MICROFINANCE INSTITUTIONS AND ECONOMIC DEVELOPMENT
Evidence from Developing Countries

Lincoln Arsyad
Universitas Gadjah Mada

ABSTRAKSI

Tulisan ini membahas sifat dan arti penting lembaga keuangan mikro (LKM) dalam pembangunan ekonomi. Bukti-bukti dari beberapa negara sedang berkembang (NSB) menunjukkan bahwa LKM telah berkembang tidak hanya sebagai lembaga keuangan per se tetapi juga sebagai alat pembangunan (development tools) di dalam mengatasi kemiskinan. Lebih dari itu, bukti-bukti juga menunjukkan pula bahwa LKM selain berperan penting sebagai lembaga perantara keuangan (financial intermediaries) yang mampu meningkatkan proses pendalaman sistem keuangan (financial deepening) juga memiliki dampak yang positif terhadap peningkatan pendapatan masyarakat miskin, menciptakan lapangan kerja, dan meningkatkan tabungan masyarakat.

Keywords: microfinance institutions, institutionist approach, welfarist approach, microfinance role

INTRODUCTION

Microfinance generally refers to the provision of financial services, primarily savings and credit but also other financial services, to poor and low income households that do not have access to commercial banks. Ledgerwood (1999) states that the term of microfinance refers to the provision of financial services (generally savings and credit) to low-income clients, including self-employed.

In practice, in addition to financial intermediation, some microfinance institutions provide social intermediation services such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group (Bennett, 1998; Ledgerwood, 1999). The definition of microfinance then often includes both financial intermediation and social intermediation. Further, in recent years microfinance is not viewed as simply banking anymore (financial intermediaries per se). Microfinance has evolved as an economic development approach intended to benefit low-income women and men. It can also be expected to reduce poverty and to develop and strengthen the institutional capacity of local financial systems through finding ways to cost-effectively lend money to poor households (Ledgerwood, 1999; Morduch, 1999; Morduch, 2000; Snow, 1999).

This paper describes the nature of microfinance institutions and its importance in economic development, especially in developing countries. The first part of this paper briefly discusses theoretical review on relationship between finance and economic development. The second part describes the microfinance institution approach to economic development. The third part discusses the role of microfinance institutions as financial intermediaries and reveals their relationship with the commercial banks. The fourth part discusses the impacts of microfinance institutions on economic development in developing countries. The last part is conclusion.
FINANCE AND ECONOMIC DEVELOPMENT

Before the Great Depression of the 1930s, economists felt that monetary changes, such as money supply and interest rates, affected only prices and wages (Long, 1983). Output and employment, the real factors in the economy, were considered to be independent of monetary events. However, as Long pointed out, the experience of the Great Depression made economists realize that monetary (financial) factors affect not only wages and prices, but also changes in output and employment over the business cycle. Financial sector has affected not only the movement of the economy over the business cycle, but also economic growth and development. After the Great Depression, many economists and policy makers have been concerned with the importance of financial institutions on economic development, particularly with regard to the developing countries. This section is a brief review of some theories on the importance of financial institutions on economic development.

One of the earlier writers who emphasised the importance of financial institutions on economic development was Joseph A. Schumpeter (Fry, 1995). In his book firstly published in German language in 1912, writing from the perspective of early twentieth century, Schumpeter stresses the importance of entrepreneurs and financial institutions in the development process (Schumpeter, 1912). In the book, he pointed out that the pure entrepreneur, who embodies development by trying out new combinations\(^1\), requires credit. Then he saw financial institutions as sources of funds for entrepreneurs and argued that someone can only become an entrepreneur by previously becoming a debtor. In his book, he described the relationship between finance and development as follows: “Granting credit in this sense operates as an order on the economic system to accommodate itself to the purposes of the entrepreneur, as an order on the goods which he needs: it means entrusting him with productive forces. It is only thus that economic could arise from the mere circular flow in perfect equilibrium” (Schumpeter, 1912: 107).

Further, Schumpeter views the banker as the key agent in this process:

The banker, therefore, is not so much primarily the middleman in the commodity ‘purchasing power’ as a producer of this commodity. However, since all reserve funds and savings to-day usually flow to him, and the total demand for free purchasing power, whether existing or to be created, concentrates on him, he has either replaced private capitalists or become their agent. He has himself become the capitalistic par excellence. He stands between those who wish to form new combinations and the possessors of productive means. He is essentially a phenomenon of development, though only when no central authority directs the social process. He makes possible the carrying out of new combinations, authorises people, in the name of society as it were, to form them. He is the ephor of the exchange economy (Schumpeter, 1912: 74).

Other more recent precursors include Gurley & Shaw were the writers to insist that development involves finance as well as goods, that the rise of (financial) intermediaries—of institutional savers and investors—accelerate the growth rate of debt relative to the growth rates of income and wealth (Gurley & Shaw, 1955). Even though they did not attempt to spell out “a growth model that incorporates the financial as well as the real conditions of growth,” they saw the

\(^1\) This concept covers the following five cases: (1) the introduction of a new good or a new quality of a good; (2) the introduction of a new method of production; (3) the opening of a new market; (4) the conquest of a new source of supply of raw material or half-manufactured goods; and (5) the carrying out of the new organization of any industry (Schumpeter, 1912: 66).
growth of financial intermediation as potentially beneficial to both savers and investors and it is an important aspect of modern economic growth. Another precursor (Goldsmith, 1969) endeavoured to establish empirically a causal connection between financial development and economic growth. However, he failed to satisfy his own exacting standards on the basis of the data available. As he described in his book as follows: “the existence and development of a superstructure of financial instruments and financial institutions is a necessary, though not a sufficient, condition of economic growth… the relationship between financial development and economic growth are very complicated and not easily amenable to generalisation” (Goldsmith, 1969: 408).

