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## THE OCCURANCE AND THEORETICAL ASPECTS OF MICROFINANCE

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### **Abstract**

Micro-lending is a financial instrument for providing small loans and other financial services (such as micro-savings and micro-insurance) for the poor segments of the population for the purpose of self-employment or to start-up their own businesses. This method enables them and their families to be employed and economically independent. To better understand the concept of micro-lending in a scientific sense, it is necessary to investigate the circumstances and factors that have created the occurrence of this form of financing. The research in this paper starts from Bangladesh which is considered to be the "cradle of microfinance" in the world. Although there are differences between the countries that have developed microfinance such as population, culture, history, geographical features, economic development etc., there are also significant similarities. The main objective of this study is to determine whether there is a common pattern and to define the corresponding moment of socio-economic development that affects the initiation and development of microfinance in the countries that are the subject of this research. The research question is: What are circumstances that caused the occurrence of micro-lending, with a focus on Bangladesh and other countries where micro-lending developed? The hypothesis proved in the paper is: Microfinance occurs in countries that have high levels of poverty and low level of economic development. The comparative method is used to prove the hypothesis.

**Keywords:** Microfinance, Poverty, Loans, Microcredit

**JEL Classification:** O16, G21, D21, I32

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## **Introduction**

In the last two decades, the rapid development of the economy, increased competition, and technological changes that have taken place in all economic areas have resulted in changing economic practices, first in the most developed countries and then in developing countries. Under the influence of global trends, the focus has shifted from industrial to environmental industries, also, information has also become a basic resource, and the most profitable industries are those in which knowledge is more important than capital. At the same time, important international institutions that monitor and assist these processes in developing countries, such as the World Bank, the International Monetary Fund and others, have begun to insist on national governments being directly involved and responsible for the reduction of poverty, the social exclusion of individuals, the inclusion of minorities into mainstream economic activities, and in connection therewith, the elimination of social differences.

The great economic crisis that befell Europe and the world in 2007 has now quite certainly proved to have greatly worsened the position of citizens, especially individuals who before the crisis belonged to the most vulnerable. Their earnings have decreased, and many have fallen into the impossibility of regularly repaying their bank debts. On the other hand, jobs have become uncertain, and in recent years a very high unemployment rate has been recorded, especially, among the young. The main problem that is associated with unemployment is the called “financial exclusion” – i.e. the lack of access to basic banking services, which can contribute to the implementation of good business ideas. All of the situations mentioned above have emphasized the acute need for alternative sources of financing for small businesses, which has placed in the foreground the issue of micro-lending which has been the focus of intense interest to the business community for more than 40 years.

The United Nations in December 1995 launched a program called Microcredit<sup>1</sup>, which was aimed at reducing poverty in the most vulnerable parts of society. This program was presented as an introductory and motivational factor for better understanding the concept of microfinance, and to encourage a greater interest in this topic in scientific circles. The World Summit of Micro-crediting in February 1997, gave us the first official definition of micro-lending: a micro-program granting small loans to very poor people for self-employment projects that provide an income and self-determination of existence for individuals and their families. At the same time, the World Bank has established a special agency that monitors trends and issues manuals and rules for the efficient performance of micro-lending (CGAP - Consultative Group to Assist the Poorest). Micro-lending is defined as offering loans, savings, and other basic financial services to the poor.<sup>2</sup>

Bangladesh is considered to be the first country in the world that has successfully established microfinance. The idea of microfinance emerged after Bangladesh achieved its independence from Pakistan in 1971. Professor Muhammad Yunus from Bangladesh is the first pioneer of microfinance in the world.<sup>3</sup> He started the project by granting small loans with the goal of helping the poor to invest funds in a business idea which they were convinced would succeed. As a result of this experimental project, micro-lending is available today in many countries around the world and provides unobstructed access to financial services for the poorest segments of the population. It took more than 20 years for the concept of micro-crediting to develop and expand to other countries.

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<sup>1</sup> The Assembly of the United Nations Resolution 50/107, December 20, 1995, "First United Nations Decade for the Eradication of Poverty (1997-2006). Resolution 51/178, 16 December 1996, confirming the importance of microcredit and Global Microcredit summit held in 1997 where the plans and objectives for the coming period were defined.

<sup>2</sup> For more information, see CGAP (Consultative Group to Assist the Poorest) / The World Bank Group, 2009 <http://www.cgap.org/>

<sup>3</sup> Muhammad Yunus was born on 28 June 1940. He is a professor, economist, and banker from Bangladesh. During 1983, he founded the "Grameen Bank" which approved loans to the poorest segments of the population to start businesses. Prof. Muhammad Yunus is considered to be the creator of the concept of microcredit microfinance in the world. This concept then spread to many countries around the world. He was the recipient of the Nobel Peace Prize in 2006.

The main task of this paper is to investigate the circumstances that caused the occurrence of micro-lending, with a focus on Bangladesh and other countries where micro-lending developed.

