an intensity never before experienced" (Dickson 1997). Because capitalism is self-propelling, neo-liberals believe that capitalist elements of globalism will push money and resources into and out of every country, so long as they participate in the international market. Because prevailing theories advocate that developing countries no longer need special attention, many policies today that are based on traditional theories are beginning to seem out of place.

MICROCREDIT DEFINED

It is within the context of the neo-liberal model of international development that this discussion will consider microcredit. The concept of microcredit was born in 1976 when Bangladeshi economics professor Muhammad Yunus loaned \$27 to 42 very poor people (about 64 cents each) in the village of Jobra (Burritt 1997). The people in the village made bamboo stools. In order to get the needed supplies, they had to borrow money from loan sharks at exorbitant interest rates. By extending credit to those rejected by traditional banks and financial institutions (i.e. the poor without collateral, the illiterate, and women), Yunus not only helped these people pull themselves slowly out of poverty by giving them the resources they needed to start small businesses, but he also got his money back. Eventually, Yunus was able to form the Grameen Bank, the world's most famous microfinancing institution (Guzzetta, Lusk, and Stoesz 1999).

In a very loose way microcredit, microfinancing, and microenterprise all refer to the same notion: the practice of extending small loans to the poor, usually in the amount of \$50, \$100, or \$300 to help establish a small business or enterprise (Ihle 1997). "It [microcredit] is firmly embedded in the notions of self-reliance and concepts of free-market capitalism" (Ros-Lehtinen 1997). Microcredit is identified by certain characteristics. First, it is informally structured, which is essential to meet the needs of the poor (Johnson and Rogaly 1997). Second, its funds are loaned to the poorest of the poor, the bottom 50 percent of people living under the poverty line in a particular country (Gibbons and Meehan 2000)[2]. Since these attributes are able to attract people who have no where else to go but up, they have helped make microcredit a success.

The *New York Times* recently reported about a microcredit program the United Nations is pursuing in Madi, Kyrgyzstan. In this community, the poorest of residents once scraped to keep their families from dying of malnutrition or exposure. When microcredit was introduced to one woman in this community, she was able to buy a few hens. Over time, the woman sold the eggs produced by these hens, and

1 That is, they understood that people in Pakistan lived completely different lives than Germans, and that holistically speaking, their customs were almost always incompatible.

2 Gibbons and Meehan use the Microcredit Summit's definition of the "poorest" families, as those who live in households with incomes that place them in the bottom 50 percent of the people living below the poverty line as defined in each country. Those in the top 50 percent under the poverty line are deemed "poor."

acquired new hens and a rooster. Eventually, she sustained a modest chicken and egg business. Today, with the help of microcredit, she has a large chicken farm, a healthy baby dressed in quality clothing, and the money to send her children to school (Frantz 2000).

WHERE DOES MICROFINANCING FIT IN THE INTERNATIONAL DEVELOPMENT DEBATE?

At a time when the United States and other nations consistently cut foreign aid budgets, it is necessary to approach international aid and development from the most basic levels. As globalization occurs, it is evident that national and regional political, social, and economic issues are becoming increasingly intertwined. Clear examples include the financial crisis in Asia, the instability in Russia, the chaos in the Balkans, and the challenges of peace in the Middle East. Even the recent US presidential election "crisis" implicated global economics. Indeed, "the so-called third world can no longer be perceived as a distant reality beset with problems that have little or no bearing on our comfortable lives here in the first world…the dangers of underdevelopment a continent away are similarly knocking on our door" (Hoy 1998). Issues of environmental degradation, infectious disease, civil war, and political uncertainty clearly no longer stop at a longitudinal line or riverbank (Hoy 1998).

The United States government does not balk at explaining why it gives aid: to protect its territorial and political security. Historically, U.S. aid was only bestowed upon allies for security purposes, often supporting the installation of abusive right-wing governments to decrease the threat of communism. Aid has been given to stimulate foreign markets for potential American business investments. In theory, aid goes towards helping people in need. In fact, nearly all donor countries give aid for the purpose of getting something (usually political or economic benefits) in return (Hoy 1998).