According to Fry (1995), the main intellectual basis for financial sector analysis and policy advice over the past 21 years lies in the work of Ronald McKinnon (1973) and Edward Shaw (1973). They both develop models of economic development in which financial liberalisation and development accelerate the rate of economic growth (McKinnon, 1973; Shaw, 1973). Prior to McKinnon & Shaw, banking did not have a good reputation among economists (Garson, 1996). Baltensperger (1980), as cited by Garson, points out that traditional micro-economic approach simply ignored it. Banking as a specific industry did not exist. Banks were considered as mere intermediaries like any other intermediaries, with no specificity of their own.

In a similar vein, Garson also argues that macroeconomic approach before the McKinnon-Shaw era had regarded money, not banking, as important. Financial intermediaries were important only because they had the capacity to create money rather than because of any specific role they might play in the economy. He cites the study of Friedman & Schwartz (1963) pointing out that the 1933 collapse of the American financial system, for example, bank failures were considered important only because the collapse of the banks contracted the money supply and not because this massive institutional failure resulted in the disruption of overall economic activity. Credit was considered a mere input to be used to stimulate production and redistribute wealth.

Garson (1996) points out that McKinnon & Shaw recommended a complete reversal of this perspective. Credit was not to be regarded as an input but rather as an engine for growth. Financial systems were not to be considered as neutral elements in the development process but as an integral part of the process. From another perspective, McKinnon & Shaw also highlighted some of the deleterious effects of financial repression—interest rate ceilings, high reserve requirements, directed credit policies, and discriminatory taxation of financial intermediaries—on economic growth (Fry, 1995). When financial systems were freed from the constraints imposed upon them, they would be able to redirect their formerly repressed credit activity to more productive uses. Once interest rates were deregulated, they would reach market levels and the mobilization of deposits would increase. This, in turn, would nurture the financial intermediation process and ultimately create economic growth. Thus, the financial development or financial deepening became a necessary step to insuring that the minimum conditions for development existed. In brief, they advocate financial liberalisation and development as growth-enhancing economic policies. Much of the empirical support for their policy recommendations is derived from the financial reforms in Taiwan (early 1950s) and Korea (mid-1960s).

However, Cole & Slade (1995) criticise the McKinnon-Shaw model. They argued that there was a naïve belief that once financial systems were liberated they would evolve in a healthy and efficient manner to serve the needs of developing economy. They raised a question whether the benefits of financial liberalisation are likely to exceed the costs and
whether it should be carried out at all. Further, they also argued that while it is clear that a well-functioning financial system can be an important factor in supporting and promoting economic development, such a system is not likely to be achieved simply through removal of direct governmental controls, or a policy of "government hands-off." However, under the influence of the McKinnon-Shaw studies, financial reform has been a common theme of policy makers in developed countries and policy advisors to developing countries since early 1980s (Cole & Slade, 1996; Fry, 1995).

In summary, an earlier study by Schumpeter has shown that the financial and banking sectors have been playing an important role in economic development by providing funds to entrepreneurs who trying out new combinations (innovations). Some studies coming later also show the close relationship between financial and economic development. The McKinnon-Shaw model shows the importance financial liberalisation and development in economic development. They view financial liberalisation and development could accelerate the rate of economic growth by increasing investment and its productivity. Since 1973 the McKinnon-Shaw financial repression paradigm has exerted considerable influence in macroeconomic policy in developing countries.

MICROFINANCE APPROACHES TO ECONOMIC DEVELOPMENT

Ledgerwood (1999) points out that the goals of microfinance institutions as development organisations is to service the financial needs of unserved or underserved markets as a means of meeting development objectives such as to create employment, to reduce poverty, to help existing business grow or diversify their activities, to empower women or other disadvantaged population groups (poor people or low-income people), and to encourage the development of new business. More specifically, in a World Bank study of lending and for small and microenterprise projects, three objectives were most frequently cited (Webster, Riopelle, & Chidzero, 1996): to create employment and income opportunities through the creation and expansion of microenterprises, to increase the productivity and incomes of vulnerable groups, especially women and the poor, and to reduce rural families’ dependence on drought-prone crops through diversification of their income generating activities.

Regarding the best way to help the poor or low-income people through access to financial services provided by microfinance institutions, there was a major debate between two views or approaches — the so called the microfinance schism — in the 1990s (Morduch, 2000). The two broad approaches are the financial system approach and the poverty lending approach (Rhyne, 1998) or, using different term, the institutionist approach and the welfarist approach (Woller, Dunford, & Woodworth, 1999).

