

EACES Workshop “The Role of Microfinance in Promoting Sustainable Development in Southeast Europe”, Faculty of Economics, University of Pula (Croatia), held on the Island of Brioni, Croatia July 5-6, 2007.

### **Summing Up – Can Microfinance play a positive role in achieving sustainable development?**

Microfinance as we know it today effectively started out with the provision of small credits to the ‘entrepreneurial poor’, but today it is a major ‘industry’ providing not only microcredit but savings, insurance and other financial services to poor individuals. The way it is institutionalized differs, going from NGOs, donor founded entities to specialised commercial microfinance banks. In the last 30 years, the idea to provide small loans to the poor as part of a poverty reduction process has become one of the most promoted concepts of all time. In its most commercial format – where microfinance institutions are expected to survive by ‘earning their keep on the market’ and thus require no further government or international donor subsidies – the concept was gradually incorporated into standard international donor-led poverty reduction programmes.

Starting at first in developing countries and later spreading to the transition countries after 1990, microfinance has now achieved iconic status. The international financial institutions (IFIs), particularly the World Bank, have been key supporters of the microfinance concept, providing not only the initial capitalisation for many microfinance programmes and large quantities of technical assistance, but also a vigorous lobbying effort to persuade governments to support the concept where they might otherwise have chosen to focus on East Asian-style ‘local industrial policy’ interventions or Keynesian-inspired national and local public works programmes. Unfortunately, the evidence on the ground that microfinance is actually ‘working’ is very thin indeed: hence the Brioni EACES seminar and the desire to examine the real, as opposed to declaratory, role of microfinance in promoting sustainable development based on the example of South East Europe.

### **Expectations**

There is increasing agreement within the microfinance ‘industry’ that microfinance has not delivered on its many promises, including targets set by both the MicroCredit Summit Campaign and by the UN. There are also those who argue that microfinance is actually ‘bad’ for the local chances of achieving sustainable local economic and social development. Several papers at the Brioni seminar referred to the increasing number of questions now being asked about the famous Grameen Bank in Bangladesh and whether it has actually been a ‘force for good’ in the local economy, or whether it might actually have precipitated the permanent marginalisation and impoverishment of the local economy. Leaving aside the fact that much of the microcredit disbursed is for simple consumption smoothing – which might be important for household management, but is not a developmental concept per se - those ‘businesses’ established with microcredit are virtually all very simple, no-growth businesses typically involved in shuttle trading, street retailing and small-scale production activities that add value very quickly (street food). In other words, microcredit promotes a local enterprise structure largely unconnected to the type of enterprises we know are most associated with achieving a sustainable development trajectory.

Moreover, because both the Grameen Bank and its many international supporters tend to focus upon individual instances of poverty reduction success – the woman who becomes a successful small rice trader, the man who repairs old tyres, etc – they leave out the rather obvious point, as highlighted by several papers at the Brioni seminar, that such success is most often achieved by simply ‘displacing’ other rice traders and tyre repairers operating in the same local economic space. Local economies in Bangladesh, as everywhere across the developing world, are in fact becoming ‘saturated’ with millions of ‘poverty-push’ microenterprises all operating in the same very simple field of business. Globalisation induced reductions in formal sector employment opportunities (especially in the public sector) have everywhere led to the massive expansion of the informal microenterprise sector, composed mainly of discarded individuals seeking out any sort of trivial money-making activity simply in order to survive. Thus, a continued microfinance-induced flow of new entrants into such ‘saturated’ local economies serves only to push down the margins and wages of those already struggling to survive, making the situation worse for everybody concerned. In the absence of measures to increase the level of business sophistication, capitalisation, technology, scale and scope of operations, and business education, microcredit does not seem to be able to achieve much more than simply “recycling” local money within traditional forms of trade and trivial production. Nor are there many positive Schumpeterian ‘creative destruction’ effects to be reaped here, since the very simplicity of the microenterprises entering and very quickly exiting precludes this. Perhaps it is not such a surprise after all that Bangladesh remains one of the poorest countries in the world and that, unfortunately, Grameen Bank still has much work to do?

