

Microfinance as a Tool for Development

“Behold what is rapidly becoming the largest self-help undertaking in human history – bringing hope, dignity, and empowerment to tens of millions of the world’s poor and poorest families.”¹

Marc-André Roy
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¹ Hatch, Levine, Penn, “Innovation from the Field: A Daringly Brief Summary of a Huge Phenomenon, June 2002. (reference for title page)

Introduction

In the Western World, capitalism and free markets are seen as the chief engine of development, and indeed, this system has generated tremendous social and economic growth, and prosperity, which in turn, has powered a general increase in standards of living. This improvement in standards of living is in many ways fuelled by an entrepreneurial spirit that strives to transform ideas into economic, social and/or environmental value. It is this type of value creation that is at the heart of socio-economic development in the West.

As will be addressed later in this paper, many of the poor in the developing world share this entrepreneurial spirit, perhaps even more so than in the West, yet they have largely been unable to unlock this energy to improve their quality of life and that of their households and communities. Development as a result, has been slow or non-existent for many of the world's poorest regions, where today, more than 2.8 billion people live on less than \$US 2 per day². Why is it that this entrepreneurial spirit has been left untapped? Why is it that most of the world's poor have been unable to use their ideas and ambitions to raise themselves out of poverty? I believe that the answer relates to their inability to obtain and leverage capital or the other resources they require to put their ideas to work.

The microfinance model, pioneered by the Grameen Bank in Bangladesh in the mid 1970's, addresses this impasse. By providing small loans to entrepreneurs and small businesses, the Grameen Bank has empowered the poor, giving them the resources to generate additional income, stimulate value creation and in turn development. It should be noted that the source of development here is not the result of a trickle-down (or "top-down") stimulus, but a "bottom-up" force, whereby the poor are empowered to, at the risk of using a cliché, pursue their own destiny.

Since the mid 1970's, there has been an explosion of activity in the microfinance sector. Several models have been developed, various services have been pioneered, and many international organizations have become involved. Today, there are over 7000 microfinance institutions worldwide, serving the borrowing and savings needs of over 54 million people, and growing.

² UNDP, "Human Development Report", New York, 2002

It is my assertion that the microfinance model, while not without its limitations, is one of the most significant and potentially successful drivers of development in the developing world.

This paper explores the role of microfinance in development and provides an outline of the microfinance sector as a whole. My analysis is structured in five parts:

- the implications and meaning of development;
- the role of entrepreneurship and small enterprise in development;
- microfinance and its role in stimulating development from “the bottom-up”;
- the shortcoming and limitations of the microfinance model, and;
- international support for microfinance and the sector’s future outlook.

Development Defined and Explored

Development has long been a contentious issue, both in how it is defined and in how it is achieved and sustained over time. While development suggests progress, growth and improvement, it is often measured in economic terms, providing a distorted, inaccurate and incomplete picture. The economics of development may be more easily quantifiable, and hence measurable, but the social and environmental aspects of development and issues of sustainability are equally important in defining and measuring development. Certainly a rising level of income per capita does not represent a balanced account of development when wealth is increasingly concentrated in the hands of the few or when increasing inequality spurs mass violence and social unrest. Similarly the unsustainable extraction and export of natural resources may create employment and generate income, but this could hardly be characterized as development. A proper definition and measure of development must address economic, social and environmental considerations in a balanced way and within a context of sustainability. In 1969, Dudley Seers, the Sussex academic, defined development as occurring with: “the reduction and elimination of poverty, inequality and unemployment within a growing economy”³. While still widely accepted as an appropriate definition of development, the indicators of development used in Seers’s definition are heavily biased towards economic considerations.

Many have since broadened the concerns of development to include social and environmental considerations. Since 2000, for example, the international development goals of the UN, IMF and World Bank, have been linked to poverty reduction, improvements in health and education, and protection of the environment⁴. Nevertheless, nothing should be more central to development as a goal than improvements in quality of life. As important is that quality of life improvements are well balanced among the population and sustained over time (a short lived increase in standard of living can hardly be characterized as development). For the purposes of this paper, I have developed a practical definition of development: *The balanced growth of social, environmental and*

³ What is Development?, Wood Green School,
www.woodgreen.oxon.sch.uk/economics/development/dev_measure/what_is_development.htm

economic value leading to an equitable and sustainable increase in quality of life. I will use this definition to assess the benefits and shortcomings of the microfinance model vis-à-vis development.

The issue of how development is achieved is also highly contentious. International organizations and NGOs alike have struggled to eradicate poverty, provide access to social and health services, and improve environmental conditions, all in the name of development, but approaches differ widely. To say that there is a standard development model would be grossly misleading. Historically, large international organizations such as the World Bank and IMF have focused their development efforts on large development projects and structural adjustments. These large scale development programs, which I refer to as “top-down” in approach, are often characterized by large, rapid and often painful change. In this sense, development is a form of “tough love”⁵. A statement, taken from a 1951 UN document, for example, states that “rapid economic progress is impossible without painful adjustments”⁶. Many large projects by other international organizations such as the World Bank aimed at ameliorating social or environmental conditions have also proved painful, often with little or no recompense for the poor. “Much of [the large development projects], it is true, have yet to trickle down to the ground – to the dams and roads and power projects around the world, where the hard-knocks paradigm often persists”⁷. The value and benefits of the “top-down” or trickle-down model of development remains highly questionable.

In contrast to the “top-down” approach to development, the “bottom-up” approach, championed by grassroots activists and NGOs, is a much more direct and in my view valuable way of addressing the issue of development. By providing credit directly to the poor, in the case of microfinance projects, for example, the poor can work to better their own lives, as opposed to waiting for an expected trickle down affect, which

⁴ What is Development?, Wood Green School, www.woodgreen.oxon.sch.uk/economics/development/dev_measure/what_is_development.htm

⁵ Kapur, Akash, “A Third Way for the Third World”, The Atlantic Online, December 1999, www.theatlantic.com/issues/99dec/9912kapur.htm

⁶ Kapur, Akash, “A Third Way for the Third World”, The Atlantic Online, December 1999, www.theatlantic.com/issues/99dec/9912kapur.htm

⁷ Kapur, Akash, “A Third Way for the Third World”, The Atlantic Online, December 1999, www.theatlantic.com/issues/99dec/9912kapur.htm

seldom reaches those at the very bottom of the quality of life pyramid. It is my contention that those living in poverty, are in a much better position, given the right resources, to spur development.