Rhyne (1998) and Woller et al. (1999) pointed out that the financial system or the institutionist approach focuses on creating financial institutions to serve clients who either are not served or are underserved by the formal financial system (commercial banks). Emphasis lies on achieving institutional self-sufficiency through achieving financial self-sufficiency, breadth of outreach (number of clients) takes precedence over depth of outreach (the levels of poverty reached), and positive client impacts are assumed. Thus the centre of attention is the institution, and institutional success is generally gauged by the institution’s progress toward achieving financial self-sufficiency. The approach actually was rooted to the Ohio School of thoughts in microfinance. The best known member of the Ohio School are Dale Adams, Carlos Cuevas, Gordon Donald, Claudio Gonzales-Vega, and J. D. von Pischke, the last of these based until recently in the World Bank rather than academe and as such a
crucial conduit for the transmission of the School's ideas into the Bank's operational practice (Hulme & Mosley, 1996a).

Hulme & Mosley points out some of the important principles of the School. First, the School believes that credit plays a facilitating and not a leading role in the process of economic development, and in consequence that financial services should be supplied to meet existing needs, and not in advance of demand. Second, the School emphasises on the savings mobilisation as a necessary financial discipline for lending institutions and as a means of enabling such institutions to get to know their market better. Third, the School believes in the efficacy of microfinance institutions in developing countries in meeting such needs. In particular, an insistence that their costs are likely to be lower and their working practices more flexible than the commercial banks. Fourth, the School eschews the idea of subsidy for financial institutions in any form. Lastly, opposition to the idea of targeting loans on specific sectors, types of economic activity or socio-economic groups.

The principles have given the basic idea for the development of the institutionist approach further. Institutionists argue that a primary objective of microfinance is financial deepening, the creation of a separate system of sustainable financial intermediation for the poor. There is a "financial systems" approach to microfinance, in which numerous large-scale, profit-seeking institutions that provide high quality financial services to large numbers of poor clients dominate the future of microfinance. As noted before, the institutionists eschew subsidies of any kind, because they insist on financial self-sufficiency.

The institutionist position is very well-articulated in the literature (Morduch, 2000; Woller, Dunford, & Woodworth, 1999) coming out of the Ohio State University Rural Finance Program as mentioned above, the World Bank and the Consultative Group to Assist the Poorest (CGAP) in the World Bank, and USAID. It is also found in the many writings of Maria Otero (ACCION International) and Elizabeth Rhyne (formerly of USAID). Most published literature in the field of microfinance espouses the institutionist view. According to Woller et al., the best-known examples of the institutionist approach are Bank Rakyat Indonesia (BRI), Banco Solidarion (BancoSol) in Bolivia, and the Association for Social Advancement (ASA) in Bangladesh.

On the other hand, the welfarists approach concentrates on reducing poverty through credit, often provided together with complementary services such as skills training and teaching of literacy and numeracy, health, nutrition, family planning, and the like (Robinson, 2001). Thus the welfarists are quite explicit in their focus on immediately improving the well being of participants. Robinson also stated that under this approach donor—government-funded credit is provided to poor borrowers, typically at below market interest rates. The goal is to reach the poor, especially the extremely poor—the poorest of the poor—with credit to help overcome poverty and gain empowerment. Woller et al. (1999) pointed out that the welfarists are less interested in banking per se than in using financial services as a means to alleviate directly the worst effect of deep poverty among participants and communities, even if some of these services require subsidies. Their objective tends to be self-employment of the poorer of the economically active poor, especially women, whose control of modest increases of income and savings is assumed to empower them to improve the conditions of life for themselves and their children. The centre of attention is the “family.” Like the institutionists, welfarists have assumed more impact than the actually have been able to document. The most prominent examples of welfarist institutions are the Grameen Bank in Bangladesh and its replicates elsewhere, and
FINCA-style village banking programs in Latin America and, more recently, in Africa and Asia (Woller, Dunford, & Woodworth, 1999).

In practice, Robinson (2001) noted that the two approaches have given a substantial contribution to the development of institutional microfinance. Some institutions using the welfarist approach have successfully reached poor people with donor- and government-subsidised credit services. However, the successful institutions following the welfarist approach, in aggregate, can meet only a small portion of the demand for microfinance. In contrast, the institutionist approach has proven that it is able to make financial services—both credit and savings-available to low-income clients in large scale, and to do so profitably. Institutions such as BRI Unit Desa System and BancoSol have demonstrated that broad outreach to economically active poor clients can be achieved without ongoing subsidies. Therefore, Robinson—as a proponent of the institutionist approach—also argue that serving millions of clients on a long-term basis in multiple, competing institutions requires financial system approach or institutionist approach.

According to Woller et al. (1999) proponent of the welfarist approach at present the institutionists clearly have won the debate. The have defined best practices and the most prominent donors and even the most prominent welfarist practitioners have embraced that definition. The institutionists have been more articulate and persuasive and certainly more prolific in their writings, and their message have been more in tune with the times, the currently dominant culture of laissez-faire business.

Based on the objective of establishment, some of microfinance institutions in Indonesia could be classified as microfinance institution following the financial system approach or the institutionist approach. According to some scholars (Bolnick, 1988; Chaves & Gonzales-Vega, 1995; Conroy, 2000; Lapenu, 2001; Meagher, 2002; Ravicz, 1998; Riedinger, 1994; Woller, Dunford, & Woodworth, 1999; Yaron, 1994), most Indonesian microfinance institutions follows the institutionist approach or are intended to support financial deepening. For examples: BRI Unit Desa System, BPR (People's Credit Bank), and non-bank financial institutions such as Village Credit Institutions (Lembaga Perkreditan Desa or LPD) in Bali, Sub-district Credit Institutions (Badan Kredit Kecamatan or BKK) in Central Java, and Rural Credit Institutions (Badan Kredit Desa or BKD) in Java and Madura. They primary objective is financial deepening, the creation of a separate system of sustainable financial intermediation for the poor.

