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Globalization of microfinance markets: an overview and some conditions for success

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Foreword

After years of neglect and contempt, microfinance markets are in the centre of attention for big private investment bankers and profit-seeking lenders, who wish to take advantage of a promising business involving millions of small creditworthy borrowers in the developing world and an increasing number of microfinance intermediate operators, mostly supported by donors, international financial institutions and development agencies.

Undoubtedly, the entry of microfinance into global markets is good news. However, it is not free of concerns for a number of financial and non-financial reasons. The central thesis of this paper is that the successful transition from local to global microfinance markets must necessarily pass through rigorous filters, and conditions must be observed by players on both sides. Players must teach and learn from each other how microfinance works and how global financial markets operate. But this is not only a two-player game. Governments should take part by establishing the rules of the game for the new business along with an adequate institutional and policy framework to ensure that the big fish do not devour the small ones. Academics should also play their role rethinking microfinance in the light of economic theory and policy.

This article approaches the problem statement above from the personal perspective of a policy advisor anxious to inaugurate a fruitful debate on an issue of increasing importance which will have consequences for millions of people all over the world. The article reviews a number of interconnected issues that can contribute to a successful transition from local to global. It is structured as follows. The first section is dedicated to the key vocabulary to be used in this paper. The second section conceptualizes microfinance for the reader in terms of its origin, evolution and rise. The third section focuses on concerns and warnings about an indiscriminate transition towards globalization. The fourth section outlines some conditions for a successful transition. The final part of the article contains concluding remarks.

1. Key words

Some of the key words used in this article have many interpretations. Therefore, it seems useful to share with the readers an understanding of the key vocabulary used.

Microfinance in developmental terms, which is our focus, refers to the process of providing financial services on a cost recovery basis to poor, self-employed, micro and small entrepreneurs, including small producer associations and co-operatives, with the aim of helping them to make business profits while at the same time retaining their own employment and creating further jobs for others. Advanced microfinance performance includes contribution to the achievement of

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further aims (e.g. those concerned with increased competition, productivity, competitiveness and entrepreneurship) as a part of focused microeconomic policies.[1] Microfinance services are comprehensive and unconventional. It is comprehensive because microfinance usually includes products like savings and credit, insurance, money transfer (e.g. remittances) and payment services. It is unconventional, in that micro lending mechanisms and modalities are different of those from the formal financial and banking system. For instance, micro creditors usually target individuals and groups who lack collateral (e.g. capital assets and valuables) and micro businesses and enterprises which lack legal registration and bank records. Loans are usually very short term, mostly on a daily or weekly basis. In addition, many microfinance institutions provide a range of complementary services linking loans with formation of borrower groups, mentorship, financial literacy, and training and management capabilities.[2]

Globalization has many dimensions and interpretations.[3] Here the terms refers to an on going worldwide process and powerful force moving towards the integration of markets for goods, capital, labour force, services and knowledge, transcending national borders. This global movement translates into an increased interdependence of countries, economies, enterprises and individuals through internationalization of trade and finance and adoption of common production and consumption patterns, management standards and commercial legislation. Financial globalization in particular is a result of liberalization of international financial markets, where capital can move freely between countries with several choices for investors. This capital movement takes place without high barriers in the search for the highest interest rates and returns, where money is relatively scarce and the demand is greatest.

Globalization of microfinance markets refers to a relatively recent international financial trend towards the integration of microfinance flows and institutions with global capital and financial flows and markets, in which private investment funds are a catalytic force.[4] This may be interpreted as a natural evolution of, on the one hand, global financial markets in the search for further expansion, more market capillarity and higher returns, and on the other hand, local microfinance markets in the quest for increased outreach and sustainability in the longer term. This is an on-going process with more questions than answers and with more concerns than joys because of the controversial evolution of overall globalization in developing countries[5] and the still immature development of microfinance as an economic phenomenon.

This is, in brief, a personal interpretation of three linked processes to which we will refer below. Before starting, perhaps, it seems useful to demarcate the field of discussion a little. As is well known, conventional microfinance is a broad concept embracing poor households, self-employed, micro and small entrepreneurs as well as a large diversity of money lenders. In this paper, 'microfinance' is associated with small entrepreneurial players and developmental lending organization, exclusively. This choice gives rise to two considerations and requires a justification. On the one hand, the paper seeks to address those microfinance consumers who make a profit, generate employment and create added value thereby contributing to economic growth. On the other hand, the paper focuses on microfinance service providers who operate with developmental purposes and tools. The justification is based on the assumption that by working with identifiable economic agents, it is much easier to develop an inclusive economic policy than with a plethora of economic agents with different needs and motivations.