The “top-down” and “bottom-up” approaches to development, however, do not in themselves address the key underlying factors encouraging development. Luckily, there has been no shortage of development theories attempting to underline the key ingredients for development. I briefly consider two, both of the “bottom-up” variety. The first, Hernando DeSoto’s theory on the importance of property rights in development and the second, Dr. Amartya Sen’s theory on the importance of freedom in maximizing people’s capabilities.

In “The Mystery of Capital”, Hernando DeSoto argues that the poor in underdeveloped and developing countries have assets, worth over US \$9.3 trillion, but these assets are usually owned informally, or extra legally, and thus cannot be used to generate capital⁸. For this reason, DeSoto calls untitled assets “dead capital”.

Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment⁹.

DeSoto argues that the lack of real property rights in particular, hamper the ability of those in developing countries to access capital to generate additional wealth, noting that in the United States the most important source of capital for new entrepreneurs is their homes¹⁰. Those without property rights or official title to their assets are forced to work and live in the informal sector, on the periphery of legal and regulatory systems. The size of the informal sector in developing countries is staggering. In Peru, for example, the informal sector constitutes 50 to 60 percent of the economy, the majority of the population working as entrepreneurs or in small scale enterprises. In the agrarian sector 90 percent of the population works in the informal sector¹¹. These people clearly have the

⁸ DeSoto, Hernando, The Mystery of Capital, Basic Books, 2000.

⁹ DeSoto, Hernando, The Mystery of Capital, Basic Books, 2000.

¹⁰ Shlaes, Amity, “Trapped in the Basement of Global Capitalism”, *The Jewish World Review*, October 4, 2000

¹¹ Hernando DeSoto, Interviewed by Dario Fernandez-Morera

ideas, ambitions, capabilities needed to raise themselves out of poverty, but their exclusion from the legal realm prevents them from ever making this a reality.

The underlying theory in DeSoto's work is that "capital is the force that raises the productivity of labour and creates the wealth of nations"¹². In other words, capital is a key ingredient in development. But without the ability to use assets as collateral to borrow, without the ability to officially and legally incorporate one's business, and without the ability to maintain ownership rights, it will be remain virtually impossible for anyone to move out of the informal sector and increase their quality of life, let alone that of households or whole communities.

The Nobel Laureate Dr. Amartya Sen offers a different perspective of development. In "Development as Freedom", Dr. Sen argues that "the 'overarching objective' of development is to maximize what he calls people's 'capabilities' – their freedom to 'lead the kind of lives they value, and have reason to value'¹³. In other words, the key to development, according to Dr. Sen, is to provide the poor with the basic freedoms and opportunities to pursue growth opportunities themselves that would, ideally allow them to escape poverty. "Development", Dr. Sen argues, "cannot be so centered only on those in power,"¹⁴ calling for more grassroots participation in development. This is a classic bottom-up approach to development, stressing that once the various "unfreedoms" are removed, the poor will be able to satisfy their own ends, and the needs of their households and communities, resulting in a general increase in quality of life.

Dr. Sen also stresses the importance of women in development. Women are in many ways the most important member of the household as it is usually they who are charged with looking after and education children, putting food on the table and so on. Dr. Sen notes that "those variables relating directly to woman's agency, such as female literacy, can play a much more important role in promoting the social well being of the family and community than variables relating to the general level of household wealth"¹⁵.

¹² DeSoto, Hernando, The Mystery of Capital, Basic Books, 2000.

¹³ Kapur, Akash, "A Third Way for the Third World", The Atlantic Online, December 1999, www.theatlantic.com/issues/99dec/9912kapur.htm

¹⁴ Sen, Amartya, Development as Freedom, New York: Knopf.

¹⁵ Sen, Amartya, Development as Freedom, New York: Knopf.

By encouraging female development, in other words, households and communities stand a better chance of increasing their quality of life.

It should be noted that Dr. Sen also considers the private sector and the use of markets to be an important contributor to development, noting that “it is hard to think that any process of substantial development can do without the extensive use of markets”¹⁶. Entrepreneurs and small businesses can be a powerful force in development, provided the conditions are in place for them to flourish. But Dr. Sen rightly points out that markets alone will not be enough to support development. For the poor to have the freedom to pursue a higher quality of life, the proper social and political systems must also be in place.

The conditions for development outlined in the works of Hernando DeSoto and Dr. Amartya Sen underline the importance of empowerment of the poor, to enable the poor to achieve a higher quality life through their own efforts, either through property rights, and all the positive spin-offs that this entails, or through the removal of various unfreedoms, and all the positive spin-offs that that entails. In short, those at the bottom of the pyramid are, and indeed should be, the key players in bringing about balanced social, environmental and economic growth and value with the ultimate aim of improving and sustaining quality of life.

The Role of Entrepreneurship and Microenterprise in Development

At the 2002 World Summit on Sustainable Development in Johannesburg, Kofi Annan declared that “without the private sector, sustainable development will remain only a distant dream”¹⁷. Although the private sector, here, most likely refers to Western business and its role in development, through FDI and otherwise, there exists in most, if not all developing countries a very significant sector of entrepreneurs and small enterprises that can play an equally, if not greater role in development. Most of these small businesses, however, are presently confined to the informal sector, for lack of property rights, proper infrastructure, social support and due to the various unfreedoms

¹⁶ Sen, Amartya, Development as Freedom, New York: Knopf.

