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Introduction

The world has experienced substantial economic development and a rising standard of living. This development is however not equally spread around the globe. Most developing countries are faced with severe economic hardships and failing levels of economic performance. The underdevelopment of any country's economy will eventually lead to the population of that country to live in poverty. Therefore, the effort to ensure economic development and the alleviation of poverty is mainly focused in the underdeveloped and developing countries. This study shall focus on two main alternative strategies: microcredit and small and medium enterprises (SMEs) that play a vital role in the economic development of any country by creating self-employment opportunities and the provision of micro-loans, and on how this has helped in reduction of poverty. The study shall mainly focus in low-income (developing) countries.

The study is structured in five parts.

The first chapter deals with SMEs, its definition, classifications, characteristics, its contributions to economic development and the constraints it faces in accessing finance. Even though there are some similarities in the definition of SMEs, the definition vary across countries and international organizations. Some countries or organizations define SMEs based on the number of employees while others define it based on capital. The European Commission, for example, defined SMEs in terms of numbers of employees, classifying micro enterprises to be firm with 0 to 9 employees; small enterprises to be firms with 10 to 99 employees and medium enterprises to be firms with 100 to 499 employees.

The second chapter focuses on the sources of financing for SMEs. The accessibility to finance for SMEs is very important; thus, SMEs cannot survive without adequate financing. There are various ways in which SMEs can be financed or get finances. SMEs can be financed both internally (with own money or family financing) and externally (for example, bank financing). Because of the size of SMEs, it is very difficult for them to gain access to external financing, particularly from conventional banks, as they tend to lend more to larger enterprises. This happens mainly in developing countries.

The third chapter of this thesis centres on microcredit and its contribution to economic development. The modern microcredit was founded in 1976 with the creation of the Grameen Bank by Muhammad Yunus, an Economics professor who gave birth to the first financial institution based on microcredit worldwide, and it has become a popular instrument in

addressing credit constraint. Microcredit is now recognized universally as an instrument to combat poverty and financial exclusion, ensuring to the weaker a useful means in order to lay the foundations for an integrated social and economic growth.

The fourth chapter focuses on the financial analysis of microcredit interest rates. From the conception of microcredit in the late 1970s, it has faced with lots of criticism as a result of the high interest rates charged by microfinance institutions (MFIs) to their clients. The interest is the main reason for all forms of financial intermediation for both formal and informal markets. Since MFIs they are considered to be not-for-profit making organizations, they are therefore supposed to meet the financial requirements of the very poor at the lowest cost possible. The poor, when provided with these services will be able to 'create, own, and accumulate assets in order to smooth consumption' (CGAP, 1998).

The fifth chapter focuses on poverty reduction. Poverty is a multidimensional phenomenon and is defined as the income/money necessary to meet basic human needs such as food, clothing, and shelter. It sets a 'poverty line' of purchasing power (or command over material resources) based on the estimated values of these needs. A person is considered to be poor if his/her income level falls below this minimum line. A poverty line of $1.90 per day was set by the World Bank in 1990. As of 2013, an estimate of 767 million people worldwide are found to be living below the global poverty line of $1.90 per person per day. From this, Sub-Saharan Africa has the largest amount of people living below the international poverty line, at 389 million people.

CHAPTER ONE

Small and Medium-Sized Enterprises

1.1 Definition of SMEs

The definition an SME is very wide and constantly vary across nations, regions and even among international organizations like UNIDO, the OECD, the European Commission, and ASEAN. They all classify and define SMEs in diverse or similar ways. Some define or classify SMEs by using number of employees, annual revenues or start-up capital; others define SMEs in terms of their legal status and method of production. With regards to this, I shall highlight different definitions and classification of SMEs from different countries, regions and international organizations.

The definition

There is no consensus on the definition of Small and Medium-sized Enterprises (SMEs). Thus, SMEs are easier to describe than to define (Beaver, 2002; Wickham, 2004). Countless efforts have been made to define SMEs using yardsticks such as number of employees, sales volume, value of assets and firm size. Some of these frequently used yardsticks include the employee size, total assets, investments and sale level. According to Hallberg (2000), the context within which SMEs are defined or classified are specific to that context. In spite of the differences, a lot of sources defined Small and Medium-sized Enterprises to have between 0 to 250 employees.

The definition of SMEs varies across countries and regions and according to the size and structure of the economy. For example, the classification of SMEs by the number of employees in countries with large populations, such as China (1.357 billion, 2013), India (1.252 billion, 2013) and the USA (318.9 million, 2014), will have a higher cut-off point than less populated countries like Sierra Leone (6.592 million, 2016) and Ghana (25.9 million, 2013). Similarly, the level of economic development can influence the classification of SMEs if the size of capital structure is used.

Normally, less than 50 employees is the most widely used value for small enterprises, and less than 10 employees for microenterprises. For microenterprises, every region reports average values that are close to the 10-empolyee threshold, and the dispersion is the lowest among firm

sizes. In other words, the definitions for microenterprises appear more uniform about the number of employees by which an enterprise is classified as a microenterprise.

According to the OECD (2005), SMEs are "non-subsidiary, independent firms which employ less than a given number of employees". This number varies across countries. Most frequently, an upper limit of 250 employees (as in the European Union) is used to describe an SME. Even though some countries may set a limit of 200 employees. The United States however, consider an SME to include firms with fewer than 500 employees.

The European Commission (EC) define SMEs in terms of numbers of employees:

- Micro enterprises – firms with 0 to 9 employees
- Small enterprises – firms with 10 to 99 employees
- Medium enterprises – firms with 100 to 499 employees

Therefore, the SME sector comprises of those enterprises (except agriculture, forestry, hunting and fishing) which employ less than 500 employees. The definition of the European Commission does not assume that SME group is the same; that is, the definition makes a distinction between micro, small, and medium-sized enterprises. However, the European Commission definition is too broad to be applied to a number of countries.

In Nigeria for instance, Alaye-Ogan (2012) defined small business to be "companies with capital base between N20, 000 and N30 million (an equivalent of US $125 and US $193,500 respectively)." Hatten (2012:4), stated that "a company is considered small if it is independently owned, operated, financed, has fewer than 100 employees, and has relatively little impact on its industry". He further describe small businesses to be those business activities of factory workers who are engage in after-hour deliveries to owners of fast food restaurants etc.

In Nigeria, the Federal Ministry of Commerce and Industry defined SMEs as " businesses with capital investment that is not over N750, 000", while the Central Bank of Nigeria (CBN) in 2010, defined SMEs to be "businesses with asset base of between ₦5 and ₦500 million and a staff strength of 11 to 300 people" (Toyin A.A et al. 2014).

1.1.1 Classification of SMEs

As stated earlier, the classification of an SME varies across countries and regions. With regards to this, I shall split the classifications into two regions: SME classification in Africa and SME classification Asia, and take some countries from each of these regions into particular consideration. Before classifying SMEs according to regions or countries (with respect to Africa and Asia), I want to highlight the UNIDO classification on SMEs.

The UNIDO defines SMEs in terms of number of employees and classifies them into developing and developed economies differently (Abor and Quartey, 2010). Classification of SMEs in developing countries like Sierra Leone, Ghana, and Nigeria etc. is usually given as:

- Large – firms with 100 or more workers
- Medium – firms with 20 to 99 workers
- Small – firms with 5 to 19 workers
- Micro – firms with less than 5 workers

On the other hand, the classification of SMEs in developed and industrialised nations like the USA, the UK, and Japan etc.is given as:

- Small – firms with 99 or less employees
- Medium – firms with 100 to 500 employees
- Large – firms with 500 or more employees

1. **<u>SME Classification in Africa</u>**

The classification of SME like the definition vary across African countries. There is no regional or national consensus on the definition/classification (Sandy, 2003).In Sierra Leone for example, the National Industrial Development and Finance Organization (NIDFO) classify a small enterprise to one which is "owned and managed by Sierra Leoneans, having the potential of employing 1 to 6 workers, and with an investment capital in machinery and equipment not surpassing SLL 500,000 (approximately $211, equivalent using the 2016 exchange rate)." And the Sierra Leone Export Development and Investment Company (SLEDIC/SLIEPA, 2006) defined or classify an enterprise to be medium if it has the capability of employing 5 to 20 workers and has a capital investment not exceeding SLL 3,000,000 (about 1,266 USD, equivalent using the 2016 exchange rate). Furthermore, the Small and Medium Scale Business Association of Sierra Leone (SMSBASL), defined small enterprises, as having an

“employment cut-off point of 1 to 10 employees with a start-up capital of SLL 250,000 (about 44.3 USD equivalent using the 2016 exchange rate).” The work of Lidedholm and Chuta (1985) in Sierra Leone defined small business enterprises as “firms having a maximum of 50 employees.”

Moreover, in Ghana there are various definitions/classifications for SMEs. Each major organization for example has its own definition of SME. For instance, the Bank of Ghana, under the Funds for Small and Medium Enterprise Development (FUSMED), defined/classify small and micro enterprises to be those firms that has a capital in assets (not including land) of ₵25 million and ₵5 million (Osei Boch-Ocansey, 1996: 92). And the National Board for Small Scale Industries (NBSSI) defined small and micro enterprises as “having net assets worth between ₵30 million (ECU 15,000) and ₵300 million (ECU 120,000) and with a gross annual sales between ₵100 million and ₵750 million; and having employees between 10 to 100 persons (NBSSI; 1996).

Steel and Webster (1990), and Osei *et al* (1993), defined small-scale enterprises as having an employment cut-off point of 30 employees. Osei *et al* (1993), further classified small-scale enterprises as:

i. Micro – employing less than 6 people;
ii. Very small – employing 6 to 9 people; and
iii. Small – between 10 to 29 employees.

In South Africa, the most widely used framework is the National Small Business Act 102 of 1996 definition of the different categories of businesses, summarised below in table 1.1:

Table 1.1: Definitions of SMMEs given in the National Business Act 102 of 1996

Enterprise size	Number of employees	Annual turnover (in South African rand)	Gross Assets, excluding Fixed Assets
Medium	Fewer than 100 to 200, depending on industry	Less than R4 million to R50 million, depending on industry	Less than R2 million to R18 million, depending on industry
Small	Fewer than 50	Less than R2 million to R25 million, depending on industry	Less than 2 million to 4.5 million, depending on industry
Very small	Fewer than 10 to 20	Less than R200,00 to R500,000, depending on industry	Less than R150,000 to R500,000, depending on industry
Micro	Fewer than 5	Less than R150,000	Less than R100,000

Source: Falkena *et al*. (2001)

2. SME Classification in Asia

As the classification of SMEs varies in Africa, so does it in Asia. Taking into consideration some countries like China, India, and the Philippines etc. we will clearly see variations in the SME classification or definition.

In China, SMEs are classified by sector. Manufacturing and construction enterprises having fewer than 2,000 employees, a turnover not exceeding Rmb300 million, or with total assets lower than Rmb400 million, qualify as SMEs. Enterprises will qualify as SMEs in the postal/telecommunications and transportation sector if their turnover does not exceed Rmb300 million, or they have no more than 1,000 (postal) or 3,000 (telecommunications) employees. In the hotel and catering sector, enterprises will qualify as SMEs if they have less than 800 employees or a turnover not exceeding Rmb150 million (Hong Kong Trade Development Council, 2012). In comparison to China, with its annual GDP of 9.78 trillion US dollars, smaller African countries such as Cape Verde, Djibouti, Comoros, the Seychelles, and Equatorial Guinea, with a population of less than a million each and a

combined GDP of 18.8 billion US dollars (IMF, 2011), classify their SMEs according to their national output and economic activities.

In India, SMEs are classified mainly on the basis of investment on plant and machinery or equipment, and not on the employees count. A summary of this is given in Table 2.

Table 1.2: Definition of Micro, Small and Medium Enterprises, India

Enterprises	**Manufacturing Sector (Investment in Plant and Machinery)**	**Services Sector (Investment in Equipment)**
Micro	Does not exceed Rs2.5 million on investment	Does not exceed Rs1 million on investment
Small	More than Rs2.5 million, but does not exceed Rs50 million on investment	More than Rs1 million, but does not exceed Rs20 million on investment
Medium	More than Rs50 million, but does not exceed Rs100 million on investment	More than Rs20 million, but does not exceed Rs50 million on investment

Source: Government of India, Ministry of Micro, Small and Medium Enterprises

It is important to note that SME classifications are subject to change. For example, the European Union continues to update its classification of SMEs to reflect policy agendas. This is given in Box 1.1.

Box 1.1. Changes in the Definition of SMEs in the European Union

The European Union in 2005 introduces a new definition for MSEs stating that "there are three different categories of enterprises with each corresponding to a type of relationship which one enterprise might have with another." This distinction is necessary in order to establish a clear picture of an enterprise's economic situation and to "exclude those that are not genuine SMEs". Most SMEs are autonomous, since they are either completely independent or have one or more minority proprietorships (each less than 25%) with other enterprises. If that holding rises to no more than 50%, the relationship is deemed to be between partner enterprises. Above that ceiling, the enterprises are linked.

The EU stated that the first step to qualify as an SME is be considered as an enterprise. An enterprise according to the new SME definition is "any entity engaged in an economic activity, irrespective of its goal or form." The scope of the new SME definition is now clearly marked out. Thus, the self-employed, family firms, partnerships and associations regularly engaged in economic activity may be considered as enterprises.

The EU defined small enterprises as those "which employ less than 50 persons and whose annual turnover or annual balance sheet total does not exceed 10 million euro." And defined micro enterprises to be "enterprises which employ less than 10 persons and whose annual turnover or annual balance sheet total does not exceed 2 million euro."

(European Commission, Enterprise and Industry Publication, 2005)

1.1.2. General Characteristics of SMEs

Small and medium-sized enterprises are of diverse groups. They more or less operate the same way across countries and regions. SMEs are found in wide a range of business activities, "ranging from the single artisan producing agricultural implements for the village market, the coffee shop at the corner, the internet café in a small town to sophisticated engineering or software firm selling in overseas markets and a medium-sized automotive parts manufacturer selling to multinational automakers in the domestic and foreign markets." (OECD, 2004).

Small-scale enterprises are usually managed by the owner(s) or relatives of the business. Family firms or enterprises are those in which 'one or more families linked by kinship, close affinity, or solid alliances, hold a sufficiently large share of the risk capital to enable them to make decisions regarding strategic management' (Corbetta, 1995). Most of the ownership

structure of family owned businesses or one man business are termed as sole proprietorship and partnership. The sources of fund for these businesses are mainly from the owners' savings, borrowing from friends, relatives and banks (Ekpenyong and Nyong, 1992). Apart from them being financed by these sources, governments and some financial institutions (depending on the country or region) like the International Finance Corporation (IFC) provide soft loans to small scale enterprises, so as to help them grow from small to multination corporations. I shall dealt more on the sources of finance for SMEs in chapter two.

Fisher and Reuber (2000) cited a number of characteristics of SMEs in developing countries under the broad headings:

- Labour force characteristics;
- Sectors of activity;
- Gender of owner; and
- Efficiency.

i. Labour force characteristics

Under labour force characteristics, and given that most SMEs are one-person businesses, the largest employment category is working proprietors. This group makes up more than half the SME workforce in most developing countries; their family members, who tend to be unpaid but active in the enterprise, make up roughly another quarter. The remaining portion is split between hired workers and trainees or apprentices. This is why Anheier and Seibel (1987), Liedholm and Mead (1987) said "SMEs are more labour intensive than larger firms and therefore have lower capital costs associated with job creation".

ii. Sectors of activity

Small and medium-sized enterprises, in terms of sector of activities are mostly engaged in retailing, trading, or manufacturing (Fisher and Reuber, 2000). While it is a common perception that the majority of SMEs fall into the first category (i.e. labour force characteristics), the portion of SME activity that takes place in the retail sector varies considerably between countries, and between urban and rural regions on the same country. Retailing tends to mainly dominate the urban regions, while manufacturing can be found in either rural or urban centres. The extent of involvement of a country in manufacturing will however depend on a number of factors, including the availability of raw materials, taste and consumption patterns of domestic consumers, and level of development of the export markets.

In some African developing countries like Ghana, SMEs can be categorized into urban and rural enterprises. The urban ones can be sub-divided into 'organized' and 'unorganized' enterprises. The organized enterprises mostly have registered offices with paid employees, whereas the unorganized ones are mainly made up of "artisans", who work in open spaces, temporary wooden structures, or at home, and employ few or in some cases no salaried workers (Kayanula and Quartey, 2000). The unorganized enterprises rely mostly on family members, trainees or apprentices. The rural enterprises are largely made up of family groups, individual artisans, and women engaged in food production from local crops. The main activities within this sector include: fabrics, soap and detergent, clothing and tailoring, textile and leather, village blacksmiths, tin-smiting, ceramics, timber and mining, bricks and cement food processing, bakeries, beverages, wood furniture, electronic assembly, agro processing, chemical based products and mechanics (Kayanula and Quartey, 2000; Osei *et al*., 1993).

i. Gender of owner

In terms of gender of owner, the majority of SMEs are female-owned businesses, which are more likely operated at home as compared to those owned by males. This, however, affects their chances of gaining access to financing schemes, since home-based businesses are being under-represented in official statistics and it is not unusual that these schemes are designed without sufficient consideration of the needs of these businesses owned by females. However, these female entrepreneurs often get the impression that they are not capable of taking advantage of these credit schemes, simply because the administrative costs associated with these credit schemes often overweigh the benefits (Fisher and Reuber, 2000). Prior empirical studies in developing countries like Nigeria, Sierra Leone, Ghana, Indonesia, etc. have showed that female-owned SMEs usually have difficulty in accessing finance. Females are mostly involved in sole-proprietorship businesses which are mainly microenterprises and as such lack the necessary collateral to qualify for loan (Aryeetey *et al*., 1994; Abor and Biekpe, 2006).

ii. Efficiency

The measure of an enterprise's efficiency (for example labour productivity or total factor productivity) vary significantly within and across industries. The size firm may be associated with some other factors that are linked with efficiency. Factors such as technology, managerial

skills and the effect of the policy environment. Many studies in developing countries have shown that "the smallest firms are the least efficient, and there is some evidence that both small and large firms are relatively inefficient as compared to medium-scale enterprises" (Little, Mazumdar and Page, 1987). SMEs are often associated to be more innovative than larger firms as many small enterprises bring innovations to the market place, but the contributions of innovations to productivity often takes time, and "larger firms may have more resources to adopt and implement them" (Acs *et al*., 1999).

Table 1.2 below shows the characteristics of SMEs (or yet still Micro, Small and Medium-Sized Enterprises) of both formal and informal sectors of various services in India.

Figure 1.2 Characteristics of SMEs in the formal and informal sectors in India

India	Numbers		Percentages	
	MSMEs (Formal)	MSMEs (Informal)	%MSMEs (Formal)	%MSMEs (Informal)
Manufacturing and Processing (Total)	**1,009,577**	**3,998,262**	**59.2%**	**16.3%**
Iron, Steel and other metals	157,231	237,376	9.2%	1.0%
Non-metallic mineral products	56,692	220,060	3.3%	0.9%
Chemicals	50,065	89,687	2.9%	0.4%
Printing	40,464	102,649	2.4%	0.4%
Textiles and Apparel	321,477	2,031,519	18.8%	8.3%
Leather products	26,741	62,549	1.6%	0.3%
Wood and Paper products	66,827	514,582	3.9%	2.1%
Refined petroleum products	2,166	3,016	0.1%	0.0%
Rubber and plastic products	35,894	25,212	2.1%	0.1%
Machinery and equipments	152,100	146,043	8.9%	0.6%
Furniture	99,920	565,569	5.9%	2.3%
Services (Total)	**290,792**	**6,601,001**	**17.0%**	**26.9%**
Construction and Real estate	496	108,188	0.0%	0.4%
Health and Education	2,172	782,435	0.1%	3.2%
Food products, beverages and tobacco	217,020	2,240,763	12.7%	9.1%
Hotels and Restaurants	1,256	1,322,994	0.1%	5.4%
Repair and maintenance of vehicles	58,021	609,843	3.4%	2.5%
Recreational, cultural and sporting activities	2,560	161,523	0.2%	0.7%
Recycling	183	15,502	0.0%	0.1%
Renting of machinery and equipment	458	265,671	0.0%	1.1%
Research and development	4	1,450	0.0%	0.0%
Other services	8,622	1,092,632	0.5%	4.5%
Trade (Total)	**142,305**	**12,624,314**	**8.3%**	**51.4%**
Wholesale trade and commission trade	1,255	655,973	0.1%	2.7%
Retail trade and repair and maintenance of goods	141,050	11,968,341	8.3%	48.8%
Extractive Industries (Total)	**13,520**	**15,597**	**0.8%**	**0.1%**
Mining and quarrying	13,478	11,750	0.8%	0.0%
Oil and Gas	42	3,847	0.0%	0.0%
Infrastructure (Total)	**195,973**	**827,860**	**11.5%**	**3.4%**
Electricity, gas, steam and hot water supply	645	15,362	0.0%	0.1%
Collection, purification and distribution of water	101	11,358	0.0%	0.0%
Sewage and reuse disposal, sanitation and similar activities	34	0	0.0%	0.0%
Supporting and auxiliary transport activities, transport agenci	2,709	149,174	0.2%	0.6%
Post and telecommunications	171,127	610,214	10.0%	2.5%
Computer and related activities	21,357	41,752	1.3%	0.2%
Agribusiness (Total)	**1,149**	**19,577**	**0.1%**	**0.1%**
Fishing	124	3,826	0.0%	0.0%
Forestry and logging	1,025	15,751	0.1%	0.1%
Primary Agriculture (Total)	**11,871**	**34,933**	**0.7%**	**0.1%**
Agriculture and hunting	11,871	34,933	0.7%	0.1%
Other (Total)	**41,304**	**426,767**	**2.4%**	**1.7%**
Total	**1,706,491**	**24,548,311**	**100%**	**100%**

Source: Government of India, Ministry of Micro, Small and Medium Enterprises. Annual report 2009-2010 (p. 179-180).