2. Contextualizing the origin, evolution and rise of microfinance markets

Origin

Lending, borrowing and saving money is an ancient financial practice that goes back to the origin of money and its associated usury practices. In contrast, microfinance is a relatively new phenomenon. According to some authors, it began in the 1950s as a part of multi-objective development projects targeted at specific communities in developing countries.[6] Other authors date the origin of microfinance, as it is known today, around the 1980s as a sub-product of internalization of financial markets. Whichever is correct, its origin has always been associated with the inability or apathy of commercial banks and the formal financial system to serve the needs of low-income households, small farmers and micro entrepreneurs. Such inability or lack of interest still continues to be the '*leitmotiv'* of any microfinance endeavor.

Evolution

The evolution of microfinance has definitely not been straightforward. Failure after failure expressed in the bankruptcy and death of thousands of micro lending projects and institutions, has been a common place in its fluctuating history. It is a paradox, but the success of microfinance can be summarized as a marvelous synthesis of failures well-assimilated by its major devoted followers, namely: donors, micro lending institutions and micro borrowers. Indeed, micro creditors and debtors have conspicuously transformed failures and mistakes into a sound credit culture, leaving behind conventional wisdom of financial management by the poor and of their funding needs. Just to give some few examples:

For years, there was a sacred belief that subsidized credits and low interest rates below the level of the market rates were synonymous with a sane and sensible financial policy addressing poor and micro entrepreneurs. What conspicuous micro creditors have demonstrated after experiences based on this erroneous belief is that prolonged subsidized credit schemes not only erode the capital of lending institutions but harm borrowers' predisposition to repay. Another even more sacred but also erroneous belief was that interest rates were the major constraint for micro entrepreneurs, when in fact lack of credit access has been encountered as the biggest barrier. As demonstrated everywhere, the poor are willing to pay extremely high interest rates but just a minority engage with banks because most micro borrowers cannot afford the minimum amount required to open an account and pay its administration costs.[7] A further misconception concerns gender. Women, mostly poor housewives and survivalists, who, because of diverse cultural biases and legal impediments, were always believed (in traditional societies) to be ineligible to incur debt, have demonstrated that they are by far the best micro borrowers and even savers Women are nowadays even becoming the focus of many successful microfinance ventures.

The list of cultural shifts in economic thinking and practice regarding the concept and management of credit becomes longer, if a number of sociological aspects are considered. These include: group formation, solidarity guarantee groups, financial engendering and other key institutional issues that have made microfinance a world financial revolution. However, this summary is enough to demonstrate that microfinance seems to be more than a fashionable issue of enthusiastic practitioners and development strategists. It is a new economic phenomenon that can contribute not only to increasing the wealth of the poor but to correcting the old beliefs and practices of orthodox bankers and investors regarding poor people's motives for saving and borrowing money.

Rise

Seen in retrospect, microfinance, formerly conceived as a rudimentary savings and lending practice of grass roots, has astonishingly turned into a development paradigm with interesting prospects of becoming a new issue in economics. The rise of microfinance up to such a celestial height is the product of a lengthy process of *trial and error,* mostly experiments by microfinance practitioners, donors and development agencies in the search for efficient mechanisms to help survivalists and small entrepreneurs pull themselves out of economic and financial exclusion. The Nobel peace prize awarded in 2006 to renowned micro bankers has been a powerful engine for making microfinance a mainstream economic and financial matter.[8]

The reasons for this rise are many and diverse. Beyond the impressive increase in the number of micro borrowers and micro lenders throughout the world and the unquestionable success of microfinance in making poor clients bankable while enabling them to establish a credit history, there are further determinant economic facts: global investment and financial markets are looking desperately for expansion through innovative ventures, less risky clients and much higher returns. Seemingly, microfinance markets can respond to this quest since they are growing very quickly, micro borrowers are good clients (high repayment rates), capital rotation is rapid and lucrative and most importantly, solid and consistent micro lenders are making profits. In addition, experience shows that the total size of small loans accompanied by other banking services, including electronic banking services (e.g. ATM, credit cards, cell phone banking) can somehow compensate for high transaction costs by management of widely spread and fragmented diminutive loan portfolios.