On the other hand, there are also some microfinance institutions following the welfarist approach such as Kredit Usaha Tani (credit for agricultural activities), which is subsidized credit for farmers and Kredit Usaha Kecil (credit for small-scale enterprises). Other examples were the Impres Desa Tertinggal (IDT) Program launched in 1993 and the Prosperous Family Program launched in 1996. These two credit schemes of government in which institutional sustainability has not been an objective (McGuire, Conroy, & Thapa, 1998). Further, the two programs reversed the movement towards sustainability in microfinance services for the poor in Indonesia (Conroy, 2000). Conroy argue that the regressive tendency was reinforced by an expansion of other forms of subsidised credit financed by central bank. These included credit for farmers, credit for members of primary cooperatives, and credit to village unit cooperatives.
THE ROLE OF MICROFINANCE INSTITUTIONS AS FINANCIAL INTERMEDIARIES

It is interesting to assess the importance of microfinance institutions as financial intermediaries on economic development. In 1992, Ghat -a scholar who intensively studied the relationship between commercial banks sector and microfinance institutions-points out that there has been debate in the literature on whether microfinance institutions and commercial banks are substitute or compliments (Ghate, 1988; Ghate, 1992b; Ghate, 1992a). He argues that commercial banks and microfinance institutions each has its areas of comparative advantage. Commercial banks are more readily able to accommodate large and long-term loans since it has greater reliance on the pooling of deposits and maturity transformation. It has a greater economies of scale and scope. Hence, the commercial banks are better suited to the needs of large and medium-scale industry, organised trade and commerce, and well-to-do urban households. But it is less successful in serving the needs of large unorganised sector in developing countries, small and microentrepreneurs, small traders, and small and poor borrowers generally. These sectors are well served by microfinance institutions since one of the characteristics and advantages of microfinance institution is provision of small and short duration loans. Moreover, its flexibility regarding collateral enables it to finance a large number of service activities where fixed assets are not created as a security for the loan. Interlinkage of credit with marketing transactions also gives microfinance institutions a comparative advantage in supplying working capital loans both in agriculture, such as crop production loans, as well as in small industry.

Based on their areas of comparative advantage, serving different borrower groups and borrowing purposes, Ghate argues that the two sectors are in broad sense complementary.

He illustrated that as the supply of commercial banks for one purpose (fixed investment), the demand for microcredit increases for complementary purpose (working capital). He then also stated that in the continuum of financial sub-markets arranged in declining order of requirements met by the formal institutions (commercial banks), one end of the continuum consists of sub-markets catered to entirely by the formal institutions (commercial banks), while those at the other end are served entirely by the informal (microfinance) institutions (Ghate, 1992b). In the middle segment the two institutions usually compete with each other, but sometimes also enjoy a complementary relationship, so both grow together in absolute size.

A well-known case of complementation is a study in South Korea (Cole & Park, 1983). The study described the complementary between the two institutions in South Korea in the 1960s and 1970s. Large-scale industry met its fixed investment requirements from the commercial banks, but borrowed part of its working capital requirements in the microfinance institutions. Since fixed investment has a longer gestation period than working capital and requires longer term loans, the commercial bank sector is in a better position to provide the loans than microfinance institutions. Cole & Park also points out that microfinance institution relies more on its own funds than on deposits, hence it is less able to provide a loans for fixed investment.

A more recent example of Taiwan shows the case of how microfinance institutions help to compensate for the limitations of the commercial banks system, especially in regard to satisfying the credit needs of small enterprises (Tang, 1995). Instead of competing directly with each other, those two sectors have largely complemented each other in solving crucial financial intermediation problems in Taiwan’s development process. This complementary function of microfinance
institutions is especially important given Taiwan’s heavy reliance on small and medium enterprises as a major engine of economic growth. As known, the role of small and medium enterprises in Taiwan’s export-driven development strategy is very important. In 1985, for example, small and medium enterprises contributed about 50 percent of value added and employed 62 percent of the workforce in Taiwan (Biggs, 1991).

Furthermore, Tang emphasises that recent changes in Taiwan demonstrate the continued resilience and relevance of microcredit markets during a process of financial liberation. He also estimated that microfinance institutions of Taiwan have provided more than one-third of the total amount of loans to private enterprises in the country. A recent study shows that microfinance institutions are heavily relied on by small business entrepreneurs in Taiwan (Kan, 2000). The empirical evidence using micro data for the period 1977-1992, the emerging period of Taiwan as an industrialised country, reveals that microfinance institutions as a source of funds are important for small investors’ capital accumulation.

In general, in many other developing countries microfinance institutions also play an important role in serving credit to individuals, farmers, and small-scale enterprises (Adams & Fitchett, 1992). The size of microfinance markets in developing countries, in particular informal microfinance markets, is documented in some studies published in the 1990s (Gerimidis, Kessler, & Meghir, 1991; Ghaite, 1992b; Ghaite, 1992a; Hoff, Braverman, & Stiglitz, 1993; Pischke, 1991). Each study is based on comparative material drawn from a number of countries. There is common evidence in these writings, that microfinance markets remain large, and that most loans in developing countries are provided by the microfinance institutions, particularly in rural areas. Conversely, the market share of formal lending (commercial banks) in rural credit markets is relatively small.

