The Cupola
Scholarship at Gettysburg College

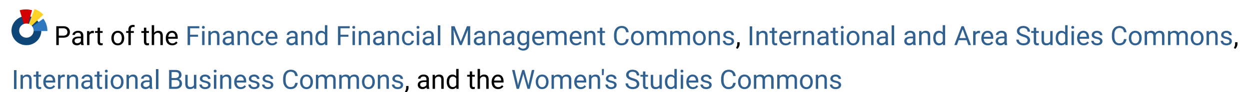
Student Publications | Student Scholarship

Fall 2019

# The Macro Drawbacks of Microfinance

Meghan E. Guy
*Gettysburg College*

Follow this and additional works at: https://cupola.gettysburg.edu/student_scholarship


Part of the Finance and Financial Management Commons, International and Area Studies Commons, International Business Commons, and the Women's Studies Commons

Share feedback about the accessibility of this item.

Recommended Citation
Guy, Meghan E., "The Macro Drawbacks of Microfinance" (2019). *Student Publications*. 872.
https://cupola.gettysburg.edu/student_scholarship/872

This open access student research paper is brought to you by The Cupola: Scholarship at Gettysburg College. It has been accepted for inclusion by an authorized administrator of The Cupola. For more information, please contact cupola@gettysburg.edu.

# The Macro Drawbacks of Microfinance

## Abstract

For decades, microfinance has been utilized as a tool to reduce global poverty rates. Many communities become entangled with microfinance institutions (MFIs) with the hope of achieving the financial independence, security, and empowerment that these institutions promise their clients. This paper highlights the negative consequences of relying on microfinance institutions to improve the development status of nations. Specifically, high interest rates attached to microloans, strict loan repayment schedules, and corrupt microloan officers threaten the safety and increase stress on majority-female microloan borrowers. MFIs fail in their mission to transform economic and social structures in developing nations.

## Keywords

international development, KIVA, financial institutions, women's empowerment

## Disciplines

Finance and Financial Management | International and Area Studies | International Business | Women's Studies

## Comments

Written for POL 252: North-South Dialogue

## Creative Commons License

This work is licensed under a Creative Commons Attribution-Share Alike 4.0 License.

This student research paper is available at The Cupola: Scholarship at Gettysburg College: https://cupola.gettysburg.edu/student_scholarship/872

Meghan Guy
Professor Hartzell
POL 252-A
9 October 2019

# The Macro Drawbacks of Microfinance

## INTRODUCTION

Microfinance, first introduced in the 1970s and later popularized by Nobel Prize winner Mohammad Yunus, was once hailed as a "magic-bullet" (Sinclair 2012, xiii) development solution with the power to "eradicate poverty in a generation" (Bateman 2018, 1). The World Bank defines microfinance as "attempts to provide financial services to households and micro-enterprises that are excluded from traditional commercial banking services" (Beck 2015, 3). This approach to poverty reduction aims to influence economics at the individual level in an attempt to improve the lives of the poorest populations around the world. The term "financial services" encompasses a variety of microfinance programs and varies by microfinance institution (MFI). Some services offered by MFIs in countries of all income levels include but are not limited to: microcredit, microloans, savings accounts, insurance, digital services, and educational programming (Sinclair 2012, 22; Kohler 2017). MFIs have grown significantly since the time of their conception, and the results of studies that scrutinize the success of these programs do not support the "magic bullet" theory. Instead, MFIs have proven to have little effect on the reduction of poverty on a global scale (Bateman 2018, 3). On the issue of entrepreneurship, the influence of microfinance programs does not lead to any significant innovation by households (Sinclair 2012, 234-235). Furthermore, some of the promises of MFIs, like women's empowerment and increased rates of school attendance, have had the opposite of the desired effects (Moodie 2013, 288; Islam 2013, 56; Lehmann 2010, 1). Microfinance programs present several challenges when practiced in developing nations, and therefore do not meet their goal of

providing solutions to ending global poverty by transforming economic and social structures ("Does Microfinance…" 2015).