Besides Bangladesh, this paper provides a detailed analysis of case studies of Bosnia and Herzegovina and Montenegro and provides an overview of the circumstances that caused the occurrence of microfinance in these countries. These countries are the objects of this detailed analysis because in the region Bosnia and Herzegovina and Montenegro are the countries where microfinance is most developed.

The first part deals with the occurrence and the theoretical framework of microfinance. The second part discusses the factors that caused the occurrence of micro-lending in Bangladesh and other countries with developed microfinance. Additionally, the paper analyses the relationship between microfinance and the banking sector in the case studies countries.

**The hypothesis proved in the paper is: Microfinance occurs in countries that have high levels of poverty and low level of economic development.**

## **1. The Occurrence and theories of microfinance**

Although microfinance has experienced success in the past 40 years, we cannot ignore the fact, which its first form, microfinance was created with the establishment of the Irish credit fund, in 1720. This institution granted small loans and proved that such lending could be financially self-sufficient and profitable.<sup>4</sup> Hans Dieter Seibel<sup>5</sup> has noted that after nearly a century since its founding an intensive development of this type

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<sup>4</sup> For more information, see CGAP (Consultative Group to Assist the Poorest) / The World Bank Group, 2009, <http://www.cgap.org/>

<sup>5</sup> Hans Dieter Seibel is a German author who writes about microfinance. He has written several research papers about financial services for poor entrepreneurs.

of lending in Ireland has initiated the following two events (Seibel, 2003, p.10):

- a) In the year 1823, a law was passed that allowed the approval of small loans with an appropriate interest rate,
- b) In the year 1836, a committee was established with the expressed goal of regulating and monitoring the Irish fund.

Another country that can be commended for granting small loans is Germany, where even as early as 1778, the authority responsible for banking and finance was involved in the institution, the control, and the supervision of microfinance in Germany.<sup>6</sup>

Two important economists who have dedicated their lives to the idea that the market economy and the loans are not the problems but the key solutions. One is Hernando de Soto, who discovered reason why loans are not favorable to entrepreneurship in poor countries: “The lack of legal property thus explains why citizens in developing and former communist nations cannot make profitable contracts with strangers, cannot get credit, insurance, or utility services: They have no property to lose” (Soto, 2000, p.55).

The whole idea of "microcredit" is the result of a successful experimental enterprise which took place in the village of Jobra in Bangladesh in 1970, and was conducted by Prof. Mohammad Yunus (Yunus, 2009, p.p.20-40). After realizing what was possible to achieve by granting small loans to poor people with solid business ideas, he came up with a new phrase – **microcredit**, which has the following characteristics:

- a) Microcredit is granted exclusively to the poorest segment of the population,

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<sup>6</sup> For more information, see CGAP (Consultative Group to Assist the Poorest) / The World Bank Group, 2009, <http://www.cgap.org/>

- b) A microcredit loan is not a consumer loan. i.e. used to buy consumer goods; but rather a small loan used to finance the development of entrepreneurship,
- c) Together with microcredit comes an advisory component. Debtors are trained by a loan officer in regards to how to transform their entrepreneurial idea into a successful business activity.

In 1976, Prof. Muhammad Yunus founded the "Grameen Bank" in Bangladesh, which has since then approved over US\$ 5 bn in small loans for about 5 million people.

Consequently, it is not a surprise that microfinance in the world is most represented in underdevelopment countries. Its primary goal is to reduce the gap between the poor who do not have access to bank and financial services to help them to set up a business, and the other more wealthy segments of the population who have access to these services.

Apart from authors who have researched the positive aspects of microfinance, there are other authors who have focused on the negative aspects of microfinance. Milford Bateman, Professor of Economist, has played an important role in criticizing microfinance (Bateman, 2010, p.p.1-5). He has analyzed the negative side of microcredit. Bateman has emphasized that proponents of microfinance argue that microfinance is crucial for the poor people in developing countries, creating new jobs while increasing their income, with special attention to women in businesses, which is according to Bateman incorrect. He argues that the "popularity" of microfinance is owed mainly to Prof. Muhammad Yunus, who due to his personal vision and reputation has managed to convince most people who are currently active on the relevant international economic scene to support his efforts (Bateman, 2010, p.p.1-5).

The main argument which Bateman developed in the book is that microfinance is largely contrary to the concept of sustainable economic and social development, and poverty reduction. He says: "Put simply,

microfinance does not work." The benefits of microfinance are insignificant compared to the huge long-term negative consequences and opportunity costs (Bateman, 2010, p.p.1-5). Also, this author believes that the increasing commercialization of microfinance is the main problem which was the cause of the destructive microfinance models in the 1990s. Since then, in his view, microfinance institutions have been oriented towards business, with the primary goal of achieving full financial sustainability and profitability, despite the fact that poor people and their projects can receive significant benefits and additional income from low interest rates. Also, he firmly believes that in any case, with a better conjunction with state structures, poor people can achieve much better results than what is currently achieved by microfinance (Bateman, 2010, p.p.1-5).

