15 years on from the International Year of Microcredit

New insights into microloans

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It is almost 14 years ago to the day that Muhammad Yunus, who is considered the pioneer of microcredits, was declared the 2006 Nobel Peace Prize-winner. He underscored in his acceptance speech the key role played by microloans in fighting poverty. One year earlier, the United Nations had launched the International Year of Microcredit. These events significantly raised the public profile of this financial instrument. Microfinance has continued to grow in the meantime, undergoing severe crises in a number of countries, and coming under pressure from the media and research community. The old narrative about microcredits is no longer applicable, as the instrument is showing its limitations when it comes to fighting poverty. It must be embedded in a larger development strategy.

The practice of providing microcredits and other financial services to those without access to conventional banks began when economics professor Muhammad Yunus established the Grameen Bank in Bangladesh in 1983. Although the concept has been copied in numerous countries, there was limited scope at the turn of the millennium for rigorous impact assessment. Public perception was shaped primarily by anecdotal evidence that microloans were enabling poorer individuals to realise their business ideas and thus lift themselves out of poverty. The market-based approach with its promise of a double dividend (economic and social) was well received by donors and promoted through grants and subsidised loans. Microfinance grew to over 211 million clients worldwide and evolved from being NGO-dominated to profit-oriented, with individual microfinance institutions even being floated on the stock market. The commercialisation of the microfinance sector led to considerable proliferation and widespread availability of microcredits, but also gave rise to severe crises in some countries, with excessive debt, loan defaults and usually drastic social consequences. One example is the major stir caused by news articles about developments in India in 2010/11, when microcredit recipients saw suicide as the only escape from their spiralling debts.

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Randomised controlled trials (RCTs) allowed reliable impact assessment in the 2010s, which substantiated neither the promising anecdotes nor the fierce criticism from microfinance opponents. RCTs from different countries show that the average impact on entrepreneurial activities is very moderate. Positive effects can be seen on investment in durable goods such as tools and simple machinery and, in some cases, on company size and profits. However, there have been no lasting changes to income or consumption at the household level and thus no transformative effects on education, health, women empowerment or subjective well-being. Based on our current knowledge, microcredits drop out as an instrument for combating poverty. Nonetheless, they do have a raison d'être from an economic and development policy perspective. On the one hand, microcredits afford poorer households greater security and scope for self-determination through occupational choice and smoothing of income fluctuation. Additionally, microcredits perform relatively well in cost-benefit analyses when compared with other development instruments, providing justification for subsidies in the microfinance sector, even if the effects may be small.

Current DIE research into small and medium-sized enterprises sets microfinance in the larger context of the national financial system. One of the findings is that a strong microfinance sector can reduce the access of successful small enterprises to sufficiently large loans. This is because, for these firms, microcredits are too small, but larger loans are not available from conventional banks. One of the reasons for this is that banks do not downscale, that is, they do not develop suitable financial instruments for these enterprises, as strong microfinance institutions narrow down this market segment and the associated profits. Hence, one unintended consequence of microfinance is that in particular successful small enterprises, which – due to their growth – provide key impetus for job creation and local economic development, are being stifled by financial constraints.

Consequently, the microfinance sector needs to be embedded in a larger strategy for financial system development. For instance, effective credit bureaus and registries to whom microfinance institutions are also required to report, could help small firms make the transition from microfinance to a follow-up loan in the conventional financial system. Microfinance institutions make a key contribution, as access to financial services for poorer individuals affords them greater security and scope for self-determination. Nonetheless, we must be aware of the limitations of microcredits. In order to achieve transformative effects and progress in fighting poverty, there is a need for social security and more comprehensive (e.g. multi-faceted) programmes, which include training, coaching and one-off grants in addition to microfinance services.

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