## HISTORY OF MICROFINANCE

Microfinance institutions have undergone several changes over the past few decades. In its infancy, most MFIs were facilitated by non-governmental organizations (NGOs) that utilized government subsidies to serve the poorest populations in developing countries (Sinclair 2012, 19). This structure has evolved over time, and today, many MFIs operate under for-profit business models in which lenders are incentivized to charge borrowers high interest rates (Bateman 2018, 1). The first modern MFI can be traced back to Yunus's Grameen Bank, founded in Bangladesh in 1983 (Sinclair 2012, x). Grameen's primary goal was to reduce global poverty by providing small loans to the "unbanked," introducing the safety net of joint financial responsibility, and targeting women to transform microeconomics by disrupting traditional gender norms (Sinclair 2012, ix; Kohler 2017). This paper presents evidence that suggests that microfinance has not accomplished this goal in the decades of its operation.

Almost fifteen years ago, the United Nations declared 2005 the "Year of Microcredit" (Sinclair 2013, 10; Beck 2015, 1). More recently, however, microfinance institutions have transitioned to focus a greater portion of their efforts on micro-savings accounts, insurance, and educational programming, in addition to microcredit and loans (Kohler 2017). Despite any small successes MFIs may achieve in the short term on the household level, Bateman and Chang argue that full trust in microfinance strategies as a magic cure for poverty distracts from other financial programs that are empirically proven to reduce global poverty on a large scale (Bateman 2009, 8). Instead of serving as a long-term solution, Bateman and Chang compare contemporary MFIs

to “bad medicine” in that they provide temporary solutions to poor communities that result in initial benefits for both the borrowers and the lenders involved, but in the long run, are “gradually debilitating, not curing” to the communities they are meant to serve (Bateman 2009, 30).

## HIGH INTEREST RATES OF MICROLOANS

The most obvious problem with the commercialized microfinance model employed in many developing countries today is the tension that exists between the desire to reduce global poverty in the “Global South” and the incentive to achieve profitability for microfinance actors in the “Global North” (Sinclair 2012, 102). In order to cover their high fixed costs and make a profit, MFIs charge microloan borrowers usurious interest rates, sometimes exceeding 100 percent (Sinclair 2012, 5-6). MFIs justify these high interest rates by touting the expansion of microfinance made possible by the capital generated from this high-interest standard. For example, Compartamos, a Mexican MFI, claims that ultra-high interest rates benefit “poor women clients and the wider local community,” although no evidence of this trend has been reported (Bateman 2010, 147). Sinclair explains that many MFIs could dramatically reduce interest rates and still cover operating costs (2012, 185); however, few MFIs are willing to sacrifice the massive net profits that ultimately benefit distant managers and foreign investors (2012, xiii).

Despite astronomical interest rates that do not seek to generate any further development in the communities that microloans are meant to serve, many borrowers agree to the terms and conditions of these MFIs. Colombo explains that in desperate times, especially when medical emergencies produce external shocks to families living in poverty, many borrowers are driven to

take any loans available, no matter the conditions, in order to pay for treatments and feed their families (2019). Furthermore, many illiterate, innumerate borrowers take out microloans without the ability to understand the interest rates or schedules of repayment that they commit to with the stamp of their fingerprint (Sinclair 2012, xvi). The consequences of high interest rates for borrowing parties are further discussed in Section IV of this paper. The unregulated, profit-driven MFIs are unable to fulfill their economic goal of far-reaching poverty reduction with standard interest rates amounting to irresponsible percentages.

## THE EFFECTS OF MFIS ON WOMEN'S EMPOWERMENT

In additional to transforming economic systems, another goal of microfinance is to transform social structures by giving women borrowers a voice in the household through increased financial responsibility; however, Moodie reports that microcredit may have the opposite effect (2013). Microcredit, intended to increase the family's financial stability by empowering women to make sound financial decisions that benefit each member of the household, may actually "exacerbate the condition of peril in which many women already live" (Moodie 2013, 288). In fact, impoverished women who take out loans feel increased pressure to abide by strict repayment schedules (Sinclair 2012, 20). These stringent timelines often prompt women borrowers to take out additional loans in order to repay initial loans in a timely manner. This system traps borrowers in a structure of debt recycling (Bateman 2010, 58; Colombo 2019), which can increase their financial burden and, as a result, their levels of stress and dependency (Moodie 2013). Because the majority (about 78%) of microfinance initiatives target women (Iskenderian 2013), it is women in impoverished communities who must suffer the consequences of repayment failure or difficulties in establishing microenterprises. In traditional group lending