Milford Bateman's controversial opinions have produced many debates and discussions on this topic, especially with the well-known theorist of microfinance such as David Roodman. In fact, David Roodman concludes that microfinance cannot continue to live on its popular image and that it is impossible that at the same time 150 million poor people (i.e. the customers of microfinance) have all made the wrong decision (Roodman, 2012, p.5).

In addition, David Roodman on his Microfinance Open Book Blog in August 2010<sup>7</sup>, while discussing, Milford Bateman's new book, *Why Doesn't Microfinance Work? The Destructive Rise of Local Neoliberalism* explains the first beginnings of microfinance in Ireland, Germany, and Indonesia. Roodman points out that microfinance institution, as claimed by Bateman, were not established by donors or NGOs and their drivers are not neoliberals.<sup>8</sup> Also, he highlights that all these microfinance institutions have a common factor of solidarity, in

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<sup>7</sup> Center for Global Development, Independent research & practical ideas for global prosperity, David Roodman's Microfinance Open Book Blog [http://blogs.cgdev.org/open\\_book/2010/08/why-doesnt-milford-batemans-book-work.php](http://blogs.cgdev.org/open_book/2010/08/why-doesnt-milford-batemans-book-work.php)

<sup>8</sup> Ibid.

that they did not give subventions by donors and they have been able to be profitable.<sup>9</sup>

## **2. Idea and purpose of microfinance**

With the development of entrepreneurship, microfinance has occurred as an answer to the need for financial institutions to respond to the growing needs for financing small and relatively risky businesses.

There are three categories of citizens who cannot get a bank loan:

- 1) The unemployed who have never been employed - a category of the population that is not creditworthy,
- 2) The unemployed who were once employed, but have lost their job due to privatization, financial crisis, etc.
- 3) All the others who do not have a stable financial income and who cannot offer adequate guarantees to serve as collateral for obtaining loans in banks. They are considered to be too risky to get a loan from a bank.

Microcredit is not a consumer loan; it is designed for investment in fixed assets and working capital. It can be obtained in a short period, and usually it is repaid by fixed annuities in several installments. Due to the huge number of small loans that require extensive processing time, microfinance institutions have high administrative costs which are a cause of high interest rates on small loans. High administrative costs are caused by the high costs of monitoring and following -up entrepreneurs. The second reason for high interest rates is high-risk clients. Credit decisions are not based on an automated system of evaluating loan applications and a scoring system (as exist in the banking sector).

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<sup>9</sup> Ibid.

Consequently, good credit decision requires significant intervention from loan officers in assessing credit risk. The next factor which influences high interest rates on loans is clients who are mainly from geographically isolated and rural areas. Specifically, microfinance institutions often operate in remote and rural areas which have low population density, which further increases the costs per loan and makes loans expensive.

The main micro products which were launched together with the idea of microfinance in Bangladesh are:

- 1) Individual loans for women in business. These are loans that are used to finance women's business ideas,
- 2) Group loans. Their main characteristic is to lend money to individuals who are organized in groups. This product has two characteristics:
  - Social collateral: If any member of this group is late with their loan repayment, nobody else in the group can get a loan again. This condition creates social pressure where each borrower is forced not to be late with repayment of their loan.
  - Cooperation: If any member of this group is faced with some difficulty in repaying their loan, another person in the group will repay the loan on their behalf because they have a mutual trust. It strengthens the group which fully protects the interests of microfinance institutions (Khan and Rahaman, 2007).

Demand for microcredit is, at this point on a global level, significantly higher than the supply (Shaohua and Martin, 2004). In order to reduce the gap between demand and supply, it is necessary to increase the capacity of the existing microfinance institutions or establish new institutions. The gap is constantly increasing and there is a need for more than an additional US\$ 300 bn of loans in order to meet the demand for microcredit loans (Unger and Hieminga, 2012, p.30).

The European Commission through funds, such as the European Investment Fund, provides financial support for micro SME customers, depending on the stage of an accession of the existing and prospective members of the European Union (EU).

### **3. Differences between countries in which microfinance occurs**

In the Balkan region, Bosnia and Herzegovina and Montenegro are the countries where microfinance is most developed.<sup>10</sup> This paper analyzes case studies of Bangladesh, Bosnia and Herzegovina and Montenegro, and gives an overview of the circumstances that caused the occurrence of microfinance in these countries.

The first impression is that among these countries there are no similarities, and only significant differences such as population, size, culture, history, and level of economic development. An example in regards to population, Bangladesh has 155 million people; Montenegro has 621 thousand, while Bosnia-Herzegovina has 3.83 million people. Additionally, Bangladesh is a country with much lower levels of economic development compared to Montenegro and Bosnia and Herzegovina. At the end of 2012, the GDP per capita in Montenegro was higher by 9.5 times compared to Bangladesh and 58% higher in relation to Bosnia and Herzegovina. The Gross National Income (GNI) per capita in Montenegro is 8.9 times higher than in Bangladesh and 32% higher than in Bosnia and Herzegovina.<sup>11</sup> On the other hand, the average amount of microcredit in Montenegro is almost 11 times higher than in Bangladesh.