¹⁷ Annan, Kofi, Opening Meeting of the World Summit on Sustainable Business” September 2, 2002

referred to by Dr. Sen. Nevertheless, this informal sector is buzzing with entrepreneurial spirit. DeSoto writes that “the inhabitants [of developing countries] possess talent, enthusiasm, and an astonishing ability to wring in a profit out of practically nothing”¹⁸. He continues to add that “you cannot walk through a Middle Eastern market, hike up to a Latin American village, or climb into a taxicab in Moscow without someone trying to make a deal with you”¹⁹. Similarly, a recent study revealed that one third to three-quarters of total employment in most developing countries is in the informal sector²⁰. It is my belief that this enterprising energy, if provided with the appropriate means to grow and flourish has the potential to be the most important driver of development. A recent paper on sustainable livelihoods and the private sector echoes this belief. “The creativity and capability of business enterprise and the entrepreneurial energy that it leverages are a powerful resource in the development of sustainable solutions to common problems”²¹. It seems clear that many of the world’s poor have the ideas, ambitions and drive to be successful entrepreneurs, but without the proper resources and skills, most will be unable to expand their businesses and increase their quality of life. It is my belief that by facilitating their access to capital, the poor will be better able to use the private sector as an avenue for development. Moreover, when combined with a sustainable development mindset, entrepreneurship and small enterprises can be a powerful force in fuelling a balanced growth of environmental, social and economic value, which in turn would contribute to a sustainable improvement in quality of life in developing countries²².

The Borrowing Constraints of the Poor

In most developing countries, the borrowing needs of the poor are largely left unmet, and so starting a small business or even putting food on the table during difficult times can be next to impossible. Low income entrepreneurs, for example, must usually rely on small loans from family and friends, or borrow from exploitative money lenders

¹⁸ DeSoto, Hernando, *The Mystery of Capital*, Basic Books, 2000.

¹⁹ DeSoto, Hernando, *The Mystery of Capital*, Basic Books, 2000.

²⁰ Webster, L., Fidler, P., “The Informal Sector and Microfinance Institutions in West Africa”, World Bank, 1996.

²¹ Wheeler, McKague, Thomson, “Sustainable Livelihoods and the Private Sector: CIDA’s Role in Strengthening Sustainable Local Enterprise, Draft, December 12, 2002

that charge astronomical interest rates²³. The capital and financial services offered by large commercial banks are out of reach for most poor. There are several reasons for this. Of most significance is the fact that the majority of the poor in underdeveloped and developing countries live and work in the informal sector and usually don't have officially recognized property rights. While they do possess capital, it usually can't be used as collateral for a loan as they don't have registered title to these assets. Without title, these assets are what DeSoto terms "dead capital" since asset value can't be represented on paper and used and secured by commercial banks as collateral. Without secured collateral, commercial banks are exposed to higher levels of risk and as a result, are usually unwilling to lend. The relatively small loan transaction size required by the poor, is usually too small to justify the per transaction costs of the banks, thus also putting commercial banking services out of reach. Geographic isolation and simple social prejudice also constrains the ability of the poor to borrow capital²⁴. Given these borrowing constraints, a new credit model for the poor is essential in bringing about development.

The Microfinance Sector and its Role in Facilitating Development

During a field trip to a poor Bangladeshi village with his class in 1974, economics professor Mohammad Yunus interviewed a woman who had a small business making bamboo stools. Lacking the resources to purchase raw bamboo, she was forced to borrow small amounts of money from a local street lender, and without collateral, could only borrow enough to buy bamboo to build one stool at a time. After repaying the lender, often at an interest rate of over 10% per week, the woman was left with a profit margin of mere pennies. Had she had access to more favourable terms for her loan, she would have been able to save enough money to protect her from future uncertainties and to, in the long run, raise herself above the subsistence level²⁵. Discouraged by what he saw, Dr.

²² Wheeler, McKague, Thomson, "Sustainable Livelihoods and the Private Sector: CIDA's Role in Strengthening Sustainable Local Enterprise, Draft, December 12, 2002

²³ Webster, L. Fidler, P. "The Informal Sector and Microfinance Institutions in West Africa", World Bank, 1996

²⁴ CGAP, website – About & History of the Microfinance industry, www.cgap.org/html/mi_about_history.html

²⁵ Yunus, Mohammad, Banker for the Poor, Introduction, www.grameen-info.org/book/index

Yunus took matters into his own hands and lent a small amount to some 42 rural basket-weavers. He found that these small loans went a long way, and that virtually all who had borrowed were keen to repay their loans. Dr. Yunus “found that it was possible with this tiny amount not only to help [the poor] survive, but also create the spark of personal initiative and enterprise necessary to pull themselves out of poverty”²⁶.

Just two years after his field trip, Dr. Yunus established the Grameen Bank, an institution providing small loans to the poor, especially women, in Bangladesh using innovative ways of getting around their borrowing constraints. The Grameen Bank has been hugely successful in generating sustainable livelihoods, reducing poverty and driving development in Bangladesh and has since grown to over 1084 national branches, in over half the villages of Bangladesh. Recognized as a huge success, the “microfinance” model pioneered by Dr. Yunus has been replicated and adopted in dozens of other underdeveloped and developing countries around the world. Today, there are approximately 7000 microfinance institutions²⁷ serving over 54 million clients worldwide who have received US\$18 billion in loans and accumulated US\$13 billion in savings²⁸.

Microfinance is defined by the Canadian International Development Agency (CIDA) as pertaining to: “the provision of a broad range of financial services to poor, low income households and micro-enterprises usually lacking access to formal financial institutions”²⁹. There is no one specific microfinance model and the term itself can refer to a wide range of financial services including credit for microenterprises, agriculture, housing, education and consumer purchases, savings programs, insurance, related training and other financial based transactions³⁰. Moreover, there exists significant variation among microfinance institutions in terms of organizational and ownership structure, lending methodologies, funding sources, and financial products offered. Some institutions are extensions of larger banks or governments or NGOs and others are client owned and governed by community members. As a proponent of the “bottom-up”

²⁶ Yunus, Mohammad, Banker for the Poor, Introduction, www.grameen-info.org/book/index

²⁷ Capital Markets in Developing Countries, Penn State, Agricultural Economics 450 online course material, <http://450.aers.psu.edu/capital.htm>

²⁸ Lapenu, Zeller, “Distribution, Growth, and Performance of Microfinance Institutions in Africa, Asia, and Latin America”, 2001, www.microfinancegateway.org/dbtw-wpd/exec

²⁹ CIDA and Microfinance: A Poverty Reduction Approach, Policy Branch, October 2002

approach to development, I focus here on those institutions which are client-owned and governed. Drawing from the microfinance sector in West Africa, I explore three distinct models of mutualist (client owned) microfinance institutions (MFIs): village banks, credit unions (or financial cooperatives), and *caisses villageoises*.