systems, women of the same community hold one another accountable for loan repayment. If one woman borrower in the group defaults on her microloan, the responsibility of repayment is transferred to the rest of the women as part of their collective repayment agreement (Sinclair 2012, 19). The prevalence of over indebtedness coupled with the pressure to uphold an agreement that affects other community members negatively impacts the mental health of microfinance participants, and in many cases, desperate women are pushed "over the edge" (Sinclair 2012, 205).

The stress that overwhelms the lives of women borrowers of microcredit in developing countries has produced tragic consequences. Over several months in late 2010, hundreds of Indian women from impoverished communities committed suicide as a result of the hardships inflicted by local MFIs (AP 2012; Sinclair 2012, 128). More recently, The Economist reports that 170 women borrowers, all clients of MFIs, committed suicide in 2018 (Colombo 2019). A Sri Lankan central microloan officer detailed his experiences of talking "desperate borrowers out of killing themselves" (Colombo 2019). These women victims of suicide share a common reality of over indebtedness and suffering at the hands of threatening, oftentimes predatory, microfinance payment collectors (Colombo 2019; Sinclair 2012, 207). In Sri Lanka, loan officers, when unable to extract repayment from borrowers, solicited "sexual favours" in return for collective leniency (Colombo 2019). Similarly, Sinclair writes that some microloan officers operating in Indian MFIs have been reported to "ask woman to take up prostitution to be able to pay their installments" (2012, 205). In addition to the negative consequences experienced by women after they borrow from MFIs, some sources indicate that microlending by female clients is not always voluntary in the first place. It is common for men, who traditionally possess financial authority in the household in many developing countries, to send their wives to apply

for microcredit in their place, since MFIs are more likely to approve women for microfinance programs, in accordance with their mission statements of female empowerment (Sinclair 2012, 5). Moodie reports that "it is often men who actually use the loans; they are justified in doing so by deeply entrenched systems of gender inequality and kinship obligation," which MFIs do nothing to address (2013, 289). MFIs establish circumstances in which impoverished women operate at the mercy of powerful lenders to whom they are indebted. This significant power imbalance in the microfinance system does not empower women, but rather instills feelings of hopelessness and desperation among the developing world's female population, leaving them vulnerable to widespread corruption and abuse.

## School Attendance and Child Labor

Another social benefit that MFIs claim to deliver is an increase in school attendance rates. The idea is that once microfinance empowers a woman to be financially self-sufficient, she will devote her resources to improving the lives of her children by ensuring they go to school (Bateman 2010, 29). In principle, the education that results from this strategy could help poor families break the cycle of poverty as future generations attain higher levels of education; however, in practice, this solution has been proven to be much less transformative. In some cases, school attendance rates have decreased while rates of child labor—a phenomenon Sinclair describes as "one of the most taboo topics to bring up in microfinance" (2012, 78)—have increased (Islam 2013, 56; Lehmann 2010, 1). Using data from a randomized controlled trial (RCT) conducted in 2003–2006 in rural parts of Ethiopia, researchers found that an increase in the number of microloans issued to poor communities was associated with an increase in child labor and a decrease in schooling among teenagers (Tarozzi 2015, 77). Another study using RCT

methodology that examined a group-lending microcredit program in Hyderabad, India found "no change in the probability that children or teenagers are enrolled in school" after their parents became involved in microfinance (Banerjee 2015, 49). Finally, in Islam and Choe's study of 91 villages in rural Bangladesh, they found that households that participate in MFIs are more likely to contribute to the problem of child labor. Results of this study also show that MFIs adversely affected school attendance rates; in particular, the schooling of young girls is compromised more often than the schooling of their male counterparts (Islam 2011, 48). Sinclair explains that the results of these studies and several others result from "labor-intensive microenterprises" that compel many families involved with MFIs to employ their own children instead of sending them to school each day (2012, 6). The adverse effects of microfinance programs on child development has the potential to trap families from poor communities in unbreakable cycles of poverty. This begs the question: are the business models of the microenterprises started by prospective entrepreneurs who take out microloans worth the sacrifice in human capital?

