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Have We Solved Poverty?

A look at the current state of microfinance

Raphael Calel¹

Since the announcement of the Nobel Laureate for Peace last year, the issue of microfinance has been on everyone's lips. Many times have I heard the following sentence uttered: "Professor Yunus could equally have won the prize for economics." This seems to be motivated by the fact that poverty is one of the most difficult economic problems, combined with the belief that Professor Yunus' contribution in microfinance has resulted in a solution to this problem. In the public eye, it appears as if Professor Yunus may have created a universal solution for poverty overnight. I do not wish to take away any of the plentiful tribute that Professor Yunus deserves for his tremendous efforts in bringing a well of previously untapped entrepreneurial drive and talent to financial services. Rather, I hope that in providing a brief exposition on the topic we will see that there are still many theoretical and practical shortcomings of microfinance. Our optimism cannot be unconditional. If your interest for microfinance has been sparked by the recent attention, but not yet ignited, I beg you to read on.

We begin with a concise introduction of the topic. Microfinance, as the name suggests, is the practice of providing financial services on a micro level, to those who generally do not qualify to enter the formal financial sector. It can be anything from providing a \$20 loan to a woman who sells flowers, allowing her to buy flowers in bulk (a micro enterprise), to the provision of savings accounts without a lower limit for poor farmers. Saving in microfinance institutions reduces risk and enables the accumulation of savings far beyond what storing unsold perishable output could. This allows for longer-term planning for these farmers, such as investing in new technologies or sending their children to school. Over the last 30 years these financial services to the poor have raised millions of people above the poverty line (in fact, it was for these successes that the Grameen Bank, a micro credit provider, and Yunus received the Nobel Prize for Peace). Several important ideas have arisen from this work, such as the use of self-selection in loan provision (i.e. offering loans to small groups of people, and conditioning future loans on repayment. Although the bank does not have access to information on the creditworthiness of these individuals, they are likely to self-select into reliable groups since they have information about each other. This resolves an important information asymmetry). The success has been

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unmistakable, with millions of borrowers around the globe and near 100% repayment rates². This success relies on building self-sustaining institutions instead of temporary poverty relief funded by economic aid. These microfinance banks are based on principles similar to any other bank, where their own profitability allows for continued existence. Microfinance has thus been hailed as the *solution to poverty* by the most optimistic.

However, through the examination of three crucial issues in micro-credit, this prevailing image can be challenged, which hopefully gives the opportunity to think about microfinance in a more realistic fashion than as *The Answer to all things poverty-related*. Firstly, a discussion of how *freedom* in various forms is of fundamental, practical and theoretical importance for the microfinance movement. Secondly, considering that the past 50 years of development policies have emanated from more developed countries (MDCs), we need to look at the real *intentions* of these policies. Thirdly, and finally, we conclude with a simple reflection of the explicit *purpose of microfinance* itself.

We begin with the issue of freedom. In the haste of hailing microfinance as *The Answer* to eradicating poverty, it seems that an elementary caveat has been marginalised. The success of microfinance initiatives across the world rests on the ability for free enterprise to exist. Essentially, the mere existence of micro-credit is insufficient, as it must also be accompanied by adequate opportunities for access and use.

For instance, when microfinance is said to provide a way out of poverty for the 4 billion people who live on less than \$2 a day (Prahalad 2006), we seem to neglect that armed conflict unfortunately exists in many developing countries. Armed conflict poses serious limitations for microfinance. Since microfinance is based on the idea of self-sustaining institutions, or even *inclusive capitalism* promoted by self-interested entrepreneurs, it requires an environment in which these economic actors would be motivated to enter. Conflict ridden regions usually do not fall into this category.

Such conflict stricken regions as Darfur are often our first association with crippling poverty and morally inadmissible conditions for human life. However, in the context of relieving poverty these circumstances are seldom the first image that comes to mind. The primary issue in these regions is conflict resolution. Only afterwards can hopes of poverty-alleviation be realised.

However, one need not go to such extremes to make this point. Some much less extreme scenarios should hamper our optimism as well. Consider the many examples of populist governments on the rise: in Bolivia, Venezuela, Ecuador, and the threat of a return to interest rate caps in Rwanda. In order for microfinance to be viable, something as simple as freely determined interest rates must be permitted. Interest rate earnings must cover three types of costs for any bank: (1) the opportunity cost of having put that money to this use, (2) the risk of losses from default, and (3) the transactions cost of administering that loan. The opportunity cost should be similar for all banks, and thus not put micro-credit initiatives at great disadvantage. The default risk facing micro-lending institutions has proven small, as we have noted. Both of these costs are proportional to the size of the loan, and therefore they do not appear to justify a significant interest rate discrepancy between micro-lending institutions and commercial banks. Transaction costs, however, are not proportional to the

² ACCION International advertises a historical repayment rate of 97% between 1996-2005, a period in which they served 3.97 million customers (<http://www.accion.org/>). Similarly, an average repayment rate near 97% for the Grameen Bank for 1983-2001 can be calculated from a time-series provided on their website (<http://www.grameen-info.org>).

loan. The cost of meeting with the borrower, processing loans, and monitoring repayment is similar for loans of all sizes. However, this cost will amount to a much greater proportion of a micro-loan than of a normal loan provided by a commercial bank. It is therefore clear that micro-lenders will have to charge higher interest rates to be economically self-sufficient. If interest rate caps are set at levels close to (or below) those charged by commercial banks, it is clear to see that micro-lending institutions would have to rely on economic aid to cover their costs. Hence, threats on the free determination of interest rates in these countries jeopardises the viability of microfinance. Though these threats may seem mild in comparison to Darfur, an economic environment with interest rate caps would be devastating for the future of microfinance. Therefore, it is apparent that far less extreme circumstances than armed conflict can be crippling for the feasibility of microfinance and that the realm that is beyond the help of microfinance initiatives is thus more substantial than we might have initially thought. The question is then if we are still justified in maintaining the extraordinary optimism of the potential of microfinance if we exclude such a large chunk of the world's poor from its benefits?