1.2. Contributions of SMEs to the Economic Development.

In this section, I shall talk about the contributions of SMEs to the economic development of developing countries. My main focus will be on Africa and the Asian regions, since SMEs play a great role in the economic development on countries of these regions. Notwithstanding this, and knowing that SMEs are evident in every region, to get a clear picture of the importance of SMEs and their contribution towards the economic development of any nation, I will also give some preferences of SME contributions on the European, American and other developed countries economy.

The SME sector is the backbone of a country's economy. The OECD in 2005 reported that "more than 95% of enterprises in the OECD area are SMEs. These enterprises accounts for almost 60% of the private sector employment, make a large contribution to innovation, and support regional development and social cohesion".

Recent research shows that SMEs contributes over 55% of GDP and over 65% of total employment in high-income countries (this is demonstrated in figure 1.1). Also, in the low-income countries, SMEs and the informal enterprises account for over 60% of GDP and approximately over 70% of total employment, while in the middle-income countries they contribute over 70% of GDP and 95% of total employment (figure 1.2). Figures 1.1 and 1.2 shows that the relative importance of SMEs and the informal sector (that is, the shadow economy) are inversely associated with economic development.

Figure 1.1 SME Sector's Contribution to Employment and GDP (Median Values)

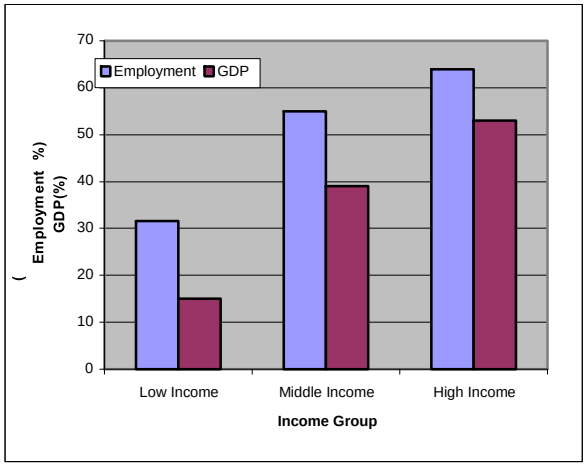
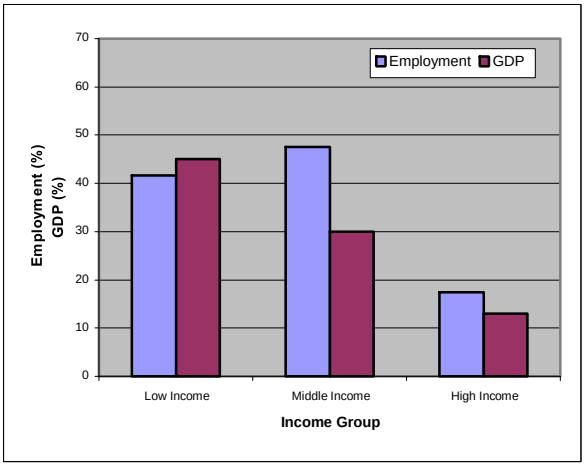


Figure 1.2 Informal Sector's Contribution to Employment and GDP



Source: Ayyagari, Beck and Demirgüc-Kunt (2003), p. 27-28.

Scholarly assessments of growth in recent times, converge on the view that "the rate at which countries grow is substantially determined by:

i. Their capabilities to maintain sustainable government finances and sound money;
ii. Their ability to put in place an institutional environment in which contracts can be enforced and property rights be established;
iii. Their ability to integrate with global economy through trade and investment." (Lawrence H. S. ,2003)

Here, the author lay emphasis on the 'abilities' and 'capabilities' to get certain growth outcomes accomplished rather than advocating specific policies.

According to Erdem & Erdem (2011) and Alaye-Ogan (2012), Small-scale businesses undeniably remain critical to the development of any nation's economy. Because, they are considered to be an excellent source of development, by helping in the development of local technology, and the development of indigenous entrepreneurs.

The small and medium-scale enterprises have been recognised with massive contribution to the economic growth of the developed economies of the world. The American economy, which is the biggest economy in the world, depends mainly on the success of SMEs for innovation, job creation productivity and stability (Chandler, 1977). In fact, there are approximately 23 million small businesses in the US; these altogether employ more than 50% of the private workforce, and generate more than half of the nation's Gross Domestic Product (GDP).

In developed nations like the European Union, SMEs are seen as an essential tool for European employment. Each year, one million new SMEs set up in the European Union and SMEs account for 99.8% of all companies and 65% of business turnover. SMEs are seen as a major source of entrepreneurial skills, innovation and employment. In the enlarged European Union of 25 countries, some 23 million SMEs provide about 75 million jobs and represent 99% of all enterprises.

In the UK, SMES do not only form the bedrock of the British economy, but they are widely accepted as the main hub of economic activity in the country. They are seen not just as job creators, but as creators of wealth. But to top it all, the UK government firmly believes that small and medium sized businesses are crucial to a successful enterprise economy and is fully committed to stimulating the creation, competitiveness and growth of new and small businesses (Ariyo D., 2000).

Ariyo (2000), also noted that SMEs are "the engine room for the development of any economy, because they form the bulk of business activities in a growing economy". This, he said is manifested through:

- ***Employment generation***: which contributes 30% to global GDP, play the role of principal safety-net for the majority of the population in developing countries' economies; employment capacity of about 58% of global working population.
- ***Economic growth and industrialization***: national economic development hinges on entrepreneurial energy of lively SMEs, as most big businesses grew from small scale businesses to become big businesses.
- ***Better utilization of indigenous resources***: considerable low capital outlay required for setting up SMEs enables them to convert minimal resources into productive ventures; offer veritable outlets for technological advancement, especially in businesses with rudimentary technology requirements.
- ***Rural development****:* SMEs constitutes major platforms for income generation and participation to the economic activities in lower income and rural developing societies. The employment opportunities offered apparently reduce rural-urban migration and allow even development.

1.2.1. SME Contribution in Africa

In this section**,** I will mainly focus on the contribution of SMEs to economic development in the Sub-Sharan African region. From what we have seen earlier, regarding the economic contributions of SMEs to countries/regions like the U.S, the U.K and the European Union, which have well developed economies, it is clearly seen that there is a consensus that the performance of SMEs is important for both social and economic development of both developed and developing economies.

In Ghana and South Africa, for instance, SMEs represent a huge portion of businesses both in the formal and informal sector. The SME sector represent about 92% of Ghanaian businesses and constitute about 70% of Ghana's GDP, and provide an employment rate over 80%. In South Africa, SMEs account for about 91% of the formal business entities, and contribute between 52% and 57% of GDP and provide employment rate about 61% (CSS, 1998; Ntsika, 1999; Gumede, 2000; Berry *et al*., 2002).

In Nigeria, small scale industry businesses are considered a better prospect for developing the domestic economy through the generation of goods and services and serve as a major source of job creation and economic growth. Therefore, the need to focus on these businesses has become very important in Nigeria, because it is a means of ensuring self-independence, job creation and import substitutions, effective and efficient utilization of local raw materials (Ojo, 2009). Small scale businesses contribute immensely to employment and path entrepreneurship. The focus of small businesses has shifted from providing only social goods to be a vehicle to entrepreneurship (Thurik and Wenneker, 2004). The SME sector account for 95% of the enterprises in the organised manufacturing sector and around 70% of industrial employment.

In 2012, the Enterprise Baseline Survey revealed that there are about 17 million SMEs in Nigeria, employing around 32.41 million persons and they contribute about half of Nigeria's GDP (46.54%) in nominal terms.[1]

1.2.2. SME Contribution in Asia

As noted earlier, SMEs tend to dominate the corporate community in all countries, at least in terms of company registration if not always in terms of aggregate size.

The rapid transformation of the high performing Asian countries like Hong Kong, India, Malaysia, Indonesia and Taiwan, have all being associated as proof that SMEs are the major substance to their economic development. The importance of SMEs to any economy centres on their ability to stimulate inventive entrepreneurship, to provide employment to a greater number of people, to mobilize and utilize domestic savings and raw materials, to provide intermediate raw materials or semi-processed products to large scale enterprises and restrict urban-rural migration. In light to this, we say SMEs provide the cornerstone on which any country's economic growth and stability rests (Ozigbo N.C. & Ezeaku P. 2009).

In less developed countries like Cambodia, Nepal, Pakistan, Bangladesh and the Lao People's Democratic Republic, SMEs represent a vast bulk of the corporate sector. In Japan, for example, SMEs account for about 99% of all firms, 70% of total employment, and 50% of GDP output.

[1] This was the revelation of the Enterprise Baseline Survey 2012, presented in Abuja, Nigeria. Available at: *http://www.vanguardngr.com/2012/12/smes-contribute-half-of-nigerias-gdp/*

In India, SMEs contribute significantly to employment, the manufacturing output and export of the country. In terms of value, it is estimated that this sector account for about 40% of the manufacturing output and 40% of the total export of the country. The sector has employed approximately 59 million persons in over 26 million units throughout the country. Furthermore, the sector has consistently registered a higher growth rate than the rest of the industrial sector.

There are over 6,000 products, ranging from traditional to high-tech items, which are being manufactured by the MSMEs in India. It is therefore well known that MSMEs (Micro, Small and Medium Enterprises) sector provides the maximum opportunities for both self-employment and jobs The MSME sector contribute 37.5%to India' GDP in the fiscal year beginning in 2012 (FY2012). Out of this, the manufacturing sector contributed approximately 7% and the services sector contributed 30.5% in the fiscal year of 2012 (Anshul P. & Sankalp S. 2016).

In the Philippines, the Micro, Small and Medium-Sized Enterprise (MSME) is doubtfully the biggest contribution to the nation's economic development. It contributes about 62.8% of the country's total workforce. Thus, the MSME sector plays a very important role in providing employment in both rural and urban areas and contribute to equitable income distribution. They account for 35.7% of the nation's total GDP (MSMED Plan 2011-2016), with the manufacturing sector contributing the largest share of about 6.8%. Also, the MSME sector contributes greatly to the export of the country, accounting for 25% of the country's total export revenue[2], and it is estimated that 60% of all exports in the country belong to the MSME sector.

1.3. Constraints of SMEs to Economic Development

Despite the potential role of SMEs to accelerate growth and job creation in both developed and developing countries, they still face a number of challenges that affect their ability to realize their full potential. The development of SMEs is hampered by a number of factors including the lack of access to finance, lack of managerial skills, lack of equipment and technology,

[2] **Source**: Bridging the Gap: Philippines SME and Globalization, Small Enterprises Research and Development Foundation (SERDEF), Inc, and UP-ISSI, 2001.

regulatory issues, and difficulties in the access to international markets (Anheier and Seibel, 1987; Steel and Webster, 1991; Ayeetey et al., 1994).

The lack of access to finance is a major setback for the SMEs sectors in many developing countries. However, I shall elaborate more on this aspect in the second chapter of this work (2.2. The constraints faced by SMEs in accessing finance).

The lack of managerial know-how places significant constraints on the development of SME. Even though SMEs tend to attract motivated aspiring managers, they can hardly compete with the larger firms. In terms of technology in under developed countries like Liberia, Sierra Leone, Bangladesh, etc., SMEs normally have difficulties in gaining access to appropriate technologies and information on available techniques (Aryeetey *et al.*, 1994). Therefore, in most cases, SMEs utilize foreign technologies with a scarce percentage of shared ownership or leasing. They often acquire foreign licenses, because local patents are difficult to obtain.

Regulatory constraints also pose serious challenges to the SME development and although wide-ranging structural reforms have led to some improvements, prospects for enterprise development remain to be addressed at the firm-level. The high start-up costs for firms, including licensing and registration requirements, can impose excessive and unnecessary burdens on SMEs. The high cost of settling legal claims, and excessive delays in court proceedings adversely affect SME operations. In the case of Ghana, the cumbersome procedures for registering and commencing business are key issues often cited. The World Bank Business Report (2006) indicated that it takes 127 days to deal with licensing issues and there are 16 procedures involved in licensing a business in Ghana. It takes longer (176 days) in South Africa and there are 18 procedures involved in dealing with licensing issues.

Meanwhile, the absence of antitrust legislation favours larger firms, while the lack of protection for property rights limits SMEs' access to foreign technologies (Kayanula and Quartey, 2000). Previously insulated from the international competition, many SMEs are now faced with greater external competition and the need to expand their market share. However, their limited international marketing experience, poor quality control and product standardisation, and little access to international partners, continue to impede SMEs' expansion in international markets (Aryeetey et al., 1994). They also lack the necessary information about foreign markets.

Chapter Two

Sources of Finance for Small and Medium-Sized Enterprises

2.1. Background

As advocated for by Cook (2001):

"*The role of finance has been viewed as a critical element for the development of SMEs*".

In this section, I will elaborate on the various sources of finance for SMEs, focusing on developing countries, mainly in regions like Asia and Sub-Sahara Africa. Some comparisons with developed economies shall also be considered. One of the major problems facing SMEs is the lack of access to finance; this in several ways restrain the continuity and slows down the growth activities and development of small businesses for both developed and developing economies, but most especially in the developing economies. With regards to this, I shall also elaborate on the constraints facing SMEs in accessing finance most particularly in developing countries. Also, SMEs can access finance from international corporations like the IFCs, which, in collaboration with other financial institutions and intermediaries, like the MFIs and banks, play a pivotal role in the financing of micro, small and medium enterprises globally. This, we shall also look at in the sub-sections that follows.

2.1.1 General Overview on the Sources of Finance for SMEs

Small and Medium-Sized (SMEs) plays a major role in most economies, especially in the developing countries. However, SMEs cannot survive and most definitely not contribute to the economic development of these economies if not financed.

According to a study done by Green, Kimuyu, Manos and Murinde (2002), "finance serves as the adhesive that collectively binds all elements of SMEs". The sources of finance for SMEs highlight the characteristics of formal and informal funding available to the firm (Gudov, 2013). SME in its form needs financing for the following two basic reasons:

i. to finance its production cycle once it has been stabilized (i.e. the working capital financing); and

ii. to finance its capital expenditure to expand the current business, to create new ones, or simply for maintenance purposes (example, plant and equipment maintenance or updates).

Small and Medium-Sized Enterprises are mainly financed through internal and external sources of financing. They can either be financed by equity (where the investor buys a share of the business/company value), debt financing (borrowing from financial institutions) or a combination of both. These types of financing are either derived from the formal or informal financial sector. The debt financing is further sub-divided into:

- Formal debt financing, which includes banks and other financial institutions;
- Trade finance, which includes obtaining credit from suppliers or customers; and,
- Informal credit from family, friends and moneylenders.

According to Ewiwile (2011), the sources of finance accessible to small businesses include:

- the personal savings of the business owner, as well as friends and family who maybe business associates;
- banks and financial institutions;
- business partners and associates; and
- members of the trade/business, as well as manufacturers, wholesalers, and in some cases, customers.

From the sources listed above, personal savings is the most accessible source of finance to a lot of small business owners. The other options (such as loan from banks and financial institutions) available for financing small businesses are essentially inaccessible.

Agwu (2014) stressed the fact that "the largest source of finance for SMEs around the world are the commercial banks". However, a lot of these banks are unwilling to provide finances to small businesses, mostly because of the risks and uncertainties that are involved in borrowing them.

With what we have seen so far, and knowing that SMEs are financed through internal and external source of financing and that they can either be financed by equity or debt financing, let us now take a look on how these sources function in relation to financing SMEs.

1. External Sources of Financing SMEs

External sources of financing SMEs are those finances that are obtained by SMEs from banks and other financial institutions, equity financing, etc.

a) Bank financing

Bank financing is an external and formal source of finance (debt finance) for SMEs and entrepreneurs, which are often heavily reliant on traditional debt to fulfil their start-up, cash flow and investment needs. Bank financing is the "most common and frequently used form of obtaining finance for SMEs" (Norton, 2003). Enterprises take banks as an intermediary to raise funds for their businesses. The lending of finance by banks to SMEs is governed by the Basel II norms, which addresses the issue of expensive credit terms by allowing a lower capital requirement for SMEs (BIS, 2003). However, information asymmetry is the most severe problem associated with the financing of small firms, despite the lower credit requirements. The bank–borrower (SME) relationship plays a significant role in the financing of SMEs, since bank financing requires long-term association (Berger & Udell, 1995). This type of lending is known as relationship lending, and this largely helps in solving the problem of information asymmetry (Petersen & Rajan, 1994). Berger and Udell (1995) also argued that if there is a long-term relationship between a bank and a SME, the bank charges lower interest rates and does not ask the SME to pledge any collateral. This supports the fact that relationship lending provides a better judgement in assessing the borrower's quality.

b) Non-bank institution financing

Small business financing from non-bank institutions have many methods, which may include finance leasing and pawn loans. Finance leasing is the transfer of risks and rewards of ownership of the leased asset to the lessee (but not the actual ownership). Financial leasing in its form has some special advantages in solving the problem of corporate financing compared with other tools. Pawn loans as compared to bank loans, need to pay a high total costs including the safekeeping fee, and transaction costs. Even though the cost of pawn loan is high, and has relatively small scale its operation process is however simple, so that it can quickly the funding needs of the enterprises.

c) Equity financing

Equity financing means that enterprises' shareholders give up part of the ownership and introduce new shareholders by increasing the capital of the enterprise. This shows an advantage that enterprises do not need to pay interests. The equity and finance obtained from a venture capitalist are not widespread especially in developing countries, this is due to an under-developed financial market and other institutional characteristics. Notwithstanding this, Berger and Udell (1998) sited that "equity finance is the most suitable form of finance available to small and young firms". Equity financing is the key for companies that seek long-term corporate investment, to sustain innovation, value creation and growth. Equity financing is especially relevant for companies that have a high risk-return profile, such as new, innovative and high growth firms. However, SMEs typically struggle to secure equity finance, because most of them (SMEs) do not offer attractive investment opportunities and they lack the necessary corporate governance to secure investors' rights (Venturelli and Gualandri, 2009), and this may therefore lead to financing gap for such firms.

Furthermore, equity finance is relatively expensive for SMEs as compared to other forms of finance. Venture capitalists, for instance, normally invest only a large amount of money and therefore finance large investments instead of smaller ones. This is because the availability of a venture capitalist and the SMEs' ability to approach the venture capitalist, especially in growing economies, are limited.

d) Public funds

Public funds mainly include commercial credits. It means that, enterprises provide credits to small businesses with direct relation to the commodity transaction of each other, such as payments by instalments or credits, and down payment, which can avoid a lot of limits to access to finances, as compared to bank loans, and decreases the cost of raising funds.

2. Internal Sources of Financing SMEs

Internal financing means that enterprises get capital from their own finances, this mainly include retained profits, and those from family members and friends. Internal financing is the first choice and the most important source of obtaining capital to finance SME activities.

a) Private lending

This is an informal form of lending that occurs between citizens and legal persons, and, citizens and other organizations, and is increasingly active with the advancement of the market economy of the society. This type of lending also includes lending from family members and friends who may or may not be associates of the business.

b) Retained profit

The retained profit form of financing is an important channel of internal financing, and most enterprises prefer this because it is cheaper. The business owner can transform retained profits into investment. This financing method enjoy some advantages such as: i) the no actual cash expenditure; ii) it keeps low debt capacity; and iii) no effects on corporate control. However, it also suffer some limits, such as time limitation; retained profits need a long time to accumulate, and besides, retained profits financing need to be balanced with a dividend policy.

3. Alternative sources of finance

With respect to all the sources of financing for SMEs discussed above, there are also some alternative forms of financing for SMEs highlighted by some scholars and international organisations.

Carey and Flynn (2005), discussed alternative forms of finance for SMEs that can be obtained through social networks. The benefits derived from these social networks define the social capital of the enterprise. This becomes more important in the context of SME financing because inter and intra-social association of SMEs can provide symbolic benefits to the related parties. Also, there are other informal sources of finance for SMEs, especially those that are designed to support new and promising ventures, where normally, formal resources are not easily approachable. Normally, these firm can generate funds through an electronic platform where several contributors put their money for a particular project. This type of source of financing (which is a new venture finance) is known as crowd-funding and in some ways appears to be useful for start-up businesses.