Aid is crucial to international development as it resolves the issues of instability in developing countries. The most universal cause of this instability is poverty. Poverty facilitates conflict as people fight over water, food, clothing, and shelter. Alleviating this global ill is the primary objective of microfinance institutions, which have grown out of the inability of many governments to look beyond their own political agendas.

Microcredit practitioners are confident they can help many people because microcredit is a simple solution to the very complex problem of development. Microcredit follows the basic principles of the free-market, giving those with innovative ideas the money to start working. When the poorest people in the world use this capital, they are often able to pull themselves out of poverty and, in the process, allow their children to escape the cyclical nature of poverty. This makes microcredit a preferred method of aid, because government involvement is minimal. It is also a relatively inexpensive method of distributing aid.

In 1997, the Microcredit Summit (made up of the world's most successful microfinancing organizations) was held in Washington, D.C. At the meeting, several international microfinance institutions pledged to reach 100 million of the world's poorest families by 2005 (Adams et al. 2000) and give them the opportunity to rise out of poverty.

Microcredit is becoming an attractive alternative to more traditional types of aid. Originally, aid was viewed as a handout to poor nations. The money was given to governments, which sometimes squandered or siphoned off money. Today, with microfinance, governments become an unnecessary and unwanted middleman. The United States Agency for International Development (USAID) has begun its own programs to further microcredit. The Microenterprise Initiative dedicated $400 million from 1994 to 1996, supporting over 150 institutions in 40 countries. Microcredit has presented itself as an answer to many nations' aid woes, creating successful businesses for the world's poor, improving economic output of underdeveloped nations, and establishing strong institutions that are not only sustainable, but in some cases profitable (Schneider, 1997).

WHY MICROCREDIT WORKS

There are three key reasons why microcredit is so reputable. First, microenterprise gives people a sense of empowerment. Second, microcredit is capable of customizing itself to those it serves and alleviating poverty. Finally, microfinancing is making a unique form of aid sustainable and is viewed more favorably than many less economical alternatives.

EMPOWERMENT

One unique aspect of microcredit is that it only works if the people choose to use it. Rather than receiving a one-time handout, people are given the opportunity to help themselves—and their community—to a better life. Empowerment comes as individuals use microcredit to lift themselves and their families out of poverty. Credit creates economic and social power, since credit affords the privilege of receiving resources. Because financial institutions decide on the credit-worthiness of an individual, they are an important social tool. Since they require collateral, paperwork, and often complicated legal procedures, banks have traditionally established what some call "a financial apartheid" (Yunus 1998). For poor people, a simplified process for receiving financial benefits decreases the level of powerlessness they experience, and enables them to begin the process of escaping poverty.

CUSTOMIZING MICROCREDIT ALONG CLASS AND CULTURAL LINES

Microfinancing also helps empower people by giving them social power. However, it can only do so if people want and understand social power. By adjusting itself to the people it serves, microcredit addresses the social issues of the country in which it is used. Customization occurs because microcredit is highly decentralized and localized. Each person finds a way to utilize their own culture and improve the likelihood for success (Guzzetta, Lusk, and Stoesz 1999).

Perhaps more importantly, microcredit is able to adjust to class. Microcredit has a powerful ability to adapt to culture. Since the concept of credit is a broad historical factor in nearly all societies, microcredit has a useful advantage; it immediately focuses on the best ways to approach extending loans to people. It is necessary to distinguish that monetary culture is usually dissimilar in different societies. What may be acceptable in China is often unacceptable in the United States[3].

The best example of this concept is the Grameen Bank. The Grameen Bank of Bangladesh is the best-known microfinance institution and a worthy example. The Grameen Bank has set up membership criteria based on two factors: (1) the maximum holdings of land can be no more than one-half acre and (2) there can be only one member per household. Obviously the first rule is founded in local economics, an individual with larger land holdings is considered middle-class or upper-class. The second rule rests on the notion that in many Bangladeshi families, whether the man or woman earns the money, the man controls it. If women are raising a family alone, it is practically impossible to secure a loan. This rule affords single mothers greater autonomy to formulate positive financial decisions regarding their family and business.

