

# A literature review on micro finance economics essay



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Microfinance refers to a variety of financial services that target low-income clients, particularly women (MIX, 2011). This has become a broadly known sector after the pioneering work and success of Grameen Bank in Bangladesh during the 80's. Following the ' Grameen Bank' model, many companies – Micro Finance Institutions (MFI's) were set up across the world with an aim of aiding the poor in having access to the financial services. The microfinance sector experienced an immense growth during the mid-2000's (India Microfinance Business News, 2010). Due to the global recession during the late 2000's, banks could not provide adequate on-lending funds to some of the MFI's. Faced with liquidity crunch, the MFI's have found new ways to access the capital market by commercialization of the business (Hoque et al, 2011). This paper's goal is to determine the effectiveness and ethical issues in the evolution of converting the non-profit microfinance business model to a profit making model.

The term “ Micro credit” did not exist before the seventies (Grameen Bank, 2011). After numerous efforts to try to eradicate poverty either by doling out handouts or subsidies, Noble Prize winner Professor Muhammed Yunus of

Bangladesh came up with a unique new concept of providing small loans to the poor as a tool for poverty reduction (SKS, 2011). One of the most important departures since then has involved the shift from “ microcredit”- which refers specifically to small loans-to “ microfinance.”

Mersland(2009) defined microfinance as the supply of banking services to microenterprises and poor families . The broader term embraces efforts to collect savings from low-income households (Armendariz and Morduch, 2010) and, in some places, to also help in distributing and marketing clients’ output. It is one of the few market-based, scalable anti-poverty solutions providing access to financial services to poor households in rural and urban areas. To most, micro finance means the provision of very small loans (micro credit) to help the poor to invest in or scale up their small business (micro enterprises).

Over a period of time, micro finance evolved a broader into a broader range of services like credit, savings, insurance, etc. This is because providers have realized that the poor lack access to traditional formal financial institutions; therefore require a variety of financial products. The clients thus were able to finance their income generation activities, build assets, stabilise consumption and protect against risk. (Grameen bank, 2011)

## **Grameen Bank**

Post the Bangladesh famine of 1974, Prof. Yunus, started a series of experiments to test the hypotheses that if poor were supplied with “ working capital” they can generate productive self employment without external assistance (Hossain, 1988). He started by lending small amounts of money to

the poor households in the village of Jobra, Bangladesh. He observed that the small money he could lend to the villagers was enough to run simple business activities. Further he found that borrowers were not only profiting greatly by access to the loans but they were also repaying it reliably even though no collateral security was offered (Armendariz and Morduch, 2010) . Thus, the Grameen Bank project was born in the village of Jobra, Bangladesh, in 1976. In 1983 it was transformed into a formal bank under a special law passed for its creation. Today, Grameen Bank has more than 7.5 million borrowers since its inception and has a success rate of 65% of their borrowers who have clearly managed to improve their socio-economic conditions and have lifted themselves out extreme poverty (Grameen Bank, 2011).

In the October of 2006, Prof. Yunus and Grameen bank jointly received the Nobel Peace Prize (Yunus Centre, 2011) for their work in field of eradication of poverty. Since then, the Grameen Bank of Bangladesh holds an iconic position in the world of microfinance and hence is used as benchmark in Microfinance by most academics. The Grameen ' model' has been copied in more than 40 countries (Hulme, 2008). The Grameen model emerged from the poor-focussed grassroots institution. It essentially adopts the following methodology:

A bank unit is set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The manager and workers start by visiting villages to familiarise themselves with the local milieu in which they will be operating and identify prospective clientele, as well as explain the purpose, functions, and mode of operation of the bank to the local

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population. Groups of five prospective borrowers are formed; in the first stage, only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to rules of the bank. Only if the first two borrowers repay the principal plus interest over a period of fifty weeks do other members of the group become eligible themselves for a loan. Because of these restrictions, there is substantial group pressure to keep individual records clear. In this sense, collective responsibility of the group serves as collateral on the loan. (Grameen bank, 2011)

The concept of Grameen bank started as non-profit organization and has now reached a point where it's owned 94% by its borrowers and 6% by the government (Grameen Bank, 2011). Like any other commercial banks existing, Grameen Bank has become " Self-reliant" and " Pays dividends" to its owners - the borrowers. The overall goal of the Grameen bank is the elimination of poverty. (Grameen Bank, 2011)

## **Literature review on Microfinance**

There is now voluminous literature analyzing different aspects of the microfinance revolution that swept across the developing world in last thirty years (Emran et al, 2007). Armendariz and Morduch (2010) further strengthen this by saying that for many observers, microfinance is nothing short of a revolution or a paradigm shift. In simple terms, microfinance presents itself as the latest solution to the age-old challenge of finding a way to combine the banks' resources with the local informational and cost advantages of neighbours and moneylenders (Pellegrina, 2006). It can be said that microfinance is not the first to attempt to do this, but it is by far the <https://assignbuster.com/a-literature-review-on-micro-finance-economics-essay/>

most successful. Pellegrina, (2006), reinstates and strengthens this point by citing Murray, 2001; Meyer, 2002 in his papers argues for example, that important differences in terms of investment decisions are due to the amount lent.