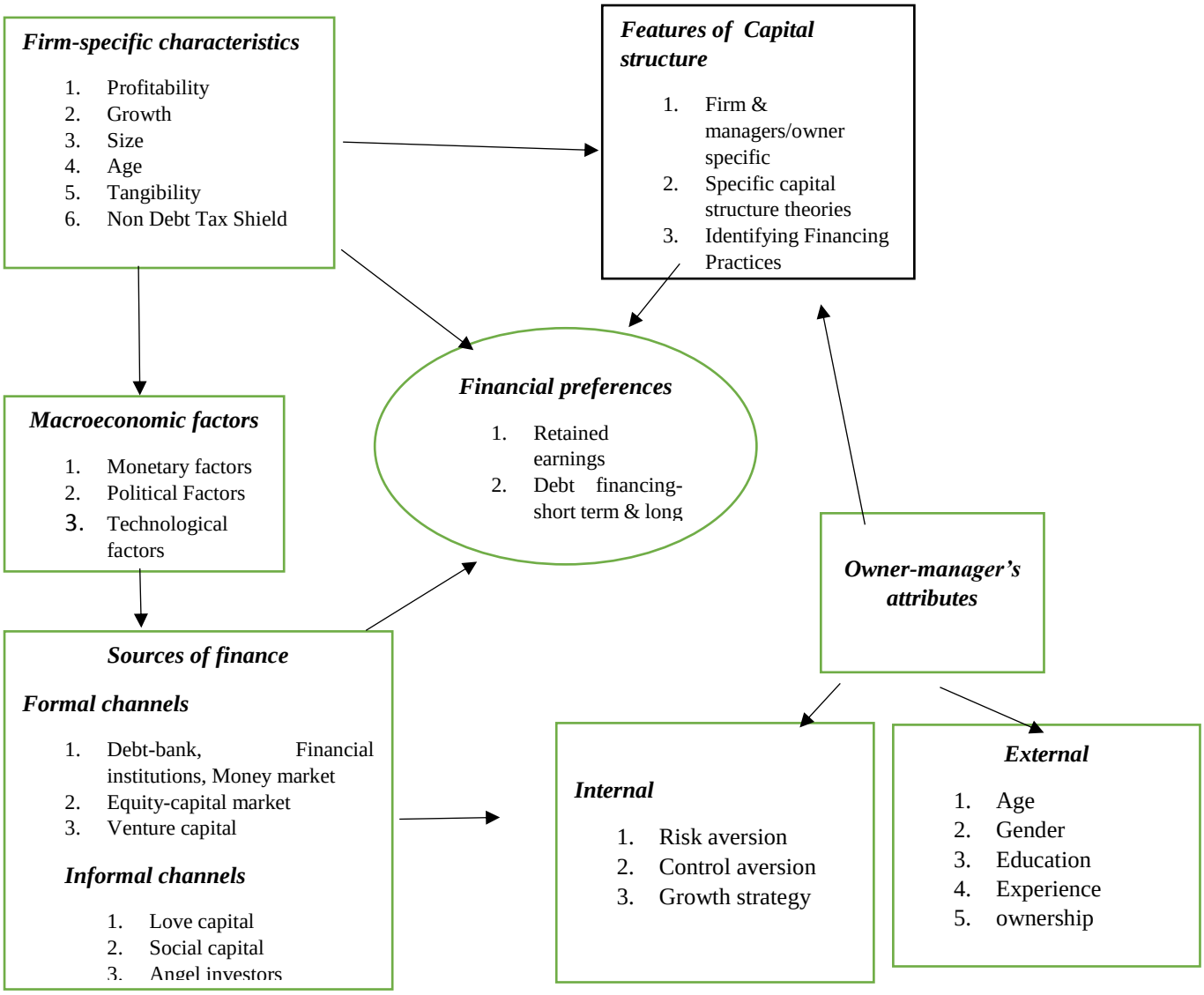
From what has been seen above and in light of various scholars, the above section examines the effect of both formal and informal resources; and one can conclude from the discussion that

informal financing is more widespread among SMEs as compared to formal financing. Even though there are some evidences that governments are taking initiatives to develop more approachable and easily accessible infrastructures to boost the economic growth of SMEs, however, there are still limitations hampering the progress of SMEs. The question of whether the existing preferred source of finance is a choice or an obligation for SMEs is yet to be answered. In order to address this question, Satish Kumar and Purnima Rao (2015) in their study, attempted to develop a conceptual framework for future research by highlighting the financing preferences for SMEs.

2.1.2 Designing a Conceptual Framework for SME Financing

The basic idea behind this is "to logically integrate all the relevant aspects of a concept to arrive at a process that can provide the best possible explanation of the problem stated" (Brown, Renwick &Raphael, 1995). It can be seen that SME financing is the most under-researched area of corporate finance (Wu *et al*., 2008). As needs and options for financing change with the size and age of a firm, it becomes vital to design a framework that can provide guidelines for the identification and analysis of the financing preferences for SMEs. The framework includes the demand side and supply side determinants of SME financing.

Figure 2.1. ***Proposed Conceptual Framework for SME financing***



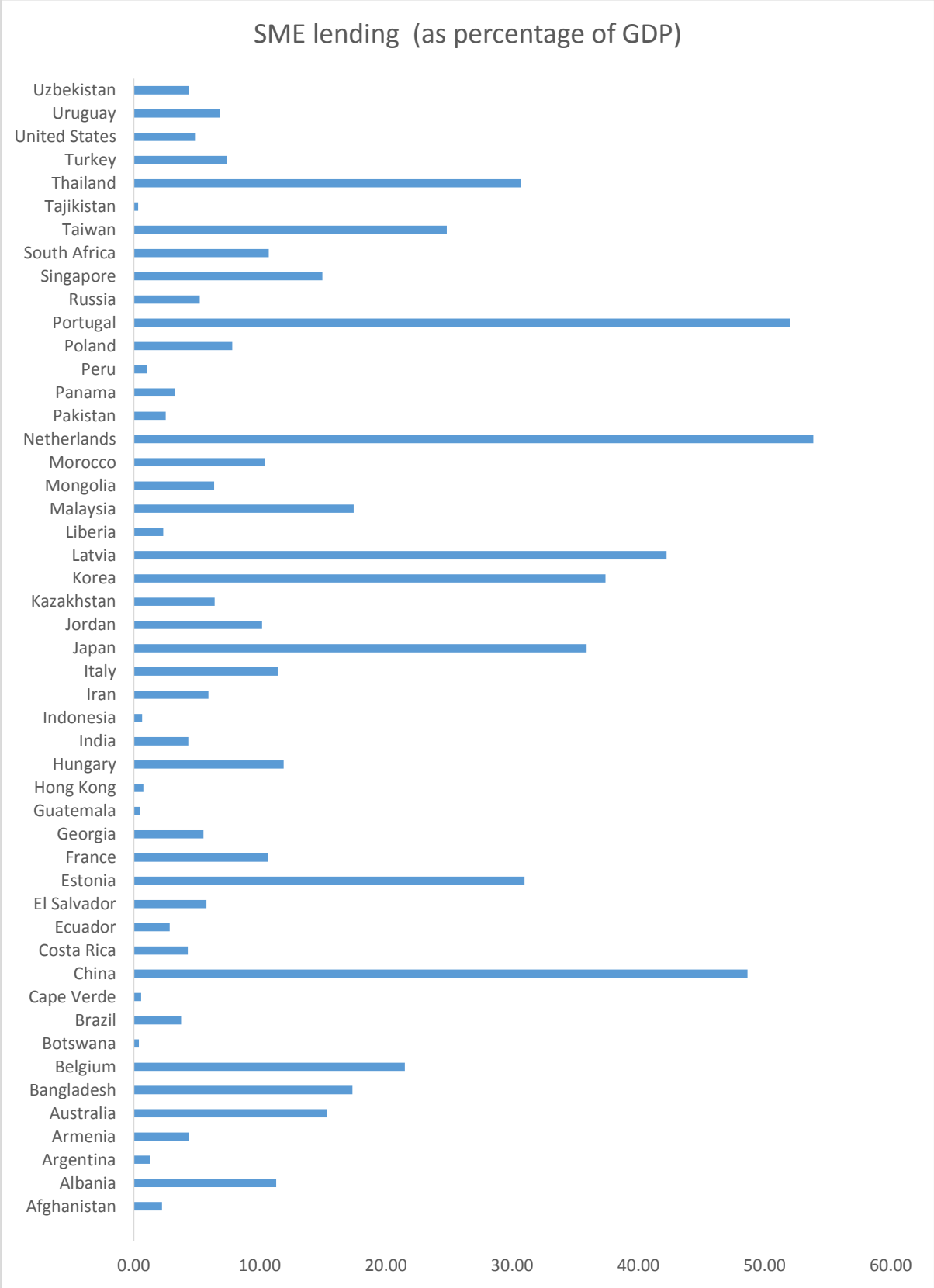
2.2. Access to Finance for SMEs

Financing SMEs has become a paramount issue, mainly in developing countries. Most international bodies are trying to identify different ways by which SMEs can gain financial access. With regards to this, G-20 countries in 2009 committed to identifying lessons learned on innovative approaches to providing financial services to SMEs and to promoting successful regulatory and policy approaches.

In this section, I will mainly focus on the access to finance for SMEs in developing economies like Asia and Sub-Saharan Africa and make some cross-country/regional analysis. I shall be using data from both the Enterprise Survey of the World Bank Group platform and the Financial Access 2010 survey by the Consultative Group to Assist the Poor (CGAP)/World Bank Group. These surveys allow a detailed exploration of cross-country and cross-firm variation in the use of financial services across firms with different characteristics. Some regression analysis is done to relate firm's access to finance and an array of firm and country characteristics.

Figure 2.2 shows SME lending as a percentage of GDP as a global comparison; 50 out of 142 economies from the Financial Access Survey 2010 database were able to provide data on SME lending. As it can be seen from the figure, the higher the GDP per capita of the economy the greater the volume of SME lending. Since countries like China (48.6%), the Netherlands (53.8%), Portugal (51.9%) etc. have higher GDP per capita, they have greater volume of SME lending as compared to countries like Afghanistan (2.25%), Cape Verde (0.59%), Liberia (2.34%), etc.

Figure 2.2 SME lending by Country as percentage of GDP



Source: Author's calculation based on Financial Access Database 2010.Available at: https://www.cgap.org/data/financial-access-2010-database-cgap

Table 2.1 shows the number and values of outstanding loan to SMEs (*Financial Access 2010* survey sample). Overall, 50 out of 142 regulators (economies) surveyed were able to provide data on the total value of outstanding loans to SMEs. 30 of these regulators are middle-income economies and 14 are high-income economies (table 2.1). Only Afghanistan, Bangladesh, Liberia, Pakistan, Tajikistan and Uzbekistan were able to provide data points among low-income economies. Tajikistan, the Netherlands and Portugal respectively have a ratio of 1% and 50% of SME lending to GDP. SME credit to GDP have a median ratio of 6.4%, while in 75% of the economies in the sample is below 15%. It is evident that high-income countries tend to have higher ratios of SME finance volume to GDP and total loans. This suggest a more developed SME finance market as compared to developing countries. Table 2.2 instead shows the monitoring of SME lending across country regulators, based on the Financial Access 2010 survey.

Table 2.1 SME lending

	Total value of outstanding loans to SMEs (USD)	**Total number of outstanding loans to SMEs**	**Total number of SMEs with outstanding loans**
Afghanistan	239,000,000	1,990	422,352
Albania	1,390,000,000		
Argentina	4,210,000,000	761,950	60,000
Armenia	520,000,000		
Australia	156,000,000,000		
Bangladesh	13,700,000,000		403,181
Belgium	107,000,000,000	325,595	172,706
Botswana	54,100,000		
Brazil	60,700,000,000	7,264,216	1,603,346

Cape Verde	10,300,000	242	190
China	2,110,000,000,000		
Costa Rica	1,280,000,000	74,863	44,979
Ecuador	1,510,000,000	771,683	
El Salvador	1,280,000,000	62,583	
Estonia	7,150,000,000	46,228	
France	303,000,000,000	499,493	270,475
Georgia	709,000,000	283,767	
Guatemala	197,000,000	155,536	
Hong Kong SAR, China	1,650,000,000	19,754	
Hungary	18,400,000,000	186,452	
India	52,900,000,000	4,851,082	
Indonesia	3,460,000,000	2,823,027	
Iran, Islamic Rep.	22,900,000,000	644,784	
Italy	262,000,000,000		915,637
Japan	1,760,000,000,000		
Jordan	2,040,000,000		
Kazakhstan	8,480,000,000		
Korea, Rep.	347,000,000,000		
Latvia	14,300,000,000	56,219	
Liberia	20,400,000	571	551
Malaysia	34,000,000,000	526,067	

Mongolia	336,000,000	45,323	45,323
Morocco	8,970,000,000		
Netherlands	463,000,000,000		
Pakistan	4,260,000,000		212,387
Panama	750,000,000	5,191	
Peru	1,390,000,000	1,896,923	1,334,794
Portugal	126,000,000,000	671,898	214,002
Russian Federation	84,300,000,000		
Singapore	27,200,000,000		
South Africa	29,700,000,000		
Taiwan, China	97,000,000,000		
Tajikistan	18,700,000		
Thailand	80,100,000,000		919,098
Turkey	58,600,000,000		1,664,254
United States	700,000,000,000		
Uruguay	2,210,000,000	298,591	
Uzbekistan	1,230,000,000		

Source: Financial Access 2010

Table 2.2 Monitoring SME lending

Country	Regulator monitors SME lending				Country	Regulator monitors SME lending			
	Yes, regularly	Yes, irregularly	No	No, but another agency does		Yes, regularly	Yes, irregularly	No	No, but another agency does
Afghanistan	+				Ecuador	+			
Albania		+		+	El Salvador	+			
Algeria	+				Estonia		+		
Anguilla			+		Ethiopia		+		
Antigua and Barbuda			+		Finland			+	
Argentina	+				France	+			
Armenia		+			Gambia	+			
Australia	+				Georgia	+			
Austria			+		Germany			+	
Azerbaijan		+		+	Ghana			+	
Bangladesh	+				Greece			+	
Belarus		+			Grenada			+	
Belgium			+	+	Guatemala	+			
Benin	+				Guinea Bissau	+			
Bosnia and Herzegovina	+				Honduras		+		+
Botswana			+	+	Hungary	+			
Brazil	+				India	+			
Bulgaria			+		Indonesia	+			+
Burkina Faso	+				Iran		+		
Cambodia	+				Israel			+	
Canada			+		Italy	+			
Cape Verde			+		Jamaica			+	
Chile			+	+	Japan	+			
Colombia			+	+	Jordan	+			
Costa Rica		+		+	Kazakhstan	+			
Cote d'Ivoire	+				Kenya	+			
Croatia			+		Korea	+			
Czech Republic			+		Latvia	+			
Denmark		+			Lebanon			+	+
Dominica			+		Liberia	+			
Dominican Republic		+		+	Lithuania			+	+

Source: Financial Access 2010 (https://www.cgap.org/data/financial-access-2010-database-cgap

Table 2.2Monitoring SME lending (continued)

Country	Regulator monitors SME lending				Country	Regulator monitors SME lending			
	Yes, regularly	Yes, irregularly	No	No, but another agency does		Yes, regularly	Yes, irregularly	No	No, but another agency does
Macedonia			+		Serbia			+	
Madagascar			+		Sierra Leone	+			
Malawi			+		Singapore		+		
Malaysia	+				Slovak Republic			+	
Mali	+				Slovenia	+			
Mauritania	+				South Africa	+			
Mauritius				+	Spain			+	
Mexico		+			St. Kitts and Nevis			+	
Moldova	+				St. Lucia			+	
Mongolia	+				St. Vincent and the Grenadines			+	
Montserrat			+						
Morocco	+				Sudan	+			
Mozambique			+		Switzerland			+	+
Namibia			+	+	Syria	+			
Netherlands	+				Taiwan	+			+
New Zealand			+		Tajikistan	+			
Nicaragua			+	+	Thailand	+			
Niger	+				Togo	+			
Nigeria	+				Tunisia	+			
Norway		+			Turkey	+			+
Pakistan	+				Uganda	+			
Panama			+		United Arab Emirates			+	
Peru	+				United Kingdom			+	
Philippines	+				United States			+	
Poland	+				Uruguay	+			
Portugal		+			Uzbekistan	+			
Puerto Rico			+		Venezuela			+	+
Russia	+				Yemen			+	
Rwanda			+		Zambia			+	+
Senegal	+				Zimbabwe	+			+

Source: Financial Access 2010 (https://www.cgap.org/data/financial-access-2010-database-cgap

2.2.1 Enterprise Access to External Finance, an International Comparison

As discussed previously, small businesses can either be financed by equity, debt financing or a combination of both. Kuntchev *et al*., (2012) stated that "SMEs in Sub-Saharan Africa rely mainly on trade credit and informal sources of financing than businesses in other regions." However, Kauffmann (2005), classified this high level reliance on informal borrowing as "unpredictable, insecure and offers little scope for risk sharing due to a local, regional or sector-based focus for lending". Also, Kuntchev *et al.,* (2012), in using the World Bank Enterprise Survey data, found that, of the small businesses in Sub-Saharan Africa that obtained external financing, 6.3% took the form of equity, 48.5% was formal external debt, 17.4% semi-formal financing and 27.8% informal financing (this is shown in table 2.3). As it can be seen from the table, the share of formal external borrowing increases as the size of the company increase, with the level of informal financing falling to 7.8% for large companies.

Table 2.3: Sources of external financing for the purchase of fixed assets, Sub-Saharan Africa.

Size of business	Equity external financing	Formal external debt	Semi-formal financing	Informal financing
Small (less than 20 employees)	6.3	48.5	17.4	27.8
Medium (20–99 employees)	6.4	59.1	21.2	13.3
Large (100 or more employees)	7.8	71.1	13.3	7.8

Source: Kuntchev et al. (2012), World Bank Enterprise Survey data.

From the previous literature review we can test a number of hypotheses to identify firm's access to external finance.

Hypothesis 1:

Firm's (SME) access to external finance by sources and types are related to:

(i) firm attributes: that is, the size of the firm, age of the firm, sector of operation of the firm, country stage of development, the business life cycle, the ownership type;

(ii) owner attributes: managerial experience, net worth, running more than one business; and

(iii) firm's past performance record: that is, profitability, and sales growth.

Hypothesis 2:

SME performance, that is SMEs' innovation capability and exports are related to:

(i) firm attributes: size, firm age, sector of operation, stage of country's development; and

(ii) access to finance.

Hypothesis 3:

Another hypothesis is one attributed to the conditions of the loan – tat is, loan size, loan duration and the interest rates offered to SMEs. These are related to:

(i) firm attributes: that is, firm size, age of the firm, sector of operation, etc.,

(ii) owner attributes: that is, his/her managerial experience, his/her net worth, running more than one business;

(iii) firm's past performance record: that is, firm's profitability, sales growth; and

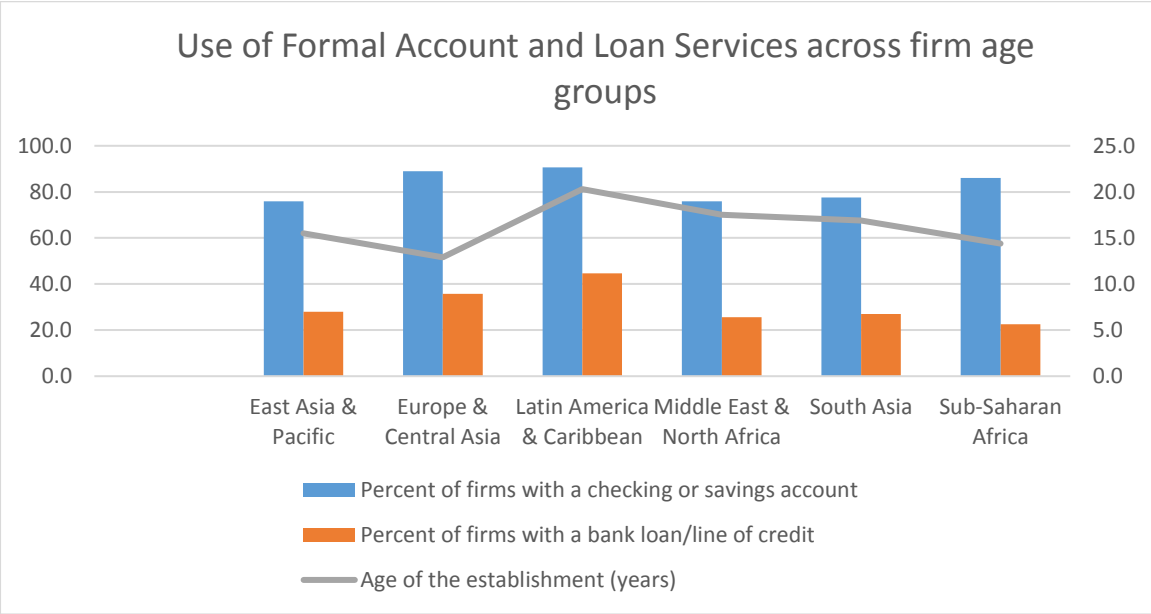
(iv) meeting lender's requirements: that is, collateral, business plan, financial statement, and cash flow.

As illustrated in figure 2.3, older firms (defined as those from 15 years of operation and above), are more likely to have a loan most especially in the Latin America & Caribbean (44.6%), South Asia (27.0%), East Asia & Pacific (27.9%), Middle East & North Africa (25.6%), and Sub-Saharan Africa (22.6%). While it is not the same with firms in Europe and Central Asia (with 12 years of operation and gaining a chance to access finance at 34.7%). There are not a lot of differences in terms of having access or a savings account facilities in all the regions, even though the percentage is higher in some regions, like Latin America & Caribbean (90.7%) and Europe & Central Asia (80.0%).

Small and Medium Enterprises (SMEs) cannot run their operations without either been internally or externally finance. With regards to this, figure 2.4 shows the regression of SME access to finance by its sources. It is evident from the regression that internal financing for firm is the most common among firms of various regions (among the selected ones). There is not

much significant difference among firms that uses internal resources to finance their operations, with the least been LAC[3] (63.7%), which is still above 50%. Small businesses as stated earlier, also use supplier credit to finance their investment operations. However, it is evident that it is not so common among the selected regions, with the highest being 7.6% (in LAC) and the least being 1.0% (in South Asia). Equity financing for SMEs is also another important aspect that have been discussed earlier. It can be seen from the regression that it so not so prominent among firms; with South Asia having 6.9% as the highest and East Asia & Pacific having 3.4% as the lowest users.