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<sup>10</sup> See Appendix 1: Development of Micro-lending in the World

<sup>11</sup> The World Bank, World Development Indicators (2012) <http://data.worldbank.org> . GDP in Montenegro was US\$ 7,253, Bosnia and Herzegovina US\$ 4,754, while in Bangladesh US\$ 732. GNI in Montenegro was US\$ 7,011, Bosnia and Herzegovina US\$ 5,301 while in Bangladesh \$ 788. The GNI coefficient prefers the MIX Market.

If one takes into account the average amount of loans relative to the GNI, as an important indicator<sup>12</sup> of comparison in accordance with the recommendations of the MIX market<sup>13</sup>, we get a comparison of micro-lending in countries, despite them having large differences. The following table shows the average amount of microcredit and GNI per capita in Bangladesh, Bosnia and Herzegovina, Montenegro, Russia, India, and Indonesia.

**Table 1:** Average Loan per Borrower and GNI Per Capita

Country	Average loan balance per borrower (ALPB)	GNI per capita in US\$ (GNIPC)	Average loan balance per borrower / GNI per capita
Bangladesh	160	753	21.24%
Bosnia and Herzegovina	1,416	4,760	29.75%
Montenegro	1,712	6,988	24.50%
Russia	2,144	10,388	20.64%
India	163	1,486	10.97%
Indonesia	133	2,910	4.57%

<sup>12</sup> The Mix Market uses this indicator for the comparison of the development of microfinance between different countries. Further, in this research paper, an interpretation of this indicator has been given.

<sup>13</sup> One of the best known global microfinance networks in the world "Microfinance Information Exchange" i.e. MIX Market.

**Source (1):** Data refers to 2012. Microfinance Information Exchange, 2012, <http://www.themix.org/publications/microbanking-bulletin/2011/10/2010-mfi-benchmarks>. For Montenegro, it refers to two Micro Finance Institutions (MFIs) and **Source (2):** World Bank: <http://data.worldbank.org/> [Table Data processed by the research paper author.]

By looking at the table above, we can see that for Bangladesh, Bosnia and Herzegovina, Montenegro, and Russia, the indicator "average loan per borrower / GNI per capita" is on a similar level, i.e. in ranges from 20.6% in Bangladesh to 29.7% in Bosnia and Herzegovina. In India and Indonesia, the ALPB / GNIPC indicator is at a lower level and ranges up to 11%. This ratio shows the average share of microcredit in average earnings of the residents living in the countries analyzed. This suggests that despite differences between countries (population, culture, history, economic development, etc.) micro-lending in these countries is comparable and among them there are similarities. **In fact, the average borrower of microcredit to generate a US\$ 100 Gross National Income borrows US\$ 21.24 in Bangladesh, US\$ 29.75 to US\$ 24.50 in Bosnia and Montenegro, which they used to buy fixed assets or working capital to setup a new business or expand an existing one.**

In the next chapter, which explores the circumstances that caused the occurrence of microfinance we will be looking for similarities and factors that have influenced micro-lending in the countries that have been compared in the table above.

#### **4. The socio-economic factors which had an influence on the initiation and development of microfinance in Bangladesh**

Bangladesh is considered to be the first country in the world which established microfinance. More than half of the population lives below the poverty line, and earn less than US\$ 1 per day. The GDP per capita in the years when microfinance first occurred amounted to only US\$ 136 in 1970, while in 2011 it amounted to US\$ 732.

The remainder of this paper identifies the main specificities of the socio-economic environment that caused the appearance of microfinance<sup>14</sup>:

**1) Conflict situations, i.e. the period of the Bangladesh war for independence;**

As a result of economic discrimination and West Pakistan's political domination of East Pakistan (now Bangladesh), East Pakistan began the struggle for independence waging a war that lasted for nine months<sup>15</sup> and declared independence on 26 March 1971. The idea of microfinance emerged after the war, i.e. in conditions when Bangladesh had been severely damaged by the war, and several million people received refugee status (Rahman, 2013, p.1).

**2) Poverty is very pronounced;**

A Number of people living with an income below US\$ 2 per day, compared to the total population of Bangladesh in 1984 was as high as 90.5% (83 million people).<sup>16</sup> Unemployment in Bangladesh has always been one of the biggest problems.<sup>17</sup> The Human Development Index (HDI) ranks Bangladesh at the 146th place in the world, out of 186 countries.<sup>18</sup> Poverty and overcrowding have forced many to start their lives in other places, i.e. in unstable and insecure areas of the

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<sup>14</sup> The World Bank, World Development Indicators, <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>

<sup>15</sup> In December 1971, Bangladesh with the support of India defeated West Pakistan and since then officially considered to be gained independence.

<sup>16</sup> It was measured in 1984 for the first time.