In Latin America, too, it was reported that expectations were greatly fuelled by Peru’s Hernando de Soto, who made the widely publicised claim that the ‘extra-legal’ microenterprise sector was the most important foundation stone for a sustainable development trajectory. De Soto also argued that if only microenterprises could ‘release’ the capital stored in their informal property then they could obtain huge quantities of microcredit, and all could then uniformly expand towards commercial and poverty reduction success. However, the ‘saturation’ phenomenon found in Bangladesh is, of course, also present in Latin America too. Thus, new microfinance-induced microenterprise entrants in Latin America also enter a market already over-supplied with the type of simple products and services they now wish to sell. Perhaps it should have been no surprise, then, that the doubling in size of the ‘extra-legal’ microenterprise sector in Latin America between the end of 1980 and the end of 1990 has resulted in no appreciable microenterprise-driven ‘boost’ to sustainable growth – quite the opposite, in fact, since margins and wages in the ‘extra-legal’ sector have declined right across the continent, leading UN Habitat among others to report that many millions of the self-employed living and working in the expanding urban slums have been thrust even deeper into so-called ‘entrepreneurial poverty’.

### **Political economy and microfinance**

Several papers provided some important background political economy explanation as to why microfinance is so cherished today by the international financial institutions, particularly by the World Bank. With the need to enforce both local financial sector discipline and the dominance of markets at the local level, no matter what the results, the microfinance concept can be used - and has been used - to edge out all non-market

local financial alternatives and non-market grass roots development trajectories. Commercial microfinance institutions legitimise the idea that only those local financial institutions that can 'earn their keep on the market' deserve to survive, or will be allowed to survive, in today's ultra-competitive environment. Moreover, with unemployment, under-employment and informalisation growing everywhere, and with no realistic solution seemingly possible within the dominant globalisation/neoliberal economic and political paradigm, it was also pointed out that the idea is gaining ground everywhere that microfinance can possibly help in the widespread employment transition now well underway - that is, from formal 'decent' forms of work being the norm for the majority, to a situation where the majority is now consigned to marginal, temporary, insecure and largely exploitative forms of informal sector employment.

### **Transition Countries**

The roughly 15 years of experience with microfinance in the transition countries of the former communist block shows such expectations to have been overdone here too. Several of the papers presented at the seminar reported that one of the most recognisable developments in South East Europe is that many microfinance institutions initially set up to deal with the most poor and excluded parts of the local economy, actually very quickly began to shake off any relationship to their former target group. This might be a sign of a lack of effective corporate governance, with local stakeholders failing to exercise their duty to ensure that the international donor funded microfinance institution retains its original mandate. It might also mean that the increasing sophistication of the surrounding financial market makes it inevitable that NGO-style microfinance institutions will commercialise and look after their own survival imperatives first, and then figure out afterwards what, or if, they make a social impact within the community (the better to justify continued international donor grants and soft loans for on-lending). It might also mean that the pressure on microfinance institutions to 'earn their keep on the market' means that they must inevitably forget about developmental goals and simply 'follow the money'. One such microfinance institution based in the town of Karlovac in Croatia, it was reported, was cynically willing to support clearly unsustainable dairy 'micro-farms', most of which predictably rather messily collapsed later on leaving their hapless owners in even greater poverty and debt, because the original microcredit could be quite easily repaid using the Croatian government's subsidy programme for 'three cow and above' farms.

Overall, the seminar reported that such commercialisation changes cannot be viewed positively if important institutional capacities related to development are effectively lost to the community and, moreover, if large initial financial endowments provided by the international donor community and governments 'to help local people' are then effectively 'privatised' by the original employees and their closest collaborators in a novel form of what David Harvey has called 'accumulation by dispossession'. Microfinance institutions have thus lost a lot of their initial importance and respect in the transition economies but not, unfortunately, because they have been able to substantively reduce poverty, but because they have changed so much after an internally sponsored privatisation process that they no longer play or seek to play any positive and pro-active developmental role whatsoever. Much finance, technical assistance and time have thus been wasted building up institutions to promote local

development, but which then 'run to the market' and disappear into the world of commercial operations.