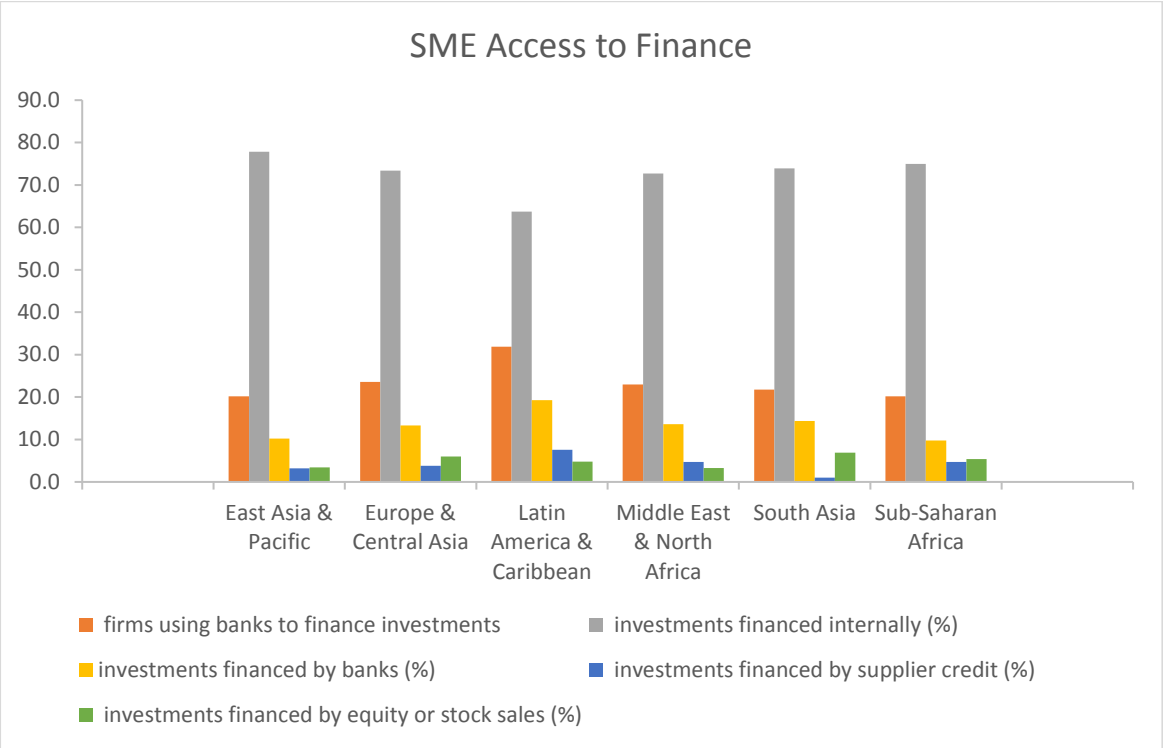
Figure 2.3. Use of Formal Account and Loan Services across firm age groups



Source: Author's calculations based on Enterprise Survey data. Available at: www.enterprisesuverys.org

[3] Latin America & Caribbean

Figure 2.4: SME Access to Finance by Sources.



Source: Author's calculations based on Enterprise Survey data. Available at: www.enterprisesuverys.org

2.3 Challenges faced by SMEs in Accessing Finance

Small and Medium-Sized Enterprise financing in developing countries is considered to be at the centre of the international development agenda and is of considerable interest to policy makers due to their importance for economic development as well as their potential contribution to economic diversification and job creation. However, SME growth potential in developing economies, especially in Africa, is limited as they are significantly more credit constrained as compared to large enterprises.[4]

In the Sub-Saharan African countries, banks have a crucial role to play in addressing the credit constraint obstacle due to their dominance in the financial systems and the lack of SME financing provided by informal financing mechanisms. In countries like Nigeria, Ghana, Sierra Leone, etc. banks such as the commercial banks, the central bank, and other international development agencies are some of the main financial institutions in the formal financial sector that have played a great role in the financing of SMEs.

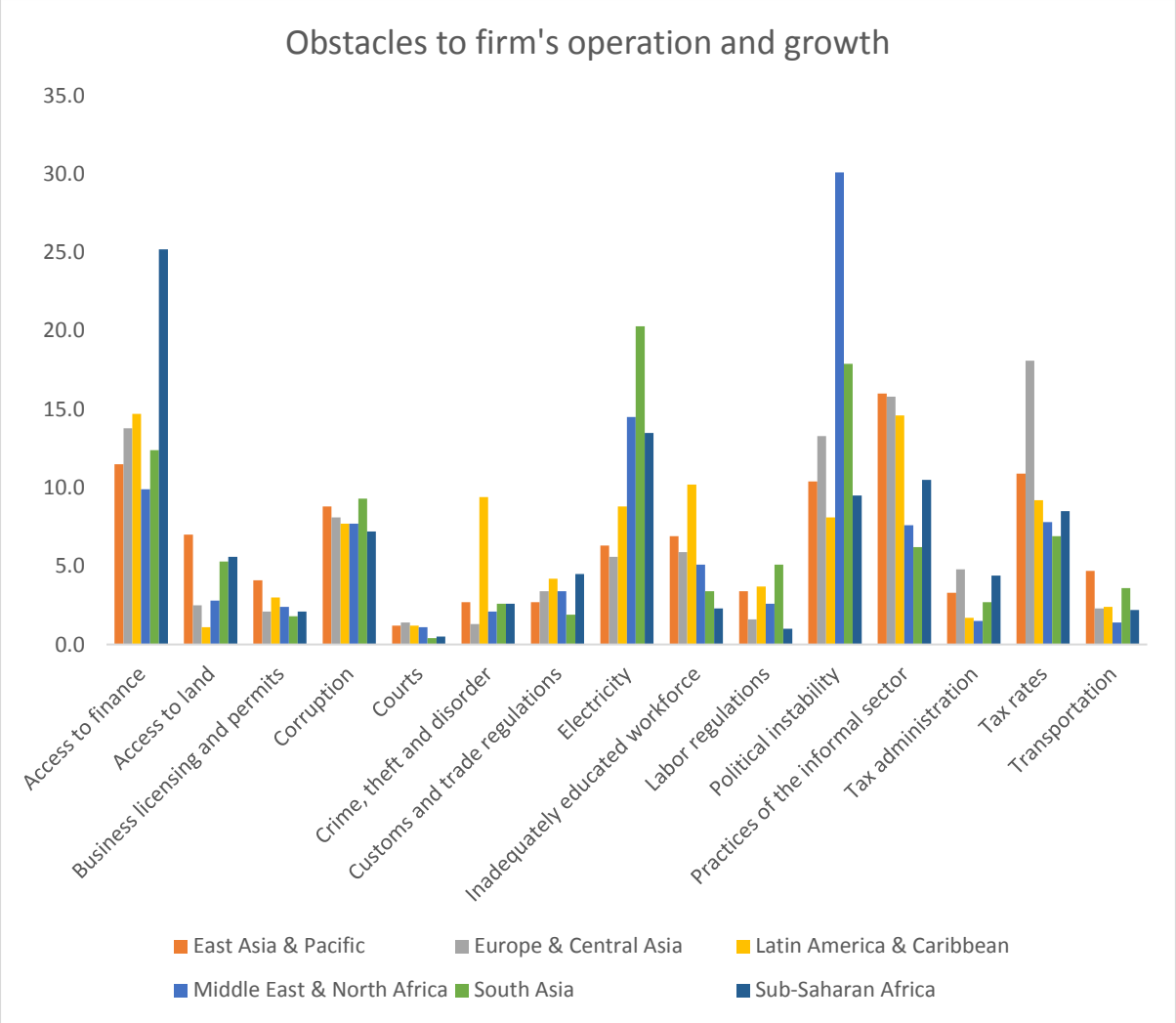
[4] Fuchs and Berg 2013; Beck and Demigurc-Kunt 2006; Beck et al 2006; Beck, Demirgüç-Kunt & Maksimovic 2005, and Beck, Demirgüç-Kunt, Laeven, Maksimovic 2006.

There is a wide-ranging concern that credit constraints will simply become "the new normal" for SMEs and entrepreneurs, and that they could disproportionately be affected by the on-going financial reforms, and especially by the rapid pace of their implantation, as they are more dependent on bank finance than large firms and less to able adapt readily (OECD 2012a). Kauffmann (2005), highlights that formal financial institutions like banks in Sub-Saharan Africa are generally less willing to lend to SMEs due to the high risk of default, insufficient competition, poor guarantees and a lack of information about SMEs' ability to repay loans. Furthermore, the financial sector in most African countries remains underdeveloped, shareholding is not commonly practiced and long-term commercial financing is virtually unheard of for SMEs. As such it is often left to non-banking intermediaries such as microcredit lending to 'fill the gap' in financing for African SMEs; however, such intermediaries are limited in their ability to support customers when they expand (Kauffmann, 2005).

Given the limited access to bank loans in Sub-Saharan Africa, it is not surprising that African enterprises are more likely to rate access to finance as the most important constraint on their operation and growth than enterprises outside Africa. In figure 2.5, more than 25 percent of firms in Africa rate access to finance as the most important obstacle, almost twice as any other region outside Africa.

It can also be seen from the graph that access to finance is cited as obstacle not only in the Sub-Saharan Africa but in other lower income regions as well, like in the Middle East & North Africa (9.9%) which is lower than that of SSA and also the East & Asia Pacific (11.5%). As shown in previous works, access to finance is not only a self-reported obstacle, but turns into a growth constraint, especially for smaller firms and in more shallow financial markets (Beck, Demirguc-Kunt and Maksimovic, 2005) and is more binding than other constraints (Ayyagari, Demirguc-Kunt and Maksimovic, 2008).

Figure 2.5: Obstacles to firm's operation and growth



Source: Author's calculations based on Enterprise Surveys. Available at: www.enterprisesuverys.org

2.4 Improving Access to Finance for SMEs

Based on what have been discussed in the previous chapter (chapter one), it is evident that SMEs are the engine to economic growth/development, especially in developing economies. However, market and institutional failures have resulted in an inadequacy of funding for SMEs which has impede their growth. In this section, I will focus on how governments and financial institutions have worked (or are still working) to resolve the problems faced by SMEs with regards to accessing finance.

The lack of access to financial services is the key barrier to the growth of Micro, Small and Medium Enterprises (MSMEs) in order to fund their operations. With regards to this, many governments and international financial institutions have implemented a wide range of measures which are aimed at addressing this problem. Many of these pro-SME initiatives however, are highly contentious, but little is known with respect to the actual evaluation of these interventions in terms of additionality, sustainability and outreach (Hallberg, 2001; Biggs, 2002).

We can stress the importance of business environment facing all firms; small, medium, and large. From this perspective, well-defined property rights, low entry and exit barriers, effective contract enforcement and firm's access to finance characterise a business environment that is conducive both to competition and private commercial transactions and a levelling of playing field for all firms. The implementation of well-defined policy measures which are aimed at improving the legal, institutional and regulatory framework, should ensure the provision that protect lenders against bankruptcy and felonious loans, thereby encouraging lending institutions to lend to SMEs.

In Africa, governments are playing a great role in trying to combat the problem of lack of access to financial services for SMEs. Countries like Ghana, Kenya, and South Africa have attempted to remedy the lack of access to finance for the SME sector by providing support for the growth of smaller commercial banks and rural banks, so as to bring traditional banks and SMEs closer, both geographically and business-wise. The South African government for instance, in 2005, passed laws to encourage the expansion of savings and loan institutions (so-called second-tier banks) and co-operative banks (third-tier banks), as well as deregulating the banking sector to allow for more flexible terms on loans to SMEs. Also, in many African countries, commercial banks that go under pressure from governments are also setting up their own microcredit services, targeting at SMEs.[5]

Moreover, governments can also intervene more directly in the financing of SMEs through the provision of subsidised credit facilities or guarantees that can either be managed by commercial banks to encourage the lending with more flexible (soft) repayment conditions and lower

[5] Cèline Kauffmann, 2005. *Financing SMEs in Africa*. Policy Insights No.7. OECD Development Centre, May 2005

interest rates, or directly by a government agency responsible for supporting SMEs and/or a particular business sector. The need to steer available funding towards SMEs has been a continuing challenge, and one which requires clear and consistent support from governments.[6]

Hallberg in 2000, discussed some market-oriented strategy for improving SME access to financing, which focuses on reducing the risks and transactions costs associated with this segment of the market, by strengthening the capacity of financial institutions to serve smaller clients, and increasing competitive pressure in financial markets. The aim of this strategy is to increase the number of financial institutions that find lending to SMEs to be profitable, and therefore sustainable. Elements of this strategy would include:

- Strengthening the capacity of financial institutions to evaluate SME creditworthiness in a cost-effective manner, for example through the use of credit scoring techniques;

- Reducing barriers to entry, e.g., by reconsidering capital adequacy requirements and prudential regulations that may be inappropriate for financial institutions serving smaller clients;

- Reducing the risks associated with lending to small businesses, focusing on laws governing the enforcement of contract, forfeiture and collection of collateral, and the use of movable assets as collateral;

- Developing the policy, legal, and regulatory frameworks that are essential to the development of innovative financial institutions and instruments, including venture capital, small equity investments, and leasing;

- Promoting innovation in specialized lending technologies that reduce the administrative costs associated with credit application, monitoring, and payment;

[6]James Haselipn, Denis Desgain, Gordon Mackenzie, 2014. *Financing energy SMEs in Ghana and Senegal: Outcomes, barriers and prospects.* Energy Policy 65 (2014) 369-376.

- Improving information on the creditworthiness of potential borrowers, by promoting the establishment of credit bureaus and ways to help SMEs prepare business plans and financial projections.

2.4.1 International Donor Support for SMEs

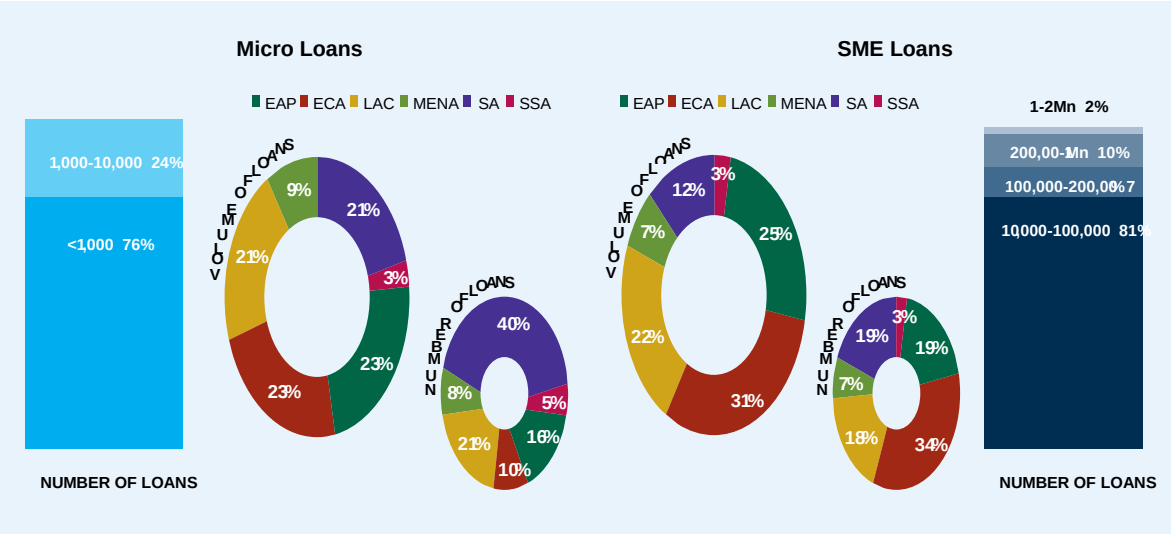
Non-bank institutions like the International Financial Corporation (IFC), in collaboration with other financial institutions across countries help to provide financial access for small businesses. The IFC for instance, in collaboration with over 314 financial institutions across more than 90 developing countries is working to develop solutions to close the SME financing gap; by partnering with many financial intermediaries, including Microfinance Institutions (MFIs), commercial banks, leasing companies and private equity funds, the IFC can reach many SME (MSMEs) through these intermediaries than it could do directly.

The International Financial Corporation (IFC), working globally with financial intermediaries, offers a wide range of financial products and services to these intermediaries that works with local SMEs. These services includes: loans, trade finance, working capital loans and advisory services. In 2015, the IFC provided USD$2.9 billion of long-term finance to financial institutions for SME support. By the end of the year 2015, the IFC's committed long-term finance SME portfolio was USD$10.9 billion with 685 investment and 162 advisory projects.

Figure 2.6 shows the IFC's Financial Institution client's Micro and SME loan portfolio by region and loan size orientation, 2014. From the charts, with both the Micro and SME loans, the IFC provides more loan volume to the East and Central Asia and East Asia and the Pacific (both 23%) than to other regions of the world, with Sub-Saharan Africa being the least (3%).
In 2014, the IFC was able to survey outreach data from 119 Financial Institution clients with microfinance-focused engagements in 54 countries, 44.5% of these clients received advisory services from IFC; also, in the same year, the IFC was able to survey outreach data from 212 Financial Institution clients with SME-focused engagements in 76 countries, 34.0% of these clients received advisory services from IFC. This is clearly shown in the IFC Financial

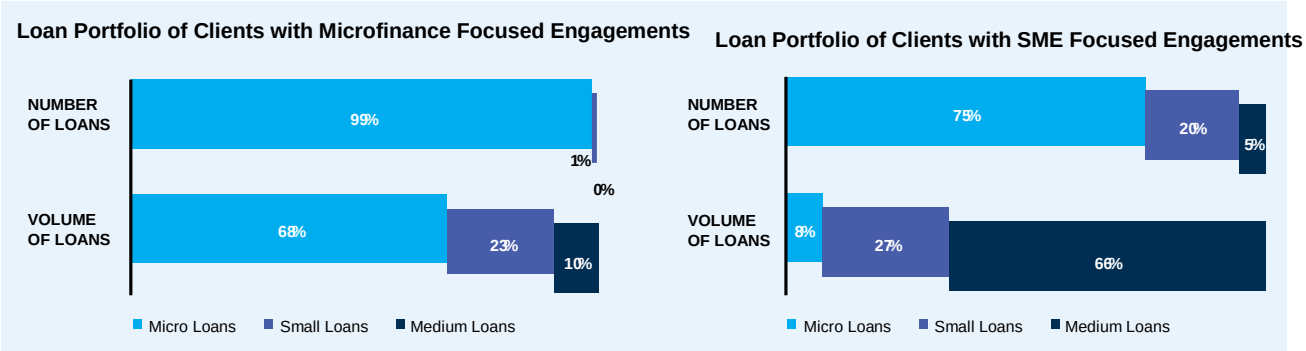
Institution client's Micro and SME portfolio and loan size 2014, in figure 2.6. Whilst table 2.4 shows the loan portfolio composition outstanding to SMEs and the average loan size.

Figure 2.6. IFC FI client's Micro and SME portfolio and loan size, 2014



Source: IFC Financing to MSME, 2014.

Figure 2.7: IFC Clients' Loan Portfolio Composition by Micro, Small and Medium Loans, 2014



:

Source: IFC Financing to MSME, 2014

Table 2.4 Loan portfolio composition

Outstanding Loan Portfolio			Average Loan Size
Loan	**number**	**USD$**	**USD$**
Micro	31,829,031	16,978,648	533
Small	385,637	5,714,342	14,818
Medium	385,637	2,443,896	121,485

Source: IFC Financing to MSME, 2014

Chapter Three

Microcredit in Developing Countries

3.1. Background

"If we are looking for one single action which will enable the poor to overcome their poverty, I would focus on credit".

Dr. Muhammad Yunus, Grameen Bank's founder. Keynote Address Delivered at 85th Rotary International Convention Help in Taipei, Taiwan, on June 12, 1994.

Microcredit can be traced back in the 18th and 19th centuries. During this period, Jonathan Swift inspired the Irish Loan Funds, which by the mid-19th century were lending to 20% of Irish households. This scheme was very much successful at transferring capital to the "industrious poor" on a large scale over a long period. Around this same period (mid-19th century), Lysander Spooner, an individualist anarchist, wrote about "the benefits of numerous small loans for entrepreneurial activities to the poor as a way for poverty alleviation".

3.1.1. Modern Microcredit

The concept of the 'modern-day' microcredit, with the extension of small collateral-free loans which are given to poor groups of people (especially women) for the improvement of their self-employment and income-generation, was an innovation put forward by the Grameen Bank's founder Muhammad Yunus, who was an economics professor. It started back in Bangladesh, in the year 1976, when he, Muhammad Yunus, according to Loth (2002), "gave $27 loan to a group of village women without demanding collateral". The women however, defied expectations by not only repaying the loan but also developed an individual sustainable business and started a self-savings account.

Over the years, microcredit has become a popular instrument in addressing credit constraints and enabling entrepreneurial activities and the Grameen Bank microcredit model has expanded globally and now involve millions of savers and borrower. The concept of microcredit has gained a worldwide recognition, most especially in developing and underdeveloped countries, and in regions like Sub-Saharan Africa, East Asia and the Pacific, Latin America and the

Caribbean, and the Middle East and North Africa, and has gained widespread acceptance by international development agencies and donors. In Sub-Saharan Africa, microcredit is viewed as "a way of correcting both governmental and market failure"; and many view microcredit as "a method for linking the informal and formal sectors of the African economies to increase the reach of the formal sector".