Von Pischke, in his book *Finance at the Frontier* (1991) published by the World bank, estimated that formal agricultural credit (subsidised credit) probably does not reach more than 20 percent of farm households in the majority developing countries. Meanwhile, Braverman and Guasch (1993) state, in Chapter 3 of *The Economics of Rural Organization* (Hoff, Braverman, & Stiglitz, 1993), that “it has been estimated that only 5 percent of farmers in Africa and about 15 percent in Asia and Latin America have had access to formal credit (commercial banks); on average across developing countries 5 percent of the borrowers have received 80 percent of the credit.”

In the same volume, a study of rural credit in Thailand (Siamwalla, Pithong, Pongsaksorn, Satsangam, Nettayarak, Moomaneenak, & Tubpun, 1993) found that almost 75 percent of those active in the credit market are still used the informal microfinance sector; in many cases, those household also used the formal sector (commercial banks). Other study in the volume report that a 1988-89 survey of four villages in northern Nigeria found that only 7.5 percent of all loans (by value) come from banks, companies or projects (Udry, 1993).

A study published in 1991 by the Development Centre of the Organisation for Economic Co-operation and Development (OECD) provides extensive findings on the share of formal (commercial banks) and informal microfinance institutions in developing countries (Gerimidis, Kessler, & Meghir, 1991). The data used in this study, which were collected at different times by different people for different purposes, vary considerably by country. Some sources provide the number of loans, while others cite the value of loans. However, the data are still useful as indications of the generally large informal microfinance markets in developing
countries. For example, the study reported that in Bangladesh, if all major studies since 1974 are taken into account, the mean size of credit from informal (microfinance institutions) sources was estimated in 1983 to be about 60 percent, with a range from 30-90 percent. But informal moneylenders were estimated to cover 77 percent of farmers’ credit needs.

The study also present that, during the early 1980s, only 17 percent of agricultural households received credit from the government’s special programmes which means that 83 percent of these households received no formal credit at all in Indonesia (Kermidis, Kessler, & Meghir, 1991). Recent data, based on the estimation of Bank Indonesia & GTZ (2000), there are 6,123 units of BRI Unit Desa and People’s Credit Bank (BPR) that are serving almost 28 million low-income clients all over the countries. There are also 7,617 units of nonbank financial institutions (such as BKK, LPD, and BKD) serving about 2.084.000 clients and 6,495 cooperatives serving about 6.1 million members. Total clients served by microfinance institutions in Indonesia included NGOs, self-help groups, and arisan (ROSCAs) are estimated about 5.1 million people (it is about a quarter of Indonesia’s population).

The study of Kermidis et al also report that it was estimated in 1985 that informal (microfinance) credit accounted for 50 percent of the average outstanding loans of agricultural households in Republic of Korea. In Thailand, it was estimated 1988 that 52 percent of the loans made to the agricultural sector were from informal (microfinance) sources.

Ghate’s studies (Ghate, 1992b; Ghate, 1992a) summarize some studies, which estimates of the relative size of microfinance institutions, and finds the general conclusion that the share of microfinance institutions accounts for about one-third to two-thirds of total rural credit in Bangladesh and China, about two-fifths in India, Sri Lanka and Thailand and two-thirds to three-quarters in Malaysia, Nepal, Pakistan and Philippines. In India and Philippines microfinance institutions comprises about two-fifths of total urban credit.

As well as other countries, in its early stage of development Japan also relied on microfinance institutions for serving credit to low-income people, particularly in rural areas. It is less well recognized, however, that microfinance institutions—the so-called kou—played such important role (Izumida, 1992). Kou is a simplified name for group savings and loans associations. They were a popular form of financial intermediation, especially in rural areas, until the mid-1900s. Sometimes the more comprehensive terms of tanomoshi-kou and mujin-kou (or simply mujin) have been used with only slightly differences in their meanings. Tanomoshi-kou connotes mutual help or helping the poor, while mujin-kou suggests money making or finance. In rural areas the term tanomoshi-kou has been more frequently used, while in urban areas the term mujin is more common. Using the data from the Central Bank of Japan, Izumida state that there were 985 registered kous in Kyoto Prefecture having 149 thousand individual members in 1910. In Fukushima Prefecture there were about 4,000 kous and in Hiroshima 22,376 kous with 3.9 million yen in kous funds. In 1934, data from the Ministry of Agriculture of Japan estimated that there were about 350 thousand kous in the country, involving 5 million people.

Izumida argues that although most kous have now disappeared from the current day of Japan, its influence can still be found in the genes of some of its offspring: the mujin-companies and the agricultural cooperatives. The discipline involved in saving, repaying loans, and making loans on the basis of creditworthiness trace many of its roots to the kou heritage. The most important feature of the Japanese experience with the kou is how it influenced formal financial institutions that evolved to provide services for the common
person. The financial services provided by the credit associations and the mujin-companies were logical extensions of the kou, built on its strengths, and were seen as indigenous rather than alien institutions by common people. This Japan’s experience with them provides interesting lessons for low-income countries that are struggling to modernise their financial systems. In the conclusion of his article, Izumida pointed out: “Perhaps governments and donors ought to take a more careful look at the existing informal (microfinance) institutions and attempt to build on that system, rather than trying to destroy it.”