After the basic criteria are established, the Grameen Bank model begins to reveal some aspects of Bangladeshi culture. In order to receive a loan, a group of five people must come to the bank. Each member must know the others and be of the same sex. Since no one in the collective has collateral, there is group liability. Loans are given to the two poorest members, who have a limited time to pay the loan back. After the loan is repaid, the next two get loans, which they must pay back. The last person gets a loan after the third and fourth members pay their loans back. The key is that because there is group liability, if anyone defaults, all members are cut off. This "peer-group monitoring" system leads to "social collateral," more commonly referred to as peer pressure (Khandker 1998). Men and women are also separated because of cultural aspects of gender. In most cases women receive upwards of 75 percent of all loans (Adams et al. 2000).

SUSTAINABILITY AND PROFITABILITY OF MICROFINANCE INSTITUTIONS

One key characteristic of microcredit is the high interest rate that is charged for a loan. This rate, which is often 30 to 50 percent higher than commercial rates, is necessary to help maintain the sustainability of microcredit programs. Additionally, even with the high interest rate, there is an average 91 percent repayment rate, much higher than many commercial banks in developing nations (Kole 1999).

Although sustainability and profitability are the desired outcomes of many microfinance institutions, it is highly unlikely that every borrower will be a success story. A recent study grouped microcredit organizations into three areas: Subsidy Dependent, Operational Efficiency, and Fully Self-Sufficient or Profitable. Subsidy Dependent institutions rely fully on donor support in the form of grants or other subsidies. Operational Efficient institutions are able to cover administrative costs (salaries, rent, etc.) with revenue from interest and fees, but unable to meet demand for new loans. Fully Self-Sufficient or Profitable institutions are completely independent and can turn to larger commercial banks for additional loans. They are also able to pay for those loans out of interest from their members. The study, which focused on eleven key microfinance institutions, found that ten had reached operational efficiency and five were fully self-sufficient or profitable. It concluded that most organizations could reach the third level within five years of operation (Christen, Rhyne, and Vogel 1994).

Most microcredit organizations have a difficult time recovering initial losses in the form of administrative costs (Khandker 1998). However, many institutions have become successful, profitable businesses serving the poor and recycling profits to expand their reach. An example of this is Banco Solidario of Bolivia, which received large subsidies from USAID. Today it serves over 81,555 clients and boasts a loan portfolio of $74 million (Guttman 1999).

SOCIAL IMPLICATIONS OF MICROCREDIT

Beyond the empowerment of the poorest of the poor and the altruistic aspects of microfinance, there have been many studies that show direct societal benefits from microcredit. Since it is most often women who are persecuted, the social and political benefits of microcredit are as positive as the economic ones. Because of microenterprise, Kuwaiti women are slowly obtaining voting rights. "In Rwanda the government is revising discriminatory laws…[and] Cote d'Ivoire (Ivory Coast), Senegal and Tanzania recently passed laws against female genital mutilation" (Loar 2000).

Development practitioners believe the ability of poor people to break away from poverty has improved general health as well. Since the introduction of microcredit, there has been greater access to education and health care, dramatically reducing the spread of AIDS and other diseases (Roemer 2000). With children free to attend schools and not having to work, many are breaking the cycle of poverty that has haunted their families for generations. Studies show there is a significant statistical increase in the number of both boys and girls that attend school when their parents receive microcredit (Khandker 1998). Health care, which few of the poor ever received, is now a possibility for many. Nutrition levels have been shown to increase, leading to decreased disease (Khandker 1998). There are even reports of microcredit increasing voter turnout. Since 1991, The Grameen Bank

3 The United States has approximately 300 of its own microcredit institutions serving people from the Arkansas delta to inner-city Chicago (Burritt 1997).

has encouraged borrowers to vote. Today, many loan recipients are campaigning and winning elections themselves (Mann 1999).

Interestingly, studies show that microlending also helps those who are ineligible or unwilling to take loans. At the village level, when microcredit is introduced, it opens up the job market, decreasing the number of eligible workers, and thereby potentially increasing the wages of the non-self-employed (borrowers). These programs significantly increase village level production, as well as household income. Household expenditures also increase, and in one case, the use of microcredit decreased the amount of extremely poor persons in a community from 33 percent to ten percent (Khandker 1998).