3. Microfinance globalization: good news, big concerns

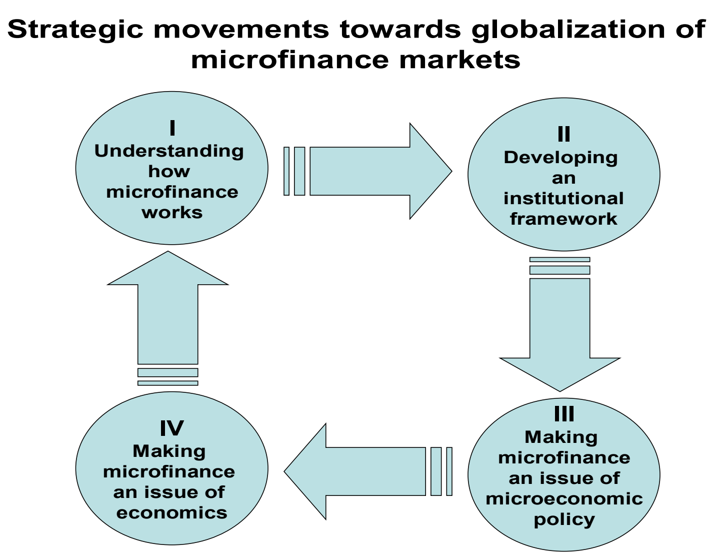
The globalization of microfinance markets and practices is good news, indeed. Over time, micro banks and lending institutions in the search of increased outreach and financial sustainability have always been ambitious to involve conventional banking and financial systems in their operations. Now, this dream is turning into reality. At the earliest stage in the microfinance evolution, a number of international development agencies and financial institutions were very receptive and enthusiastic. Microfinance was central to anti-poverty strategies, giving an economic base to conventional compensatory public policies and interventions. More recently, big financial players have shown keen interest in taking over microfinance investment funds from traditional micro creditors and donors with a serious intention of penetrating more deeply into the microfinance markets and taking advantage of the impressive economic and financial boom in emerging economies, as registered during the present decade.[9]

But this good news is not free of concerns. Without wanting to be a killjoy, a number of factors call for prudence, discretion and accurate analysis in order to prevent the evolution of indiscriminate microfinance globalization where big fish can devour small ones or where small fish can complicate the digestion of big ones. Microfinance does not mean just one thing. It has different meanings depending on the angle of observation and interest. Whilst the essence of microfinance for classic developmental micro lenders has been creating wealth for the poor, the core motivation of 'Wall Street' bankers, to label big bankers generically, is making money. On the other hand, microfinance is not a loan by pawnshops who charge staggeringly high interest rates, hurting the economy of poor people. Its focus is on creating a more egalitarian and participatory market society through promotion of the wealth of self-employed and small actors both as borrowers and savers. A further major concern is the unpredictable course of the global financial markets in both developed und emerging economies, perhaps more critically today in the first world, as recently experienced after the collapse of the property bubble (sub-prime mortgage misery and credit crisis), which has affected millions of poor households and even the world's largest investment bankers.

This contrasting approach to microfinance is the type of topic that deserves critical observation and reflection during the discussing of globalization of microfinance markets. Microfinance globalization is not just a simple process of absorption of concurrent markets by making the best micro credit lenders and micro borrowers new customers of conventional banks and financial institutions. It is first of all a process of accession to global funding sources with the aim of scaling up microfinance services, while strictly adhering to microfinance best practices. It is also a permeation process by which the new microfinance culture pervades the conventional financial and banking environment and thinking on small borrowers, within a development environment and a new business eco-system. Otherwise, if the dominant approach lies in the orthodox mercantilist thinking of globalization, by which purely speculative and usurious motivations are at the summit of the endeavor, the collapse of microfinance globalization is a '*chronicle of a death foretold'* to quote the famous work of the Colombian Nobel Prize laureate for literature Gabriel Garcia Marquez.

4. Some strategic factors for success

The preceding sections have paved the way for discussion of propositions regarding the strategic factors that can contribute to making microfinance globalization a success. These are described briefly in the diagram and text below.



First step*: Understanding better how microfinance works* is a fundamental step towards sane entry into the logic of microfinance markets and practices. The microfinance approach has a dual expression. One embraces its financial facet as pure banking services designed for the entrepreneurial poor through a diversity of products, modalities and options. The other expression is concerned with its developmental dimension as a learning endeavor, which aims to make small undertakings profitable and banking accountable. The different facets are consubstantial with each other, thus they are inseparable. In addition, most microfinance ventures are linked with diverse business support programs encompassing training, mentoring, marketing and technology support for product development. The unification of these two approaches plus the attached business support programs have configured a complex building block of interventions framed within a particular financial philosophy and lending technology. Conventional bankers lack this dual approach and extra-banking support facilities. Thus, they have much difficulty in understanding microfinance and managing microfinance portfolios effectively. Hence, learning and assimilating microfinance precepts firstly, before undertaking any blind venture, should clearly appeal to conventional bankers.