<sup>17</sup> According to official data published by the World Bank, the unemployment rate was around 4.5% at the end of 2012 and 1.8% in 1984, when it was first measured. For more information, see The World Bank: <http://data.worldbank.org/indicator/SL.UEM.TOTL.ZS/> ; The Global Economy: <http://www.theglobaleconomy.com/Bangladesh/indicator-SL.UEM.TOTL.ZS/>). However, unemployment was estimated at 40% or 30 million people. One of the main reasons these indicators vary is that the employees are considered as people who work a few hours a week with low wages. For more information see CIA World Factbook: <https://www.cia.gov/library/publications/the-world-factbook/fields/2129.html>. and Academia.edu: [http://www.academia.edu/859072/Unemployment\\_Problem\\_in\\_Bangladesh](http://www.academia.edu/859072/Unemployment_Problem_in_Bangladesh)

<sup>18</sup> UNDP (United Nations Development Program), with the International Human Development (IHD) indicators for 2013, <http://hdrstats.undp.org/en/countries/profiles/BGD.html>

country, but with better job opportunities. In the years when microfinance first appeared the majority of the populations were of working age but still unemployed. They had no income or other types of collateral that could have been used as a guarantee for obtaining loans from banks, which would have been used to create a business activity.

**3) Unstable economic and political conditions followed by military intervention;**

From 1975 to 1991 in Bangladesh experienced frequent military interventions during changes of government, which is usually reflected through the introduction of a state of emergency in the country.

**4) Mostly rural population;**

Bangladesh is one of the most densely populated countries in the world.<sup>19</sup> Population density in 2011 was 1,174 inhabitants per square kilometer and in the period from 1961 to 2011 the population increased more than 3 times. For the purpose of comparison, in Montenegro, the population density was 46.14 while in Bosnia and Herzegovina it was 75.28 inhabitants per square kilometer. The Bangladesh population lives mainly in rural areas and is primarily orientated towards agricultural production. In 1960, as many as 95% of the total population lived in rural areas, compared to the percentage in the year 2012, when rural population dropped to 71% (110 million). Although the number of the rural population has more than doubled in the studied period from 1961 to 2012, the rate of population growth from year to year has constantly decreased.<sup>20</sup>

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<sup>19</sup> By population density of Bangladesh occupies eighth place in the world. The World Bank: <http://databank.worldbank.org/data/views/reports/tableview.aspx#>

<sup>20</sup> The World Bank, World Development Indicators (2012), [http://data.worldbank.org/country/bangladesh#cp\\_fin](http://data.worldbank.org/country/bangladesh#cp_fin)

**5) Weak education system and a high percentage of illiterate population;**

In the period from 2001 to 2006, the average investment in education accounted for about 2.2% of the GDP.<sup>21</sup> This indicator in Montenegro is 4.5%. In 1981, only 29% of the population over 15 years was literate (Rahman and Yusuf, 2011).

**6) Poorly developed banking system;**

After the war for independence, in 1971, the banking financial system was poorly developed. The banks were state-owned, and their main purpose was to give money to sectors (primarily state companies) that were supposed to speed up the reconstruction of the heavily damaged country. Expansion loans with conditions that were not stipulated according to the real market and were granted without adequate risk assessment caused a delay of loans and the bad bank management. The Bangladesh banking sector was dominated by four state-owned banks known as the "Nationalized Bank (NCB)," which controlled close to half of the total assets in the banking system.<sup>22</sup> Bangladesh banks had not considered having the poor segment as their clients because they represent a high credit risk, do not have stable income managed through banks and do not have adequate collateral, which could serve as a loan guarantee.

**7) Very low level of economic development;**

At the moment of the creation of microfinance, in Bangladesh economic development was at a very low level. The GDP per capita was at a very low level, and in 1971 it amounted to US\$ 129 whereas in 2012 it was US\$ 747. This shows that the rate of GDP growth was

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<sup>21</sup> For example, at the end of 2010, investment in education in Germany is 5%, and in Austria 5.9%. For more information, see <http://databank.worldbank.org>.

<sup>22</sup> The World Bank, World Development Indicators (2012), [http://data.worldbank.org/country/bangladesh#cp\\_fin](http://data.worldbank.org/country/bangladesh#cp_fin)

absorbed by the rate of population growth that also increased.<sup>23</sup> At the end of 2010, approximately 80 million people in Bangladesh did not have access to electricity. This indicator, even though it, shows a very low level of economic development, also demonstrates that Bangladesh has great potential for economic growth in the future.

### **8) Low level of economic freedom;**

According to data from the Heritage Foundation, in the last 19 years, the Index of Economic Freedom has not experienced any major fluctuations. Namely, in 1996, when they introduced the first measurement of economic freedom in Bangladesh, this indicator was 51.1, which then ranked Bangladesh at the 98th place in the world. At this time the world average was 57.1. In 2013, the Index of Economic Freedom was 52.6, ranking this country at the 132nd place in the world.<sup>24</sup> These indicators classified Bangladesh in the group of the poorest countries in the world with weak public institutions and strong state intervention that led to corruption. Consequently, it can be assumed that at the time of the occurrence of microfinance, economic freedom was at a low level.

