

## **Discuss the benefits and detriments of micro finance in emerging markets.**

First Prize – 1<sup>st</sup> Year Undergraduate Category

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### **Introduction**

In recent years microfinance has been heralded as the development Holy Grail, providing a growth path for emerging markets that is both sustainable and progressive. The basic idea is that the provision of financial services to the millions of people in developing countries who are currently without access will empower these people to create jobs and services thus lifting themselves out of poverty and becoming incorporated into the economies of emerging markets. Microfinance can occur in three forms: microcredit, micro-insurance and micro-savings. For the purposes of this essay I will focus solely on microcredit as the other two forms are substantially less prevalent in emerging markets and as such play only minor roles in the debate surrounding microfinance. Three of the main alleged benefits of microfinance in emerging markets will be discussed firstly: poverty reduction, the ability to become self-sustaining and the empowerment of women. The aim of this essay is to argue that none of these supposed benefits stand up to the evidence and in fact microfinance has on aggregate had detrimental effects in emerging markets.

### **Poverty reduction**

The reduction of poverty in emerging markets is an important step towards their continued economic development. Poverty prevents labour being utilised efficiently and therefore the reduction of poverty brings with it a more efficient utilisation of one of the key factors of

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production, thus leading to long term economic development and growth. Microfinance reduces poverty by allowing the poor to start or expand income-generating microenterprises such as a stall selling fruit or handmade clothing (Johnson and Rogaly, 1997: 11). These income generating microenterprises provide the poor with a regular source of income which they would otherwise be without. This income creation effect lifts the poor out of poverty thus producing positive effects in emerging markets. However this is based on the assumption that microfinance is used for the purposes on income-generating activities. This assumption is brought into question by studies such as the one undertaken by Aminur Rahman which found that up to 70 per cent of the microloans sampled were used not for the creation or expansion of microenterprises but for other uses such as consumption (Rahman, 1999: 106). Such findings seriously undermine the argument that microfinance provides a sustainable path out of poverty for the poor in emerging markets.

### **A self-sustaining development policy**

Prior to the rise of microfinance there had been a greater emphasis on aid as a development policy. There is rarely, if ever at all, any return on aid spending so more and more funding is continually required to keep aid programmes going. A reliance on foreign aid is often said to have been one of the major barriers to development in emerging markets (Asante, 1985: 265) and therefore if microfinance is able to minimise such reliance then it provides a clear benefit in emerging markets. One of the main reasons microfinance gained popularity in the international development sector was its alleged ability to become self-sustaining. The argument was that once microfinance institutions received their initial start-up capital they could then use the microcredit repayments to fund further loans and running costs. This assumes of course high repayment rates and the ability for microfinance institutions to lend at interest rates which cover their costs. These assumptions have proven to be optimistic at best, leading to the situation where 'of the 10,000 MFIs currently estimated to be operating in the world, only 3-5 per cent will become financially self-sustaining.' (Bateman, 2010: 59). With such low proportions of microfinance institutions estimated to become self-sustaining the argument that microfinance is a benefit to emerging markets is again undermined.

### **Women's empowerment**

Women have often been the subject of discrimination and marginalisation in developing countries. This means that potentially up to half the labour force is not being properly utilised which is an inefficient use of valuable factors of production. This will consequently have negative consequences for the prospects of economic growth in emerging markets. Many microfinance institutions prioritise women as clients because they believe them to produce higher repayment rates, spend the loan more efficiently and are more likely to share the benefits with their families and communities. This prioritisation is said to empower women to be liberated from male dominance (Faraizi, Rahman and McAllister, 2011: 10) through their ability to gain financial independence and increased social standing. This has been regarded as one of the most significant and important benefits of microfinance in emerging markets as evidenced by the press release for the 2006 Nobel Prize won by Muhammad Yunus and Grameen Bank for their work on microfinance which stated that “Micro-credit has proved to be an important liberating force in societies where women in particular have to struggle against repressive social and economic conditions. Economic growth and political democracy can not achieve their full potential unless the female half of humanity participates on an equal footing with the male.” (Nobel Prize, 2006).

However it has been proven that women often lose control of the loan to their husbands but nevertheless retain responsibility for its repayment (Goetz and Sen Gupta, 1996: 55) thus their microloans do not become sources of empowerment but rather act so as to further marginalise and disadvantage the recipients. Worse still evidence has emerged that social violence and public humiliation have been used in Bangladesh against women who have been unable to keep up with repayments (Karim, 2008), further calling into question just how much of a benefit microfinance has been for women in emerging markets. This point is well summarised by Linda Mayoux when she states “Unless microfinance is conceived as part of a broader strategy for transformation of gender inequality, it risks becoming yet one more means of shifting the costs and responsibilities for development onto very poor women’ (Mayoux, 2002: 80). Thus in theory microfinance does appear to be able to offer empowerment to women in the developing world, however upon analysis of the evidence it appears that it has not been the case in reality. In fact in some cases microfinance has actually been shown to actively disempower women leading to a less efficient utilisation of a valuable resource (human capital/labour) in emerging markets.

## Displacement

Displacement effects occur when jobs and incomes in non-client microenterprises (the individuals and firms not receiving microfinance) are negatively impacted upon as a result of the entrance into the market of client microenterprises (the individuals and firms receiving microfinance). There are two main reasons for this. The first is that market entry or firm expansion may only be achieved through the reduction in market share previously held by the incumbent firm(s). The second is that market entry or firm expansion will lead to downward pressure on prices and wages caused by increased supply.

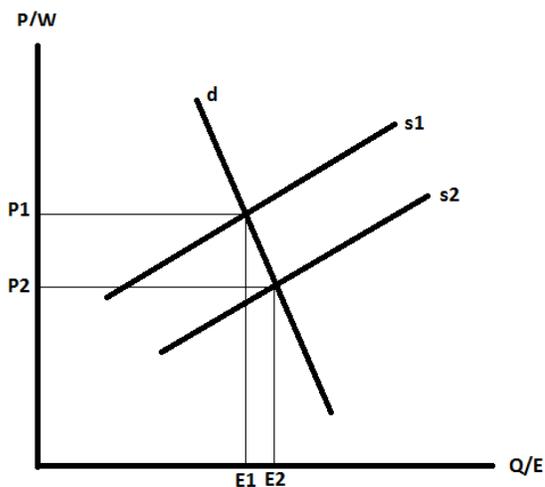


Figure 1: Response to an increase in supply of microenterprises

Figure 1 shows the response to an increase in supply of microenterprises. Here demand is assumed to be relatively price inelastic. The demand for the kind of goods or services produced by microenterprises (e.g. hairdressing) in emerging markets is not likely to fluctuate much in relation to small changes in the price of those goods or services. As a result of the increase in supply from s1 to s2 employment and output have increased slightly from E1 to E2 however that has been more than offset by a much larger decrease in prices and wages from P1 to P2. Here it is obvious that the increase in supply of microenterprises has had no overall positive effect due to the large downward pressure it has caused on wages.

The majority of the supposed benefits of microfinance in emerging markets rest on the assumption that there are no significant displacement effects, however there is evidence to suggest otherwise. In *Planet of Slums* Mike Davis argues that the doubling in supply of microenterprises in Latin America during the 1980s and 1990s was matched with significant increases in poverty and deprivation and that the explanation for this was that 'space for new entrants is provided only by a diminution (sic) of per capita earning capacities and/or by the intensification of labor despite declining marginal returns.' (Davis, 2006: 182). Thus microfinance does not increase overall levels of output or employment but rather redistributes existing levels between new entrants and incumbents resulting in lower incomes across the board which is only going to entrench poverty resulting in a detriment to emerging markets. The microfinance industry can be seen to have fallen victim to the 'fallacy of composition' flaw in that it 'is wrongly inferring that something is true of the whole – microfinance must create additional jobs and incomes in the community – based on the fact that it is true for part of the whole – microfinance can create additional jobs and incomes in one client microfinance.' (Bateman, 2010: 66).

### **Economies of scale**

A crucial factor in sustainable economic development is for firms to realise economies of scale, which is the reduction in unit costs resulting from increased output. This ensures low cost production and vitally the ability to accumulate a surplus which can then be used for the purposes of investment. Microfinance is predominantly used to fund the creation or small scale expansion of microenterprises which inherently are too small to reach minimum efficient scale. An example of this is the agriculture sector which has traditionally been regarded as an important source of development in emerging markets. The types of firm which are best able to reach minimum efficient scale have been said to be small family farms (Pretty, 1999), however microfinance is of no use to these types of firms as the amounts available to borrow are insufficient for their needs and more aimed at smaller scale producers who are less able to realise economies of scale. Thus a focus on microfinance, as opposed to a focus on providing funds to SMEs more capable of realising economies of scale can be seen as a barrier to sustainable development in emerging markets.

**Informalisation**

The microfinance model channels funding to the informal sector: the part of the economy that is not taxed or monitored by government due to its activities taking place on a small, informal scale. With the massive expansion of microfinance has come the expansion of the informal sector in emerging markets. This process of informalisation allows informal firms, who do not have to pay tax or comply with industry and employment legislation, to gain a cost advantage over formal firms who do have to pay tax and comply with relevant legislation. This allows the informal firms to compete artificially despite operating on a much less efficient scale meaning that the more productive and efficient formal firms are prevented from gaining the market share they would otherwise achieve, resulting in a 'negative impact on economic growth and job creation.' (Farrell, 2004: 28).

With the expansion of the informal sector larger firms in emerging markets have been able to move away from a supply chain consisting of SMEs with unionised work forces towards a supply chain consisting of non-unionised microenterprises thus drastically reducing their production costs. They have also been able to minimise any social responsibility they owe towards their supply chains as in the informal sector there is no employment or health and safety legislation to protect the workforce (Rainnie, 1989). Thus the growth of the informal sector associated with microfinance can be seen to cause microenterprises to 'crowd out' more efficient and productive larger firms as well as reduce wages and labour rights all of which is detrimental to the prospects of sustainable growth in emerging markets.

**Industrialisation**

Development economists such as Erik Reinert have argued that one of the most significant factors behind the superior relative economic development of Western economies has been their embrace of industrialisation through the adoption of policies which encouraged industrial firms (Reinert, 2007: 57). Microfinance however in its attempts to maximise profits over short periods tends to encourage microenterprises that are engaged in simple retail operations as opposed to complex industrial firms which may be less profitable in the short term but lay the foundations for long term economic growth. This point is well made by the American economist William Baumol who argues that successful entrepreneurial activity is not necessarily conducive

to the long term health of the economy, it depends what form the entrepreneurial activity takes (Baumol, 1990: 918). This again links back to the argument mentioned earlier, made by Bateman, that the concept of microfinance as a development policy in emerging markets falls victim to the 'fallacy of composition' flaw whereby the short term success of individual microenterprises are taken to equate to long term sustainable economic growth even though it is clear that this is not the case. In fact as shown here with the example of non-industrial micro enterprises microfinance can be seen to have a detrimental effect in emerging markets through its focus on short terms profits as opposed to long term development.

### **Conclusion**

It has been shown how there is strong evidence to reject claims that microfinance has had any significant impact upon: poverty reduction, the levels of economic activity and the empowerment of women in emerging markets. In fact often the complete opposite has proven to be the case. Not only has microfinance failed to produce the benefits it promised but it can be seen to be playing an active part in the prevention of sustainable development in emerging markets. The influx of microenterprises into local markets has acted so as to displace incumbent firms resulting in downward pressure on prices and wages further entrenching poverty. Microenterprises also systematically fail to reach economies of scale and appropriate the limited finance available in emerging markets that would better be aimed at SMEs capable of achieving minimum efficient scale. The rapid expansion of the informal sector associated with the increased provision of microfinance has acted so as to subsidise inefficient firms and reduce worker's wages and employment rights. Perhaps most significantly the idea of long term sustainable development in emerging markets through the provision of microfinance forgets how Western economies became so powerful and encourages a situation where the value and benefit of industrialisation is not properly realised. Far from being the development Holy Grail microfinance has brought about a situation where emerging markets are being led away from a path of sustainable growth by microfinance providers and government institutions keen to make short term profits and provide a quick fix respectively, neither of which is good news for developing economies and emerging markets.

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