Second step: *Creating an adequate institutional framework for microfinance at country level* is an essential condition to protect the interests of all the parties involved. The entry of microfinance into the major leagues requires governance, rules of the game and high doses of technical and policy advice. A comprehensive institutional framework consists of putting together in a strategic manner four key pieces of the puzzle. In short, one piece talks about the establishment of an appropriate legal, regulatory and policy environment conducive to microfinance markets.[10] The second piece is concerned with the adjustment of the service infrastructure and lending technologies of the conventional banking system in accordance with the needs of micro borrowers. The third piece refers to increasing the efficiency and effectiveness of non-bank microfinance intermediaries, helping them to associate with the conventional banking system and/or transform themselves into sustainable financial and banking institutions.[11] Finally, the fourth piece relates to the inclusion of the small business and enterprise sector in the new institutional framework treating the small entrepreneurs and their associations as an identifiable and active policy player. [12] All this discussion can also suggest the need for the establishment of an international governance framework aimed to protect the microfinance development funds from speculative and volatile financial flows and sub-sequent financial crashes.

Third Step*: Making microfinance an issue of microeconomic policy* is a crucial movement towards globalization. So far, microfinance has not been considered as a relevant tool of any microeconomic policy endeavor. At best, it is mentioned as a smart tool for supporting focused anti-poverty strategies with diffuse microeconomic policy links. Hence, it is very difficult to evaluate the impact of microfinance on global economic aggregates. To recall, microeconomic policy is associated with concepts such as competition (*market transparency*), productivity (*economic efficiency*), competitiveness (*value added*) and entrepreneurship (*innovation*) and with the achievement of specific goals derived from those concepts mentioned in brackets. Obvious questions to evaluate the impact of microfinance as a policy tool would be, for instance, how can microfinance contribute to the achievement of such microeconomic policy goals and to what extent does microfinance push economic growth, increase employment and generate income; all this, behind the overarching goal of abolishing poverty and fostering a more equalitarian market society. Answers to these questions can improve both policy design and microfinance performance.

Fourth step: *Making microfinance a matter of economics* is an obvious consequence of this circular conceptual journey towards a sound globalization process. This driving factor emphasizes the need to link the microfinance revolution with academic economic thinking and analysis in order to succeed. It is crucial because we believe that no microfinance revolution is possible without a solid economic theory behind it. Fortunately, there are new developments and trends in this respect with conspicuous contributions from a new legion of academics and researchers, who are trying to give microfinance a place in economics, embracing diverse domains such as economic theory, financial theory and managerial economics, particularly.[13] Let's briefly expand this statement. In terms of *economic theory*, microfinance is seen as an effective tool to correct market failures and improve efficiency of global capital allocation by facilitating capital movements from rich countries to poor countries behind greater return rates in the latter. It also reframed old debates about the demand for money from the perspective of poor productive households and informal actors in connection with the money supply from non-conventional banking institutions covering their needs. In respect of *financial theory*, issues such as risk and investment decisions deserve special observation and analysis since classic risk theory seems not to match at all with the logic of lending to the poor without capital assets (collateral). In turn, the classic theory of investment decisions, which is more sensitive to the level of interest rates than the rates of return, clashes with the rationale of poor borrowers, who in contrast privilege rates of return rather than the level of interest rates. The issue of 'moral hazard', which recalls the potential 'immoral' behavior from the agent (private investment funds) against the interest of the principal (savers), nowadays acquires resonance in the economics of uncertainty and information by observing, for instance, the origin and perverse consequences of the American sub-prime mortgage crisis. In the context of *managerial economics*, discussions about, for example, why enterprises with little capital should be able to earn higher returns on their investments than enterprises with a great deal of capital, are in the center of academic reflection and analysis. Managerial economics is also about the optimization of financial resources available for small firms and helping them to solve managerial problems to increase efficiency and economic and business profits.

If all four of these steps are taken, it is expected that globalization of microfinance can enter into an innovative knowledge spiral or virtuous circle, transforming itself into a real issue of political economy. This is this paper's highest aspiration. Microfinance *per se* as a mere financial tool does not go beyond itself. It will achieve its highest value when the concept and practice are associated with the creation of wealth as a key focus of the political economy.