## The Myth of a Universal Entrepreneurial Spirit

Another objective of microfinance is to empower poor entrepreneurs to establish small businesses through access to microcredit that would have been unavailable to them before the introduction of MFIs (Bateman 2009, 2). The issues that arise from this emphasis on entrepreneurship as the perfect market-based solution are multifaceted. First, it must be pointed out that like people living in the "developed" world, not all people born in developing countries are innate entrepreneurs (Sinclair 2012, 234). A lack of entrepreneurial spirit or drive does not align with microfinance's plan for the poor, but this is the reality for some borrowers of microloans. Moodie notes that the entrepreneurial enterprises that women do undertake "are

predominantly domestic in nature—reproductive—even when they are sold as goods or services outside the domain of the household" (2013, 289). Second, borrowers who do establish successful microenterprises suffer from what Sinclair coins as the "missing middle" (2012, 235). Successful entrepreneurs in developing countries fall into this gap when the size of their growing businesses require funding that exceeds the limit of a microloan. In many cases, the regions in which MFIs operate lack traditional banks with the ability to issue bigger loans. Furthermore, even if another financial institution was accessible, many of these business owners still would not possess enough collateral to be approved for a traditional bank loan. Finally, most microfinance loans are not used for income-generating projects. As previously mentioned, many borrowers direct their microcredit toward the repayment of other loans and associated interest. Additionally, a large portion of microcredit finances household consumption. In fact, about 50–90 percent of all microcredit goes into funding consumption—paying for food, medical expenses, and retail goods— rather than financing entrepreneurial activity (Bateman 2010, 204; Sinclair 2012, 78). In central Uganda, for example, where conventional mortgages are rare, about one fifth of microloans intended for business activity is diverted into housing projects (Kampala 2019). In Sri Lanka, women borrowers intended to invest in sustainable income outlets instead "buy consumer goods on hire purchase and take loans for coming-of-age ceremonies" (Colombo 2019). Evident by the nature of many microenterprises coupled with the recorded spending habits of borrowers using microcredit, the belief that poor people can achieve "bottom-up" development through establishing small businesses with microcredit is a myth. With empirical evidence to suggest this most basic principle of microfinance does not function as intended when employed in developing countries, it is clear that MFIs fail their millions of desperate borrowers.

## Conclusion

There are piles of empirical evidence that refute the fundamental claims of MFIs, however, the information presented in this paper highlights cases that support one of the most important takeaways of microfinance research: MFIs do not provide a definitive solution to the problem of global poverty by transforming economic and social structures, despite what Mohammad Yunus promised. Even if supporters of microfinance can show small successes of MFIs, especially if defending a broader definition of microfinance, Chang and Bateman make a compelling argument for why microfinance efforts should be diverted to other programs, despite some short-term benefits (2009). In “The Illusion of Microfinance,” these microfinance critics argue that emphasis on MFIs as miracle cures for global poverty distract from proven solutions at the national level (Bateman 2009, 27). International support of MFIs absolves state governments in developing countries of any responsibility to aid the poor through social welfare spending (Bateman 2009, 26). The “bottom-up” development model, supported by Neoliberalism, is based on the illusion that impoverished communities are “empowered” by access to microcredit to pull themselves out of poverty “by their bootstraps”; in practice, however, usurious interest rates, child labor, unsustainable microenterprises, over indebtedness, and other conditions cited in paper demystify which microfinance actors really have the power.

Works Cited


AP. 2012. "Hundreds Of Suicides In India Linked To Microfinance Organizations." *Business Insider*. https://www.businessinsider.com/hundreds-of-suicides-in-india-linked-to-microfinance-organizations-2012-2 (October 7, 2019).