## **Impact**

One of the greatest caveats regarding microfinance is that there is little evidence to suggest it makes a real impact in local communities. In many cases in South East Europe, impact is very crudely measured as "financed enterprises that are sustainable" or "new microenterprises established". However, as several papers emphasised, the net effects might actually be close to zero or even negative because of simple 'displacement effects' – that is, new microenterprise entrants simply result in a crowding out of incumbent market actors without any real positive effect on economic growth or efficiency or poverty. The microfinance 'industry' in South East Europe is full of stories of new micro-entrepreneurs having established successful little operations, but there is no publicity concerning those typically pushed out of the same market niche, who may have invested or used a previous microcredit and are now even more fully trapped in poverty and debt. Both papers presented on Croatia and Bosnia, however, suggest that 'displacement' effects are likely to very significantly reduce the declared impacts of microfinance programmes in these countries.

Several of the papers also raised the issue of microenterprise failure. Many, if not most, microenterprises end up exiting after a few years. For example, increasingly replicating Bangladesh, in Bosnia the World Bank reported that of the cohort of new microenterprises that was established between 2002 and 2004 probably around 50% of them failed before even one year of operation. So what happens to these microenterprise failures? Do they fall further into poverty? Do they become a new under-class with all social contacts disrupted because of their, perhaps unwise, idea to establish a new microenterprise? Do they regret their decision? Would public and community-designed works programmes not have been a better solution to address their immediate poverty?

Several papers also explored the fact that the microfinance model at best produces local economies full of very simple, often trade-based microenterprises. There was broad agreement that this simple structure of microenterprises is not a real foundation for future sustainable growth. Creating it absorbs scarce resources and registers important opportunity costs. As in the examples of Bangladesh and Latin America, in South East Europe the microenterprise sector has expanded exponentially since 1990, absorbing many people made redundant as a result of large enterprise closures and fiscal austerity imperatives imposed by the international financial institutions. Is the typical local economy recovering because of such microenterprises? The evidence seems to indicate that there is little contribution from microenterprises to sustainable local economic development. In fact, the channelling of international donor funds – and increasingly local savings too – into the very simplest of microenterprises is gradually creating a series of 'stripped out' local economies each with no real future potential for sustainable growth. One paper pointed out the stark contrast between South East Europe, where a previous high-level endowment of skills, technologies and innovations has effectively been abandoned as the 'raw material' for new microenterprises, and East Asia, where micro and small enterprise programmes are very precisely predicated upon developing new and raising the general level of technology, scale, skills and business sophistication.

Finally, recognising the many demerits to the simple microfinance model, several presentations at the end explored possible alternative local financial systems. The local financial institutions that emerged as part of the cooperative movements in the Italian Emilia-Romagna and the Spanish Basque regions provide some obvious food for thought. Also established in post-war conditions similar to South East Europe after 1995, the use of 'community-embedded' local financial institutions made possible both the targeting and achievement of sustainable development trajectories. There was also a useful informal presentation on the excellent results emerging from the Credit Dejudines experience in Quebec in Canada. Russia's experience with rural credit cooperatives also appears to hold out the promise that marginalised rural communities might be able to access meaningful quantities of finance at realistic terms and conditions, and thereby grass roots development can begin again. Italy's experience with the 'Confidi' – pooled resources used by SMEs to obtain favourable loan funding opportunities from local commercial banks – was examined and, albeit there are some problems, it was found to be a potential solution to the need for larger loans and more commercial bank support for larger enterprises.

### **Sustainability of the local economy**

All in all, the seminar concluded that microfinance is certainly not a panacea and it could possibly undermine the chances of sustainable economic and social development, and thus sustainable poverty reduction too. Microfinance possibly works best by providing microcredit for consumption purposes, displacing informal sector moneylenders and their ultra-expensive credit. But as a sustainable poverty reduction and development tool it has major limitations and few real, as opposed to declaratory, successes to date. More research is needed to ascertain where it might be possible for microfinance models to evolve to make a positive sustainable impact, such as in post-war Italy and Japan, and to avoid the instances where it simply helps to infantilise and de-industrialise a local economy and thus effectively ends all chances of future development and progress. Thus, evolving today's microfinance institutions into more developmental local financial institutions seems to be a priority, but at least it appears there is much positive experience across the EU and elsewhere to show what needs to be done.

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