The village bank model originated in Bolivia in the 1980's but has since spread internationally. By 1995, the village banking system had been implemented in 28 countries, 12 of which were in Africa. Village banks are typically organized by local partners of international NGOs and are funded by international development agencies such as CIDA. They tend to be small in terms of scale and scope and usually restrict membership to 50 people. Loans are typically small, averaging between US\$44 and US\$80, and are primarily used by entrepreneurs and microenterprises. Village bank loans tend to be backed by group liability rather than collateral. This group lending approach, first pioneered by the Grameen Bank, creates a form of peer pressure among borrowing groups, whereby members rely on each other to repay loans to avoid losing access to additional funds. Groups meet on a regular basis to ensure appropriate use of funds and to track the performance of the businesses using these funds. In addition by providing small loans to micro-enterprises, most village banks also offer savings programs. Bank members are usually required to save small amounts on a regular basis. Although village banks encourage voluntary savings, most also have compulsory savings requirements for members. Because of their small size, however, most village banks suffer from diseconomies of scale, making most unsustainable as institutions. Village banks in West Africa, for example, only recover 40% of their operational costs on average, making them more dependent on continued external financial aid. Of the three mutualist microfinance models examined in this paper, village banks are the least financially sustainable³¹.

Credit Unions, also known as financial cooperatives, differ from the village bank model in several respects. Rather than relying on external funding from international organizations, governments or NGOs, credit union programs are typically funded by member deposits and savings, especially in the first few years of operation. The uses and purposes of credit union loans are much broader than that of village banks. These include

³⁰ CIDA, Reference Guide for the Microfinance Sector, August 1999

loans for microenterprises, personal loans and loans for the purposes of income smoothing, purchasing food for the household, etc. Loans are typically made on an individual, rather than group basis and are backed by collateral or the guarantee of a co-signer. Loan sizes vary, and are typically tied to the borrower's level of savings at the institution. In West Africa, credit union loans averaged US\$190, significantly higher than that of village banks³². Credit unions are also much more self sufficient than village banks. A typical credit union in Niger, for example, has an operational self sufficiency of 120%, making these types of MFIs much more sustainable.

The third mutualist microfinance model examined, is that of the *caisse villageoise*, first introduced in Burkina Faso by the Canadian group Développement International Desjardins (DID) in the mid-1980's. Like the credit union model, *caisses villageoises* rely primarily on member deposit and savings as a source of funding, although other external funding from development banks such as the Agricultural Development Bank in Africa or international Agencies such as CIDA is also common. Financial products offered include microenterprise loans, agricultural loans and demand and term deposits³³. Loans are made on an individual basis and are backed by physical capital such as tools, equipment, animals, jewellery and so on, the value of which limits the size of the loan granted. In West Africa, loan size from *caisses villageoises* average US\$ 99 and usually have a 1 year term to maturity. Of the three microfinance model discussed, *caisses villageoises* are most sustainable, with operational self sufficiency averaging 177%³⁴.

Interestingly, loan repayment rates are very high, particularly in the context of mutualist models of microfinance, proving that the poor are a good credit risk, take their credit responsibilities seriously and do repay their loans. This is typically the case, regardless of institutional model used. "A common factor across methodologies is that

³¹ Ouattara, Gonzalez-Vega, Graham, "Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa", December 1999

³² Ouattara, Gonzalez-Vega, Graham, "Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa", December 1999

³³ Ouattara, Gonzalez-Vega, Graham, "Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa", December 1999

³⁴ Ouattara, Gonzalez-Vega, Graham, "Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa", December 1999

the poor can and do repay loans. Repayments of better than 95% are seen in many microfinance initiatives³⁵. Note that this repayment rate is higher than that in many commercial banks in the developed world.

Focus 1: The Microfinance Sector in Western Africa³⁶

The Monetary Union of the West African States (UMOA) comprises eight countries: Benin, Burkina, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo. With the exception of Guinea Bissau, microfinance has been in existence in these countries for many years – about 30 years in Benin, Burkina Faso, Côte d'Ivoire and Togo and 10 years in Mali, Niger and Senegal.

Today, there are over 400 MFIs and over 3000 service locations in the UMOA operated by roughly 6000 employees, and serving the borrowing and savings needs of over 2.9 million individual members, and some 90,000 groups, comprising an additional 1.6 million people. Compared to the commercial banking system in the UMOA which comprises 26 establishments and 603 service locations, usually in urban centers, the MFIs have a significantly better breadth of reach.

The microfinance sector has been growing at an astronomical rate in the UMOA. Between 1993 and 2001, funds coming into the microfinance system, either through savings or international funding, increased from 12.7 billion Central African Francs (CFAF) to CFAF 140 billion. During this same period, total loans outstanding increased from CFAF 17.9 billion to CFAF 115 billion. This equates to about 430,000 new loans granted per year.

In terms of resources, the microfinance sector has a surplus of CFAF 25-30 billion deposited with the commercial banking system. The net financial benefits of microfinance activities in the UMOA, that is the net surplus to MFIs, are estimated to be around CFAF 2 billion.

The three microfinance models described above: the village bank, the credit union, and the *caisses villageoise* are owned by clients and members and typically governed not by an NGO or outside body, but by the communities themselves, typically with some form of elected governance or management committee. There are several advantages to the mutualist model, among them, better access to information about prospective borrowers, and better contract enforcement. “Members of a small credit union, for example, can use their stock of knowledge about other individuals members in screening and monitoring borrowers and can mobilize peer pressure for the enforcement of contracts³⁷.”