5. Concluding remarks

This paper provides a succinct overview of a new trend that may reshape financial markets. This is the entry of private investment funds into the microfinance markets. We argue that globalization of microfinance markets is good news but not free of concerns. Good news because the integration of financial markets can reduce market failures and give micro lenders and creditworthy borrowers access to more funding sources, increasing the outreach and sustainability of microfinance institutions. Concerns arise when the different business philosophies and capabilities of orthodox bankers and classic microfinance lenders, are compared. While the ultimate business goal for the former is making money, for the latter it is increasing the wealth of poor people, who struggle to escape from financial exclusion. In addition, conventional bankers do not know much about microfinance precepts and practices, and classic micro lenders are still immature and lack knowledge of how international financial markets work. Certainly, these are big constraints but not irremediable. In order to make a sound transition from local to global financial markets, this paper proposes a strategic game which consists of four sequential movements: (i) understanding much better how microfinance works; (ii) developing an institutional framework conducive to microfinance markets; (iii) making microfinance a microeconomic policy issue; and (iv) making microfinance a matter of economics. In this way, we expect to protect all parties concerned from unexpected and undesired developments.

NOTES

[1] A more extensive discussion on this topic can be found in my article: *Exploring new scopes of microeconomic policy for change"* AfricaGrowth Agenda. Vol..4, issue 2. published in the magazine AfricaGrowth Agenda. July 2007.
[2] A good description of microfinance services is contained in the book by Joanna Ledgerwood (1988). *Microfinance Handbook: an Institutional and Financial Perspective*. The World Bank. Washington, D.C.
[3] For a more comprehensive understanding of globalization, see Manfred Steger (2003), *Globalization: a very short introduction*. Oxford University Press.
[4] An interesting overview of the new microfinance trend can be found in the book edited by Ingrid Matthaeus-Maier and J.D. von Pishke. (2006). *Microfinance Investment Funds*. KfW. Springer Verlag. Berlin Heidelberg.
[5] See the international bestseller "*Globalization and its discontents"* by Joseph Stiglitz (2002), winner of the Nobel Prize for Economics 2001. Reading of this book leaves a bitter taste of the virtues of globalization showing that something is not working well.
[6] See CGAP. "*About Microfinance"*. Consultative Group to Assist the Poor World Bank Financial Sector Network.
[7] This minimal amount required some times is equivalent to what poor individuals earn in a year.
[8] Microfinance raised its highest degree of public interest when both Mr. Muhammad Yunus, an economist of Bangladesh, and the Grameen Bank, which he founded in 1976, were jointly awarded the Nobel Peace Prize in 2006, in recognition of their impressive and innovative contribution in creating social stability and economic development from below through revolutionary micro-lending practices, mostly addressed to poor business women, rural and landless people, who lack collateral.
[9] According to The Economist magazine, "Emerging economies account for 30% of world GDP at market exchange rates (and over half using purchasing-power parity to tale account of price differences). At market exchange rates they already account for half of global GDP growth. And by a wide range of measures, their weight is looming larger. Their export are 45% of the world total; they consume over half of the world's energy and have accounted for four-fifths of the growth in oil demand in the past five years…The increasing strength of emerging economies has been reflected in their stock markets, which have climbed steeply in recent years". See the Article "*Dizzy in Boomtown"* in The Economist. Volume 385-Number 8555. November 17th 2007. P.74-76.
[10] This includes a series of public interventions aimed at discouraging usury, maintaining interest rates at cost recovery levels, achieving economic stability by controlling inflation and devaluation, applying tax incentives for microfinance institutions and borrowing savings accounts, regulating and controlling intermediary financial institutions to avoid unsound evolution of the microfinance system, and so on. An interesting discussion on these points of view can be found in: The World Bank (1998). "*Findings*" Africa Region, Nr.106. See also UNCDF/SUM (2001). *"Policy Impact and Replication in Micro-finance*". Final Draft, New York.
[11] A good example of this development is Grameen Bank of Bangladesh, which in 1996 started successfully providing micro credit to the poor as a pilot project and today is one of the most recognized microfinance institutions in the world.
[12] This can happen for instance through improving information and knowledge of the sector and fostering the associateship of small entrepreneurs with chambers of commerce and similar organizations.
[13] One of the works with most impact within this context is the book by Beatriz. Armendariz and Jonathan Morduch. (2007). *The Economics of Microfinance.* The MIT Press. Cambridge, Massachusetts.

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