Microfinance and Poverty Alleviation

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Abstract: The paper discusses the rudiments of what has become known as the microfinance industry, prominently including microloans. It seeks to define with some measure of precision what a microloan is, which turns out not to be quite as straightforward as one might imagine. It attempts, further, to explain the benefits of microloans to the poor and the indigent in both developing and developed countries; and finally to describe some of the problems that have beset the industry. It is argued that, while there is corruption in the microfinance industry, as there is in the finance industry in general, this is not a sufficient reason to discard the basic and essential idea.

In the last couple of decades the microfinance industry has appeared and grown, bringing with it the prospect of significantly alleviating poverty both in developing countries and in poor, rural areas of developed countries. The present paper seeks to address and answer 3 central questions: (i) What is microfinance (and what are the associated microloans)? (ii) What is the benefit of microfinance and microloans? And (iii) What are the chief obstacles standing in the way of more widespread use of these effective tools to alleviate poverty? Through answering these 3 questions support will be provided for the paper’s central thesis: That microfinance and microloans are some of the most effective extant means of alleviated poverty, and ought therefore to be developed and supported more widely, in increasing areas in which poverty and hunger are prevalent.

What is microfinance (and what is a microloan)? Microfinance may be provisionally defined as the provision of financial service to those who are for whatever reason unable to avail themselves of institutional financial sources and programs. This definition is slightly too broad, however, in that it applies to those who provide loans (for example) at extraordinarily high rates of interest. (A parallel in the West would be ‘Payday Loan’ operations and associated entities, which prey upon the poor and the indigent.) These loans target the poor, but they also exploit them by charges interest rates that no one who had any alternative means of accessing capital would think of paying. Therefore, we may say that microfinance and microloans are not only institutions that seek to make their services available to the poor, but also do not seek to exploit the poor—they offer loans and other banking services that charge reasonable interest and other rates to people who for whatever reason do not have access to more traditional (macro-) financial and loan institutions. Microfinance companies may or may not be geared toward making a profit, but even those that are so oriented charge interest rates that are reasonable and often affordable for those in need of microloans. A useful and largely accurate definition of microfinance and microloans is therefore this: They are financial objects that are made available in a non-predatory way to the poor, who cannot avail themselves of more traditional institutions.

The second question is why microfinance and microloans are important. What has already been said may be sufficient to answer this question, but we can say something more specific. Now it used to be contended that the practice of making small loans to the poor simply did not make any sense. Some of the reasons offered were that the poor are not credit-worthy, and that they are unable to provide insurance against risk. We now know differently. As two researchers have put it, That these assumptions are wholly unfounded has by now been demonstrated time and again by empirical research on informal financial markets and risk-coping behavior of households.

Let us take for example a poor agriculturist who aspires to little more than to provide sufficient food and other necessities of life for his or her family. There are 3 central reasons that such a person might be greatly benefited by, for example, a microloan—beyond the aforementioned fact that a traditional macro-loan will not likely be available in such a situation. First, agriculture is inevitably, at least to some degree, seasonal. Perhaps the poor person in question provides readily enough for those who depend upon him or her during the favorable season. But to make it through the non-favorable season may require a small influx of capital, at a reasonable interest rate, that only a microloan can provide. Second, the poor and indigent, by virtue of the very nature of their predicament, cannot easily manage
occasional and inevitable crises—whether they be ill-health, a poor crop, or damage done to the relevant domicile by the elements. Microloans can provide precisely the sort of short-term economic relief that such unfortunate situations call for. Third, it is not infrequently the case that a poor person has the knowledge and skills to make a decent living, but lacks the ‘start-up’ capital necessary to launch the relevant operation—something that might be as simple and relatively cheap as buying seeds to plant and from which later to harvest. A microloan is ideally suited to such a situation.