³⁵ CIDA, Reference Guide for the Microfinance Sector, August 1999

³⁶ The Microfinance Situation in West Africa, www.microfinancegateway.org

³⁷ Ouattara, Gonzalez-Vega, Graham, “Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa”, December 1999

It could also be argued that the most significant advantage of the mutualist model is that of ownership. Because these MFIs are client/member owned and run, they are a source of pride, empowerment and create a strong incentive within communities to ensure that they are well run. “An organization’s performance is the result of decisions influenced by incentives that emerge, in turn, from the structure of property rights of the organization”³⁸. This is very much consistent with a famous quote, by James Wilson (signatory of the Declaration of Independence and Associate Justice of the US Supreme Court, 1789 to 1798) who stressed the importance of ownership and property rights in development: “What belongs to one man in particular is the object of his economy and care”³⁹. The shared interest in the success of mutualist MFIs ensures not only that the institution succeed, but it also creates a support network within the community to ensure that the borrowers succeed in their ventures, be it microenterprises, agriculture, or otherwise, and can repay their loans. In other words, with mutualist institutions, the community as a whole has a shared interest in development, increasing the probability of this end.

Hernando DeSoto argued that property rights are the key to unlocking the value of capital and to generate additional wealth and in turn development. While the microfinance model does not (nor can it) address the issue of real property rights such as land titling, it does circumvent the borrowing constraints resulting from lack of official property rights. It does this in two ways. First, unlike commercial banks, many MFIs recognize the value of what DeSoto calls “dead capital”, that is capital that is not officially titled and thus lacks “representational” value as collateral. Jewellery, textile, livestock, and equipment, for example, are recognized by many MFIs as a legitimate form of collateral, eliminating a major borrowing constraint for most poor. Collateral can therefore be used to borrow additional capital, which can in turn be used, by an entrepreneur or small enterprise for example, to generate income and additional wealth. Second, and more importantly, deposits made by members of mutualist MFIs allow

³⁸ Ouattara, Gonzalez-Vega, Graham, “Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa”, December 1999

³⁹“ Individual Ownership: Bedrock of Modern Affluence”, Demographia, <http://www.demographia.com/db-indivown.htm>

members to take an ownership stake in their institution, creating in itself a form of property rights. It is interesting to note that in Bangladesh, 92% of the Grameen Bank is owned by its borrowers, who can purchase a share for the equivalent of US\$3 when they have sufficient savings⁴⁰. As mentioned, in West Africa, loans from credit unions and *caisses villageoises* are tied to a client's savings with the institution. These deposits, which represent ownership in the institution can be used to take out a loan, and again, generate income and additional wealth, in a very similar fashion that a mortgage would in the developed world. Therefore, even with little or no "official" property rights, such as titled land, in many of the world's developing countries, MFIs can play a role in creating quasi-property rights, that can then be used to generate additional capital, with the long term aim of development. Although a far cry from the type and role of property rights that DeSoto is calling for, property rights generated through ownership in mutualist MFIs (via savings or shares), can have a very useful function in development.

The role of microfinance in development is also very much consistent with Amartya Sen's theory of development, which call for eliminations of the so called "unfreedoms" that limit people's capabilities so that they may "lead the kind of lives they value, and have reason to value"⁴² (i.e. development from the "bottom-up"). For the most part, the poor in developing countries are resourceful, enterprising,

Focus 2: Mole Motuke, mother of four⁴¹

Mole Motuke, a mother of four, was living in a broken down abandoned car with her children in a suburb on Kinshasa, Zaire.

When she managed to find food, she would usually only have enough to feed two of her children, the other two had to wait until next time. When the members of a microfinance organization found her, they learned that Mole was skilled in the preparation of chikwangue (Central African dish). With just a few dollars, Mole explained that she could start a business selling chikwangue. Shortly thereafter, Mole received a loan of \$100 with which she bought all the necessary ingredients to prepare chikwangue.

Today, she and her family live in a rented house with washroom and living room and her four children attend school regularly. Mole is currently saving up to by land outside the city where she hopes to build her own house.

⁴⁰ Impact of Grameen Bank of Local Society, <http://www.rdc.com.au/grameen/Impact.html>

⁴¹ Microfinance Success Stories, www.planetfinance.org

⁴² Kapur, Akash, "A Third Way for the Third World", The Atlantic Online, December 1999, www.theatlantic.com/issues/99dec/9912kapur.htm

ambitious and have a strong drive to be successful. The only problem is that they often lack the resources and support structures to leverage their ideas, ambitions and drives to pull themselves out of poverty. In this respect, poverty is in itself the cause of a number of unfreedoms. By providing small loans to entrepreneurs, microenterprises, small scale farmers, among others, MFIs reduce the financial unfreedoms that prevent the poor from generating enough income to increase their quality of life. In other words, access to small loans through microfinance provides the poor with opportunities to pursue growth opportunities which would ultimately allow them to escape poverty, and promote development at the community, regional and country level.

Focus 3: Mariama, food stall operator⁴³

With the help of a small \$30 loan, Mariama was able to open a small food stall in Togo which now brings in enough profits that she can buy her materials and ingredients with cash instead of credit. This has saved her a great deal of money as the interest rates she used to pay were quite high.

Today, Mariama sells bread in the morning, corn pastries (local specialty) in the evening and pays 5 cents less than before, which has allowed her to increase her profit margin and avoid being taken advantage of by money lenders. Mariama now earns her livelihood and can buy soap and other necessities for her family.

Recently, her brother, who helped watch her children, passed away. With no one around to watch her children, Mariama could no longer travel to the north to look for corn and groundnuts which she sold at her stall. With the help of a second loan, she could arrange to buy these goods and resell them in her stall. Despite the death of her brother and the impact this had on her small enterprises, Mariama was able to maintain her family's quality of life.