Microcredit is designed not only for the alleviation of poverty, but to also support entrepreneurship and the empowerment of women. Microcredit is part of microfinance, which provides a wide range of access to various financial services required by the widely varying needs of the poor in order to enhance their abilities to increase income and alleviate vulnerability in terms of economic stress. Such financial services include credit, money transfers, savings, insurance and asset building mechanism.

In Sub-Saharan Africa, microcredit has emerged recently as a major thrust in development policy across the region, and is supported by multilateral and unilateral donors such as the World Bank, the United States Agency for International Development (USAID), the United Nations Development Program (UNDP) and the European governments.

3.1.2. Definition of Microcredit

Microcredit is regarded as a financial instrument to support the poor, and is therefore a consistent first-hand innovation for economic development in all under developed, developing and developed countries. It is seen as a practical way of boosting personal income by providing credit as well as consultancy for income generating activities.

The word "microcredit" is a name given to small loans that are given to poor people, since they have insufficient collateral that will enable them to obtain bigger loans from conventional banks; hence, these banks regards them as 'bad financial risks'. Microcredit also have a variety of other terms that are used commonly in different countries such as 'informal credit', and 'barefoot bank' (an analogy to the Chinese 'barefoot doctors'). In recent times, the term 'microcredit' has been joined by others beginning in 'micro', that are related to aspects of the process such as microenterprise, microbusiness, microfinance and micro-lender. Despite the variety of definitions, the word 'microcredit' generally means:

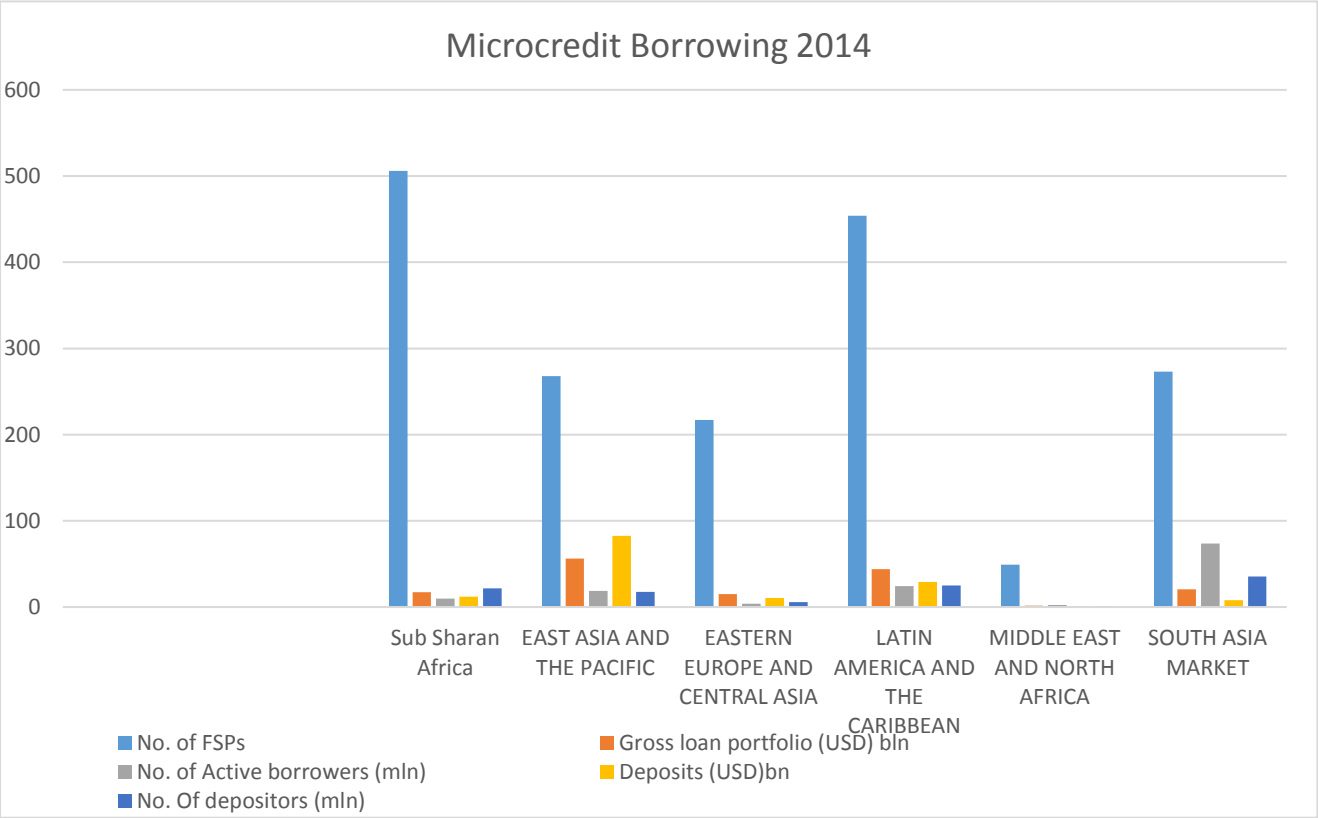
- small-sized loans at low interest rates;
- shorter repayment periods;

- small scale activities based on local conditions and needs; and
- loans used to generate income, develop enterprises and used by the community for social services such as health and education.

3.1.3. Financial Inclusion on Microcredit

Financial institutions have over the years played a great role in giving microcredit to people and lending to small business owners. Figure 3.1 shows per region, the number of Financial Service Providers (FSPs), the number of active borrowers, the gross loan portfolio, deposits and number of depositors.

Figure 3.1 Microcredit Borrowing 2014



Source: Author's input based on data from MIX Market. Available at: https://www.themix.org/mixmarket/countries-regions/africa

3.2. Microcredit Programs

Microcredit lending programs, which can also be referred to as 'microcredit schemes' ensure optimum services for poverty reduction, ensure gender equality, contribute immensely to women empowerment and the improvement of good standard of living. Microcredit programs contribute towards the development of all sectors including agriculture and infrastructural development by providing diversified financial products in several ways. With lots of researches been carried out on microcredit, it is worth knowing that microcredit have substantial positive impact on the borrower's welfare (Hulme and Mosley, 1996; Pitt and Khandker, 1995). Khavul 2010 defined microcredit schemes as "the issuance of small unsecured loans to individuals or group of individuals for the purpose of starting or expanding their businesses".

Microfinance[7] programs have over the years evolved into many forms fulfilling different market functions. These programs offer a variety of household benefits and when guided well, these benefits can extend beyond the household into the community. With microcredit programs, the physical deprivation of goods, services, material poverty and the income to obtain them can be properly addressed. The most significant impact of microcredit programs lies in the empowerment of women, as more than 90% of microcredit loan recipients are women. Therefore, fostering women's participation in income-generating activities, microcredit has emerged as the most powerful driver of financial inclusion. The main goal of microcredit programs is to provide small loans in non-traditional economic sectors.

Microcredit programs perform strongly at community level; in that, officers issuing the loans establish a cordial relationship with borrowers and understand both their proposed use for capital and their (borrowers) sources of income. The success rate of microcredit programs can be measured by:

a. Paying attention to the long-term goals of the borrower;
b. returning the loan mechanism to a basic market function; and
c. ensuring proper institutional management and operation raises.[8]

[7] Microfinance and microcredit will be used interchangeably
[8] The International Development Fund (ICDF) Annual Report 2002, p.172. Available at: https://www.icdf.org.tw/web_pub/20030429170522PP171-174%20C3-3.pdf

In Sub-Saharan Africa, the direct lending of microcredit to the very poor is significant because such investment:

- Promote free markets, thereby lessening the influence of centrally planned economies;
- bypass corrupt central government when channelled through nongovernmental organizations (NGOs);
- promote democracy;
- reduce dependency of poor people; and
- are perceived to be cost beneficial.

There are lots of microcredit lending programs/models around the world and some of these credit models provide technical training and educational assistance, which helps to raise the ability of the borrowers to repay the loan. These models include:

1. Nongovernmental (NGO) model
2. The Grameen Bank model
3. The BRAC model
4. The ROSCAR model
5. Community Banking model
6. Group model
7. Bank Guarantees model

1. Non-governmental (NGO) Model

Nongovernmental organizations (NGOs) have played a major role in the field of microcredit. They play the role of intermediary in various ways, including the creation of awareness on the importance of microcredit, within the community, as well as various national and international donor agencies, and have created opportunities to learn about the principles and practice of microcredit, including publications, seminars and workshops, and training programmes. NGOs have developed resources and tools for communities and microcredit organizations to monitor, progress and identify good practices.

2. The Grameen Bank Model

The word ‘Grameen’ is a Bengali word which means ‘rural or countryside’. The Grameen Bank was founded in Bangladesh in the year 1983 by Muhammad Yunus. It is considered to be the first modern microcredit institution to officially practice microcredit. There are lots of fundamental differences between the Grameen Bank and other conventional financial institutions. One of the main differences being that, the Grameen Bank provide collateral-free

loans to the very poor especially women, who have little or no assets of any kind to serve as collateral when receiving a loan; due to the failure of formal financial institutions in reaching them. Theoretically, this will help the poor escape extreme poverty.

According to Yunus, "poverty is not a chronic condition and felt that it could be fought by adopting long-term strategies, not short-term and off-the-cuff measures" (Yunus, 1997). Despite being a specialized financial institution, the Grameen Bank incorporated many of the principles of dynamism of the informal sector, which made it a bank for the poor, most of whom are engaged in the informal sector for their livelihood. The Grameen Bank credit model has lots of features. Some of its main features are "flexible repayment procedures, reasonable interest rates and is not based on any form of collateral or legally enforceable contracts, rather it is based on 'trust' and not on legal procedures and system". Other features being:

- The promotion of credit as a human right;
- Base on the principle that the people should not go the bank, and that the bank should go to the people, the Grameen Bank credit model provides service at the door step of the poor;
- It deals with creditors in group;
- It requires borrowers to deposit savings in the bank.

The Grameen credit model makes credit available to the poor and illiterate people especially women, who do not know how to invest their money and to earn income. It has created "a methodology around the financial needs of the poor, and created access to credit on a reasonable term, thereby enabling the poor to build on their existing skills to earn a better income in each cycle of loans they receive."

Methodology of the Grameen Bank Model

The Grameen model adopts the following methodology:

In a village or township where a Grameen Bank unit is set up, covering approximately about 15 to 22 villages and having a field manager and workers, the manager and workers will start by visiting the villages to familiarize themselves with the local community people and identifying future borrowers in the process. Thereafter, a group of five prospective borrowers is formed and the credit procedure begins wherein:

Stage 1: Among the group of five borrowers, only two are eligible for and receives a loan. The group will then be observed for a month to see and/or make sure that the members are in compliance with the rules of the bank.

Stage 2: Only after these two borrowers repay the loan plus the interest over a period of fifty weeks will other members in the group be qualified for a loan themselves.

Because of these restrictions, according to the Grameen Bank there "is substantial group pressure to keep individual records clear and therefore, collective responsibility of the group will serve as collateral on the loan".[9] And the focus group helps to "strengthen the guarantee for loan repayment and long term sustainability of the program".

Grameen Bank Borrowing Rate

Over the years, the Grameen Bank has contributed immensely in terms of economic development by issuing out microcredit to poor people who do not have access to formal financial services. Table 3.1 shows the yearly disbursement of loans for the past fifteen years (2000 to 2015), total members, villages covered, total deposits and total number of women who are Grameen Bank's members.

[9] Virtual Library on Microcredit. Available at: http://www.gdrc.org/icm/model/model-fulldoc.html

Table 3.1: Grameen Bank's performance indicator

Year	Cumulative Disbursement (All Loans)	Disbursement During the Year (All Loans)	Total Deposits (Balance)	GB Members' Deposit as % of Total Deposit	Number of Members	Percentage of Female Members	Number of Villages covered
2000	3060.44	268.44	126.78	79	2378356	95	40225
2001	3347.98	287.54	137.92	50	2378601	95	40447
2002	3620.5	272.52	162.77	78	2483006	95	41636
2003	3986.46	365.96	227.66	68	3123802	95	43681
2004	4416.82	430.36	343.52	67	4059632	96	48472
2005	5025.61	608.79	481.22	64	5579399	96	59912
2006	5954.02	724.96	633.31	62	6908704	97	74462
2007	6685.51	934.94	756.61	57	7411229	97	80678
2008	7591.32	905.81	933.89	54	7670203	97	83566
2009	8741.86	1150.54	1200.49	54	7970616	97	83458
2010	10124.64	1382.78	1484.28	54	8340623	97	81376
2011	11597.09	1472.45	1466.99	57	8370998	96	81380
2012	13043.8	1446.71	1628.06	60	8373893	96	81386
2013	14652.23	1608.43	1908.09	62	8543977	96	81389
2014	16370.79	1718.56	2190.59	62	8640225	96	81390
2015	18284.37	1913.58	2405.81	63	8806779	97	81392

Source: Grameen Bank: Bank for the poor. Available at: http://www.grameen.com/

3. The BRAC Bank Model

The Bangladesh Rural Advancement Committee, now Building Resources Across Communities, commonly known as BRAC, was founded by Sir Fazlè Hasan Abed in

Bangladesh in 1972. The BRAC Bank, like the Grameen Bank, is a private financial institution formed in 2001. Unlike the Grameen Bank credit model whose main focus is issuing collateral-free loans to the very poor, the BRAC Bank's main focus is providing financial services/credit to retail, corporate, and small and medium enterprises, who do not have access to formal financial institutions. BRAC's enterprise loans are offered to entrepreneurs who seeks to enlarge their businesses. Small and medium enterprises represented 63% of the bank's total loans and advances in 2008 (BRAC Bank, 2008, p.38), and 59% in 2009 (BRAC Bank, 2009, p.26). All of BRAC's microfinance clients have access to its other programmes such as education, legal aid, and health care.[10]

BRAC believes that "in order for the poor to come out of poverty, they must have the tools needed to fight it across all fronts, and with regards to this, the BRAC Bank have developed support services in areas of human rights and social empowerment (especially to women), education, health, economic empowerment, enterprise development and livelihood training". (BRAC Bank Annual Report, 2015, Liberia)

Since launching its microfinance programs in 1974, BRAC has grown to be one of the world's largest provider of financial services for the poor. And through its innovative client-focus and sustainable approach, BRAC is continuing to show that microfinance can have a powerful impact on the lives of the poor. The BRAC Bank has many programs and operates in many underdeveloped and developing countries including Bangladesh, Uganda, Sierra Leone, Pakistan, Liberia, Tanzania, and Myanmar.

BRAC Bank Credit Programs

The BRAC Bank is engaged in many development and credit programs in many regions (Asia, Africa and the Americas) over the years. BRAC Bank is engaged in programs such as: microloans (or microcredit loans), small enterprise loans, and agricultural loans, poultry and livestock and in development activities such as education, health and women's and youth empowerment.

[10] BRAC Bank. Available at: http://www.brac.net/microfinance

In Uganda, BRAC programs have served about 4.4 million people, which is almost 12% of the country's population (BRAC Annual Report, Uganda, 2015). Below is a highlight some of BRAC's credit activities as of 2016 by country report.

I. Microloans

BRAC's microcredit loan procedure is similar to that of the Grameen Bank's. Borrowers (who are mostly women) are organized into groups, referred to as village organization, within their communities, through which microcredit services are delivered. Table 3.1 shows the amount of loan that has been given out, the numbers of borrowers, and so on, in different selected countries.

Table 3.1 Microloans as of 2016

Country	Branches	Borrowers	PAR	Loan Disbursement (USD in Million)	Principle Outstanding (USD in Million)	Average micro loan size (USD in Million)
Liberia	22	17,291	4.91	4.92	2.97	193
Sierra Leone	28	31,597	8.25	4.46	3.07	130
Uganda		176,629		281	35.5	
Pakistan		56,602		18		386
Tanzania		50,107				285
Myanmar	23	16,837		3.39		

Source: The BRAC Bank 2016. Available at: http://brac.net/microfinance-programme/item/857-small-enterprise-finance

I. Small Enterprise Loans

BRAC's small enterprise credit facilities targets both men and women who have limited access to formal financial services and are seeking to meet working capital requirements or expand their existing businesses. These loans enable the enterprise owner to create not only self-employment but employment opportunities for other people and offer new services to the community. Small enterprise loans are given to individuals rather than in groups and repayment is made on monthly basis.

Table 3.2 Small Enterprise Loans (SEP) as of 2015

Country	Branch	Borrowers	Loan Disbursement (USD in Million)	Principle Outstanding (USD in Million)	Average SEP loan size (USD)
Liberia	18	820	1.58	0.98	1,604
Sierra Leone	18	1,534	1.6	1	1,281
Uganda	93	8,142	38.7		
Pakistan		1,357	1.9		2,047
Tanzania	127				1,707

Source: Author's input based on different country reports from the BRAC Bank as of 2015. Available at: http://brac.net/microfinance-programme/item/857-small-enterprise-finance.

Table 3.3 Bangladesh's Small Enterprise Loans

Borrowers	418,784
Total savings	USD 85 million
Total outstanding	USD 687 million
Average loan amount	USD 2,500

Source: BRAC, Bangladesh. Available at: http://brac.net/microfinance-programme/item/857-small-enterprise-finance

II. **Agriculture Food Security and Livelihood Programme**

For these programs, BRAC do not only issue out loans to local farmers but also provide training and educational support to them. It is aimed at improving the "livelihood and food security of rural population by increasing their productivity". Through training activities and access to information on crop production, supplying high quality inputs (fertilisers, and pesticides) at an affordable cost and the provision credit services through BRAC's microcredit programs, farmers will be able to improve their overall agricultural productivity at community level. In Uganda, it is sponsored by the MasterCard Foundation.

Table 3.4 shows the number of farmers (by country) who have received specialised training through the BRAC microfinance programs.

Table 3.4: Agriculture Food Security and Livelihood Programme as of 2015

Country	Branch	Borrowers	Loan Disbursement (USD in Million)	Principle Outstanding (USD in Million)	Average SEP loan size (USD)	Trained agriculture farmers	Trained livestock farmers
Liberia	22					12,726	13,000
Sierra Leone						139,728	82,959
Uganda						1,206	
Pakistan	16	2,967	0.92		431		
Tanzania						139,728	82,959
Bangladesh	51					156,352	

Source: Author's input based on different country reports from the BRAC Bank as of 2016. Available at: http://brac.net/microfinance-programme/item/857-small-enterprise-finance

4. Bank Guarantees model

As the name suggests, a bank guarantee is used to obtain a loan from a commercial bank. This guarantee may be arranged externally (through a donor/donation, government agency etc.) or internally (using member savings). Loans obtained may be given directly to an individual, or

they may be given to a self-formed group.
Bank Guarantee is a form of capital guarantee scheme. Guaranteed funds may be used for various purposes, including loan recovery and insurance claims. Several international and UN organizations have been creating international guarantee funds that banks and NGOs can subscribe to lend or start microcredit programmes.

5. **Community Banking Model**

The Community Banking model essentially treats the whole community as one unit, and establishes semi-formal or formal institutions through which microfinance is dispensed. Such institutions are usually formed by extensive help from NGOs and other organizations, who also train the community members in various financial activities of the community bank. These institutions may have savings components and other income-generating projects included in their structure. In many cases, community banks are also part of larger community development programmes which use finance as an inducement for action.

6. **Group Model**

The Group Model's basic philosophy lies in the fact that shortcomings and weaknesses at the individual level are overcome by the collective responsibility and security afforded by the formation of a group of such individuals.
The collective individual members coming together is used for a number of purposes: educating and awareness building, collective bargaining power, peer pressure etc.

7. **Rotating Savings and Credit Associations**

Rotating Savings and Credit Associations (ROSCAs) are essentially groups of individuals who come together and make regular cyclical contributions to a common fund, which is then given as a lump sum to one member in each cycle. For example, a group of 12 persons may contribute Rs. 100 (US$33) per month for 12 months. The Rs. 1,200 collected each month is given to one member. Thus, a member will 'lend' money to other members through his regular monthly contributions. After having received the lump sum amount when it is his turn (i.e. 'borrowed' from the group), he then pays back the amount in regular/further monthly contributions. Deciding who receives the lump sum is done by consensus, by lottery, by bidding or other agreed methods.

3.3 Women and Microcredit

According data from the World Bank, as of 2015, women are 49.55 percent of the world's population, and they contribute immensely towards economic development and sustainable livelihood of their families and communities. However, development cannot be effective if women are excluded from the development process and/or are unable to gain access to financial services which will enable them to be "adept at savings, be highly creative entrepreneurs in ensuring that earnings go directly to meeting family needs" (Microcredit Summit, 1997).

Moreover, in any development programme, making women a point of target will yield good (if not excellent) results in that, the incomes earned by women is spent ways much more beneficial to the household than that of their male counterparts. This means that women spend more of their extra income on things/activities that helps develop human capital such as: better education and good health care for their children (thus when women earn, children learn), better sanitation and better nutrition for the family.[11] Therefore, the welfare of the whole is improved when women are helped to increase their income. The Special Unite on Microfinance of the United Nations Capital Fund states that "women's success benefit more than one person; and many numerous financial institutions have confirmed the well-documented fact that women are more likely than men to spend their profits/income on household and family needs" (Deshpanda, 2001).

Microcredit, which is, the provision of small collateral-free loans to the poor in a sustainable manner, targets mainly female clients to help them take advantage of income-generating activities and to better cope with risks. And most importantly, targeting female clients is very important, as female borrowers register the highest repayment rate with respect to male borrowers, in spite of the daily hardship they may face. In the empowerment for women, microcredit plays a critical role in women's empowerment: "it helps deliver newfound respect, independence, and participation for women in their communities and households".[12] The access

[11] Islam Tazul. Microcredit and Poverty Alleviation, 2007. Ashgate Publishing Ltd, Abingdon, GB.
[12] Juan Somavia, ILO Director-General: Small change, Big changes: Women and Microfinance. pp1. Available at : http://www.ilo.org/wcmsp5/groups/public/---dgreports/---gender/documents/meetingdocument/wcms_091581.pdf

to microfinance for women can also lead to women's empowerment by "positively influencing their decision-making power and enhancing their overall socio-economic status".

Many see microfinance as "all about banking for women". However, not all microfinance institutions focus on women. Studies from the microcredit summit campaign, 2007 states that "over 3,300 microfinance institutions have reached 133 million clients with a microloan in 2006, 93 million of these clients were among the poorest when they took their first loan and 85 percent of these poorest clients were women".

According to the Human Development Report of 2008, the United Nations Development Programme stated that "70 percent of world's population living on less than 1USD a day are women" (UNDP, 2008). In many developing countries like Bangladesh, India, Nigeria, etc. women are almost always at a particular disadvantage because of poverty. They need capital but cannot borrow from banks that require high collateral. Recently, microcredit programs such as the Grameen Bank, the BRAC Bank etc. have helped women, particularly the poor, to become self-employed and increase their income through the microcredit program design. From the inception of the Grameen Bank, its founder Muhammad Yunus has always recognized the importance of the inclusion of female borrowers in its microcredit loan programs and when confronting poverty.

3.3.1 Microcredit and Women's Empowerment

What is empowerment?

The term 'empowerment' has different meaning in different contexts – political and sociocultural. Many scholars and nongovernmental organizations use different local terms in defining empowerment. These terms include: self-power, own choice, self-reliance, self-strength, control, life of dignity in line with one's values, independence, the capability of fighting for one's rights, own decision-making, and being free, etc. These definitions are set in local values and beliefs. Empowerment, depending on which context, is relevant at both individual and collective level; and can also be used to characterize relations within the household.

The definition of empowerment has both diversity and commonality. While most definitions focuses on issues of gaining power and control over decisions and resources that will determine

the quality of one's life, others consider structural disparities that affect the entire social group rather focusing only on individual characteristics.

The United Nations Children's Fund (UNICEF) Women's Equality and Empowerment Framework emphasizes "women's access, awareness of causes of inequality, capacity to direct one's own interests, and taking control and action to overcome obstacles to reducing structural inequality"(UNICEF, 2001). The United Nations Development Programme's Gender Empowerment Measure focuses on "inequalities in economic and political participation, decision-making power, and power over economic resources". (UNDP, 1995).

According to United Nations Fund for Women (UNIFEM), empowerment means "gaining the ability to generate choices and exercise bargaining power", "developing a sense of self-worth, a belief in one's ability to secure desired changes, and the right to control one's life independently." The World Bank in 2009 defines empowerment as "the process of increasing the capacity of individuals or groups to make choices and to transform those choices into desired actions and outcomes. Central to this process are actions which build both individual and collective assets, and improve the efficiency and fairness of the organizational and institutional context which govern the use of these assets".

Empowerment of women was defined by Sanyal, 2009 as "the capacity of women to increase their social and economic self-reliance, their right to determine choices, and their ability to influence the direction of change by gaining control over material and nonmaterial resources".

3.3.2 Microcredit Impact on Women's Empowerment

The impact of microcredit on women's empowerment still remain a debate so far. In addition to the improving income-earning capability, as discussed earlier, and the aim to reducing female instability and poverty, there has been an increasing expectations on microcredit and other strategies to positively affect women's empowerment – especially the poor who have participated in a microcredit loan program over the years. As it was pointed out in section 4.2, microcredit programs are an effective entry point for women's empowerment.

Moreover, empowerment is an inherent goal of most microfinance institutions around the world, such as the Grameen Bank, the BRAC Bank and other NGO organizations. And for women to be empowered, they must have access to financial services, human and social resources which are necessary to help them make strategic choices in their lives. However,

having access to these resources does not inevitably translate into empowerment or equality; rather, women most also have the ability to use these resources, most especially credit obtained from financial institutions, to meet their goals.

Poor women are widely believed to be empowered when they gain access to microcredit loans. Cheston and Kuhn 2002, noted that microcredit enables women's empowerment by placing capital in their hands, thus, allowing them to earn independent income and contribute economically to their households and communities. Women will therefore invest these loans in their own income-earning activities, either in the form of microenterprise that is, starting a small-scale enterprise (business) like buying a sewing machine and using it comfortably at home to making new dresses or patching old clothes (that is, assembling piecework) etc., or renting a stall in the local market; or in the form of agricultural production, for example, owning or renting a piece of land to grow crops (e.g. rice, vegetables, etc.) which would be harvest and sold in the local market, either wholesale or retail. It will be no doubt that when women succeed in these income-generating activities they and their families will be better off than they were before the loan.

Microcredit have impacted the empowerment of women in several ways, some these are discussed below:

I. Impact on Decision-Making

Many scholars consider women's ability to influence or make decisions that affect their lives and their future to be the main factor of empowerment. Many microfinance institutions (MFIs) are finding ways to weigh their impact on women's decision-making. For example, the Women's Empowerment Program in Nepal has conducted a study which showed that an average of 68 percent of women in its program experienced an increase in their decision-making roles in the household; decisions in areas such as, sending their children to school, buying and selling of property, and children's marriages, all of which were dominated by the men[13].

[13] Jeffrey Ashe and Lisa Parrott, Impact Evaluation of PACT's Women's Empowerment Program in Nepal: A Savings and Literacy Led Alternative to Financial Institution Building (Cambridge, Mass.: Brandeis University, 2001), 8.

II. Impact on Women's Status and Gender Relations in the Home and in the Community

The access to credit and participating in microcredit credit programs such as: Susu Groups (a Ghanian Credit Group, which is under the umbrella organization called the Ghana Co-operative Susu Collectors' Association (GCSA)), also known as Osusu in Sierra Leone, Community Banking, Rotating Savings and Credit Associations (ROSCAs), Credit Unions, etc. will help strengthen women's bargaining position within the household and thereby allow her to influence strategic decisions. These programs have helped (are still helping) the improvement of women's status in their communities. Several studies on microfinance clients around the world have shown that women themselves have recognized that they receive profound respect not only from their families (particularly men) but their communities as well than they did before joining a microfinance program. Women from one of the Women's Entrepreneurship Development Trust Fund (WEDTF) credit groups in Zanzibar, Tanzania for example, have enjoyed immense prestige and empowerment as a result of their successful joint business in selling kerosene. Cheston and Kuhn, 2000 quote one of the group members of WEDTF, Halima:

> "Before the credit, we never even went to the market. We were solely dependent on our husbands. Now group activities and the intensive training from the scheme have open our eyes. We now know that we are better in business than men. The whole community admired our determination. We have urged our fellow women to put down their veils. Some have now started their own income generating activities"- Halima Juma Hamandi. [14]

III. Impact on family relationships and domestic violence

As it has been discussed in point II, the participation of women in microcredit programs can help to strengthen and improve their family relationships, and most especially help women who were subject to abuse, to escape from their abusive relationships or put limit in their abusive relationships. A study from the Working Women Forum found that, about 40.9 percent of

[14] Cheston, Susy, et al. "Measuring Transformation: Assessing and Improving the Impact of Microcredit, Part II: Implementing Impact Assessments and Monitoring Systems: A Practitioner Perspective from Zambia." Washington, D.C.: Microcredit Summit Campaign, 2000. Available at: http://www.genfinance.info/documents/Gender%20Impact/ChestonandKuhn_2002.pdf

women who are its members and had experienced domestic violence have stopped it, this is due to their personal empowerment, while 28.7 percent of women were able to do so through group action.[15]

In Bangladesh, for example, where the social pressure to remain married is significantly high, Kabeer found that a lot of women in abusive relationships were able to create a sphere of influence for themselves in their marriages so that they would not have to depend on their husbands or depend on them as little as possible.[16] Another study done by Kabeer of the Small Enterprise Development Program (SEDP) in Bangladesh shows that there are direct fundamental links between their contribution to the household and reduction in abuse. One client of SEDP quoted by Kabeer for example said:

> "He gives me more value since the loan. I know, because now he hands me all his earnings to me. If I had not gone to the meeting, not taken a loan, not learned the work, I would not get the value I have. I would have to continue to ask my husband for every taka I needed…. Before, my husband used to beat me when I asked him for money, now, even if he doesn't earn enough every day, I can work, and we don't have to suffer".

Many other studies (for example, Hashemi et al. 1996) also found that women who belong to microcredit programs are less prone to domestic abuse than they found among the general population.

3.3.3 Gender Inequality and Loan Access

While many studies suggests that "microcredit helps women to improve their income-earning capabilities, thereby leading them to have greater power in the household" (Holvoet 2005; Schuler, Riley and Hashemi, 1996), other studies argues that "men take total control of the loan which was allocated to them (the women), and thereby leading women to have a more vulnerable position in the household" (Goetz and Gupta 1996; Ackerly, 1995). This is also due to the fact that many developing countries are male-dominated and women being much poorer

[15] Working Women's Forum (WWF). *Social Platform through Social Innovations*: *a Coalition with Women in the Informal Sector*. Chennai, India, 2000.
[16] Naila Kabeer. '*Money Can't Buy Me Love'?* Re-evaluating Gender, Credit and Empowerment in Rural Bangladesh. Institute of Development Studies (IDS) Discussion Paper 363. Brighton, England: University of Sussex, 1998. Pp 43-54.

than men, become more vulnerable both in the household and in the community. And therefore, some serious voids in women's independence and rights still exist in those countries.

According to the World Bank 2001, discrimination still remains prevalent in many dimensions of life (world-wide), and in all developing regions (and even some developed regions), women are not equal to men whether in legal, social, or economic rights; the gender gap therefore remain widespread both in access to and control of resources, in economic opportunities, in power and political voice.[17] However, the nature and extent of discrimination may vary extensively across countries; but the patterns remain the same.

From a financial inclusion point of view, women are still struggling to be at par when it comes to receiving a loan from a financial institution. Even though women's access to financial services may have increased over the past 10 years, their ability to benefit from this access is still often limited by gender discrimination. And moreover, the interest rates charged on these loans by microfinance institutions and the repayment period and/or methods (most especially the group pressure from the Grameen's loan circles can easily create conflict among women's solidarity) are making it hard for women to push through with the loans after taking their first loan. This topic shall be discussed further in the next chapter of this thesis.

Most microfinance institutions (MFIs) are providing a decreasing percentage of loans to women, most especially those from poor households. Salim, 2013 noted that "as microfinance institutions (MFIs) grow and mature, they tend to lend and/or focus less on poor households". Other studies have found that on average, women's loan size are much smaller than men, even though they might be in the same credit program, same community, and the same lending group. Studies done by the World Bank, United Nations Development Programme (UNDP) and the United Nations Fund for Women (UNIFEM), indicates gender inequalities in developing societies hinder economic growth and development. For example, a report from the World Bank recently confirms that societies that discriminate on the basis of gender pay the cost to greater poverty, slower economic growth, weaker governance, and a lower standard of living.

From the Global Findex (Financial Inclusion) Database 2014, table 3.5 below shows the percentage of access to formal credit, Formal Savings and Account at a Financial Institution for both men and women, from different developing economies/regions; a comparison is also

[17] The World Bank, 2001. "*Enduring Development: Through Gender Equality in Rights, Resources, and Voice*". Oxford University Press, Washington D.C, 2001, pp. 1. www.worldbank.org/gender/prr/engendersummary.pdf

made to high-income OECD economies (such as Canada, USA, the UK etc.). From the table, only 10.18% of women have access to formal credit in East Asia & Pacific as compared to 12.01% of men, with a difference of 1.83% to be filled. Comparing this with figures with high-income OECD economies (21% for male and 16% for female), even though the difference here between men and women is also great, we see that both men and women stand a good chance to formal credit services (men stand a higher chance) as compared to other regions. Women from the Middle East & North Africa stand a much lower chance of access to formal credit (at 4.11%) as compared to women from other regions. In Sub-Saharan Africa, only 6% of women get access to formal credit with respect to their male counterpart (at 7%); while 10% female get formal credit in Latin American & Caribbean to men at 12%.

Region	**Access to Formal Credit**		**Formal Savings**		**Account at a Financial Institution**	
	Male (% age 15+)	**Female (% age 15+)**	**Male (% age 15+)**	**Female (% age 15+)**	**Male (% age 15+)**	**Female (% age 15+)**
East Asia & Pacific	11.77756	10.18189	36.77554	36.20813	70.91905	66.98103
Europe & Central Asia	14.28852	10.77729	10.44543	6.492169	55.84159	47.44849
Latin America & Caribbean	12.75808	9.948268	15.71768	11.33889	54.35538	48.6426
Middle East & North Africa	7.102079	4.118817	4.756881	3.209457	19.1762	9.232844
South Asia	7.636481	5.107777	16.11524	9.106198	55.07759	37.42701
Sub-Saharan Africa	6.852827	5.741539	18.3657	13.49477	38.57785	29.92887
High-Income OECD	20.8423	16.07521	52.87862	50.35394	94.26682	93.76927

Source: Author's input based on data from Global Findex 2014. Available at: http://datatopics.worldbank.org/financialinclusion/indv-characteristics/gender

Chapter Four

Financial Analysis of Microcredit Interest Rates in Developing Countries

4.1 Microcredit and Interest Rates

In this chapter, I will be focussing on the analysis of various interest rate methods used by microfinance institutions (MFIs) to charge interest on the loan given to and/or received by their clients. The analysis will further include discussions on whether or not these rates are excessive for the borrowers, especially the poor who, in most circumstances, cannot afford to repay even the original loans and talk less of interest rates being added to them.

4.1.1 The Controversy of Microcredit

Microcredit[18], from its conception in the late 1970s, has faced with lots of criticism. This criticism arise as a result of high or excessive interest rates charged by microfinance institutions (MFIs). These rates are normally higher than conventional bank rates. Thus, the criticism has increased over the years, and is mostly due to the fact that MFIs are considered to be financial providers to the poor in developing and transition countries who, because of lack of collateral, cannot obtain a formal bank loan. And since they (MFIs) serve as deliverers of financial services, credits and savings to the very poor, should therefore not exploit them by charging them high interest rates. And since they are also considered to be not-for-profit making organizations, they are therefore supposed to meet the financial requirements of the very poor at the lowest cost possible. The poor, when provided with these services will be able to 'create, own, and accumulate assets in order to smooth consumption' (CGAP, 1998).

However, setting interest rates is a central issue for microfinance institutions (MFIs) and for them to remain in operation, and thus to be able to cover their operating expenses, they are expected to charge reasonable interest rates on the cost of borrowing. This is a vital requirement for the financial sustainability of microfinance institutions. For those MFIs who charges more than 15% over cost of funds are no longer considered a not-for-profit organization but a for-profit organization that have just joined the 'loan-shark' area. Government from many

[18] Microcredit was defined earlier as the extension of very small, short-term loans to poor entrepreneurs who are unqualified to obtain loans from conventional banks.

developing economies have raised concerns with regards to high interest rates and several questions such as: why is it that institutions which are set out to help the poor, turn out to exploit them by charging high interest rates which allows them (the MFIs) to earn high profits? And how is that the poor should be the ones to pay for the high costs incurred by MFIs due to their inefficiencies?

4.1.2 Justifications of the Controversy

The justifications put forth by MFIs with regards to charging high interest rates are that:

1. It is more costly to lend and collect a small amount of loan than a bigger one (loans given by banks). For example, if we consider the actual cost per loan to be $15, then for a 10,000 dollar loan, the percentage cost is 0.15, this is less, as compared to 15% for a 100 dollar loan.
2. Another justification is that, MFIs charge high interest rates because this will help to cover for the high/costly administrative expenses they incur. And unless they do so, they may not be sustainable enough to continue their operations. Interest rates are a key aspect for microfinance sustainability.

In a nutshell, microfinance institutions believe that charging their clients high interests will 'best ensure the performance and expansion of the services they provide', and certainly, its sustainability. Also, interest rates generate on income for MFIs and subsequently allows them to grow bigger so as to depend less on donor support.

4.2 Interest Rates of Microcredit

Definition

Before defining what interest rate mean, here is a simple definition for the meaning of interest: interest is simply defined as "the charge for the use of money over time". It is the monetary compensation taken out of the client's (the borrower) pocket, and given to the lender for having ensured the monetary availability of capital. This is usually expressed in annual percentage rate. On the other hand, interest rate is defined as the amount charged on a particular loan by the lender to the borrower (it is expressed as a percentage of the principal) for the use of

assets/loan. Business Dictionary defined interest rate as "the annualized cost of credit or debt-capital computed as the percentage ratio of interest to the principal".[19]

The interest is the main reason for all forms of financial intermediation for both formal and informal markets. Most importantly, those who play an essential part of this intermediation process are microfinance institutions who, like any other players in the global financial system, emphasises the resource allocation mechanism by managing high return profiles and high levels of risk.

4.2.1 Types of Interest Rates

Before highlighting the types of interest rates, it is necessary to take into account the two ways of calculating interest which can be applied either on loans (that is both loans from microfinance institutions and bank loans) or savings accounts (banks).

1. **Simple Interest**

The simple interest is the most basic way of calculating interest; it is only paid one time and it does not change. This is set on the principal amount that is given/lent to the borrower. It is calculated by multiplying the principal by the interest rate and term (the time the loan is due):

Principal x Interest Rate x N = Interest

Where: N = no. of months or years.

Example: if a borrower borrows, say $100 (principal) for one year, at a rate of 10%, he will owe $110 at the end of the one year that is, paying $10 as interest and adding it to the principal. This is shown as:

100 x 0.1 x 1yr = 10

1. **Compound Interest**

This is earning interest on top of interest. It charges interest on the principal and any interest earned. Compounding is done by calculating the interest rate of each year (if payment is done on a yearly basis) or month (if payment is done monthly) and adding it to the balance (principal) before calculating the interest payment of the next year; in which case, it will be based on both

[19] Available at: http://www.businessdictionary.com/definition/interest-rate.html

the principal and the interest earned. And this is repeated for all the years of the loan or deposit (for banks savings account). The frequency of compounding will determine or influence the rate at which the interest compounded accumulates overtime. This means that the longer the compounding periods the higher the interest compounded (that is, the interest earned from the principal amount). For example, the amount of interest accumulated for a $100 loan at 10% annually, will be lower than the same amount at 5% semi-annually (that is, 6-monthly) at the same period (say 1 year). Microfinance institutions for instance, prefer monthly compounding of interest; because it yields more profit for the lender or lending institution and eventually more cost for the borrower. The banks on the other hand, compound interest just once every year, until the loan is fully paid.

Suppose that an amount A is given as loan for n years at an interest rate of R per annum. The value of the loan when the rate is compounded yearly is:

$$A(1+R)^n$$

If however, the rate is compounded m times per annum, the value of the loan will be:

$$A(1+\frac{R}{m})^{mn}$$

Where m is number of periods compounded. For example, given a loan for a 3-year period with annual interest rate of 10%, table 4.3.1.1 summarises the fact stated earlier, that is, the longer the compounding periods the higher the interest compounded.

Table 4.1. Example of compound interest

Compounding frequency	**No. of compounding periods (*m*)**	***Rate* ® and no. of periods (*n*) values**	**Total interest**
Annually	1	R=10%, n=3	3,310
Semi-annually	2	R=5%, n=6	3,400
Quarterly	4	R=2.5%, n=12	3,448.89
Monthly	12	R=0.833%, n=36	3,480.21

Where: m = 1, 2, 4, 12

$R = \frac{R}{m} = \frac{0.1}{1} = 10\%$ and so on, and

$n = n*m = 3*1 = 3$ and so on.

Using the compounding formula:

$$10{,}000 * (1 + \frac{0.1}{1})^{1*3} = 13{,}310$$

We minus the principal from this amount to get the interest: 13,310-10,000 = 3,310. This formula is used throughout to get the total interest.

There are several types of interest rates on microloans, ways such as: the nominal rate; real rate; effective interest rate (EIR); and annual percentage rate (APR). The nominal rate (*i)* or nominal interest rate, is the stated rate to be paid on a loan contract, not reflecting inflation (that is, the rate before adjustment for inflation) or taking related fees, commissions and other expenses into account. It is basically the simplest type of interest rate. It is usually applied as a monthly or annual percentage. The real rate (*r*) is the rate adjusted for inflation. The (EIR) - also called the annual equivalent rate (AER) - is the actual rate that is applied on a loan (that is, the rate the borrower is 'actually' paying based on earnings from the loan during each period) and is usually enhanced by other components such as taxes payable, insurance premiums and any other compulsory savings guarantee. The EIR represent a financial cost to the borrower. The EIR is calculated as a percentage of total financing, taking the financial charges into consideration. The (APR) on the other hand is the rate of interest on a declining balance over a set of period of months (a month for example) and is calculated by multiplying the monthly rate corresponding to the number of months in a year.

However, there are differences between these rates. The main difference between the annual percentage rate (APR) and the effective interest rate (EIR) is that, while the EIR includes the effect of compounding and forced savings, the APR does not include neither effect. Another important differentiation in calculating the interest rate is the difference between the nominal rate (*i*) and real rate (*r*). The difference between the two is minimal for low values of the inflation rate, the increase of the real rate tend to grow considerably. The following formula makes it possible to determine the real rate (*r*):

$$r = \left[\frac{1+i}{1+p}\right] - 1$$

Where: p is the inflation rate (annual); r is the real rate; i is the nominal rate.

4.3 Calculating Interest Rate Payments

The microfinance industry have over the years, been charging high interest rates (as we stated earlier) on its clients; and investors and market participants have altogether ignored and/or paid less attention to the principles of customer protection, with regard to the prices charged on loan products. Also, microfinance prices are very difficult to understand. This, as a result will lead prices to be far higher that they really appear. An example is telling clients that they are paying 5% per month (which is 60% for 12 months) of interest on a loan when in reality (or at the end of the loan) they might really be paying 10% or more per month. In most cases, customers are fooled into thinking that the loan given to them by the institution is more of a free gift than a credit; this is simply because clients lack the knowledge of knowing how confusing these interest rates (prices) works.

In this regard, financial regulators and/or governments have (or have often) intervened with the 'Truth-in-Lending' legislation of 1968 in order to help with the correction of deceptive prices (this law is, however, absent in most countries where microfinance is practised). When this is put in place, the client has the right to receive a standardized price figure, which is often known as the effective interest rate (EIR) or sometimes known as the annual percentage rate (APR) (Chuck Waterfield, Microfinance Transparency, 2011). Microfinance Transparency (MFTransparency) – a nongovernmental organization – promotes transparency by enabling the distribution of microfinance market prices. It also works as an educator to investors on issues of transparency as well as the publication of true costs of microfinance products in a clear and reliable manner, so as to create a transparency environment. The Microfinance Transparency also provides a free platform for the calculation of very important indicators for the setting of interest rates.

4.3.1 Approaches and Methods used for Calculating Prices (APR & EIR)

A typical way of setting the interest rate is to calculate the annual percentage rate (APR) and the effective interest rate (EIR) which allows the determination of the actual cost of the loan contract between the borrower and the lending institution. This will offer the customer/client the opportunity to clearly and directly evaluate the various conditions that are offered by financial intermediaries which allow them to measure the gap between the nominal interest offered and that which is actually paid; and check whether or not they correspond.

Microfinance institutions, like other money lender (s), are interested in receiving interest for the money they give out to their clients as loans; and in most cases, they may need this sooner rather than later, so as to reuse it (the money they receive) to make new loans to other clients (whether old or new clients).

Many (as we have seen so far) financial institutions uses a variety of techniques to cover the true cost of the loan. With respect to this and starting with the simplest of formulae, we go through with the calculations of interest rates (prices) and the amortization schedule, thereby disclosing the actual value (cost) of the loan.

A future value (*A*) with a present value (*PV*) amount capitalized on an interest rate (*i*) and number of periods (*n*) is:

$$A = PV * (1 + i)^n$$

The present value (PV) is represented as:

$$PV = \frac{A}{(1 + i)^n} \qquad or \qquad PV = A * (1 + i)^{-n}$$

The formulae above represent a single monetary transactions and the use of either formula will yield the same result. The present value of a series of future cash flows is given as:

$$PV = \sum_{n=0}^{t} \frac{A}{(1 + i)^n}$$

The present value of a five (5) year loan term is given, for example, as:

$$PV = \frac{A}{(1+i)^1} + \frac{A}{(1+i)^2} + \frac{A}{(1+i)^3} + \frac{A}{(1+i)^4} + \frac{A}{(1+i)^5}$$

The effective interest rate (EIR) and annual percentage rate (APR) can be defined as the declining balance interest rates that makes the present value (PV) of the loan received by the customer to be equal to the present value of the payments the client is asked to repay over time (or at the end of the loan term). The equation below describes the equivalence between the values of advances (*A*) of the credit received by the customer and the periodic instalments (*P*) paid by the client. This is called the discount rate method shown below:

$$\sum_{k=1}^{m} \frac{A_k}{(1+i)^{q_k}} = \sum_{j=1}^{n} \frac{P_j}{(1+i)^{t_j}}$$

Where:

A_k: k-th value in advance;

q_k: Time between the start of the transaction and k-th advance;

P_j: Value of the j-th payment;

t_j: Time between the start of the transaction and j-th payment;

m: Number of advances;

n: Number of payments;

i: Interest rate percentage on unitary period.

Let us see an example where this formula is applicable. Consider a simple loan of $1,000 with a monthly interest of 1% for 12 months with equal instalments. Table 4.2 shows the nominal values of the disbursement and repayment schedule and the discounted values at 1% discount rate. We can see that the client receives $1,000 but pays back $1,066.2 at the end of the loan term. The divisor/denominator was computed as:

$$(1+1\%)^0 = 1.000, \qquad (1+1\%)^1 = 1.0100, \qquad \ldots.\,(1+1\%)^{12} = 1.1268$$

Table 4.2. Amortization schedule and actual value of rate (US$)

	Nominal Values		**Discount Rate *i* = 1%**	**Discounted Values**
Period	**Loan Disburse**	**Loan Repayment**	**Divisor/Denominator** $(\mathbf{1}+\boldsymbol{i})^{\boldsymbol{n}}$	
0	1,000	0	1.0000	
1	0	88.85	1.0100	87.97
2	0	88.85	1.0201	87.10
3	0	88.85	1.0303	86.24
4	0	88.85	1.0406	85.38
5	0	88.85	1.0510	84.54
6	0	88.85	1.0615	83.70
7	0	88.85	1.0721	82.87
8	0	88.85	1.0829	82.05
9	0	88.85	1.0937	81.24
10	0	88.85	1.1046	80.44
11	0	88.85	1.1157	79.64
12	0	88.85	1.1268	78.85
Total	**1,000**	**1066.2**		**1000.02**

Source: Microfinance Transparency, 2013.

4.3.2 Loan Amortization Schedule

When financial institutions (like microfinance institutions, banks) and money lenders disburse loans to their clients, there includes a contract which details out the terms and conditions relating to the repayment of the loan and interest to be paid, and extra fees (sometimes). In most cases as we know, the loan repayment is split, so that it can be paid overtime by instalments. Let us consider the two methods used to calculate interest on the loan: the declining balance method and the flat method.

1. **The Declining Balance Method**

The declining balance method on an interest, imposes lower costs to the borrower on one hand and generate lower yields for the lending institution on the other hand. In the declining balance method, the interest is computed based on the current balance on the borrower's hand (that is, actual money he/she has in hand) rather than on the original principal. As the principle is repaid successively, the balances decline. It could be noticed that as the principle balance decline so does the contribution of interest payments to the payment made each period (PMT).

An effective way of using the declining balance method of interest rate calculation is to amortize the principle repayments. By doing so, the principle repayment for each loan instalment will increase overtime, whilst the interest repayment will decrease (decline) over the loan term and the total repayment for each period remains the same. Even though the interest paid on the amortized loan (that is, paying equal instalments) is high as compared to equal principle repayment, the annual percentage rates (APRs) will remain the same. This is so because through amortization, the borrower will have more time to use the principle balance to generate more income while repaying the loan more slowly. With this, it is much easier for the borrower to remember what he/she pays for each instalment (either monthly, weekly or fortnightly, that is, every two weeks) and will subsequently help also the lending institution to keep track of payments. The declining balance method calculation is considered as the 'only' valid approach, because it 'properly reflects the true definition of interest rate'.

Let us consider an example where a client is given as loan the sum of $10,000 to be paid in 2 years with equal monthly instalments with an annual rate of 20%. Table 4.1 below shows the amortization schedule of the loan.

Table 4.1. Loan Amortization Schedule (US$) – Equal Instalments using the *PMT* method.

Month	Payment	Interest	Principal	Balance
0	-	-	-	10,000
1	508.958	166.67	342.291	9657.71
2	508.958	160.96	347.996	9309.71
3	508.958	155.16	353.796	8955.92
4	508.958	149.27	359.693	8596.22
5	508.958	143.27	365.688	8230.54
6	508.958	137.18	371.782	7858.75
7	508.958	130.98	377.979	7480.77
8	508.958	124.68	384.278	7096.5
9	508.958	118.27	390.683	6705.81
10	508.958	111.76	397.194	6308.62
11	508.958	105.14	403.814	5904.8
12	508.958	98.413	410.545	5494.26
13	508.958	91.571	417.387	5076.87
14	508.958	84.615	424.343	4652.53
15	508.958	77.542	431.416	4221.11
16	508.958	70.352	438.606	3782.51
17	508.958	63.042	445.916	3336.59
18	508.958	55.61	453.348	2883.24
19	508.958	48.054	460.904	2422.34
20	508.958	40.372	468.586	1953.75
21	508.958	32.563	476.395	1477.36
22	508.958	24.623	484.335	993.022
23	508.958	16.55	492.408	500.614
24	508.958	8.3436	500.614	0
Total	**12,215**	**2,215**	**10,000**	

As demonstrated above, the customer will pay an equal monthly instalment of $508.96 with decreasing monthly interest repayments. The customer will make a total payment of $12,215 at the end of the two years period paying a total interest repayment of $2,215.

The monthly Interest rate (i) is the same for all, computed as:

$$\frac{Annual\ Interest\ Rate}{12} = \frac{20\%}{12} = \mathbf{1.667}\%$$

This is used throughout (multiplying by the current principal on the client's hands) to determine the monthly interest to be paid. For instance, we got the first interest paid as:

Interest Payable per Instalment (1st month) *= Interest Rate per Instalment (i) * Remaining Loan Amount (principal)*

= 1.667%*10,000 =**166.67**

This formula is used throughout the life of the loan. The payment made each period (PMT) is computed as:

$$\frac{(PV * i)}{(1-(1+i)^{-n})} = \frac{(10{,}000 * 0.01667)}{1-(1+0.01667)^{-24}} = \mathbf{508.97}$$

Where PV is the present value (the principal) and i is the interest rate per period

Both the effect interest rate (EIR) and the annual interest rate (APR) are computed to be:

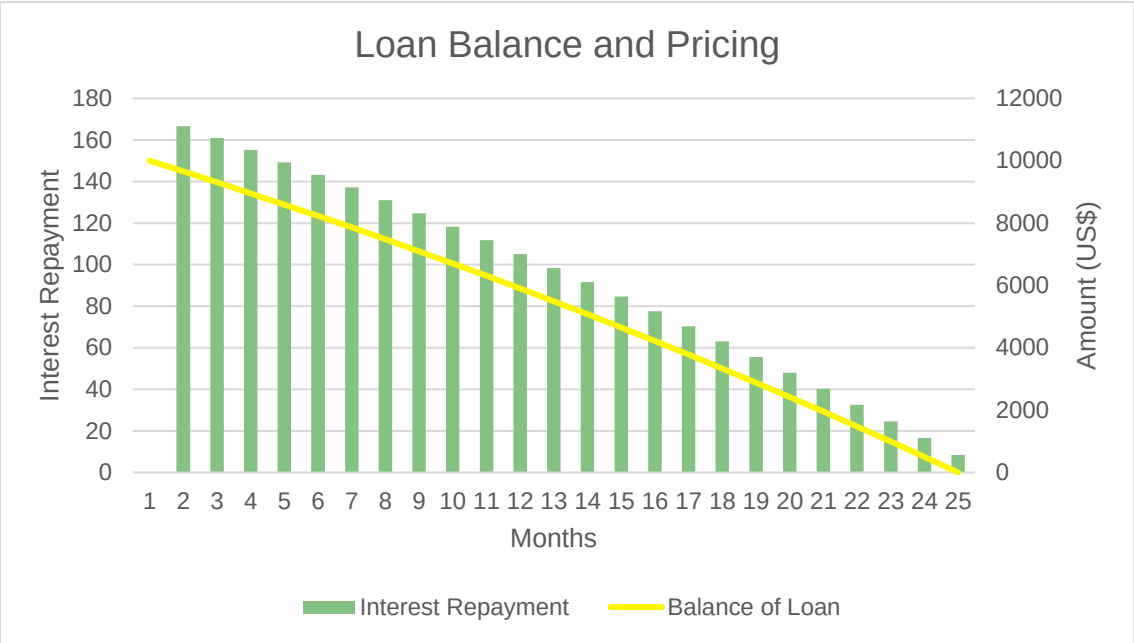
EIR: = $(1+i)^n - 1 = (1+1.667\%)^{12} - 1 = 0.219 * 100 = \mathbf{21.9}\%$

APR: = $i*n$ =0.01667*12 = **20%**

Where: ***i****:* is monthly interest rate; ***n***: is term, or number of periods.

A graphical illustration is shown below (figure 4.1.) to demonstrate the loan balance and pricing. It can be seen that as the principle (that is, the current principle on the borrower's hand) decreases so does the interest payment for each period.

Figure 4.1. Loan Balance and Lending



The repayment schedule in table 4.2., shows a repayment schedule with equal principle repayments. This was done considering the same example as the previous one, but with equal principle repayment. Here, the borrower will pay a total interest of $ **2,083.33** at the end of the loan term, thus the total cost of the loan, which is less than the amortized loan (with equal payments) with total interest repayment of $**2,215.** The borrower at the end of the loan term will pay **$12,083.33** as total repayment. The APR here is the same as with the previous (20%), and the effective interest rate on the other hand remains the same:

APR: = $i*n$ =0.01667*12 = **20%**

EIR: = $(1+i)^n - 1 = (1+1.667\%)^{12} - 1 = 0.219 * 100 = \mathbf{21.9}\%$

Table 4.2 shows the repayment schedule with equal principle repayments. The equal principle payment is computed as:

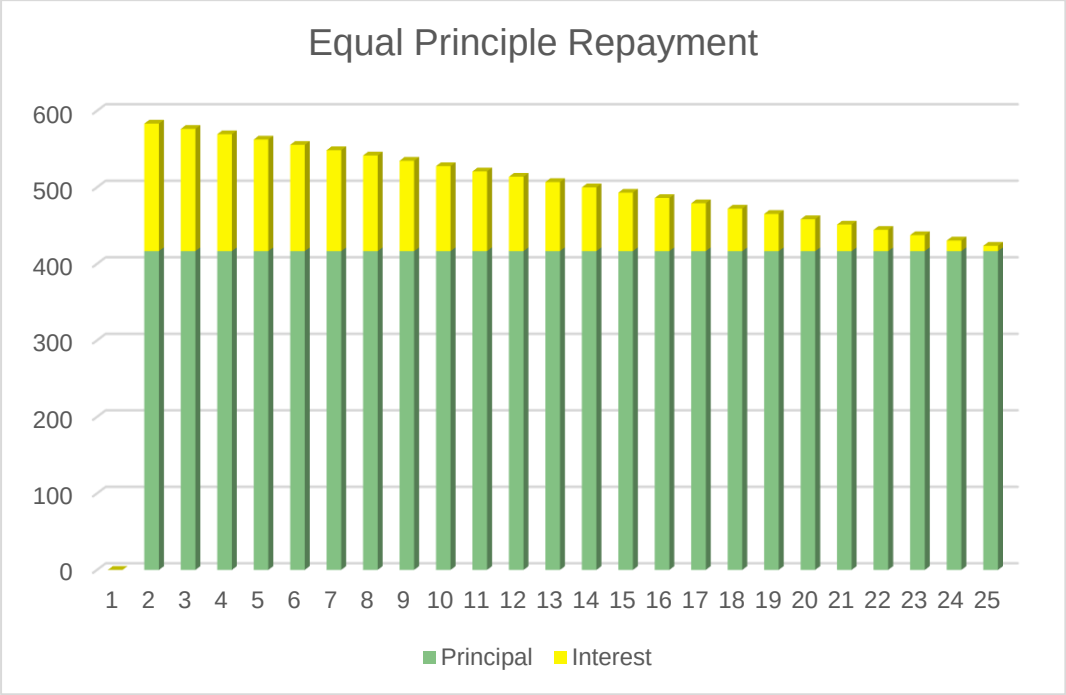
$$\frac{Prinple}{Actual\ number\ of\ payments} = \frac{10{,}000}{24} = 416.67$$

Table 4.2. Repayment Schedule –Equal Principle Payments

Month	**Payment**	**Principal**	**Interest**	**Balance**
0	0	0	0	10,000
1	583.33	416.67	166.67	9583.33
2	576.39	416.67	159.72	9166.67
3	569.44	416.67	152.78	8750.00
4	562.50	416.67	145.83	8333.33
5	555.56	416.67	138.89	7916.67
6	548.61	416.67	131.94	7500.00
7	541.67	416.67	125.00	7083.33
8	534.72	416.67	118.06	6666.67
9	527.78	416.67	111.11	6250.00
10	520.83	416.67	104.17	5833.33
11	513.89	416.67	97.22	5416.67
12	506.94	416.67	90.28	5000.00
13	500.00	416.67	83.33	4583.33
14	493.06	416.67	76.39	4166.67
15	486.11	416.67	69.44	3750.00
16	479.17	416.67	62.50	3333.33
17	472.22	416.67	55.56	2916.67
18	465.28	416.67	48.61	2500.00
19	458.33	416.67	41.67	2083.33
20	451.39	416.67	34.72	1666.67
21	444.44	416.67	27.78	1250.00
22	437.50	416.67	20.83	833.33
23	430.56	416.67	13.89	416.67
24	423.61	416.67	6.94	0.00
Total	**12,083.33**	**10,000.00**	**2,083.33**	

This is demonstrated graphically in figure 4.2:

Figure 4.2. Loan Repayment Schedule – Equal Principle Repayment



1. **The Flat Method**

With the flat method, interest is computed based on the original face value of the loan rather than on the declining balance. This method has the effect of raising the payment made by the borrower each period, thereby increasing the 'effective' interest rate to the borrower, meaning that the loan is more expensive/costly to the borrower than the lending institution. Using this method to calculate interest yields higher returns for the lending institution. Microfinance institution normally use this method of interest calculation when giving out loans to their clients.

Considering the same example, only that this time we use the flat method of interest rate calculation with equal principle repayment; the loan amortization schedule is shown below in table 4.2.

Table 4.3. Loan Amortization Schedule (US$) with the flat method

Period	Total Payment	Principle Repayment	Interest Repayment	Balance of Loan
0	0	0	0	10000
1	583.33	416.67	166.67	9583.33
2	583.33	416.67	166.67	9166.67
3	583.33	416.67	166.67	8750.00
4	583.33	416.67	166.67	8333.33
5	583.33	416.67	166.67	7916.67
6	583.33	416.67	166.67	7500.00
7	583.33	416.67	166.67	7083.33
8	583.33	416.67	166.67	6666.67
9	583.33	416.67	166.67	6250.00
10	583.33	416.67	166.67	5833.33
11	583.33	416.67	166.67	5416.67
12	583.33	416.67	166.67	5000.00
13	583.33	416.67	166.67	4583.33
14	583.33	416.67	166.67	4166.67
15	583.33	416.67	166.67	3750.00
16	583.33	416.67	166.67	3333.33
17	583.33	416.67	166.67	2916.67
18	583.33	416.67	166.67	2500.00
19	583.33	416.67	166.67	2083.33
20	583.33	416.67	166.67	1666.67
21	583.33	416.67	166.67	1250.00
22	583.33	416.67	166.67	833.33
23	583.33	416.67	166.67	416.67
24	583.33	416.67	166.67	0.00
Total	**14,000**	**10,000**	**4000**	

As demonstrated in the loan amortization schedule table 4.3 above, and unlike the declining balance method, the borrower will pay a total of $583.33 of equal monthly instalment of the loan, summing up to a total repayment of $14,000 at the end of the loan term (in 2 years). Here, the interest is charged based on the original face value of the loan even though the principle is declining at each instalment. The borrower pays $166.67 equal monthly interest and $416.67 equal monthly principle. Both the principle and interest repayment for each period remains the same. The monthly interest rate is 1.67%. The interest payable per instalment was calculated as:

$$Interest\ Payable\ per\ Instalment = \frac{Principle * No.of\ years * Interest\ Rate\ (p.a)}{No.of\ Instalments}$$

$$\frac{10{,}000 * 2 * 0.2}{24} = \mathbf{166.67}$$

To get the annual interest rate (APR) and the effective interest rate (EIR) for the flat method, the monthly nominal interest rate (i) cannot be used for the calculation of these two indicators; it is necessary to use the internal rate of return (IRR) in order to find $i*$ which is the present value of total instalments paid by the borrower. This is the United States' way of calculating the APR. The process to find "$i*$" is an iterative process, where different values are tried until the sum of both the present value (principle) and repayments are equal. That is:

$$\sum_{k=1}^{m} \frac{A_k}{(1+i)^{q_k}} = \sum_{j=1}^{n} \frac{P_j}{(1+i)^{t_j}}$$

$$\mathbf{10,000} = \frac{583.33}{(1+i)^1} + \frac{583.33}{(1+i)^2} + \frac{583.33}{(1+i)^3} + \cdots + \frac{583.33}{(1+i)^{24}} = \mathbf{10,000}$$

Using the iterative method, we find i to be 0.0288 (2.88%). We can use this to determine the EIR and APR.

APR: i*n = 0.02887*12 = **34.65%**

EIR: $= (1+i)^n - 1 = (1+2.887\%)^{12} - 1 = \mathbf{40.83}\%$

Compared to the declining balance method and with the values obtained serving as evidence, it can be seen that using the flat method for calculating interest rates bears a big burden on the part of the borrower. The annual interest rate that the borrower pays to the lending institution is higher as compared to that of the declining method. The effective interest rate here is so excessive that it doubles the previous rate (using the declining balance method). The pattern of the interest charged and the principle balance is demonstrated graphically in figure 4.3 below.