## **5. Interdependence between microfinance, economic development, and poverty in the world**

Although there are large differences between countries in which microfinance occurred such as economic development, poverty, culture, history, etc., the goal of this study is to determine whether there is an interdependence between microfinance and economic development on the one hand and interdependence between microfinance and poverty on

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<sup>23</sup> In the period from 1971 to 2012, the population increased by 129% (87 million) while the GDP per capita increased by 477%. The World Bank, World Development Indicators (2012), [http://data.worldbank.org/country/bangladesh#cp\\_fin](http://data.worldbank.org/country/bangladesh#cp_fin)

<sup>24</sup> Heritage Foundation, 2013 Index Economic Freedom, [www.heritage.org](http://www.heritage.org), graphics and historical trends can be seen in <http://www.heritage.org/index/visualize#>

the other hand. Consequently, if there is interdependence, then a discernible pattern still needs to be identified.

By the data obtained from the international institutions which research microfinance<sup>25</sup> (Mix Market, CGAP, Microfinance Centre), microfinance has not developed in countries with high levels of economic growth measured by GDP per capita. Accordingly, the subjects of this research are the countries where microfinance has been developed.<sup>26</sup>

To determine the interdependence between microfinance, economic development, and poverty, the following indicators are used: the number of active borrowers per microfinance institution<sup>27</sup>, the GDP per capita and the poverty rate<sup>28</sup>. The following graph shows the interdependence between microfinance and economic development (**Graph 1**):

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<sup>25</sup> See data: MIX market : <http://www.mixmarket.org/>; CGAP-a: <http://www.cgap.org/>; Microfinance Centre: [www.mfc.org.pl/](http://www.mfc.org.pl/);

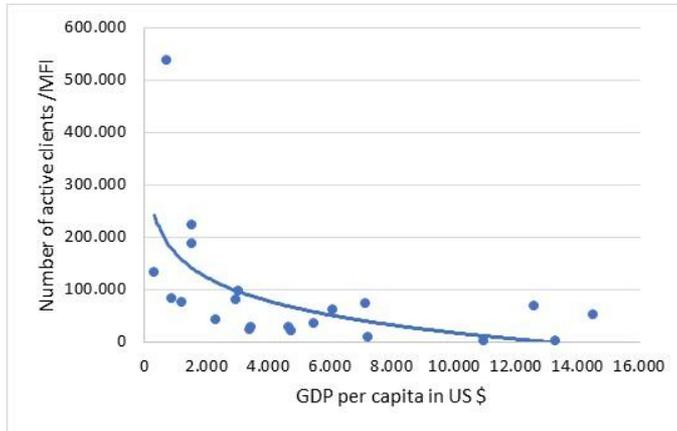
- MIX market on a monthly basis collects, systematizes, and publishes financial data for microfinance institutions located worldwide.

- How the microfinance model was successful during the last financial economic crisis, it has stimulated the interest in education and research by universities and institutions in developing countries as to the possibility of also applying this model used by underdeveloped and poor countries to developed countries. Examples are the University at Albany, the State University of New York, UN Capital Development Fund Partners with SUNY Institutions to Expand Education on Microfinance, European Investment Fund, and KIVA (the non-profit organization in USA).

<sup>26</sup> See Appendix 1.

<sup>27</sup> Active borrowers are clients who at the reporting date have not paid their loan, i.e. they have a debt to microfinance institutions. Additional indicators of the development of microfinance in one country can be used such as the number of active loans or loan portfolio per microfinance institution.

<sup>28</sup> The poverty rate was determined by using the Poverty headcount ratio at US\$2 a day (PPP) (% of population)

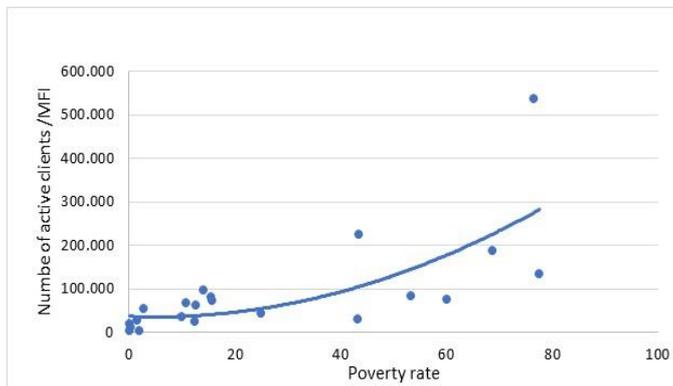


**Graph 1:** Interdependence between microfinance and economic development

**Source (1):** MIX market, <http://www.mixmarket.org/> [Data processed by the research paper author] **Source (2):** World Bank: <http://data.worldbank.org/> [Data processed by the research paper author]. See Annex 1

From the graphics, it can be seen that microfinance occurs in countries with low levels of economic development. In addition, there is regularity between these two occurrences, i.e. a negative correlation exists between microfinance and economic development. With decreasing GDP per capita, the number of active borrowers per microfinance institution grows and vice versa. It can be concluded that in countries with a lower level of economic development, microfinance is more developed, while in countries with higher levels of economic development, microfinance is undeveloped.