Dr. Sen also stressed the role and importance of women in development. Women, for example, are often seen as “a vehicle for reaching the most vulnerable family members, particularly children”⁴⁴. Women, however, are often unable to provide for their households for lack of resources. Recognizing that they are often more disadvantaged than men, many microfinance programs have deliberately targeted their services to women. In Bangladesh, for example, 90% of microfinance clients are women. On average, outreach to women in developing countries is approximately 78%⁴⁵. By providing women with microfinance services, such as loans or access to savings facilities, they are

⁴³ Microfinance Success Stories, www.planetfinance.org

⁴⁴ Coady International Institute, “How Micro-Finance Providers Target the Poor”, 1998

⁴⁵ Lapenu, C., Zeller, M., “Distribution, Growth, and Performance of Microfinance Institutions in Africa, Asia, and Latin America”, International Food Policy Research Institute, Washington D.C., June 2001

better able to manage the household's finances, which is often the responsibility of the mother, and provide the family with more financial security. It should be noted that loans need not be used for starting micro businesses necessarily, rather, loans can be used for other asset-building activities such as education for children, fixing a leaky roof, providing better nutrition or responding to other household needs⁴⁶.

Access to microfinance can also help families better manage their financial lives, helping them maximize their capabilities, as would argue Dr. Sen. The ability to better manage their financial lives in turn creates a number of freedoms for these households, which helps maximize their capabilities to raise themselves out of poverty. Many poor households, especially those dependant on seasonal businesses such as agriculture, for example, experience fluctuating levels of income throughout the year. During the dry season, these households may not be able to put food on their tables, let alone look for work or start small businesses. Also "microfinance enables the poor to better manage the uncertainties underpinning their economic (and social) vulnerability – such as unemployment, natural disasters, and seasonal fluctuations in income"⁴⁷.

By making it possible for households to own, create and accumulate financial capital and assets, the microfinance model has an especially important role in development. While not without its limitations and shortcomings, the microfinance model has a number of positive and beneficial spin-offs. The microfinance model is a powerful tool for leveraging the entrepreneurial spirit of those in developing countries, and bringing about development. When used to finance microenterprises, for example, loans allow small entrepreneurs to develop their businesses, which in turn lead to income generation, improved working conditions and productivity, empowerment, improved self-esteem, creation of value (though the sale products/services) and as the business grows, job creation. (See Appendix 3 for other benefits of microfinance).

⁴⁶ Helms, Brigit, "Microcredit For Enterprise Development vs. Microfinance as an Industry", www.microfinancegateway.org/viewpoint_entdev.htm.

⁴⁷ CGAP, website – About & History of the Microfinance industry, www.cgap.org/html/mi_about_history.html

There could be a number of other positive spin-offs depending on the nature of the microenterprise. In Bangladesh, for example, loans provided through the Grameen Bank to women from rural villages to buy cell phones and in turn sell phone services on a per minute basis in their communities not only empowered women and improved their household income, it also created a communications network across Bangladesh leading to further positive spin-offs. Small businesses in rural Bangladeshi villages could now use the phone services to coordinate their supply chains more efficiently, quickly get reliable information about market prices, negotiate with middlemen in distant villages, and avoid travel costs and lost productivity⁴⁸. The original loans provided by the Grameen bank to these enterprising women went a very long way, and lead to the creation of value many, many times greater than that of the original loan.

MFIs can also have positive spillover effects at the community and regional levels “By providing services to the poor, microfinance practitioners expand the frontier of a country’s financial sector, drawing in previously excluded groups, increasing the economy’s financial depth, and generating more broad-based economic growth”⁵⁰.

Focus 4: Didier Koffi, tailor⁴⁹

Didier Koffi is a young, experienced tailor, living and working in Benin. After being trained in his trade, Didier couldn’t get the necessary funds to buy the basic equipment for his workshop and as a result, couldn’t get his business off the ground.

A friend suggested that he look into the VITA microbank in Benin. He did and was quickly able to borrow CFCA 400,000 (\$650) by using what equipment he did own as collateral.

Shortly thereafter, Didier got a CFCA 500,000 contract to manufacture ready-to-wear shirts. Didier was able to then reinvest his profits in his business, recruit two employees, and provide his family with a better quality of life.

In short, microfinance has a very significant role to play in stimulating development, and it does so from the “bottom-up” by allowing the poor to take control of their own development, particularly when used to fuel a burning entrepreneurial spirit. As defined earlier in this paper, development is represented by the *balanced growth of social, environmental and economic value leading to an equitable and sustainable*

⁴⁸ Hatch, Levine, Penn, “Innovation from the Field: A Daringly Brief Summary of a Huge Phenomenon, June 2002.

⁴⁹ Microfinance Success Stories, www.planetfinance.org

increase in quality of life. It is quite clear that microfinance promotes social and economic growth and value creation in a much more balanced way than large “top-down” development projects. Moreover, the poor can depend on themselves and their communities to increase quality of life rather than hoping for a trickle-down effect that will not likely materialize. Through microfinance, borrowers can build livelihoods that are much more sustainable in the long term. The high repayment rates of microfinance loans attest to this the financial sustainability.

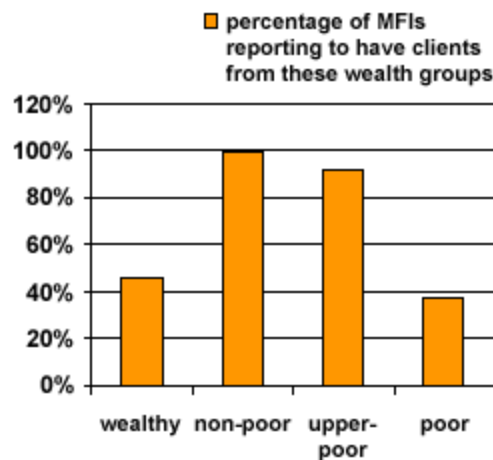
The old model of relying on foreign aid is not sustainable in the long run and is inconsistent with the definition of development developed in this paper (you give a man a fish, he can eat for a day, you teach him how to fish and he can eat for a lifetime). Through the use of microfinance, the poor leverage their own capabilities and ideas and work to increase their own quality of life, either through entrepreneurial projects, microenterprises, or otherwise. The positive spin-offs of microfinance, as in the case of the cell phone program in Bangladesh, also have an equalizing effect, allowing whole communities to share in the benefits. In this regard, microfinance programs promote a more equitable increase in quality of life, both at the household and community levels. With the exception of environmental value creation and a few other limitations, the microfinance model fits rather well with the definition of development developed earlier. The environmental and other limitations of microfinance are addressed below.