There are two answers to this question. One argument is that the obstacles that prevent the use of microfinance tools are, of course, important to remove. But once they have been removed, microfinance solutions can serve an important function in building wealthy societies where conflict has previously occurred. However, this reply underscores the fact that the effectiveness of microfinance as a tool for poverty relief is not unconditional. By recognising conflict resolution as a precondition in many cases, we are attributing at least equal importance to this aspect of poverty-alleviation.

The second answer is that if microfinance can help many of those living in poverty, it would have single-handedly provided more people with a higher quality of life than any other poverty relief policy. If microfinance realises a fraction of its hyped promise, has it not deserved this hype? Or rather, can we still call this *hype* if such fantastic results are in fact achieved? When considering this response carefully, we realise that at the very outset it is recognised that there are situations in which microfinance is not a suitable solution.

These two answers do not contradict each other, nor do they provide any arguments against microfinance solutions. They are both cause for optimism, but at the same time concede a more reasonable view of the potential of microfinance, by making explicit some of its key limitations.

Moving on to the second issue, one must consider the intentions of MDCs (More Developed Countries). For over 50 years these nations have helped shape the development agenda. Many forms of economic aid, disaster relief and policy prescriptions are just some solutions that have come out of this five-decade process. Evidently, these have not solved the problem of poverty. While this opens up an uncomfortable line of inquiry, one is obligated to ask the following two questions: (1) to what degree has the objective of development policies been to relieve poverty? And (2) can we attribute some of the reason for failure of development policies to the degree to which the underlying objective has diverged from poverty-alleviation?

To imagine that the goal of development policies has not been development may be of great concern and unrest to many. While in most cases development has probably been the goal, we look at international labour standards (ILS) as an illustration of what other motives *might* be in play, and how this affects the outcome of such policies.

ILS have been an important component of development policies. For example, there has been much pressure from MDCs to end child labour, to give workers fair wages and provide the right to unionise. Superficially this is an admirable agenda, and it may

be considered a noble achievement even if it was pursued for the wrong reasons. However, if these *wrong reasons* prevented their realisation, then we would be less forgiving. A cynic may argue that ILS is merely an attempt by MDCs to remove some of the low-cost competition from the less developed countries (LDCs). If LDCs take this view, this would make them very sceptical of implementing these policy recommendations. Although it may be in their long run interest to do so, the process is greatly slowed down because of this distrust. So we can see that the mere perception of a divergence between the outward and inward agenda of a particular development policy may be enough to halt its successful implementation.

We are forced then to think about microfinance in this context. Microfinance is not a policy developed by MDCs, and therefore does not raise the same suspicions. Furthermore, it directly serves the purposes of both development, and hypothesised economic interests such as removing low-cost competition by raising living standards. Thus, microfinance provides joint motivation for LDCs and MDCs in a way that prior development policies perhaps could not. This is a fairly unique characteristic, and we are therefore justified in being optimistic about microfinance solutions in a way that perhaps has not been warranted by earlier propositions.

The third and final discussion pertains to the intentions of microfinance itself. It is perhaps here that we are most clearly able to appreciate the enormous potential, but also the inherent limitations of microfinance. It is perhaps in highlighting this question that Professor Yunus deserves most praise (although media seemed less concerned with exploring this issue).

Microfinance embodies a bottom-up participatory approach to development, which aims to create wealth at the bottom of the income pyramid. We can imagine many other economic sectors where this approach is severely lacking, such as infrastructure and healthcare. Nevertheless, proponents of microfinance have not claimed that microfinance institutions have the capability of creating *all* the tools necessary for a society to develop. It is but one manifestation of the participatory approach. *Social enterprises*, as Yunus refers to them, are another. 'Large-scale-by-necessity' components of development are difficult for a micro enterprise to provide. Traditionally they have been provided via simple top-down policies, but the participatory approach of social enterprises provides the opportunity to combine bottom-up and top-down strategies into a single solution. By employing local resources, the top-down provided financing would fall into the hands of the people it aims to help, while at the same time providing the large-scale solutions that micro enterprises cannot.

Here we see that the pure bottom-up approach of microfinance solutions is inadequate. However, as a complement to the top-down approach, the potential of the participatory approach is greatly amplified. This only diminishes praise for microfinance to the extent that we realise that it is not a complete model for alleviating poverty. Instead, it is only by looking at the principles that have made microfinance so successful, and adapting them to the realities of the developing world, that substantive progress can be made.

In summary, I have dealt with three important, and often overlooked aspects of microfinance. While there is great potential for microfinance solutions, this potential needs to be qualified. Its utilisation is not unconditional, its application is not universal, and its use does not suit all problems. Our opinions on microfinance must take account of all of these issues, and hopefully this will help us in developing even more successful microfinance initiatives in the future.

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Other Resources Used

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Grameen Bank Annual Reports. Key statistics available at www.grameen-info.org

CGAP. www.cgap.org