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Macroeconomic Challenges of Microfinance

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Introduction

Microfinance has been one of the boom sectors in development cooperation over the past years. At times, it was almost seen as a panacea for development. After a number of large-scale projects had failed over the 1960s and 1970s, microfinance was seen to have a number of advantages over traditional approaches of official development aid: First, as funds were disbursed at a decentralized level, political economy problems of planning and implementing projects centrally should be avoided. Second, as a microcredit is to be seen different from a grant, but has to be repaid, it was assumed to motivate people who had remained mostly passive to take the initiative themselves. Third, as a market-based instrument, it was hoped to create entrepreneurial spirit in the population which might trigger a sustained increase in economic activity.

Current state of microfinance

Worldwide, today, there are almost 200 million customers of microfinance institutions. While this number does not sound too impressive given the billions of people living in low-and middle income-countries, in some countries, microfinance covers a significant share of the workforce. For example, in Bangladesh, one of the beacons of microfinance, about 20 million people are customers of microfinance institutions, roughly 20 percent of the workforce.

Yet, while the economic success of microfinance as a sub-sector of the financial sector is undisputed, the actual developmental impact is. While there are a significant number of studies finding positive effects of microfinance, there is a roughly equally large number of studies questioning either the methodology of the studies with positive results, qualifying the success or finding no positive impact at all. Summarizing the empirical literature, it seems safe to say that it looks certain that microfinance helps at a household level to stabilize consumption levels (i.e. measured in calorie intake), but does not necessarily increase significantly disposable income (after interest rates) and consumption.

Another important issue yet widely underexposed is the question of possible macroeconomic impacts of microfinance. If microfinance institutions manage to reach out to a significant share of the labor force in one country, one should at least check for the possibility that this development impacts on the overall level of investment, output, GDP, import and exports. However, the literature on this issue is scarce so far and sometimes not easily applicable to real-world developments.

Microeconomic impact of microfinance: More consumption, more investment

From neoclassical microeconomic theory, we get strong predictions about what happens if a group of the population formerly excluded from access to financial markets is given the ability to borrow: Households which expect a decent growth of their income in the future will borrow in order to increase consumption already today, thus smoothing lifetime income. Similarly, households which are hit by adverse events lowering their income temporarily (like a sick family member) will borrow in order to sustain current consumption levels. Finally, households which run their own small business, but lack capital stock (as most informal and/or microenterprises do), will borrow in order to obtain either working capital or actually to buy capital stock. If we assume that this mechanism works for a sufficiently large part of the population, we would first see an increase in aggregate investment, and hence the aggregate capital stock and aggregate output. Second, we should see an increase in aggregate consumption and the current account, which both can be expected to be larger than that in investment as consumption first increases because of the positive income effect of more investment and second because consumption is moved forward.

The existing literature on the macroeconomic effects of microfinance usually takes these basic considerations and aggregates them over the whole economy and consequently comes to the conclusion of strong positive macroeconomic effects of microfinance in terms of investment, output and income equality.

An important problem: High interest rates and short maturities

However, the question is in how far these models are really applicable to what can be observed in many countries with a large microfinance sector. Especially, the macroeconomic models usually do not take into account to central characteristics of real world microfinance: The very short maturity of most microfinance loans and the high interest rates. Microfinance loans are often lent only for a few weeks or a few months. At the same time, they are very expensive and effective interest rates can sometimes reach as much as 100 percent in dollar terms (in the widely discussed case of the economically very successful Compartamos bank in Mexico). Even for NGO-run institutions, the median interest rate is still about 25 percent.

High interest rates and short maturities mean that these loans are not very well suited for real investment in fixed capital. Even though informal microenterprises usually work with a very simple capital stock (i.e. a stove or a cart), amortization periods can be expected to be longer than the few months for which most microcredits run. Consequently, microloans seem to be best suited as working capital. This need not be bad by definition. However, one should ask what kind of effect it has if firms are given loans as working capital, but not for fixed investments. The result most likely is an increase in activity in retail and services.

Potential negative macroeconomic side effects

For example, in Maputo, the capital of Mozambique, typical activities for customers of microfinance institutions is to buy imports and sell them in the market or in the streets. Two activities are very common place: The first is to buy used donated clothes in the port in bales and reselling them and the second is to buy food stuff (processed or unprocessed) and other goods for daily use in South Africa, take them informally across the border and resell them in Maputo. Both of these activities most likely have unintended consequences for the domestic economy: Supporting the growing import of used textiles from Europe might increase the purchasing power of the population (as these clothes are much cheaper than local production), but they also clearly endanger any domestic textile industry. Buying food produced in South Africa does the same for the local agricultural sector and agro-business.

In both cases, the overall macroeconomic impact is potentially negative: Productive capacities might be destroyed and the current account deficit will be increased. While at first sight, the activities seem to alleviate poverty as the small retailers are making profits and hence increasing their household incomes, it is not clear if the net effect is still positive if one takes potential job losses in other sectors into account.

In addition, if a microfinance institution is founded and funded by a foreign NGO or foreign investors, there is the danger that the profits resulting from high interest rates will be repatriated or at least moved to other countries. All this will burden the current account and increase the country's vulnerability to financial and currency crisis.

Evaluating the size of the macroeconomic impact

Looking at all these effects, one has to ask how relevant they might be. This crucially depends on the size of the microfinance sector to the total economy. Admittedly, this size is limited. Even in Bangladesh, microfinance loan in 2009 only added up to 121 bn takra, only about 5.5 percent of total loans or 2 percent of GDP. In Nigeria, microfinance loans in 2005 only accounted for less than 1 percent of total loans to the private sector and for 0.2 percent of GDP.

These numbers are very small. Even if all microfinance loans would be used to finance fixed investments and hence the capital stock, the potential positive macroeconomic effect would be small. However, one has to ask whether this also holds for the negative effects on the economic structure and the current account described above. If microfinance loans are used as working capital to finance imports, a single dollar of an outstanding microfinance loan can support a multiple of additional imports, quickly making the potential macroeconomic impact significant.

Does this mean that microfinance is harmful instead of a useful tool for poverty reduction? Not necessarily. However, what should be clear is that there are potential side effects that should be monitored. This poses a number of challenges for donors as well as institutions in aid-receiving countries and/or countries in which private microfinance institutions seek to operate. First, donors supporting microfinance institution should conduct comprehensive and regular impact analyses of their microfinance programs including possible impact on macroeconomic variables. Second, banking regulators and the central bank should conduct a similar analysis on a sectoral level to gauge the impact of microfinance as a whole.

This two-sided approach is necessary as the donors and private investors might lack the expertise for such impact analysis and their view might be biased. Moreover, while a single small microfinance institution clearly can do no macroeconomic harm, the aggregated sector can and data for the whole sector is only available at the central bank or at the regulatory agency. If regulators or the central bank find adverse macroeconomic effects of microfinance, they should consider limiting the further growth of the sector by limiting the number of new institutions or branches to be opened. This of course implies that microfinance institutions need to be properly supervised by the regulatory body. An approach with very little supervision or regulation as it has been practiced in some countries is clearly not appropriate.

In addition, policies to support the growth of a domestic productive structure might be needed as a tool supplementing the growth in microfinance activities. A number of approaches could be used here. One option would be a requirement (passed by legislators and implemented by regulators) that microfinance institutions use a share of their revenue for training activities of their customers. Another possibility would be to require microfinance institutions to give a certain share of the loan portfolio to productive enterprises instead of primarily financing small-scale trade and service activities. Concerning aid, donors could finance parallel programs training small business in skills necessary to improve the productive base.

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