Interdependence between microfinance and poverty shows the following graphic (**Graph 2**):



**Graph 2:** Interdependence between microfinance and poverty

**Source (1):** MIX market, <http://www.mixmarket.org/> [Data processed by the research paper author] **Source (2):** World Bank: <http://data.worldbank.org/> [Data processed by the research paper author]. See Annex 1

Microfinance occurs in countries with higher levels of poverty. There is a positive correlation between microfinance and poverty. With increasing rates of poverty, the number of active clients per microfinance institution grows and vice versa. This refers to countries where poverty is more pronounced microfinance is more developed, while in the less poor countries, microfinance is less developed.

6. The circumstances that caused the occurrence of microfinance in Bosnia and Herzegovina and Montenegro

Although Serbia is a country in development, microfinance in Serbia has not been developed. One of the main reasons is the lack of adequate regulations by the National Bank of Serbia, which should define and establish the normal functioning of microfinance institutions. In regards to neighboring countries, microfinance is most developed in Bosnia and Herzegovina. In this country, microfinance occurred after the war ended in 1995. After the termination of this war, Bosnia and Herzegovina was faced with two problems:

- 1) How to rebuild the country's infrastructure;
- 2) How to implement market reforms in the economy.

Similar to Bangladesh, in Bosnia and Herzegovina there were socio-economic characteristics which caused the occurrence of microfinance which is as follows:

- 1) **Conflict situation, i.e. Period of War;**<sup>29</sup>
- 2) **High unemployment;**

It is estimated that in 1998 the unemployment rate in Bosnia and Herzegovina was 70% - 80% (Hukic, 2002).

- 3) **Expressed poverty;**

More than 60% of the population after the war lived below the poverty line (Hukic, 2002).

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<sup>29</sup> With the end of the war and the signing of the Dayton Agreement in 1995, a very large number of factories and homes had been destroyed, and micro-entrepreneurs, for the most part, were returning from the war, i.e. demobilized soldiers who before the war had been workers in factories

#### **4) Low level of economic development;**

In 1997, the first year of microfinance in Bosnia and Herzegovina, the GDP per capita was US\$ 1,038. However, by the end of 2011, the GDP per capita amounted to US\$ 4,754.<sup>30</sup>

#### **5) Donations;**

Microfinance institutions originally were created in the form of non-governmental organizations with the aim of providing assistance to the most vulnerable parts of the population. After 1995, the microfinance sector grew rapidly, transforming itself from institutions that received grants in sustainable microfinance institutions.

#### **6) Poorly developed banking system in state-owned banks**

#### **7) Unstable economic and political conditions;**

After the war, the Dayton Agreement in 1995 defined the relations of the constituent nationalities in Bosnia and Herzegovina. However, even today there is no consensus among the national leaders of the different political parties.<sup>31</sup>

#### **8) Low level of economic freedom;**

In 1998, when microfinance first occurred in Bosnia and Herzegovina, the Index of Economic Freedom was at a low level and

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<sup>30</sup> The World Bank, World Development Indicators (2012) <http://data.worldbank.org/country/bosnia-and-herzegovina>

<sup>31</sup> EBRD (2013): *Strategy for Bosnia and Hercegovina*, EBRD; <http://www.ebrd.com/downloads/country/strategy/bosnia-herzegovina-draft-local.pdf>

amounted to 29.4 until the end of 2013 when it was at 57.3. This puts Bosnia and Herzegovina at 103rd place in the world.<sup>32</sup>

Much like in Bosnia and Herzegovina, microfinance in Montenegro is relatively recent. Microfinance institutions in Montenegro are governed by the regulations that were created by the Montenegro government in 1998 which defined the first legal conditions for the functioning of microfinance in Montenegro. The main circumstances that led to the emergence of microfinance are:

### 1) Donations;

Much like in Bosnia and Herzegovina, microfinance institutions were initially created as a non-governmental organization with the aim of providing grants to poor sections of the population, to be later transformed into organizations that grant micro-credits.<sup>33</sup>

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<sup>32</sup> The World Bank, World Development Indicator (2012): <http://data.worldbank.org/country/bosnia-and-herzegovina>

<sup>33</sup> There were three microfinance organizations: a) Opportunity Bank developed by the NGO Microcredit Montenegro in 1999. This bank had very strong support from the United States Agency for International Development (USAID), and during the transformation this bank also had technical support provided by the "Rabobank." An international organization called Opportunity International, using Opportunity Transformation Investments (OTI) is the majority owner of the Opportunity Bank Montenegro with over 75% of the bank's core capital which is approximately € 3 million. Opportunity International in cooperation with the local NGO Microcredit Montenegro offered microcredits to the entire population in Montenegro. NGO Microcredit Montenegro in 2002 was transformed into a bank and they expanded their range of financial services to include traditional services while also continuing to give strong support to micro-entrepreneurs.

b) In 1999, the international organization World Vision founded and established a local non-governmental organization called Agroinvest, with the support of the National Agency for International Development Canada (CIDA), and Sweden (SIDA). Agroinvest offers microcredits to the members of the population who live in the rural areas of central and northern Montenegro. Microcredits from Agroinvest are intended solely for agro-businesses, i.e. agriculture: livestock farming, fruit growing, processing and marketing of agricultural and dairy products and the like. The main goal of creating a microfinance institution like Agroinvest is to better develop the less modernized regions in Montenegro, as well as improving the conditions of life and work in the countryside.