The Shortcomings and Limitations of the Microfinance Model

While a powerful force in brining about development, particularly when used to fund entrepreneurs and microenterprises, the microfinance model is far from perfect. At an institutional level, the ultimate aim of most MFIs is financial self-sufficiency, and long term sustainability. But often, a focus on institutional sustainability limits an institution’s ability to reach the poorest of the poor, particularly in rural areas. The issues of breadth and depth of reach comes up often in microfinance literature. Breadth refers to the ability of reaching and offering financial services to a large percentage of the population across

⁵⁰ CGAP, website – About & History of the Microfinance industry, www.cgap.org/html/mi_about_history.html

geographic regions, and depth refers to the ability of reaching the poorest⁵¹. In most discussions of outreach, breadth and depth are seen as requiring a trade-off when considering the sustainability of MFIs⁵². In most developing countries, the majority of the poor live in rural areas. Targeting, and reaching the rural poor usually entails additional costs for MFIs as most are located in populated centers. Increasing geographic reach, therefore, often involves traveling to rural communities to promote microfinance services through such means as house to house visits or community meetings⁵³. This usually requires hiring additional field workers and incurring higher travel costs, threatening the financial sustainability of the MFIs. Pressures of financial-self sufficiency, therefore, limit targeting strategies for reaching those if rural and remote regions. For this reasons, it is estimated that MFIs have penetrated less than 2% of the total market for microfinance services⁵⁴. The issue of depth of reach (i.e. reaching the poorest) is also an important one. The poorest are often seen as a greater credit risk and as a result are often discriminated against when attempting to take out a loan. Mutual liability groups often discriminate against the poorest because no one wants to cover their risk⁵⁵. In addition, maintaining financial sustainability as an institutional priority results in more stringent loan requirements, making loans inaccessible to many of the poorest. Compounding the issue of reach, the poorest often live in rural areas, far removed from populated centers and are often not targeted by MFIs as a result. Those that are, are often reluctant to take out loans for fear of credit. It should also be noted that financial products offered by MFIs often don't fit the needs of the poorest. As a result, many MFIs cater primarily to the non-poor. A recent study by CGAP indicated that most microfinance clients "tend to come largely from households than can



⁵¹ CGAP defines the poor as people living below the poverty line established in each country. The poorest are those whose income is less than half of the national poverty line income.

⁵² Thys, Didier, Depth of Outreach: Incidental Outcome or Conscious Policy Choice?“, www.microfinancegateway.org/viewpoint_outreach.htm

⁵³ CIDA, Reference Guide for the Microfinance Sector, August 1999

⁵⁴ CGAP, “The Consultative Group to Assist the Poorest”, Focus Note No.1, September 1998

⁵⁵ Mayoux, Linda, “Women’s Empowerment or Feminization of Debt?“, One World Action Conference Report, March 2002.

meet their daily needs...they enjoy a relatively stable income source and sufficient livelihood diversification, allowing them to service regular repayments, even when faced with small crises”⁵⁶. The above graph represents the depth of reach of MFIs in East Africa⁵⁷.

Gender discrimination and related gender issues are another significant issue for the microfinance sector. The emphasis on female targeting by MFIs is growing, but many still have a significant gender bias. In fact, many mixed-sex programs either provide women with smaller loans than men, or exclude them entirely⁵⁸. Moreover, women in developing countries often only have limited control over household income limiting their ability to use loans for anything other than basic consumption needs. In some more extreme cases, women have been forced by their husbands to take out microfinance loans, to be used for the husband’s business or personal consumption. These gender issues and problems, however, are not easy to address as they stem from deep rooted cultural norms. As outlined in “Women’s Empowerment or Feminization of Debt”, published by One World Action, the issue of gender must be put on the forefront of the microfinance development agenda⁵⁹.

The issue of environment is also one that is not adequately addressed by microfinance programs. In fact, entrepreneurs and microenterprises that borrow funds may use these for activities that can have damaging impacts on the environment. For example, the use of chemical dyes in the production of in textile or cloths, the disposal of wastewater from catering enterprises or the heavy use of pesticides in agriculture are all negative environmental impacts that can arise from the activities of small microfinance dependant businesses. Similarly, the use of makeshift workplaces, or use of old defective machinery or equipment by small entrepreneurs can pose additional health and safety risks⁶⁰.

⁵⁶ CGAP, “Those Who Leave and Those Who Don’t Join”, Focus Note No. 16, May 2000.

⁵⁷ CGAP, “Those Who Leave and Those Who Don’t Join”, Focus Note No. 16, May 2000.

⁵⁸ Mayoux, Linda, “Women’s Empowerment or Feminization of Debt?”, One World Action Conference Report, March 2002.

⁵⁹ Mayoux, Linda, “Women’s Empowerment or Feminization of Debt?”, One World Action Conference Report, March 2002.

⁶⁰ Pallen, Dean, “*Reinventing the City: The Role of Small Scale Enterprise*” CIDA, Asia Branch 2001

Typically, MFIs do not consider the environmental, health and safety impact that may result from the use of their loans. As the microfinance sector and the number of its beneficiaries continue to grow the issue of environment will become an increasingly important one. It will be important for MFIs to promote a sustainability mindset for microfinance to truly contribute to development as defined in this paper.

Lastly, it should be noted that although loans help entrepreneurs and microenterprises get their ideas off the ground, their lack of management and skills training can often hinder the success of their enterprises and expansion of these beyond micro businesses. It has been argued in the past that MFIs should also be involved in the provision of training to help maximize the likely success of borrowers, much like the incubator approach of many venture capitalists. While these training programs would surely help promote the sustainability of the small borrowing enterprises, such services are usually beyond the financial capacity of the MFIs, and as a result threaten their own sustainability. With a focus on institutional sustainability, MFIs rarely move beyond the financial services which they have traditionally offered. This dichotomy will have to be resolved for the potential of microfinance to be realized.