Banerjee, Abhijit, Esther Duflo, Rachel Glennerster, and Cynthia Kinnan. 2015. "The Miracle of Microfinance? Evidence from a Randomized Evaluation." *American Economic Journal: Applied Economics*, 7 (1): 22-53. (October 3, 2019).

Bateman, Milford & Chang, Ha-Joon. 2009. *The Microfinance Illusion*. SSRN Electronic Journal. 10.2139/ssrn.2385174.

Bateman, Milford. 2018. "How the Bank's Push for Microcredit Failed the Poor." *Bretton Woods Project*. https://www.brettonwoodsproject.org/2017/12/banks-push-microcredit-failed-poor/ (October 4, 2019).

Bateman, Milford. 2010. *Why Doesn't Microfinance Work? The Destructive Rise of Local Neoliberalism*. London: Zed.

Beck, Thorsten. 2015. "Microfinance—A Critical Literature Survey." *Independent Evaluation Group, The World Bank Group.* https://openknowledge.worldbank.org/bitstream/handle/10986/23546/Microfinance000al0literature0survey.pdf?sequence=1&isAllowed=y#targetText=2.4%20Microfinance%20can%20be%20defined,from%20traditional%20commercial%20banking%20services. (October 5, 2019).

Colombo, and Nachchikuda. 2019. "Microfinance Is Driving Many Sri Lankan Borrowers to Despair." *The Economist*. https://www.economist.com/finance-and-economics/2019/08/15/microfinance-is-driving-many-sri-lankan-borrowers-to-despair (October 7, 2019).

"Does Microfinance Still Hold Promise for Reaching the Poor?" 2015. *World Bank*. https://www.worldbank.org/en/news/feature/2015/03/30/does-microfinance-still-hold-promise-for-reaching-the-poor (October 2, 2019).

Iskenderian, Ellen. 2013. "Prove It: Measuring Gender Performance in Microfinance." *CGAP*. https://www.cgap.org/blog/prove-it-measuring-gender-performance-microfinance (October 4, 2019).

Islam, Asadul, and Chongwoo Choe. 2011. "Child Labor And Schooling Responses To Access To Microcredit In Rural Bangladesh." *Economic Inquiry* 51(1): 46–61. doi: 10.1111/j.1465-7295.2011.00400.x.

Kampala. 2019. "Housing Microfinance Can Help Poor People Build Better Homes." *The Economist*. https://www.economist.com/finance-and-economics/2019/07/18/housing-microfinance-can-help-poor-people-build-better-homes (October 5, 2019).

Kohler, Damien, and Claudia Belli. 2017. "History of Microfinance: Small Loans, Big Revolution." *BNP Paribas*. https://group.bnpparibas/en/news/history-microfinance-small-loans-big-revolution (October 7, 2019).

Lehmann, Christian. 2010. "Unintended Effects of Microfinance: An Increase in Child Labour in Some Contexts?" *International Policy Centre for Inclusive Growth* 108. https://ipcig.org/pub/IPCOnePager108.pdf (October 7, 2019).

Moodie, Megan. 2013. "Microfinance and the Gender of Risk: The Case of Kiva.org." *Signs:*

*Journal of Women in Culture and Society* 38(2). https://www.journals.uchicago.edu/doi/pdfplus/10.1086/667448 (October 1, 2019).

Sinclair, Hugh. 2012. *Confessions of a Microfinance Heretic: How Microlending Lost Its Way and Betrayed the Poor*. San Francisco, CA: Berrett-Koehler Publishers.

Tarozzi, Alessandro, Jaikishan Desai, and Kristin Johnson. 2015. "The Impacts of Microcredit: Evidence from Ethiopia." *American Economic Journal: Applied Economics*, 7 (1): 54-89. https://www.aeaweb.org/articles?id=10.1257/app.20130475 (October 2, 2019).

**Honor Pledge**: *I affirm that I have upheld the highest principles of honesty and integrity in my academic work and have not witnessed a violation of the Honor Code.*

Meghan E Guy