Another sense in which the commercial banks and microfinance sectors are complementary are the considerable flows of funds, or “linkages” that already exist between the two sectors. These funds flow in both directions, although in rural credit the predominant flows seem to be from the commercial banks to microfinance institution. Hence, the banks are often an important source of funds for traders and moneylenders (microfinance institutions) who onlend informally. A study by Alam (1989), cited by Ghate (1992a), revealed that one half to two-thirds of rural informal loans originated with the banks and was on lent by informal lenders (microfinance institutions). In India, a study by Timberg & Aiyar (1984) found that traditional or “indigenous” banks (microfinance institutions) actually obtain refinancing from the banks, although this has now been discontinued.

In the reverse direction, the banks are repositories of funds that flow in from informal lenders (microfinance institutions). Ghate (1992a) stated that rotating savings and credit associations (ROSCAS), which are ubiquitous in Asia and mobilize considerable savings, often deposit idle funds in the banks. So do credit unions, savings groups, and money lenders. These funds are “on-lent” formally.

For the most part, however, in the middle segment of the continuum the two institutions usually compete with each other in meeting the same borrowing purpose (e.g. crop loans) as against complementing each other in fulfilling the credit needs of complementary purpose (Ghate, 1988; Ghate, 1992b). In this substitutive relationship, as commercial loans from commercial banks become more easily available, they displace loans from informal (microfinance) institutions. This is what happened in the some developing countries—for example: in Thailand, Sri Lanka, and Philippines—where subsidized agricultural credit has expanded in the last three decades, reducing the share of credit of microfinance institutions. In Thailand, it has been observed that microfinance institutions has declined relative important (Onchan, 1992). It has been mainly due to large expansion in subsidised agricultural credit.

In Sri Lanka, microfinance institutions also experienced a declining trend from 1957 to 1976 (Sanderatne, 1992). This was also mainly caused by the substantial increase in various agricultural credit programs. A study by Agabin et al. (1989) cited by Ghate (1992a), revealed that in the Philippines a substantial contraction of microfinance institutions took place in 1980s. An earlier expansion had taken place in 1970s with the Masagana 99 and other programs, but met with large-scale loan repayment problems, after which cheap rediscounting from the central bank was discontinued. This, and the economic crisis of 1983 - 1985, led to the closure of a large number of rural banks which, along with negative real interest rates, drastically reduced the supply of formal credit (commercial banks). Microfinance institutions made a come-back, and by the mid-1980s had reclaimed their 1960s share of total rural credit.

**ECONOMIC IMPACTS OF MICROFINANCE INSTITUTIONS**

The importance of microfinance institution on economic development can be analysed by
giving attention to variables and measures related to economic aspects. In this article, the economic importance will be seen by looking at three most important variables in the following paragraphs.

The first is the impact of microfinance institution on income. The study of Sebstad & Chen (1996) documented several studies on the impact of microfinance institutions both on enterprises and households income. Based on the documented studies, they found that the impacts of microfinance institutions on enterprise income, were generally positive, with average increases attributed to the loans ranging from 25 to 40 percent (Sebstad & Chen, 1996). Income increased for at least half of the enterprises in most of the studies, while it remained the same or even declined for a significant proportion. Several studies found the effects of credit on enterprise income to be cumulative - among repeat borrowers, enterprise incomes were higher, and comprised a higher proportion of total household income. They also found that the higher incomes resulting from credit were associated with increased capacity utilisation, diversification of goods or services sold, or lower cost supplies and raw materials. With respect to lowering costs, several studies, most notably from Egypt, found an important impact of program credit to be reduced reliance on supplier credit, resulting in lower cost inputs, more choice and quality in inputs, and less dependence on supplier controlled marketing channels (Sebstad & Chen, 1996).

Regarding the impacts of microfinance institutions on household income, Sebstad & Chen report that many studies find that microfinance has also a positive impact on households income, although the increases are variable. They report that a few studies show that all income groups experience increases, although the absolute amount of change is less for poorer households. A study from Sri Lanka shows large different in the amount of change between communities, indicating the important of local economic conditions (Hulme, Montgomery, & Bhattacharya, 1996). The findings from Africa were more mixed than from Asia. Clients from one program in Kenya had lower household incomes than the control group while clients from another program had higher household incomes (Buckley, 1996a). An clients in one program in Malawi experienced no change in this area (Buckley, 1996b).

In Indonesia, based on his study on BRI Unit Desa, BKK, and KURK, Mosley concludes that across the three institutions there was a tendency for households income to be increased in the period following the loan program (Mosley, 1996a). He points out that the BRI Unit Desa has the highest increases in household income. The average household (BRI's clients) income increase was 20.7 percent per year. The increase in household income is seen to be substantial across all loan size groups, but not to vary systematically by loan size. The largest increases in household income appear to have been obtained by borrowers operating just below the median loan and income.