The issues, limitations and shortcomings raised are by no means comprehensive, but they do represent some of the most significant challenges facing the microfinance sector and it is important that they be addressed if the role of microfinance in development is to grow.

International Support for Microfinance and Future Outlook for the Sector

In spite of these challenges, the future of the microfinance sector looks bright. International agencies and organizations have recognized the importance of credit in development and are keen to support the microfinance model. In 1997, for example, CIDA allocated almost 5% of its aid budget, or over CAN\$100 million to fund microfinance and microenterprise initiatives in developing countries with the aim of strengthening the enabling environment for MFIs and microentrepreneurs, reinforcing capacity building initiatives and to provide direct support to MFIs⁶¹. Other international

⁶¹ CIDA, "Report on CIDA's Programming in Microfinance and Microenterprise Development, 1998.

initiatives have also been developed in support of microfinance. In 1995, for example, the Consultative Group to Assist the Poorest (CGAP) was established “as a consortium of donor agencies that support microfinance with a mission to improve the capacity of MFIs to deliver flexible, high quality financial services to the poor on a sustainable basis”⁶². The Micro Credit Summit Campaign, initiated two years later brought together 137 countries to launch a campaign to reach 100 million of the world’s poorest families with credit by 2005⁶³.

The growth of the microfinance sector doesn’t appear to be slowing. With increased attention from the international community, and microfinance development projects such as the Micro Credit Summit Campaign, microfinance will continue to be an important tool for development well into the future. Whether the microfinance sector will be able to respond to the many challenges it faces and improve its effectiveness in spurring development is a question that will certainly dominate the microfinance discourse in coming years.

⁶² CIDA and Microfinance: A Poverty Reduction Approach, Policy Branch, October 2002

⁶³ CIDA and Microfinance: A Poverty Reduction Approach, Policy Branch, October 2002

Conclusion

The provision of credit to the poor has proved to be a powerful tool in development. By leveraging the entrepreneurial spirit, ideas and ambitions of the world's poor, and by allowing the poor to better manage their financial lives, microfinance facilitates development from the bottom up. Without the proper regulatory and legal supports such as real property rights or the ability to legally incorporate a business, the majority of the world's poor will continue to live and work in the informal sector. Nevertheless, the quality of life of the world's poor can be vastly improved through access to credit, savings and other financial services. As determined, the microfinance model is far from perfect, but with continued support from international organizations, continued improvements in microfinance practices, and the growth of existing MFIs, the microfinance sector will be an increasingly powerful force in bringing about sustainable and balanced increases in the quality of life of the poor in developing countries. In short, microfinance will be an increasingly important tool for development.

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Appendix 1 – Outreach of Client Owned Microfinance Institutions in West Africa

Type of Organization	Average Loan Size	Total Loans Outstanding	Numbers of Active Borrowers	Average Loan Size as % of GDP
Caisse villageoises (in Mali)	\$99	\$918,748	8,383	40%
Credit unions (CPEC in Niger)	\$190	\$187,332	1,144	73%
Village banking programs:				n/a
▪ Kafo Jiginew, Mali	\$44	\$273,576	5,859	
▪ Save the Children, Mali	\$50	\$50,082	2,378	
▪ Catholic Relief Services, Benin	\$80	\$89,705	2,313	

Ouattara, Gonzalez-Vega, Graham, “Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa“, December 1999

Appendix 2 – Features of Client-Owned Microfinance Institutions in West Africa

Type of Organization	Lending Methodology	Product	Outreach	Financial Sustainability	Funding Sources	Ownership and Governance
Caisse villageoises in Mali	Individual, w/ collateral	Microenterprise loans; Agricultural loans; Demand and term deposits	21,950 members as of December 1996; 20-50% are women	177% operationally self-sufficient	Deposit mobilization; external borrowing from BNDA	Client/member-ownership; governance by an elected management committee; performance-based incentives for management
Credit unions (CPEC in Niger)	Individual, w/ collateral or cosigners	Production and personal loans; Demand and term deposits	12,700 members as of April 1997; 35% are women	120% operationally self-sufficient	Deposit mobilization	Client/member-ownership; governance by one person-one vote
Village banking programs	Group lending, w/ joint liability as substitute for collateral	Microenterprise loans; compulsory savings (and voluntary savings in some cases)	<ul style="list-style-type: none"> ▪ FFH-Kafo Jiginew, Mali: 14,051 members as of December 1998. ▪ Save the Children, Mali: 2,580 members as of December 1997. ▪ Catholic Relief Services, Benin: 2,702 member as of June 1997; 82% are women. 	<40% operational costs recovered	Loan from implementing agency for on-lending; compulsory savings	Client/member-ownership; governance by an elected management committee

Ouattara, Gonzalez-Vega, Graham, “Village Banks, Caisses Villageoises, Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa“, December 1999

Appendix 3 – Benefits of Microfinance at the Client Level

Individual Client

- Increase in personal income
- Increase in personal savings over which individual has control
- Increase in number and type of personal assets
- Change in % of assets owned by women
- Lower costs for accessing credit and savings
- Greater control over resources
- Improved leverage in household decision making
- Improved control over enterprise decisions by women
- Participation in social networks
- Improved skills including financial
- Improved social skills & mobility
- Enhanced perception of own ability
- Increased respect within community

Household Level

- Increase in family income
- Increased stability of income (e.g. less seasonality)
- Improved economic stability of households (e.g. decreased in risk by diversifying activities)
- Decrease in overall indebtedness (e.g. by generating income to pay existing loans)
- Growth in household assets
- Growth in savings
- Improvement of status and power of women within the household
- Changes in decision making within the household
- Improvement of financial independence of women within the household
- Increased levels of education of children
- Increased levels of nutrition (e.g. increased expenditure on food)

Micro enterprise Level

- Increase in enterprise sales or profits
- Increase in wages within enterprise
- Increase in productivity of enterprise
- Increase in level of technology
- Growth in enterprise assets
- Growth in investment
- Improved access to financing for expansion
- Increased role of women in microenterprise decision making
- Increased control by women of business income