While there is nearly universal agreement that the availability of microfinance can help to alleviate the sufferings of the poor, there is not nearly so much agreement upon how best to set-up and operate a micro-financial operation, on one hand, and what are the chief difficulties standing in the way of making the availability of such operations more nearly universally available. But the literature does offer some useful suggestions concerning each of these sub-questions. Concerning the first, a valuable recent study emphasizes four general points concerning the optimal development and maintenance of a micro-financial operation. The authors of the study prescind from concern with any actual country that can benefit from microloans, and make points that are by-and-large valid across countries and economies.

The first general point is that a microfinance institution can usefully broaden its resource base by “mobilizing savings, accessing capital markers, loan funds and effective institutional development support” (Vetrivel and Kumarmangalam 2010, 436). The key point here is not merely that some actual way must be found to make available funds for microloans, but also that diversity of holdings and structure can benefit a micro-financial institution (whether free-standing or incorporated into a traditional bank or other financial institution). Second, savings facilities are a necessary part of any viable micro-financial institution. Whether or not the poor are able to save, mobilization of savings has the benefit of making relevant financial institutions answerable to its shareholders (ibid.). Third, there are several essential elements to successful mobilization of a relevant savings base—positive rate of return, convenience of location, security, and liquidity. And finally, fourth, successful Non-Governmental Organizations (NGOs) and community banks tend to provide their viability and profitability prior to their involvement in micro-financial transactions (Vetrivel and Kumarmangalam 2010, 438). Obviously this point applies only to non-free-standing micro-financial institutions.

Our final question, and arguably the most pressing one at the moment, is what barriers currently stand in the way of making micro-financial options available to the poor of developed and developing countries around the world? One obvious problem is that even if for-profit micro-lending institutions are able to turn a profit, they are not—and arguably will never be—hugely profitable endeavors. Indeed, some have argued that microloans are bad for the growth of local economies (Emerson and McGough 2010). For this reason and others it makes more sense to view micro-lending as a charitable service, or as a potential part of aid-packages that are provided to developing countries.

Similarly, it is not obviously to the point to argue that corruption, cover-ups, and a lack of transparency characterize much of today’s micro-lending enterprises (Sinclair 2012). No doubt this is true, but it is also true of the traditional banking industry. At most this point serves as a warning not antecedently to assume that all those involved in micro-lending and microfinance are motivated by altruism and good-will. [Surowiecki (2008) provides some valuable detail on these points, both critical and constructive.]

India is one of the countries that possesses the most experience with micro-lending. The National Bank for Agriculture and Rural Development (NABARD) has set up many Micro Finance Institutions (MFIs) in India, and some genuine problems have been reported. One is similar to the corruption charge mentioned just above, which is that some MFIs end up misusing their government-allocated funds, and indeed exploiting the people that they are supposed to be helping. The collection methods of those who issue microloans are sometimes inhumane, featuring intimidation, abuse and even (emotional and physical) torture. There is also sometimes a vicious cycle which occurs, wherein a person borrows a certain amount of money from one MFI, and then takes out a second loan from another MFI to pay the first one. Some MFIs have also been accused of violating the spirit of micro-lending, by charging exorbitant interest rates (microlan.in 2011).

However, by the admission of the same reporting agency which records these problems, they are not insuperable, nor are they a necessary concomitant of the administration of microloans in general. What they point to is the need for supervision of the industry, which would presumably be conducted by NABARD or a related governmental entity: “What these problems
highlight is the need of monitoring of MFIs. There are a huge number of good MFIs who have been working in this field with commendable success” (ibid.). A final problem to be mentioned is that the growth of microfinance has prompted some traditional banks to try to capture some of the profits to be made in the industry, with results that are not always positive for those in need (Gokhale 2009).

In conclusion, microloans are by definition the non-predatory lending of small amounts of money to the poor, usually loans that are taken out to help to provide the bare necessities of life. They are important because the poor often have no access to traditional financial institutions, and because microloans can provide a poor person with a much needed financial safety net, as well as providing some start-up money for a modest business. While there are certainly problems with some of the details of MFIs, and related organizations, they pale in significance to the fact that microloans offer many among the poor as the only realistic chance to avoid hunger, homelessness, and other privations.

References:


