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Microfinance: A Tool for Poverty Reduction?

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Section 1. Microfinance

Introduction

Imagine living on less than US $1.00 a day. It would take two days of saving to buy a candy bar, a week of saving to buy a hot meal, and over six months of saving to pay rent on an apartment. It is hard to relate this example to developed countries, where few live in such extreme poverty; but this is reality for 1.4 billion people on the globe. When this data began to be collected in 1981, extreme poverty was pervasive in the developing world (Source: Chen & Ravallion, 2008).

Twenty-four years later the data reveal that extreme poverty has been reduced in every region of the globe. Most striking is the reduction in South and East Asia, who had the largest reductions in extreme poverty. This reduction has been the result of many factors and developmental policies implemented over the past 30 years. In 1983, a 43 year-old man from South Asia pioneered one of the most unique developmental policies.
This policy was called microfinance, and its pioneer was Muhammad Yunus. In the late 1970’s, after returning from the U.S. where he obtained his Ph.D in economics, Yunus started an organization called Grameen Bank. Back in his hometown in Bangladesh, Yunus saw the extreme poverty in his country. Yunus was angry with the formal institutions (e.g. the World Bank, commercial banks) who had failed to help his fellow citizens. Yunus believed that formal institutions “pronounced a death sentence on the poor” because they “rejected the poor as unworthy of credit,” imposing a “financial apartheid” (Yunus, 1999, p. 149). Yunus decided he would help the poor by stepping outside of the formal institutions and providing small loans without collateral to groups of 5 borrowers; this became known as the Classical Grameen model. One village bank\(^1\) (of several groups of borrowers) grew to two, and two grew to three, until Grameen Bank became one of the largest microfinance organizations in the world. Yunus classical Grameen model came to be known as “microfinance.”

Thousands of microfinance institutions sprang up around the globe, the majority modeled closely on the classical Grameen model. Morduch (1998) emphasizes that Grameen Bank is the flagship of the international microfinance movement, whose model has been replicated on four continents (pp. 2). Ironically, the very development institutions that Yunus condemned began to incorporate microfinance in their development plans. Microfinance became a formal tool for global poverty reduction.

Microfinance is an inspiring story. Started by a man from one of the poorest regions of the globe, microfinance claims to have faith in the world’s poorest and most vulnerable people. It claims that by allowing the poor an opportunity they were previously deprived, the poor can and will pull

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\(^1\) One village bank consists of several groups of borrowers.
themselves out of poverty. But does microfinance live up to its claims? This paper will analyze how has microfinance performed as a tool to reduce poverty?

**Microfinance and Poverty Reduction**

Poverty reduction was institutionalized in 1944, with the establishment of the World Bank at the birth of the Bretton Woods system. With the IMF and GATT assigned the tasks of stabilizing the world’s economy and promoting free trade in the post WW II world, the problem of poverty was delegated to the World Bank. The industrial nations felt some responsibility for the world’s poor; after all since Africa and parts of Asia, including India, had been colonies in European empires and they would need some help once they gained their independence. The strategy, with the U.S. as leader, was to bring free trade to the developing world with the hope of integrating them into the formal economy.

Since the World Bank’s earliest days attempts to reduce poverty have centered around large global organizations. Working through state governments and other formal institutions, credit was distributed to developing countries as long as they adhered to policies prescribed by the World Bank. The focus of poverty reduction from the 1950s-1980s was to integrate poor populations into the economy through better macroeconomic performance. Economists had identified the poor as part of a huge “informal” sector that remained “essentially invisible, in government plans and budgets, in economists’ models, in bankers’ portfolios, and in national policies” (Robinson, 2001, pp. 12). As onlookers observed, the attempt to reduce poverty seemed hopeless. These programs were called structural-adjustment programs, and they were highly unsuccessful. States’ loan

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3 Bretton Woods was a system of rules, institutions and procedures established to regulate the international monetary system after the end of WWII. The system was centered around the United States, the world’s premier industrial state post WWII. The International Monetary Fund and the International Bank for Reconstruction and Development (what became the World Bank) were established here.

3 Here “state” takes the political science definition of country.
repayment dropped below 50%, costs of subsidies ballooned, and much of the funds were diverted to the politically powerful. As reports of corruption surfaced and decades of aid proved fruitless, many came to believe that government assistance created dependency and that aid was doing little to help communities (Murduch, 1999, pp. 1569-70, Diop et al., 2007, pp. 36). If such grand global organizations and state governments could not “solve” the poverty problem, then what was to be done?

Microfinance emerged at the beginning of a shift in development thinking. This shift mirrored change in economic thought at the time. The movement that brought Thatcher and Reagan to power promoted free market solutions and a general distrust in formal institutions. The ideological pendulum had shifted to the right providing an opening for microfinance. With microfinance at the helm, focus moved toward the fostering and support of the “informal” sector, in hopes that a helping hand would allow people to essentially pull themselves above the poverty line.

As Robinson (2001) explains:

> Until the 1980s the presence of informal microenterprises—street vendors, home workshops, market stalls, providers of informal transportation services—was generally perceived by policymakers and economists to be a result of economic dysfunction. Microenterprises were thought of as little more than an indicator that the structure and growth rate of the formal economy were inadequate to absorb the national labor force, and so were perceived as a disguised form of unemployment (pp 11).

Microfinance supported these informal microenterprises through microcredit. The microcredit approach to poverty reduction is “the provision of small loans to individuals, usually within groups, as capital investment to enable income generation through self-employment” (Weber, 2006, pp. 50).
The poor’s businesses were now seen as a symbol of unmet demand for credit. Poverty was now thought to be the result of market failure:

…Market imperfections, asymmetric information and the high fixed costs of small-scale lending, limit the access of the poor to formal finance, thus pushing the poor to the informal financial sector or to the extreme case of financial exclusion. In addition, it is argued that improving the access of the poor to financial services enables these agents to build up productive assets and enhance their productivity and potential for sustainable livelihoods.

(Green, Kirkpatrick, & Murinde, 2006)

Microfinance would correct the market failure, providing access to credit to the poor. Credit would create economic power that would generate into social power, lifting the poor out of poverty (Yunus, 1999, p. 150).

In 2008 it was estimated that there were 2,420 microfinance institutions (MFIs), representing 99 million borrowers in 117 countries (Gonzalez, 2008). Many of these programs did not require collateral, reported loan repayment rates above 95 percent, and reached poor individuals who had formerly been difficult to reach. As Velasco and Marconi (2004) describe:

Microfinance performs a conjuring-trick: it achieves higher rates of loan repayment than conventional banking, without having access to the collateral which conventional banks employ to protect their loan portfolio. It performs this trick through constructing social relationships, which substitute for collateral by putting pressure on the borrower to repay loans. These relationships may be either group-based (in which case peer pressure within the group is an important element in pressure to repay) or individual-based, in which case the pressure comes from loan officers and in some cases mentors and others within the client’s community (pp. 521). Microfinance appeared as a fresh solution to an old problem. It appeared to be a “win-win”
situation, where both financial institutions and poor clients profit. The “win-win” appearance of microfinance created unparalleled excitement in the world of economic development.

In 1997, Yunus helped organize the first international Microcredit Summit. At the conference 137 countries were represented and they agreed to build will, build capacity, and end poverty in the world (Yunus, 1999, p. 256, 259). In the Summit’s Declaration (co-written by Yunus), the message is clear:

Microfinance, as a part of a much larger effort to end poverty, will provide “microfinance services, specifically credit for self-employment and savings capabilities” and shall focus on the world’s poorest people. Women’s access should be prioritized, as they are “very adept at saving, highly creative entrepreneurs, and consistent in ensuring that earnings go directly to meeting family needs.” Microfinance is an important tool for sustainable social and economic progress, and a key strategy in ending poverty (“Declaration”, 1997) (Yunus, 1997, pp. 256).

The goals of the movement were further refined when the Microcredit Summit Campaign established four core themes: reaching the poorest, ensuring a positive measurable impact on the lives of clients and their families, building financially self-sufficient institutions, and reaching and empowering women (Daley-Harris, 2002). These are the goals of the microfinance movement, first established at the Summit, and later refined in the four core themes.

This paper will analyze microfinance in terms of how well it achieved its own goals: to reach the poorest populations, to ensure a positive measurable impact on the lives of clients and their families, to build financially self-sufficient institutions, and to reach and empower women.
Section 2. The Goals

**Goal 1: Targeting the Poor**

In microfinance, there is debate about whether institutions should target simply the “poor” or the “poorest” segments of the population. The poor are those who live below the poverty line established by each country, and the poorest are those in the bottom fifty percent of that group (“Declaration…”, 1997)

Although there is a consensus that microfinance should target the poor, there are different schools of thought on who should be targeted; essentially, should the poorest or the poor be targeted? The first school of thought believes that microfinance should target the poor, those closer to the poverty line. Since the poor are most likely to have income-generating activities, their loans are theoretically more likely to lead to the creation of jobs in the local community, and benefits will trickle down to the poorest. In this case, financial efficiency is a goal because it allows the MFI to expand its financial services, reducing poverty on a larger scale. The second school of thought criticizes this strategy because “redistribution by the creation of jobs or consumption does not necessarily benefit the poorest” (Diop, Hillenkamp & Servet, 2007, pp. 33). This second school prefers MFIs to target the poorest directly, no matter how costly. The theory behind targeting the poorest is that the inability to invest is the principal block to productive activity. Increasing productivity in turn increases income, enabling the borrower not only to repay the loan and interest, but also to save. Some methods for targeting the poorest have been to target women because they are generally poorer than men, or to target rural populations because they are generally poorer than urban areas. Diop et al. (2007) argue that these methods are insufficient because the poorest can only be
identified through in-depth local knowledge. If MFIs wish to target the poor, they have to employ staff with good local knowledge (pp. 35).

Other studies question the ability of microfinance to effectively reach clients significantly below the poverty line or suggest that poverty impacts may be greater for non-poor than for poor clients (Hulme and Mosley, 1996; Mosley and Rock, 2004; Chowdhury, Mosley, & Simanowitz, 2004). As a result of the difficulty in making a distinction between the poorest and the poor, however, most academic studies discuss only microfinance as it affects the poor versus the non-poor: those below the poverty line and those above it.

Clients of microfinance tend to be hunched around the poverty line, rather than below it (Hulme and Mosley, 1996; Copestake, Bhalotra, & Johnson, 2001, pp. 85). In addition to not reaching the poorest, the benefits of microfinance correlate positively with income. For example, Kochar (2011) finds that a government program in India with the goal of increasing the availability of capital to the poorest regions of India “had a larger effect on the per capita expenditure of the nonpoor than on the poor” (pp. 278).

Why are the poorest least likely to benefit from microfinance? One possibility is that some MFIs may not even think about the poorest of the poor when defining their eligibility standards, placing bias in the design and management of MFIs toward better-off clients at fault. A second possibility is that the standard model of microfinance is simply inherently incapable of reaching the very poor. A third possibility is that other institutions may simply not succeed in gaining the poorest clients because of problems of self-exclusion, or lack of sustainability of their participation (Diop et al., 2007, Chowdhury et al., 2004).

The literature has shown that the poorest are least likely to benefit from microfinance. Since
microfinance participants number in the hundreds of thousands, however, and it is important to analyze the benefits and/or consequences of participation.

**Goal 2: Provide a Positive Measurable Impact**

Microfinance has been promoted as a tool to reduce poverty. It has been argued that microfinance will achieve this by promoting productive activity, spurring self-employment and income generating activity. This is predicted to spur consumption, stimulating local economies and reducing general poverty reduction both in the household and in the community. Based upon this argument, the first logical assessment is to analyze the impact of microfinance on borrower income.

**Increasing Income Through Self-Employment**

The first impact assessments of microfinance attempted to measure the causal impact of microfinance on borrowers’ income. Calculating these effects is challenging, as researchers face obstacles such as non-random program placement, client selection and self-selection, and attrition.\(^4\) Armendáriz & Morduch (2005) provide an example of this. They explain that, microfinance may make households wealthier, yielding an “income effect” that should push up total consumption levels and, holding all else the same, increase the demand for children, health, children’s education, and leisure. But, they state, running microenterprises may also take time, yielding “substitution effects” that may counterbalance the effects of increased income (pp. 201). For example, if a borrower has to devote more time to their microenterprise, s/he may choose to keep their children at home to help with the business instead of sending them to school.

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\(^4\) For an in-depth analysis of methods and types of data used in attempts to overcome these problems, see Armendáriz & Morduch (2005, pp. 203-224) where literatures that address selection bias, attrition bias, using longitudinal data, quasi-experiments, cross-sectional data, and full panel data are reviewed and critiqued.
The very first impact assessments of microfinance argued that loans to the poor do generally raise incomes (Hulme and Mosley, 1996; Khandker and Pitt, 1996; Khandker and Pitt, 1998).

The most cited and noted studies on the impact of microcredit come from Pitt and Khandker. The first few works of Pitt and Khandker center around data from the most extensive surveys conducted and attempt to assess the impact of microfinance on borrowers. The 1991/92 and 1998/99 surveys were collected from households in 87 villages of 29 randomly-selected thanas (subdistricts) in rural Bangladesh. The authors argue the credit is a significant determinant of household behavior and that credit increases total per capita consumption of the poor and the asset holdings of women (Pitt and Khandker, 1996, pp. 42). Estimating the impact of participation by gender, they find that “annual household consumption expenditure increases 18 taka for every 100 additional taka borrowed by women from these credit programs, compared with 11 taka for men” (Pitt and Khandker, 1998, pp. 988). Their main argument is that participation in microfinance program increases consumption, which they believe is the first step in the cycle out of poverty predicted by Yunus.

Khandker (2001) judges whether the World Bank’s 1996 investment of $115 million in a Bangladesh microfinance project was a good decision in spite of the fact that less than 5 percent of borrowers lift themselves out of poverty each year” (Khandker, 2001, pp. 5). Khandker finds that “microfinance participants do better than non-participants in both time periods in per capita income, per capita expenditure, and household net worth. The incidence of poverty among participating households is lower in 1998/99 than in 1991/92, and lower than among non-participating households in both periods” (Khandker, 2001, pp. 11). He argues that easy loan repayment terms help the poor by leveling off consumption, by building assets and net worth, and by helping the

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5 The 1998/99 follow-up survey revisited all 1,798 households and added 17 new villages to allow comparison of program impacts between old and new program villages.
6 The World Bank also invested $160 million in 2000.
7 This is less than one percent of the population.
unemployed to become self-employed (Khandker, 2001, pp. 4). Microfinance, he states, is not to blame for the high incidence of poverty; it is an instrument among a large number of poverty reduction strategies.

Pitt and Khandker (2001) analyze whether the effects of microcredit programs are sustainable over time. They found that household welfare is increased in terms of net worth and per capita consumption, but effects are much larger for female borrowers. They also found that the labor supply of both men and women is increased by microfinance, supporting the view that programs generate employment. In terms of credit, they found the potential for borrowers to experience diminishing returns to consumption; in other words, each new loan has a smaller effect on per capita consumption (Pitt and Khandker, 2001). Khandker (attributes the lower rate of poverty reduction among program participants\textsuperscript{8} to: (1) diminishing returns to additional borrowing that meant increases in consumption were not large enough to reduce poverty; and (2) better economic conditions which lowered the gains in real consumption (Khandker, 2005, pp. 285). Despite these factors, Khandker argues that microfinance accounts for more than half of the observed annual reduction in poverty among participants and that there was growth in local income. The “average village poverty level [fell] by 1 percentage point each year” and, “microfinance continues to reduce poverty among poor borrowers and within the local economy, albeit at a lower rate” (Khandker, 2005, pp. 285).

Pitt and Khandker’s findings center around increases in consumption among borrowers, which they predict will lead to increased income, then to job creation, and finally to poverty reduction. They acknowledge the potential for microfinance to be less effective over time, but emphasize the importance of microfinance as a poverty reduction tool and its potential for empowering women.

\textsuperscript{8} A three percent decrease from 1991/92-1998/99.
Morduch & Roodman, the premier respondent/evaluator of the previously mentioned studies, believe it is critical to evaluate Pitt and Khandker’s studies because their analyses remain the most-noted studies on the impact of microcredit on households (Morduch & Roodman, 2009).

Morduch (1998) refutes Pitt and Khandker’s main argument, stating, “borrowers’ self-employment activities rarely generates jobs for others” and “…no evidence was found to support claims that the programs increase consumption levels” (Morduch, 1999, pp. 1610; 1998, pp. 30). Morduch does agree with Pitt and Khandker’s assertion that microfinance provides consumption-smoothing effects. Consumption smoothing means that although neither consumption nor income may increase, borrowers have a better balance of spending and saving during different seasons of the year. Since the poor are highly susceptible to seasonal changes, consumption-smoothing allows them to better withstand economic shocks such as natural disasters, health care costs etc. Importantly, “benefits from risk reduction may be as important (or more important) than direct impacts on average levels of consumption” (Morduch, 1999, pp. 1606).

Morduch and Roodman (2009)’s replication of Pitt and Khandker (1998), Khandker (2005) and Morduch (1998) concludes that the positive results in all three works are questionable. The instrumentation strategy used in analysis is failing, they argue, and that there is little solid evidence that microfinance improves the lives of clients in measurable ways. Pitt and Khandker prominently reinforced three broad ideas about microfinance: “that it is effective in reducing poverty generally, that this is especially so when women do the borrowing, and that the extremely poor benefit most” (Morduch and Roodman, 2009, pp. 39). Decisive statistical evidence in favor of

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9 Due to their employment in and/or dependence upon agriculture.

10 Morduch and Roodman (2009) generate results opposite in sign to PK (1998), and with regard to Khandker (2005), they find that the methods do not compensate “for the lack of clearly exogenous variation in the treatment variable” (pp. 3). They conclude, “when studying causality in social systems with strong endogeneity, claims of non-experimental identification need to be held to demanding standards” (pp. 4).
Morduch does not argue against the potential for MFIs to “make important absolute differences in the lives of borrowers, even if the relative differences are small” (Morduch, 1998, pp. 31). His concern lies with the tens of millions of dollars worth of subsidized resources supporting these programs. Morduch worries that the funds are being taken away from traditional poverty alleviation strategies and are being channeled into untested institutions. These untested institutions (MFIs) have not lived up to their promises, he argues; “high repayment rates have seldom translated into profits as advertised” and, the “win-win” rhetoric promising poverty alleviation with profits has moved far ahead of the evidence (Morduch, 1999, pp. 1572, 1609). Morduch’s main argument is that although microfinance can help households, full-scale poverty reduction requires increasing overall levels of economic growth and employment generation.

Another critique of microfinance is that microfinance loans have varying effects on micro-enterprise profits and may be used for consumption outside of the business. A study in Zambia revealed that the second loan to borrowers had a significantly positive impact on business profits whereas the first loan had no impact (Copestake et al., 2001, pp. 87). Some borrowers were made worse off, particularly among the 50 percent who left the program after receiving only one loan (Copestake et al., 2001, pp. 95). A study in Indonesia found that low-income households use loans for financing income generating activities such as small businesses only about one third of the time (Morduch, 2007). For borrowers below, above, and well above the poverty line, loans are used for

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11 Morduch and Roodman (2009) suggest that randomized trials are a form of decisive evidence and provide a short literature review of recently published randomized trials (pp. 40-41).
12 For example the Microcredit Summit’s goal to raise over $20 billion for microfinance start-ups from 1997-2007.
13 Interviews suggest that the rigid repayment schedule were linked to participants leaving the program.
other uses such as paying for school fees, medical treatment, meeting daily consumption needs, and meeting social and holiday expenses (Morduch, 2007, pp. 5). Furthermore, a study of the Bolivian textile sector founds that loans were usually used to reinforce an existing activity and not to create a new one (Diop et al., 2007, pp. 36). MFIs have admitted it is difficult to monitor the use of the loans they grant, and some MFIs do not monitor the use of their loans at all.

MFIs may serve an important role by providing consumption-smoothing effects, which stabilize income for the poor, who are highly susceptible to seasonal changes. The issue lies with the argument for microfinance as a poverty reduction tool; where loans for self-employment practices are expected to translate into an increase in productive activity and income generation. Based upon the literature, microfinance has not lived up to its promise of generating income for its borrowers through its borrowers’ micro-enterprises.

**Extending the Definition**

Microfinance may fail to generate income through self-employment, which reduces support for using microfinance as a poverty reduction tool, but the goal of ensuring “a positive measurable impact on the lives of clients and their families” is vague, and other positive impacts have been identified. We will look at two – savings and community externalities.

**Savings**

Implicit in the argument for microfinance as a tool to provide fiscal stability through consumption smoothing effects is the fact that the borrowers must store or save extra money until a time when it is needed. Morduch (2007) argues, “with savings, households can build up assets to use as
collateral, smooth seasonal consumption needs, self-insure against major shocks, and self finance investments” (pp. 16). There has been a transition toward expanded microfinance, and savings services are now seen as a means of securing savings and of encouraging the poorest to save more and more systematically (Diop et al. 2007, pp. 37). Although not established in the goals of microfinance, many MFIs have come to provide valuable savings services to their participants.

Grameen serves as an example of this transition. The classical Grameen model had mandatory savings\(^\text{14}\) that seemed “like a way for the bank to acquire relatively cheap capital and to secure a form of collateral from borrowers” (Armendáriz & Morduch, 2005, pp. 149). When Grameen came out with a new model in 2002, the savings products were more flexible and were marketed to a broader community outside of the realm of borrowers. In July 2003, “Grameen was holding deposits equal to three-quarters of its loan portfolio, allowing it to substantially reduce reliance on external financing” (pp. 150). Another example is Bank Rakyat Indonesia (BRI), the global leader in the provision of open-access and voluntary savings accounts (Armendáriz & Morduch, 2005, pp. 147). BRI actually serves more poor savers than poor borrowers, thus it is on the “savings side that BRI achieves its greatest social outreach” (Morduch, 2007a, pp. 17).

The build-up of savings can be seen as one of microfinance’s most promising contributions to reducing the vulnerability of the poor and is another tool in the antipoverty arsenal (Diop, 2007, pp. 37; Armendáriz & Morduch, 2005, pp. 148).

**Wider Impacts**

Another series of positive impacts exists in what has been termed the “wider” impacts of

\(^{14}\) For more on Grameen’s savings products see (Dowla & Barua, 2006, pp. 72-74) or (Armendariz & Morduch, 2005, pp. 149).
microfinance, shifting focus to analyzing effects on the communities and societies of the borrowers. The general argument for the wider impact of microfinance is that it generates greater social networks and a greater sense of community, which translates into accumulation of information contributing to greater political participation, education rates, and better health care. These social qualitative measures are argued to be more difficult to measure than quantitative measures and have been cited as important evidence of microfinance’s ability to reduce poverty.

In the early 2000s, an important shift in microfinance was made. Grameen and other leading microfinance organizations, such as BancoSol of Bolivia, abandoned the group-lending scheme and began to move their portfolios out of the solidarity group (joint-liability, group-lending) method to individual contracts. Diop et al. (2007) suggest that changing the system of loans may result in voluntary departures. If material collateral is required, the clients or members who are in not a position to provide it leave and it is the poorest segment of the clientele that finds itself unable to provide this collateral (Diop et al., 2007, pp. 41).

It is interesting to note that the argument for increased examination of wider impacts increased in the same time period that the new Grameen model was introduced. Khandker (2001) measures the impact on village welfare, finding “the programs have spillover effects on the local economy, but the impacts are very small” (pp. 13). In 2005 Khandker argues that microfinance accounts for more than half of the observed annual reduction in poverty among participants and that there was growth in local income, “the average village poverty level by 1 percentage point each year” (pp. 285).

Copestake et al. (2001) found that although MFI borrowers in the community indirectly harmed some of the poorest residents in the village, the injection of loan capital into the communities helped sustain the circular flow of income within the village. This likely benefited “the often very poor
consumers of goods and services provided by (MFI) participants” (Copestake et al., 2001, pp. 90). Interviews found that some participants resented the group-method and urged the MFI to switch to direct loans to individuals; but borrowers also cited benefits from group membership such as advice and information sharing. Interestingly, “the group-lending method did not lower overall screening, monitoring and enforcement costs as much as expected” and it shifted costs to clients instead (Copestake et al., 2001, pp. 91). The findings provide some support for microfinance’s shift to individual loans, but also reiterate support for routine quantitative and qualitative assessment in order to gain a better understanding of the impact of microfinance. Chowdhury et al. (2004) argue there is reason to believe that some of these ‘wider impacts’ may well be poverty-reducing, but “… not many of (the wider impacts) have not been measured” (pp. 293).

A study of six African MFIs found that “many benefits to the poor from microfinance programmes, in Africa at least, are likely to come via an indirect route, via ‘wider impacts’ or ‘spin-offs’, rather than by through direct impacts on borrowers” (Mosley and Rock, 2004, pp. 467). They argue that microfinance can reduce poverty through job creation and by the improvement of household risk management through MFI training and the building up of social networks. This improvement is said to stabilize village income, reducing the vulnerability of the poorest (Mosley and Rock, 2004, pp. 467). They also argue that microcredit enhances human capital regardless of poverty level because expenditures on education and health care are increased, “which may then extend to poor individuals through intrahousehold and inter-generational effects” (Mosley and Rock, 2004, pp. 467).
A study of BRAC’s IGVGD scheme\textsuperscript{15} found that although many borrowers experienced few improvements to their income, they spoke of improvements in autonomy and social status. For example, males and females teamed up to manage their investments after participating in the program. This was reported to build confidence, “the higher the level of participation the greater the perceived positive change in the quality of life (Halder and Mosley, 2004, pp. 404). The authors state, “the not-so-poor do better on quantitative than a qualitative methodology, whereas for the ultra-poor the story is reversed” (pp. 404).

In addition to aforementioned economic and social wider impacts, Mosley, Olejarova & Alexeeva (2004) find evidence of wider political impacts. A survey in Russia, Solvakia and Romania revealed “an influence from the provision of finance to informal political organization, beginning with the solidarity group model, but also found among individual clients” (Mosley et al., 2004, pp. 2). The authors found that some groups had come together in a struggle against local authority corruption and on average, microfinance participants were found to have a higher level of trust than the control groups. Although microfinance was not found to increase formal associational membership (in political groups), it was found to influence informal political participation. Microfinance may have the ability to: increase trust by indirect channels, to reduce corruption, and to reproduce group formation and the extension of social capital through networks. The authors suggest the potential for microfinance to minimize corruption and induce greater trust in government through political participation (Mosley et al., 2004, pp. 2-3).

Velasco and Marconi (2004) use both quantitative and qualitative data to analyze the effects of the Bolivian economic crisis on microfinance institutions in Bolivia. The authors confirmed Mosley et

\textsuperscript{15} The BRAC Income Generation for Vulnerable Group Development (IGVGD) scheme aimed to target the ultra-poor and provide human capital inputs that would allow them to start the cycle of poverty reduction.
al.’s (2004) findings of the potential benefits of groups, providing for social learning, group reproduction and group solidarity. Their main finding, however, is that ‘integrated’ institutions that provide services in addition to credit lending (e.g. training, legal, and health and educational services) were better able to exert a counter-cyclical influence on the macroeconomy. These integrated “nice guys” (as the authors call them), provide their clients with a microfinance package, whose elements are part of their clients’ coping strategies; leading to client loyalty in repayment toward the institutions that have provided these services. This is in contrast with the procyclical influence exercised by other institutions, including the Bolivan MFIs who were strictly profit focused. They note that the integrated MFI is a minority, thus their role as a macro-economic counterweight has been limited, in contrast to Indonesia’s BRI who “grew through the 1997–99 recession and was able to pull the entire macro-economy upwards” (Velasco and Marconi, 2004, pp. 525).

Authors that discuss the wider impacts of microfinance generally emphasize the importance of using both quantitative and qualitative methods to analyze MFIs. It is argued that both types of data are required to give a complete picture of the impacts of the institutions on the individuals and on their communities.17

16 “‘Group reproduction’—as when a group formed for loan monitoring and training purposes develops into a pressure group to secure better health or education, or to pursue a common political objective” (Velasco & Marconi, 2004, pp. 522).

goal three: sustainable progress through mfi fiscal sustainability

approaches to institutional lending

Microfinance’s third goal was to build financially self-sufficient institutions. This goal is consistent with what has been termed the financial systems approach to microfinance. Robinson (2001) describes:

The financial systems approach…emphasizes large-scale outreach to the economically active poor—both to borrowers who can repay microloans from household and enterprise income streams, and to savers. The financial systems approach focuses on institutional self-sufficiency because, given the scale of the demand for microfinance worldwide, this is the only possible means to meet widespread client demand for convenient, appropriate financial services (pp. 22).

There is an alternative approach to lending called the poverty lending approach:

The poverty lending approach concentrates on reducing poverty through credit, often provided together with complementary services such as skills training and the teaching of literacy and numeracy, health, nutrition, family planning, and the like. Under this approach donor- and government-funded credit is provided to poor borrowers, typically at below-market interest rates. The goal is to reach the poor, especially the extremely poor—the poorest of the poor—with credit to help overcome poverty and gain empowerment (Robinson, 2001, pp. 22).

Grameen is an example of both systems. It began as a poverty-lending program, relying largely on donor subsidies, mandatory savings, and aimed to target the poorest of the poor. In 1998 Grameen stopped receiving donor funds and in 2002, Grameen II was launched, promoting greater outreach,
and more flexible financial services such as individual loans and open savings accounts. Yunus sees the financial systems approach as a method to reach greater numbers of people. Yunus dislikes enterprises dedicated to making money (profit maximization), but promotes the use of profits as a method to build what he calls a social business:

A social business is a non-loss, non-dividend enterprise, created with the intention to do good to people, to bring positive changes to the world, without any short-term expectation of making money out of it (Yunus, 1999, pp. 265).

Yunus sees the social business as fiscally sustainable, avoiding the large portion of time and energy non-profits spend on fundraising. The appeal of fiscally sustainable institution is the possibility that MFIs can reduce poverty through the use of profits, eliminating the requirement of ongoing subsidies. The virtuous cycle of credit is being promoted on a larger, institutional scale. Weber (2006) describes, “credit is distributed, credit is invested, profits are generated by the institution, profits plus additional lending could lead to larger investments, which will in turn lead to a repetition of the credit cycle” (pp. 52). Cull, Demirgüc-Kunt & Morduch (2007) question this cycle, as it “requires translating high repayment rates into profits, a challenge that remains for most MFIs” (pp. 2).

**The Trade-Off**

MFIs must meet both financial and social goals. This is often referred to as the double bottom line, where MFIs must trade-off social performance (including poverty reduction) and financial performance (hence growth and potential future capacity) or find innovative ways to do both at once (Copestake et. al., 2005). Several express concerns over ‘mission drift’, when MFIs’ focus on

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18 It is assumed that Grameen’s goal was to become a fiscally sustainable institution, since Yunus wrote fiscal sustainability as a goal in the Summit Declaration of 1997.
financial performance causes them to drift away from their social mission, resulting in decreased social performance (Cull et al. 2009a and 2009b, Diop et al., 2007; Simanowitz, 2006; Mersland & Oystein Strom, 2008).

The concern over mission drift is closely related to the previously discussed argument of reaching the poorest versus the poor. Financially focused MFIs are more likely to reach clients well above the poverty line, a result of lowering transaction costs in order to increase profitability and the number of clients.\textsuperscript{19} Cull, Demirgüç-Kunt, and Morduch (2009b) find that when they use loan size as a proxy for the poverty of customers (smaller loans roughly imply poorer customers), microfinance banks appear to serve customers who are substantially better off than the customers of nongovernment organizations (pp. 181).

The financial systems approach implies that subsidy dependence is a bad thing. Morduch (2007b) explains, “badly designed subsidies have too often led to inefficiency, dependence, and a failure to effectively meet the needs of the poor. But economic analysis also shows that in principle, subsidies in modern microfinance can be well designed” (Morduch, 2007b, pp. 82). The reality is that much of the microfinance movement continues to take advantage of subsidies- some from donors, some from governments, and some from charities and concerned individuals.\textsuperscript{20}

Some scholars fear that MFIs lack of qualitative data may cause them to unwittingly focus on financial performance. Since MFIs have to make operational decisions, they are more likely to respond to their collected quantitative data and prioritize financial over social objectives

\textsuperscript{19} Diop et al. (2007) explain, “Three factors can explain the high cost of transactions if MFIs wish to reach the poor clientele: small loan amounts, the location of poor people and the method of joint groups” (pp. 38). Fixed costs make small loans expensive, the poor live in difficult to reach areas, and the joint liability method requires weekly meetings and regular monitoring. All of these costs generate obstacles that act as a constraint and weaken the financial performance of MFIs. The reduction of these costs would imply reaching the poor at reduced rates.

\textsuperscript{20} The Microbanking Bulletin of July 2003, for example, found that just over half of MFIs surveyed were fiscally sustainable (Morduch, 2007b, pp. 75).
(Simanowitz, 2007, pp. 67). This concern has led to a movement toward promoting the increase in assessment of social performance.\textsuperscript{21} Not surprisingly, the consensus among scholars is that MFIs must strike the appropriate balance between financial and social performance.

\textit{Profit and Interest Rates}

The financial systems approach implies a for-profit status for the MFI, while the poverty lending approach implies receiving donor subsidies. Cull et al. (2009) illustrate that differentiating between approaches is not so easy. Profit is loosely defined in the realm of microfinance, making differences between MFIs unclear. In Figure 1, it is clear that the statuses of for profit and non-profit are not as closely related to fiscal sustainability as proponents claim.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure1.png}
\caption{Figure 1}
\end{figure}

\textsuperscript{21} An example is the Imp-Act consortium, a group of twelve leading MFIs, which promotes and provides guidelines to MFIs on how to systematically measure social performance.
Figure 1 (Cull et al., 2009b) illustrates that the status of MFIs as nonprofit or for-profit does not predict fiscal sustainability or type of funding. Many for-profit MFIs are fiscally sustainable and exhibit minimal subsidy reliance, but several are not fiscally sustainable and/or receive subsidies. Although the non-profit MFIs in Figure 1 show no clear pattern, many are fiscally sustainable, and the type of funding varies dramatically. The main difference between nonprofit and for-profit is the ability to distribute profits. This means that “the microfinance industry’s drive toward profitability does not necessarily imply a drive toward ‘commercialization,’ where the latter status reflects institutions that operate as legal for-profit entities with the possibility of profit-sharing by investors” (pp. 175-176). Although for-profit institutions tend to be more fiscally sustainable, non-profits are equally likely to be fiscally sustainable.

Of the MFIs in the sample, 57% are fiscally sustainable, and they serve 87 percent of all clients (Armendáriz & Morduch, 2010, pp. 318). But as figure 2 (Cull et al., 2009b, pp. 174) illustrates, NGOs subsidy share “is disproportionately large in the sense that they serve only 51% of all borrowers,” but “their clients are considerably poorer on average than those of banks and nonbank financial institutions and the majority of NGOs (54 percent) are actually profitable” (Armendáriz & Morduch, 2010, pp. 318). Most striking is the proportion of female borrowers served by NGOs, who serve almost three quarters of the 12 million female borrowers. Figure 2 contradicts the argument for fiscal sustainability, since nonprofit status does not prohibit outreach and for-profit MFIs tend to serve wealthier clients.

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22 The banks and credit unions are for-profit, NGOs are non-profit, and non-bank financial institutions include both for-profits and nonprofits.

23 Reaching more poor comes at a cost, however, with NGOs facing higher operating costs. Consequently, NGOs accept subsidies and raise their interest rates (Cull et al. 2009b, pp. 9). NGOs tend to have higher interests rates than banks (median of 25 percent annually to bank’s 13 percent), but the increased rate reflects the increased risk and higher cost (Cull et al., 2009a, pp. 182). Commercialized MFIs, like Banco Compartimentos, have been accused of charging usurious rates of interest (90-plus percent on average). Questionable practices related to commercialization are also reflected in a recent movement made by transnational corporations, see (Schwittay, 2011, pp. S71).
Despite the existence of a trade off, advocates of one approach need not condemn the other. Morduch (2007) explains, “Borrowing for business is the most common purpose for loans from the formal sector banks, which tend to serve those clients higher above the poverty line, while loans for “household” purposes dominate loans from cooperatives and non-bank financial institutions such as MFIs (pp. 21). Although goal three of microfinance is incompatible with goal one of reaching the poorest, each approach can serve different clientele. Each approach has something valuable to offer.
Goal Four: Reach and Empower Women

This promise of microfinance to reach and empower women inspired hope because:

“The majority of the world’s poor are women. Despite the fact that women constitute approximately 50 percent of the world’s working population, and do roughly 67 percent of the world’s work, they earn only 10 percent of the world’s wages and hold 1 percent of its wealth. The type of work performed by women is similar to that performed by men, yet women share a greater burden of poverty within the household. Their work remains invisible, unpaid, and unaccounted for in studies concerned with economic development (Fernando, 2006b, pp.23-24).

Microfinance believed that providing credit to women would enhance economic power that would translate into increased social power. The provision of and access to private infrastructure, credit, and assets was argued to have the potential to reduce gender disparities and empower women.

Women’s Empowerment

Empowering women is an extremely complex and difficult matter. Jackson (2001) explains that gender inequality is a form of oppression that requires indelible marks, usually visible physical features. Women’s physical difference from men has allowed men to use violence to impose their will on women. Over time, this difference became embedded within society, so that subjugation of women became routinely accepted by both sexes without the use of force. As Vonderlack and Schreiner (2002, p. 607) explain, “Within a household, violence or its threat is often still a central way by which individual men assert authority over individual women. A central privilege of husbands is to make wives do difficult, boring, unrewarding, or unglamorous work.” This has become embedded in the state’s institutions:

For women who might resist drudge work and domestic violence, a series of penalties and impediments may make no marriage worse than a bad marriage. For example, in some countries,
the assets of a couple are legally the property of the husband. Girls typically receive less education than boys. If a woman leaves a marriage or never enters one, then she may be at a severe disadvantage in the labor market. In short, women are systematically stripped of human capital and other assets, and this discourages resistance to unpleasant tasks or exit from bad marriages (Vonderlack & Schreiner, p. 608).

The subjugation of women is culturally *embedded* within a society.

The concept of empowerment is a dynamic subject whose definition has evolved over the years. Today when one thinks of empowerment it is thought of as both a process and an outcome. Empowerment is “power” as control over material assets, intellectual resources, and ideology, and is the action of challenging existing power relations and gaining greater control over power sources 24 (Datta & Kornber, 2002, p. 2). Empowerment of women requires not only access and control of material resources, but also challenging culturally embedded ideology and practices.

Advocates of microfinance are quick to make the leap from economic to social power (e.g. Yunus). Pitt and Khandker (1996, 1998) and Khandker (2001, 2005) argue that household welfare increases in terms of net worth and per capita consumption, with larger effects for female borrowers. Pitt and Khandker (1998) find that microfinance credit has a larger effect on the behavior of poor households when women are the program participants as, “annual household consumption expenditure increases 18 taka 25 for every 100 additional taka borrowed by women from these credit programs, compared with 11 taka for men” (p. 988). The authors use this and other evidence as support for the argument that women should be targeted as borrowers and believe women will be empowered via increasing their contribution to household consumption expenditure, hours devoted

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25 Bangladesh currency.
to production for the market, and the value of their assets. Nallari and Griffith (2011) argue that “Access to finance and credit empowers women. This empowerment is manifest in the form of increased earning capacity and control of household assets, resulting in greater autonomy and decision making within the household”\(^{26}\) (p. 127). They also state, “Increased gender equality in households, markets, and society increases women’s access to markets, education, and health and gives them greater control over decision-making in the household” (p. 126). Empowerment through access to credit only occurs if everything else is held constant, but “of course, not all else is constant” as “the mere receipt of loans need not empower women financially or socially”\(^{27}\) (Vonderluck & Schreiner, 2002, p. 608). Access to credit does not automatically translate into positive changes in financial or social circumstances. There is a general consensus among scholars that microfinance does not necessarily increase consumption or income, and that microfinance does have consumption-smoothing effects (Armendáriz & Morduch, 2005; Morduch, 2007). Scholars have begun to actively promote savings because they believe the provision of savings accounts is one of microfinance’s most promising contributions to reducing the vulnerability of the poor (Armendáriz & Morduch, 2005, pp. 148; Diop, 2007, pp. 37). “Microfinance practitioners have come to understand that small loans are not always appropriate for poor women” and savings can provide resources such as resisting (and perhaps leaving) a bad romantic relationship (Vonderluck & Schreiner, 2002, pp. 603). This and other factors mean savings is likely a better mechanism than loans to help poor women and should be offered in conjunction with loans (Vonderluck and Schreiner, 2002, p. 610).

Access to credit also does not ensure that women have control over the loan money (Goetz & Sen


Gupta, 1996). High demand for loans by women may be from social pressure to access the loans for in-laws or husbands who then take the loans from women or use the money to invest in male activities. Additionally, high repayment levels by women do not mean that the women used the loans for their productive activities, because in some cases repayment is the result of women foregoing their own consumption or lending from other sources. Evidence indicates that men may be withdrawing from the household income for their own luxury expenditure or men’s support of their wives participation may be so their wives no longer “nag” them for money. When women run into trouble repaying the loans, they may experience increases in domestic violence or severe ridicule and censure from their husbands and/or family (Goetz & Sen Gupta, 1996; Mayoux, 2006; Vonderluck & Schreiner, 2002). Access to credit certainly doesn’t generate economic power (as control over the loan), so how can MFIs expect that it would translate into social power automatically?

Fernando (1997) explains the cultural factors that underlie why economic power does not translate into social power:

Generally, investment decisions are made jointly by men and women; women monopolize the technical aspects of the micro-enterprises while men look after the financial and marketing matters. This division of labor is partly reinforced by the fact that women do not have access to markets (Fernando, 1997, pp. 171).

Although women are the direct recipients of microcredit loans, there is no indication that they maintain control over the money. In fact, cultural circumstances prohibit women’s control over money as they are not even accepted into the place where most of the women’s goods are sold and transactions occur. This idea is supported by Mayoux (2006), women are “constrained by gender inequalities in access to other resources for investment, responsibility for household subsistence
expenditure, lack of time because of unpaid domestic work and low levels of mobility, constraints on sexuality and sexual violence which limit access to markets in many cultures.”

**Wider Impacts?**

Another hope of microfinance was that social services offered by some MFIs would educate women, promoting the education of their children and enabling them to provide better healthcare for themselves and their families. A survey by the United Population Fund (UNFPA) found, “more than one quarter (29.5 percent) of the women in the survey dealt with microfinance institutions that provided health education services” (Exploring linkages, 2010, pp. 11).

Some authors report increases in health care as a result of MFI education sessions, such as increased use of contraceptives (Schuler, Hashemi, and Riley, 1997). Clients who had been with their MFI for over three years were 6 percent more likely than non-participants to use contraception; however, 78 percent of clients still experienced financial difficulties in purchasing contraception (Exploring linkages, 2010, p. 12). Reports of microfinance’s effect on child education rates are mixed. Khandker (1995) found that a “one percent increase in credit to women increased the probability of school enrollment by 1.9 percent for girls and 2.4 percent for boys” and the presence of an MFI in the village “increased village-level school enrollment rates by 6 percent overall.” However, other scholars have found minimal to no effects on rates of education (Morduch, 2007; Peace and Hulme, 1994). In other cases microfinance can actually decrease education rates of children, primarily among girls (Kabeer, 2001). Mayoux (1999) and Armendáriz and Roome (2008) support the idea that spending on health and education is region-specific and is exceedingly difficult to change because of social and institutional norms.
Qualitative research is required to gain insight into the effects on women’s empowerment. Personal accounts by women have shown differing effects, but while some women report feeling empowered and MFI websites promote success stories, many women report feeling as if their role has not changed at all and in some cases felt disempowered. Although in many cases women can experience improvements in domestic relations and their daily lives, other cases reveal that women may be suffering because of heavier workloads and increased stress.

**Criticism of Microfinance: a Method of Disempowerment**

Microfinance’s decision to target women may not be as philanthropic as it first seems. The decision to focus on women has some obvious advantages. The lower mobility of women may be a plus because they are less likely to ‘take the money and run.’ Additionally, women have fewer alternative borrowing possibilities than men and would be more dependent upon microfinance (Morduch, 1999, pp. 1586). Targeting women may have more “to do with the ease of disciplining” with the goal of higher repayment rates (Brigg, 2006). Kabeer (2008, pp. 206) finds that women are frightened or more afraid of not repaying the loan because they fear the shame and criticism of failing to repay.

There is a relatively large argument in the microfinance literature that microfinance is a method of capitalistic accumulation. As Keating, Rasmussen, and Rishi (2010, pp. 153) explain, capitalistic accumulation is “a set of processes by which new subjects are brought into the structure of capitalism in exploitative and often violent ways.” As neoliberal policies, structural adjustment policies, for example, became pervasive women were disempowered and moved into the precarious informal sector. Microfinance appeared to be a movement that focused uniquely on serving women. Fernando (2006a, pp. 24) explains, “The framing of gender relations in the discourse of
empowerment through microfinance appeared as a sound compromise for feminists concerned with both gender inequalities and capital to achieve their respective goals” and, “…microcredit proved to be an instrument of building worldwide consensus between not only between feminists with different ideological perspectives on empowerment, but also between them and the governments, World Bank, and commercial banks.” However, this harmonizing of feminization and development institutions was ill fated if women have not been empowered.

The notion of empowerment that microfinance promotes “rests on the capitalist and masculinist assumption that the market is an arena of free action, whereas the compulsory nature of work and the tendency of that work to be physically and mentally draining means that many women experience the market as coercive” (Keating et al., 2010, pp. 156). Brigg (2006, pp. 77) identifies a statement made by Muhammad Yunus as evidence for a neoliberal approach to development. Yunus states, “Grameen literally runs after poor women who are terribly alarmed at the very suggestion of borrowing money from the bank… Grameen tries to convince them that they can successfully run a business and make money.” This statement, according to Brigg, illustrates the creation of demand for loans as local people needed to be convinced of their need for credit. Furthermore, microfinance makes the poor responsible for their poverty and reduces the use of redistributive approaches (Brigg, 2006, pp. 79). Microfinance has contributed to an increase of poor women as debtors, laborers, and consumers.

MFIs offer credit to poor women “under conditions that few affluent individuals would find acceptable” and they do so on a long-term basis (Keating et al., 2010, pp. 158). Microfinance expands the reach of the financial services industry, for although microfinance was started with the
claim of going outside the formal sector, microfinance is a formal sector in itself. The work of women is often in vulnerable, informal sector work, and “microcredit lending programs have, in many cases, reinforced traditional gender structures in spite of shifting economic relationships within households” (Keating et al., 2010, pp. 166). Women are often expected to be rational economic actors while still maintaining their traditional role in the household.
Section 3. Conclusion

This paper has revealed that the goals of microfinance as established in the 1997 Microcredit Summit have been largely unmet. The poorest are the least likely to benefit from microfinance and incomes are not increased though the provision of microfinance. Important benefits have been identified, however, such as consumption smoothing and the establishment of social networks. These benefits can be equally as important. The goal of fiscally sustainable institutions has proved incompatible with the first goal of reaching the poorest. The argument for fiscal sustainability assumed for-profit MFIs would reach greater numbers of poor, but for-profit MFIs reach the poor at a lower rate compared to non-profit MFIs and the definition of profit is not as clear cut as previously believed. Non-profit MFIs are equally as likely to be as fiscally sustainable as for-profits and they reach the poor and women at higher rates. The most lofty goal of microfinance turned out to be the empowerment of women. Empowering women requires more than economic power, it requires changing culturally embedded practices. This is a challenge that cannot be overcome as a “side-effect” of microfinance. It requires direct and intensive work, and the use of qualitative data.

Overall, microfinance has provided important contributions to the development world. It was found that savings are vital and are perhaps more important to the poor, that the poorest are probably better served by direct subsidies rather than loans, that qualitative data needs to be collected and analyzed, and former developmental methods were questioned and innovation was encouraged. Although microfinance is certainly not a panacea for poverty, it can prove itself a useful tool in the fight against poverty.
Bibliography