c) A local Montenegro NGO Alter Modus was founded in 1997 with the financial support of the High Commissioner for Refugees (UNHCR), Church World Service (CWS), the Dutch Agency for International Development Cooperation (NOVIB), American Section of Agriculture (USDA), the European Bank for Reconstruction and development (EBRD), Oikocredit, and other institutions offer microcredits to the total population of Montenegro with great attention given particularly to refugees, displaced persons, and women which represent over 60% of the total loans given by NGO Alter Modus.

**2) Poverty;**

According to the first official study published in 2005, there were 11.2% of the population who were living below the poverty line.<sup>34</sup>

**3) Low level of economic development;**

The GDP per capita in 2000 was US\$ 1,610 while in 2011 it was US\$ 7,253.<sup>35</sup>

**4) High unemployment;**

In 2005, according to a study, the unemployment rate stood at 30.3%, and in 2012 it had dropped to 19.6%.

**5) Unstable economic and political circumstances before Montenegro became independent;**

**6) Poorly developed banking sector;**

The Central Bank of Montenegro was founded in 2000 and was later followed by a reformation of the banking system and the expansion of commercial banks. Before the reformation, the control of the banking system was not well-organized. In this period there were no foreign-owned banks. Banks were not interested in lending to the poor strata of the population.

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<sup>34</sup> The World Bank, *World Development Indicators (2012)*, <http://data.worldbank.org/country/montenegro>

<sup>35</sup> Ibid.

## **Conclusion**

This paper concludes that microfinance developed in countries with different demographic, economic, social, cultural, political, and historical circumstances. Large differences between countries were aggravating factors in the comparative analysis and proving hypotheses. Nevertheless, micro lending is comparable among different countries, as proved by the Average loan balance per borrower (ALPB) in US\$ / GNI per capita. Based on the data obtained by international institutions engaged in researching microfinance in the world, countries with high levels of economic development are not on the list of countries where microfinance has been developed. The results of this study showed that there is a negative interdependence between microfinance and business development. Microfinance is underdeveloped in countries with higher levels of economic development, and vice versa. On the other hand, between microfinance and poverty there is a positive correlation, i.e. in countries with a higher level of poverty, microcredit has developed and vice versa. Also, this paper had identified the common factors of socio-economic development that caused the occurrence of microfinance (statistics in the provided research apply to the period when microfinance first occurred in the considered countries). These factors are high unemployment, post-conflict situations, low levels of economic development, expressed poverty, and donations from international institutions, unstable economic and political conditions, poorly developed banking systems, and low levels of economic freedom.

All these arguments confirm the hypothesis that microfinance occurs in countries that have expressed poverty and low level of economic development.

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**Appendices**

**Appendix 1: Microfinance in the world**

Country	Number of MFI	Gross loan portfolio in US\$	Number of active borrowers	GDP per capita in US\$	Poverty headcount ratio at \$2 a day (% of population)	Number of active borrowers/MFI
Argentina	14	26,178,637	31,401	10,952	1.87	2,243
Armenia	13	696,549,113	300,186	3,422	12.43	23,091
Bangladesh	38	1,627,628,179	20,397,678	732	76.54	536,781
Bolivia	24	3,025,855,624	998,991	2,320	24.89	41,625
Bosnia and Herzegovina	12	536,166,681	238,822	4,754	0.19	19,902
Brazil	30	1,825,792,245	2,012,465	12,576	10.82	67,082
Cambodia	17	1,624,491,258	1,385,589	878	53.27	81,505
Chile	5	1,622,372,953	261,649	14,513	2.72	52,330
Colombia	31	5,266,444,942	2,275,136	7,149	15.82	73,391
Dominican Republic	12	646,764,662	403,554	5,493	9.88	33,630
Egypt	11	209,709,677	884,433	2,973	15.43	80,403
Ethiopia	7	191,366,855	928,176	335	77.63	132,597
India	117	3,587,246,055	21,887,497	1,540	68.72	187,073
Indonesia	16	10,069,158,618	455,356	3,471	43.33	28,460
Jordan	8	193,631,935	220,176	4,666	1.59	27,522
Montenegro	2	34,392,972	19,480	7,253	0.30	9,740
Morocco	7	504,036,071	679,630	3,044	14.03	97,090
Pakistan	26	219,397,556	1,968,477	1,214	60.19	75,711
Peru	60	8,732,062,543	3,623,360	6,112	12.74	60,389
Russia	41	241,615,361	89,271	13,284	0.05	2,177

Vietnam	33	5,296,099,213	7,365,619	1,543	43.46	223,201
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**Source (1):** MIX market, <http://www.mixmarket.org/> [Data processed by the research paper author]

**Source (2):** World Bank: <http://data.worldbank.org/> [Data processed by the research paper author]