A different study (Khandker, 1996) finds that the Grameen Bank, with more than 2 million members and a loan recovery rate steadily above 90 percent, has helped to increase household income by 29 percent in Bangladesh. The increase has in turn a positive impact on the poverty reduction in the village level. In another study, Khandker et al. (1998) find that the Grameen Bank, BRAC, and RD-12 increases household income by 29 per cent, 33 per cent, and 21 per cent respectively. The Grameen Bank and BRAC villages benefit more from a high growth in non-farm income rather than farm income, while RD-12 villages benefit more from the growth in farm income conversely. Overall, the studies confirm that the impacts of microfinance on enterprise and household income are generally positive, although the increases are variable.
The second is employment creation. Many studies analyse the impact of microfinance on employment creation and most of the studies found positive, but small, impacts on the number of paid employees (excluding owners) in enterprises (Buckley, 1996b; Khandker, Samad, & Khan, 1998; Khandker, 1998; Khandker, 1996; Mosley, 1996a). The increases were generally concentrated among a small proportion of borrowers, in most cases less than 25 percent of enterprises. Most enterprises experienced no change in paid employment. One study from rural Malawi finds that the impact on employment was primarily due to the start up of new enterprises, but this was a typical, since most programs tend to support ongoing rather than new enterprises (Buckley, 1996b).

A study from Bolivia shows that credit was used to take on paid labour only after the business has grown to a certain critical size in terms of sales or output. Before that increases in employment tend to be confined to family labour (Mosley, 1996a). A study from Bangladesh shows that borrowers of microfinance institutions may use family labour in and derive more income from rural non-farm sources than their non-borrowers because the microfinance institutions have made it possible to diversify their labour portfolio more toward non-farm activities (Khandker, Samad, & Khan, 1998).

Hulme & Mosley (1996) conclude that the limited impact on paid employment is a natural result of limited technological change that would demand more labour, and the risks associated with bringing in additional paid workers (Hulme & Mosley, 1996a). The impacts on paid employment are minimal among poorer borrowers and among first time borrowers. Programs serving more prosperous customers with larger enterprises generate more employment.

The studies generally indicate that the most significant employment impacts are related to increased use of family labour, or increased hours of work by owners or current workers. The Overseas Development Administration (ODA) studies find that increased output resulting from loans initially increases the demand for family labour (Hulme & Mosley, 1996a). Based on Nelson’s study (1984), Sebstad & Chen concludes that in Indonesia microfinance credit tends to have more impact on job stability and improved labour productivity than job creation. Hypothetically, increased use of family labour can be positive when it results in higher productivity; but negative when the returns to labour do not offset opportunity costs associated with an increased workload for women or with the use of child labour at the expense of their education. A more recent study from Indonesia (Mosley, 1996a), mentioned before, as well as the positive impact on income, Mosley also concludes that microfinance institutions tends to have positive impact on employment creation. However, the BRI Unit Desa scheme has the greatest impact. It has been able to double the employment across the sample as a whole over the recall period.

Another study at the impact of credit on household labour supply, defined as hours of work in remunerative activities, was Pitt and Khandker’s study (1996) from Bangladesh. Borrowing from a micro-credit programme such as the Grameen Bank increases per capita consumption, women’s non-land assets, women’s labour supply to cash income activities, children’s school enrolment, contraceptive use and fertility. However, programme benefits vary by the gender of programme participants. This study finds overall increases in women’s labour supply but decreases in men’s labour supply. Credit to women increases women’s labour supply but reduces men’s, while credit to men has no affect on women’s labour supply, while also reducing men’s (Pitt & Khandker, 1996).

The third is savings mobilisation. Savings mobilisation is the other side of the financial services coin. Savings constitute the basis for
achieving financial independence and the path toward microfinance self-sufficiency. Among others, Dale W. Adams (1978), Stuart Rutherford (1998), Laura Elser, Alfred Hannig, and Sylvia Wisniw (1999), and Marguerite Robinson (1994, 1995, and 2001) have provided the issue of the importance of microfinance institutions on savings mobilization.

Adams (1978) argues that the assumptions that households in developing countries are too poor to save and that they spend their windfall additional income on consumption or ceremonial sprees are incorrect. Based on his study on some Asian and African countries (such as Taiwan, Korea, Malaysia, and India), he found that substantial rural household capacities exist and the households savings are strongly influenced by rural financial markets (Adams, 1978). By offering various types of financial savings instruments, microfinance institutions (rural financial markets) have induced the household to convert some of its excess liquidity into financial savings in those countries. This has increased the average rate of return realised by the household on its savings portfolio and induced the household to divert more of its income to savings-investment activities.

Rutherford (1998) finds that the capacity of the poor of Bangladesh to save is large. He points out that the capacity has been used as the basis for self-help savings-and-loan devices that the poor (like others) have used in the absence of commercial banking services. An introduction of an innovative form of financial service provision in Bangladesh by microfinance institutions such as the Grameen Bank, BRAC and ASA which has exploited this capacity, has benefited millions of rural people and at the same time brought profits to the institutions (Rutherford, 1998). He argues that the successfulness on savings mobilisation is mainly due to that the mechanisms involved in the institutions are rooted in the realities of household economies, are well-understood by the poor, and are the basic to most traditional forms of self-help financial intermediation.