For MFIs, therefore there is ethical and economic justification for looking beyond income poverty or to move from financial intermediation to social intermediation as they use 'trust' (Hans, 2009) to foster group cohesiveness through networking. The model developed by Prof. Yunus is such that it has given MFIs the capacity and responsibility of empower the most vulnerable, such as women, rural artisans etc; to allow the not-yet economically-active to become so; and to create community-based structures that build mutual support and trust. Microfinance is a well-suited financial service for the micro entrepreneurs helping them in running and expanding business. These definitions not only indicate the scope of microfinance per se but also point out the need to balance the social objectives with the financial objectives of microfinance. In fact the latter is really challenging (DHAN Foundation, 2003).

Literature points out that MFI' have responsibility to graduate as institutions of socio-economic development. Social intermediation can come naturally to them (Hans, 2009). In the emerging economies they have immense scope of functionality for developing not only financial assets but also physical and human assets. This is further argued by Prof. Yunus who claims that the sole reason for setting up the 'Grameen Bank' was to help the poor become self-sustained (Yunus Centre, 2011) without trying to make profits.

Another key element that cannot be overlooked in the literature is that the formal banking sector has had a very limited impact on microfinance or lending to the poor (Chakrabarti, 2005). Armendariz and Morduch (2010) in their journal cite Lucas (1990) that based on his estimates of marginal returns to capital, finds that borrowers in India should be willing to pay fifty-eight times as much for capital as borrowers in the United States. This occurrence can be justified by the principle of diminishing marginal returns which says that, a simple cobbler working on the streets or a woman selling flowers in a market stall should be able to offer investors higher returns than General Motors or IBM or the Tata Group can-and banks and investors should respond accordingly. Money should thus flow from New York to New Delhi. The logic can be pushed even further. Not only should funds move from the United States to India, but also, by the same argument, capital should naturally flow from rich to poor borrowers within any given country. This goes against the argument as the poor are not accessible to financial services in spite of the broad coverage of the commercial banks (Han, 2009).

This was the starting point for microfinance as new ways of delivering loans had been needed precisely because borrowers were too poor to have much in the way of marketable assets. The biggest challenge in development, however, is the simultaneous development of investment potential and improvement of skill levels of the borrowers. There is a very real need of investments that yield higher returns than the sustainable microcredit interest rates for the microcredit initiative to be truly successful.

(Chakrabarti, 2005). Due to increasing lends to non-poor clients, Prof. Yunus moved aggressively into savings mobilisation, and is very much concerned

with the overall profitability of the mix of its products and has change the Grameen strategy to Grameen II, which Rather than challenging the market-based ' financial systems approach' the contemporary Grameen Bank vindicates it (Hulme, 2008)

Another issue with the contemporary literature is the major factor holding up the scaling of operations which is cited to be the lack of funds. Many MFIs are moving in the direction of commercialisation, specifically since 2001. (Hans, 2009) The only solution is to enhance the volume of credit in line with the growth of the productive activities i. e. ' Macro' and not ' Micro' finance is needed for a larger scale of operations Access to commercial funding gives microfinance institutions freedom from reliance on donor support, but at a price. In general, commercial sources of funding are accessible only to lenders that have demonstrated that they can turn a profit, and often lenders achieve profitability by raising their interest rates on loans or serving better-off customers able to take larger, more profitable loans. That issue- the transfer of costs to poor borrowers and " mission drift"-is the basis for an at times heated disagreement around the commercialization of microfinance. (Gosh, 2005)

This is the current debate where on one hand, the commercialization, reaches more clients than any other micro lender (Gosh, 2005) , for example in Latin America. On the other, to win the (Mexico) A+ rating granted by Standard and Poor's rating agency and to get attention for its public offering, it covered a relatively inefficient administrative structure by charging borrowers effective interest rates above 100 percent per year, putting its



charges close to the range of moneylenders upon which microfinance was meant to improve.

## **Conclusion**

The literature shows that internationally, MFIs are perceived as a micro lending institution, focused on extremely poor women, despite the fact that it has adopted a market-based, ' financial systems' approach since 2001 (Hulme, 2008). It also shows that over the last 30 years, it grown from the initial model and is now a unique amalgamation of industrial (including financial) and institutional reforms in the present scenario of development economics (Hans, 2009). The current literature also lacks gap in explaining the current situation of commercialization of the microfinance industry - whether it is justified for MFI's to have private investors? Or the does having private investors makes them a " loan-sharks" (Prof. Yunus, Forbes, 2010) and " change" the name of the business as it is no longer microfinance. Where the other argument is how much of a difference will it make to the poor borrowers as they are not concerned with the name but the " capital" the receive (Dr. Akula, Forbes, 2010).

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