THE LIMITATIONS OF MICROFINANCE

Up to this point, it may seem that microfinance is a key solution to many of the world's problems. It is not. At least, it is not if used alone. Even the most ardent supporters of microcredit admit that it is not a panacea, but rather a key element in the fight against poverty (Serageldin and Yunus 2000). In fact, many even doubt that the microcredit system is even the best alternative for helping the poorest of the poor.

One recent study examined the viability of the poorest people to use credit if given to them. It found that in general, without any land, or other assets, it was irrelevant if they were given money. Why buy a cow when there is no where to graze it? The study concluded saying that the better off the borrower is, the more effective use of the loan; while moderately poor people did well with the loan, the extremely poor, in some cases, were worse off. For these people, business failure meant bankruptcy, seizure of assets, and in a few cases, suicide due to peer pressure (Hulme and Mosely 1996). Another study found that many microfinance organizations slowly moved away from helping the poorest people to helping those only moderately poor (Tomlinson 1995).

Often, what benefits the poorest even more than credit is the opportunity to save. Traditionally, this is not guaranteed because of the formal business practices of most banks. Informal savings accounts are especially valuable to the poor because it gives them a place to put their money. For many poor, illiteracy and other issues keep them from creating a savings account at a formal banking institution. A great example of these informal accounts is Bank Rakyat Indonesia (BRI). In December of 1993, BRI had $2.1 billion in individual savings accounts, by December 1995, there was over $14.5 million in fully accessible savings accounts (Robinson 1994). Some microfinance institutions, such as Grameen Bank, mandate savings as a precondition to receiving a loan (Khandker 1998).

Finally, about eight percent of the poorest people in the world live in developed countries. Many of these countries, including the United States, have experimented with microfinance. In general, the U.S. does not possess key empirical aspects that would make microcredit work. First, a majority of its workforce is not self-employed. Developing countries have a very large amount of people that are self-employed, while developed states tend to larger service sectors. Second, rules regarding banking and lending eliminate the possibility of an informal economy. Without this informality, the poorest people in developing countries are dependent (or at least more dependent) upon others to fully understand the ramifications of their actions. Third, in the developing world, the main deterrent for most people is a lack of credit. In the U.S., just about anyone can get a loan. Even if one cannot, the primary issue is typically not money but a lack of skills (Buntin 1997).

There are examples of microcredit in the U.S., many of which have failed. One example of this is the Good Faith Fund, which was established to function like the Grameen Bank. While two million people joined the Grameen Bank, just fifty joined Good Faith Fund (one of the first microcredit funds in the U.S.); and while the Grameen Bank had a two percent default rate, the Good Faith Fund had a 40 percent default rate (Buntin 1997).

CONCLUSIONS

Microcredit, as a concept, is perhaps the most exciting concept in applied international development in the last 30 years. Within the context of the neo-liberal agenda, microfinancing fits in perfectly with globalization while maintaining the flexibility necessary to make it feasible anywhere in the developing world.

However, while it is very promising, microfinance has limitations, and is not the cure-all for poverty. Incorporating different types of aid, in the form of training, access to land, and technology all depend greatly on the public sector. Microfinance institutions show the best results when they work hand in hand with governments, both developed and developing (United Nations 1998). Still, with organizations like USAID giving a larger percent of its budget to microcredit programs, while maintaining others, international development aid is going the right direction.

The most valuable aspect of microcredit monies, as a form of aid, is that they go directly to the people that need them. There is an effective system of loan repayment, usually resulting in a higher ratio than exists with commercial banks. This happens because the people receiving the loans feel a sense of control over their own lives, and are given a form of social power. Additionally, the ability of microfinance institutions to acculturate and become sustainable is essential to helping the people served.

Although microcredit may not reach the poorest of the poor, it does help alleviate the plight of many moderately poor people in the developing world. Stories like Rajamma's are not uncommon in the halls of Grameen Bank or the BRI. In addition, the social benefits of microcredit extend beyond just those who borrow into the entire community. Microcredit is an essential tool in the continued development of the world. It is the most effective way developed nations can create profitable aid programs, and give directly to those who need it most. Unlike many other development programs, microcredit is not giving a handout, but rather, it is giving a hand up to millions of the world's poor.

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