Based on the experiences of six microfinance institutions in Asia, Africa, and Latin America, a study by Elser et al. (1999) has also shown the successfullness of microfinance institutions in savings mobilisation. Elser et al found that all six institutions show impressive outreach quantity and quality. Comparing the actual number of depositors and borrowers with the size of their potential markets, these intermediaries reach between 10 percent and 85 percent of households, attracting a much larger number of depositors than borrowers. In general, the average loan size is much lower than per capita income with average deposit balances being much smaller than average loans. These indicators demonstrate that all institutions reach the poor with financial services (Elser, Hannig, & Wisniwski, 1999).

Elser et al. (1999) argue that there are at least two factors caused the success of savings mobilisation. First, savings product and mechanisms were tailored to the preferences of customers. A broad range of deposit facilities, offering different levels of return and access, has been most attractive for small savers. Clear and simple design of savings products alongside expressive trademarks and product names has helped customers choose a product and strengthen the corporate identity of the financial institution. Second, it is evident that successful savings mobilization requires a conducive macroeconomic environment. Where political turmoil, high inflation and uncertainty about the future prevail, savers will try to accumulate real assets rather than deposit their money in savings accounts.

From an institutional point of view, incorporating savings mobilisation in microfinance programs make sense for a variety of reasons (Robinson, 1995). First, it can provide a relatively inexpensive source of capital for re-lending. Second, today’s depositors may be tomorrow’s borrowers, so savings program
creates a natural client pool. Third, building up savings may offer important advantages to low-income households directly: households can build up assets to use as collateral, they can build up a reserve to reduce consumption volatility over time, and they may be able to self-finance investments rather than always turning to creditors. On the other hand, handling lots of small deposit accounts can be prohibitively expensive.

Drawing mainly on the experiences of BRI Unit Desa in Indonesia, Robinson (1994, 1995, and 2001) pointed out the benefits of savings mobilisation by microfinance institutions. First, benefits to individuals and enterprises. Robinson emphasises that when voluntary savings are mobilised by microfinance institutions, households and enterprises can benefit. Small-scale enterprises can self-finance in full or in part their working capital needs, as well as save toward investment needs. Substantial growth in an institution’s deposit can significantly increase the amount of credit available to small entrepreneurs. She also argues that savings accounts could provide security, legal recognition of the asset, and improve household financial management (Robinson, 1995; 1994; and 1998).

Second, benefits to groups, organisations, and institutions. BRI Unit Desas also provide savings accounts that can be held in the name of a group, organisation, or institution. This strategy has opened a substantial market for deposits such as from schools, village treasuries, religious institutions, informal savings and loans associations, and government offices. Previously, the group’s president or treasurer had usually held the organisation’s funds at home in cash, providing easy opportunities for corruption and mismanagement.

Third, benefits to the implementing financial institutions. Robinson point out that deposits mobilised in conjunction with commercial credit programs enable the growth of sustainable microfinance institutions. This could eliminate in turn the dependence of microfinance institutions on governments or donors agencies. Fourth, benefits to governments and donors. Robinson states that governments and donors also benefit since they can use the funds they previously provided to finance microfinance institutions for other development programmes. Lastly, benefits to the economy, development, and equity. Robinson argues that institutional savings mobilisation at the local level will deepens financial markets. Higher domestic savings enable higher gross domestic investment, contributing to higher economic growth. Finally, as microfinance helps to alleviate the poverty, equity will improve.

In conclusion, based on the studies above it could be concluded that microfinance institutions have had significant impact on economic development in terms of income generating, employment creation, and savings mobilisation.

CONCLUSION

Microfinance institutions can be defined as institutions whose major business is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises. However, some microfinance institutions provide social intermediation services such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group. Hence, microfinance institutions can also be expected to reduce poverty and to develop and strengthen the institutional capacity of local financial systems through finding ways to cost-effectively lend money to poor households.

Many studies have shown that the financial and banking sectors have been playing an important role in economic development.
Specifically, the McKinnon-Shaw studies show the importance of financial liberalisation and development in economic development. They view financial liberalisation and development could accelerate the rate of economic growth by increasing investment and its productivity. Since 1973 the McKinnon-Shaw financial repression paradigm has exerted considerable influence in macroeconomic policy in developing countries.

Microfinance institutions have two approaches in helping poor people. The first is the institutionist approach (the financial system approach) that focuses on creating financial institutions to serve clients. Emphasis lies on achieving institutional self-sufficiency through achieving financial self-sufficiency, breadth of outreach (number of clients) takes precedence over depth of outreach (the levels of poverty reached), and positive client impacts are assumed. Thus the centre of attention is the institution, and institutional success is generally gauged by the institution’s progress toward achieving financial self-sufficiency.

The second is the welfarist approach (the poverty lending approach) that concentrates on reducing poverty through credit, often provided together with complementary services such as skills training and teaching of literacy and numeracy, health, nutrition, family planning, and the like. Thus the welfarists are quite explicit in their focus on immediately improving the well being of participants. The goal is to reach the poor, especially the extremely poor—the poorest of the poor—with credit to help overcome poverty and gain empowerment. The welfarists are less interested in banking per se than in using financial services as a means to alleviate directly the worst effect of deep poverty among participants and communities, even if some of these services require subsidies. The centre of attention is the “family.”

The importance of microfinance institution on economic development is not only as financial intermediaries but also on income generation, employment creation, and savings mobilisation. Abundance of studies has shown that microfinance institutions development has positive impacts on those aspects.

REFERENCES


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