Figure 4.3 Loan Pricing and Balance

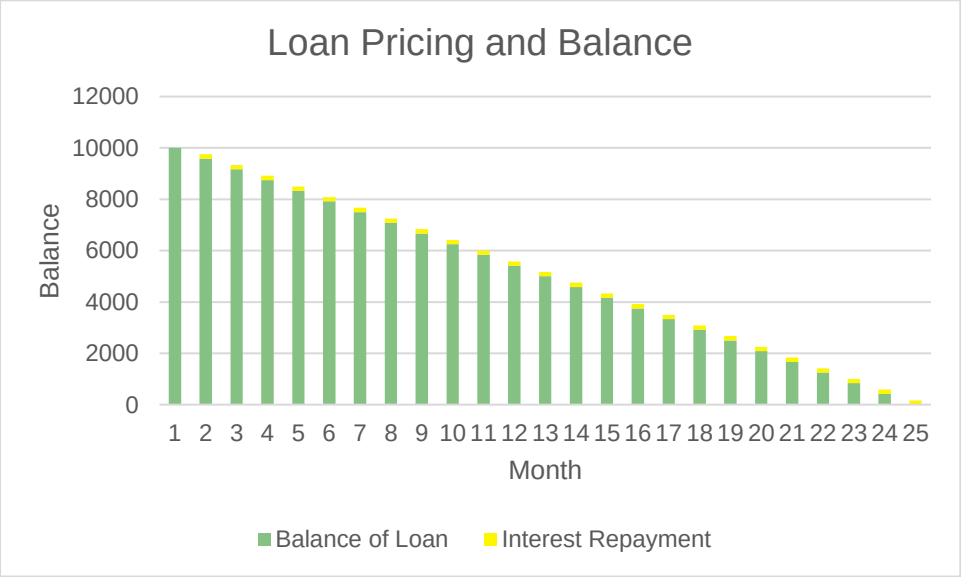
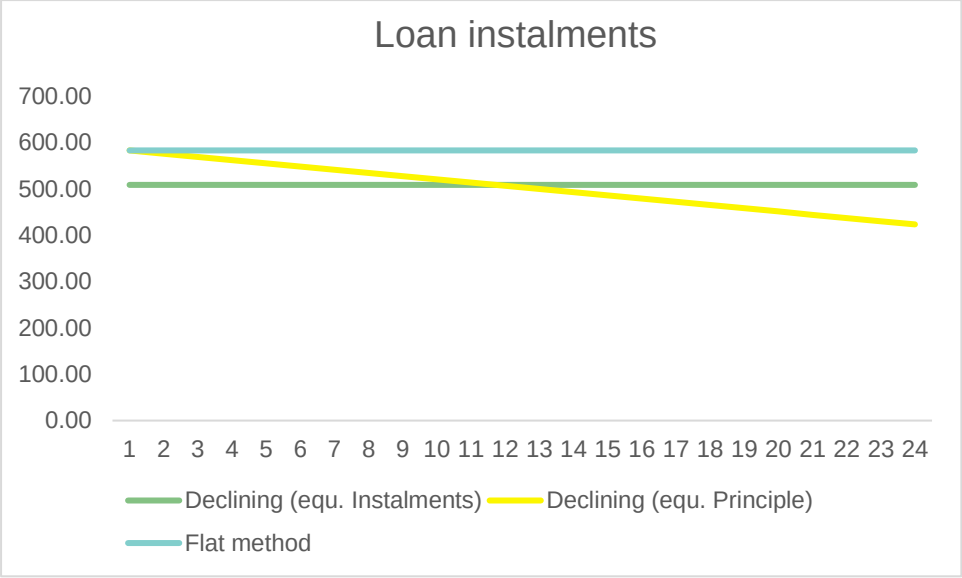


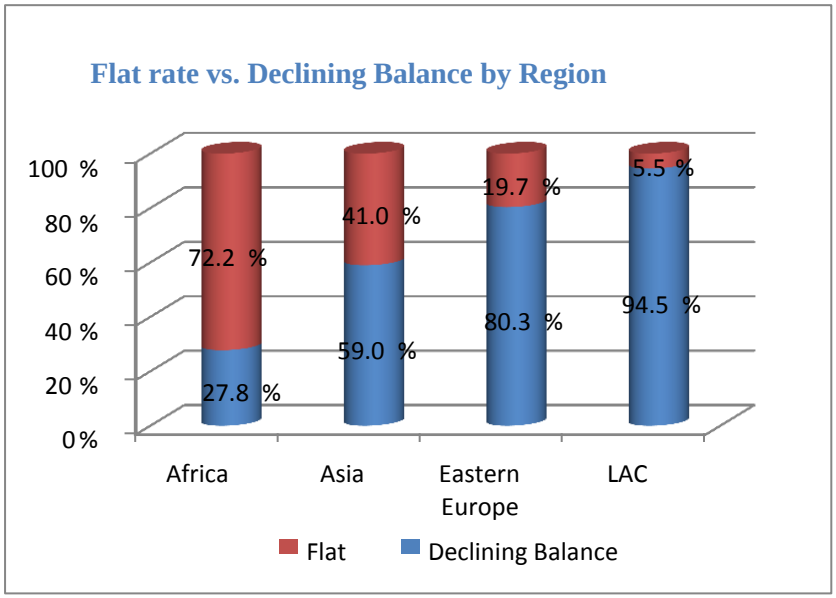
Figure 4.4. Loan instalment comparison



As explained earlier, the flat method of interest rate calculation is widely used by microfinance institutions to compute interest. This is so because, using the flat method will yield more income for the lending institution at the expense of the borrower. With the flat method, lending institutions are able to advertise interest rates that are twice as high as they appear to be. However, the clients see the flat rate method to be cheaper. This perspective comes especially from those clients with minimal financial education who lack the know-how of what the rate presented really signifies. Also, borrowers view the flat rate method to be easier to calculate as compared to the declining balance method.

The use of the flat method is particularly common in developing countries and/or regions where there is lack of transparency and the mechanism to facilitate it. According to the Microfinance Transparency database (2013), "interest for more than 3 in every 10 micro loan products is calculated using the flat rate method". In Africa for instance, about 70% of loan products are calculated using the flat rate as compared to the declining balance method. In Latin America, on the other hand, the ratio is just 5%. This is low because all the Latin American markets represented in the database operates under a legislation that promotes the use of the declining balance method.

Figure 4.4. Flat Rate versus Declining Balance by Region



Source: MFTransparency 2013.

Table 4.4 show the percentage use of flat rate method on loan products by some countries from Asia and Africa according to MicroFinance Transparency dataset.

Table 4.4. Use of Flat Rate Method by country

Country	% Products Using Flat Interest Rates
Azerbaijan	14%
Bolivia	9%
Bosnia and Herzegovina	22%
Burkina Faso	86%
Cambodia	8%
Colombia	3%
Ecuador	2%
India	57%
Kenya	81%
Malawi	79%
Rwanda	50%
Senegal	68%
Uganda	77%
TOTAL	**35%**

Source: MFTransparency Dataset, 2013. Available at: http://www.mftransparency.org/microfinance-pricing/

Why should institutions use the Declining Balance Rate?

The dissemination of the methodology "declining balance" has benefits both for borrowers of microfinance and for the market as a whole, for several reasons:

- It represents clearly and accurately the costs linked to a loan. There is no theoretical basis in support of "the flat" method and it is ethically and economically unjust to charge additional interest on amounts already returned by the borrower.
- Expresses a price level that is the closest to the total cost of the loan (transparency).
- If all institutions used the same calculation method then borrowers would be able to make more informed decisions. It is very difficult for example, for borrowers to compare a loan with a 15% flat interest rate to a 25% declining balance rate.
- The comparison of prices by borrowers can trigger institutions to compete more effectively, potentially resulting in better services and ultimately lower rates. Institutions can also make smarter price-setting decisions which might eventually lead to transparency.

4.4 Interest rates components of microcredit and their determinants in developing countries

The purpose of this section is to analyse the components/levels of interest rates applied by microfinance institutions, and to deepen the study the main determinants that influences the trends. As explained earlier, since the beginning of modern microcredit, one of its most controversial and debated dimension is undoubtedly on the interest rates charged by microfinance institutions. The main reason underlying the application of high rates on loans is to be found in the nature and characteristics of the credit products offered by these organizations to their customers.

The large number of small loans to manage, together with the lack of adequate facilities and organizational network established, involve a significant increase in administrative expenses and management costs that must be covered by increasing significantly the level of interest rates. However the alleged increased costs should not be a pretext to take advantage of borrowers who have little bargaining power, especially with the recent conversion of numerous institutions in organizations based on profit, where high interest rates could

easily translate into higher returns for shareholders (Rosenberg et al, 2013). In the recent decades, microfinance organizations that dealt to provide credit to low-income individuals in transition and developing economies, have focused their efforts and attention on the quest for full financial independence against external grants or supports from charitable organizations.
The main consequence of the choice was the significant increase in interest rates, arguing that doing so would best ensure the permanence and the expansion of the services offered. A sustainable microfinance program, and hence are able to generate profits, allows full independence from external sources of financing subsidiaries, ensuring continuity and, subsequently, the expansion of the products and services available to customers.

The main components of MFIs' interest rates are represented by the cost of funding, loan loss expense, operational and management expenses, and the profit margin. Microfinance institutions, as repeatedly pointed out, use net interest income to cover the costs, and the difference between income and expenses incurred determines the profit or loss obtained from management. A decrease in the rate of interest requires therefore lowering at least one of the four above mentioned components and judgment regarding the reasonableness of the level reached by the same relates to the performance of its component variables (Rosenberg, Gonzalez, Narain, 2009).
The following equation allows to formalise the concept just described:

Income from loans = Cost of funds + Loan loss expense + Operating expense + Profit

A full formula is given as:

Income from loans + other income = Cost of funds + Loan loss expense + Operating expense + Tax + Profit

Before analysing data and results, it appears useful to distinguish about two different ways of measuring the interest rates on micro lending, which is the rate of return on the loan interest (interest yield) and the annual percentage rate (APR). Understanding the differences between these two rates is fundamental for a correct interpretation of the data that will be presented later. From the point of view of customers, the most widely used method in assessing the level of interest rates is to calculate the annual percentage rate (APR) on a given financing, which takes into account the amount and the timing related to cash flows associated with the loan, taxes and charges and the mandatory deposit may be required.

On the contrary, the MFI is more intuitive and express the rate of return linked to the interest, or the interest yield (which includes all revenue made by the Organization following the granting of credit as interest, Commission and other charges) comparing then to gross loan portfolio managed directly.

The yield on the interest in relation to the gross loan portfolio is one of the main indicators used by Microfinance Information exchange (MIX, www.themix.org), which contains a database that includes within it several financial data about hundreds of microfinance institutions, which is widely used in the course of treatment.
From the lender's point of view, this report is far more significant than the assessment of annual percentage rate. However, it is a misleading indicator when used by individual clients because, on equal terms, the interest yield is much lower than the APR. The following example will help clarify the differences between the two indicators under consideration. Currently, about one-third of microfinance institutions provide for the creation of compulsory deposits to their clients after the disbursement of the loan, increasing the effective interest rate, since the deposit reduces the credit actually available to the borrower. The annual percentage rate incorporates this effect while the interest yield does not account for this variation.

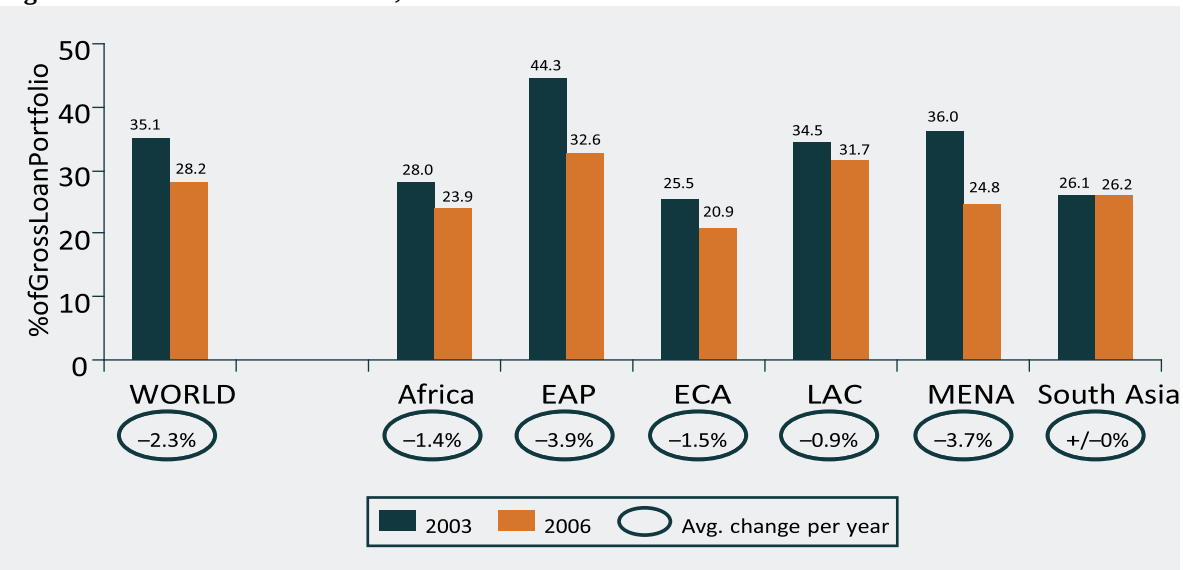
The calculation of the return on interest made by MIX considers a single loan portfolio, although the same may contain credit products with significantly different characteristics. The loan portfolio also includes inside those loans that have not been regularly repaid over time, leading to a noticeable distortion in the calculation of its productivity.
Suppose, for example, that the total interest margin for any microfinance institution is $300 and the total gross loan portfolio is equal to $ 1000, the final rate of return is equal to 30% ($ 300/$ 1,000). If, however, only a portion of the loan, such as $ 900 on the overall portfolio, is paying regularly interest, the rate of return actually achieved by the Organization should be equal to 37.5% ($ 300/$ 800), because the $ 100 of non-performing loans or overdue does not bear interest.

Using data of 175 sustainable MFIs reported in the MIX database for both 2003 and 2006, the analysis of the imported data are reported in Figure 4.3.1. It shows the distribution of microcredit rates of return on their combined gross loan portfolio of microfinance institutions

in developing countries and a world average comparison. The regional breakdown in figure 4.3.1 includes Africa (Sub-Sharan Africa), East Asia and the Pacific (EAP), East and Central Asia (ECA), Latin America and the Caribbean (LAC), Middle East and North Africa (MENA), and South Asia (SA). Over the period 2003-2006, there has been a significant decrease in the average rates of return in all regions thus, worldwide, except for South Asia, which is the only region that shows no significant decline. On the other hand, there are significant decreases in other regions such as Africa, East and Central Asia, each showing a decrease of 4.1% and 4.6% with and average change per year of 1.4% and 1.5% respectively. This change is due to the fact that they were the least developed market at the time. MENA and the Pacific shows the largest decline of 11.2% and 11.7% respectively, with a respective yearly average decline of 3.7% and 3.9%. On the whole, there is a world average decline of 2.3% per year.

This decline may have been caused mainly by two factors: the lowering of interest rates on loans from microfinance institutions or the reduction of the operational cost burdens on cases of such organizations, thanks to the increased efficiency of same or to increased competition in the market.

Figure 4.3.1: Interest Yield Trends, 2003–2006



Source: Rosenberg, et al.2009.

4.4.1 Detailed analysis of the determinants of interest rates of microcredit

This section will be focused on analysing the interest rates determinants, which are the principal elements that determine these rates. Before looking at individual determinants, we recall the formula:

Income from loans = Cost of funds + Loan loss expense + Operating expense + Profit

A full formula is given as:

Income from loans + other income = Cost of funds + Loan loss expense + Operating expense + Tax + Profit

1. **Cost of funds**

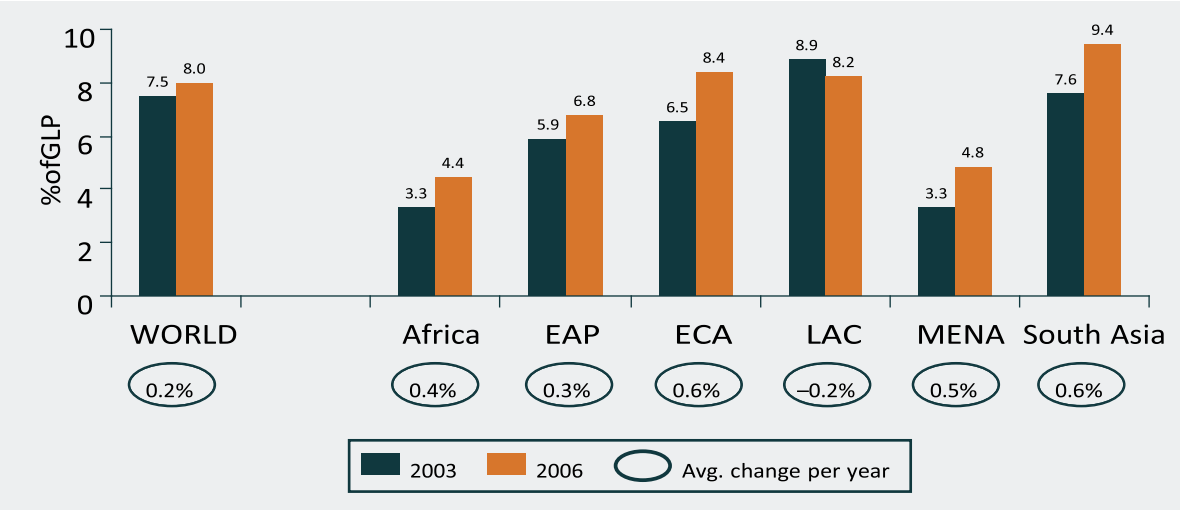
This represent a cost category that is quite relevant for microfinance institutions. Like any other institution or organisation (private or public), microfinance institutions have their own sources of finance. This could either be through equity (own funds), or debt (money from depositors or outside lenders). The influence of the financial costs on the profitability of MFIs depends mainly on the financing structure adopted. Those organisations/institutions that have the ability to take advantage of grants and soft loans will have financial costs lower than those forced to finance itself solely through business loans. The rate of the cost of financing (funding expense ratio) is the most widely used indicator to assess the impact of costs relating to the collection of funds. It expresses the relationship between the financial costs incurred and the gross loan portfolio of a particular institution, by measuring the total spending on interests supported by the Organization to fund its core business. The high prices MFIs have to pay for obtaining funds that are necessary to continue their lending activities contributes significantly to the interest they charge to borrowers.

Figure 4.3.2 shows the trend in funding costs otherwise known as interest expense, expressed as a percentage of the ratio of interest expense to the gross loan portfolio. The impact of the financial burden on the gross loan portfolio is substantially increased over the years. Globally, the percentage increase from 7.5% of 2003 to 8.0% in 2006. At the regional level, the

increase in trend is evident in all regions except Latin America which shows a positive decrease of 0.7% (from 8.9% to 8.2%).

The increasing use by the MFI to deposits required sums disbursed to customers can be a useful solution to lower costs in the long run. However, this option is not available in countries where there is no adequate regulation about it or for those institutions that have not yet shown the strength needed to meet the minimum requirements to get a license (Rosenberg, Gonzalez, Narain, 2009).

Figure 4.3.2: Trend in Funding Costs (Interest Expense as Percentage of GLP), 2003–2006



Source: Rosenberg et al.2009.

2. Loan Loss Expense

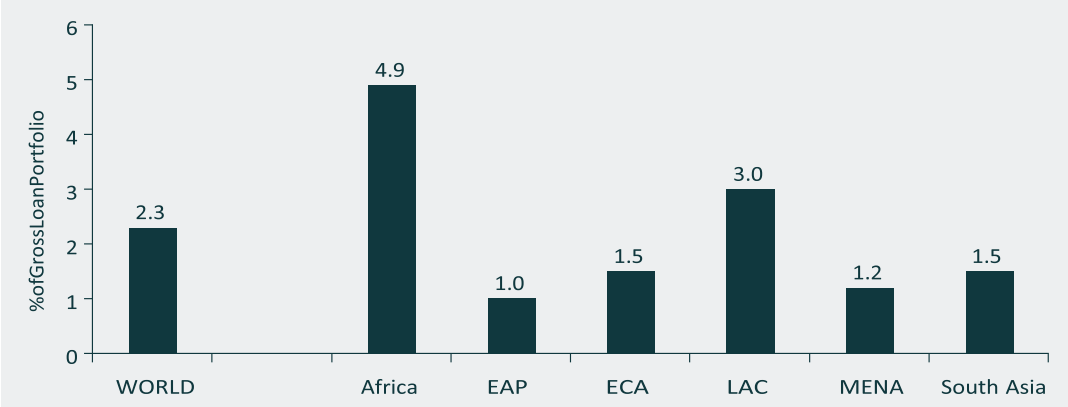
As most microloans are backed by no collaterals or by collateral that will most likely not be able to cover a defaulted loan once collection expenses are taken into account, failure for customers to repay the loan is the most important risk for microfinance institutions, with a significant impact on the profitability of organizations.

The correct definition of provisions for credit losses is a very important step, because the underestimation these costs can lead to a bias in the assessment of the viability of microfinance institutions. The provision for bad debts represents the cost amount (non-monetary) that have

to be recorded in the income statement so as to increase the fund budget prepared to cover the defaults provided in the loan portfolio. Banking institutions generally do not have much room for planning in defining this policies of loan loss provision (predicting credit losses) due to the numerous checks carried out by the competent tax authorities and by the external auditors. Microfinance institutions by contrast are free to adopt their own policy of provision, with the exception of regulated institutions that are forced to comply with different national legislations. There is emerging evidence that suggests that MFIs are more stable than banks when it comes to the effect of a general economic stress on their loan collection (Gonzalez, 2007).

Figure 4.3.3 shows the global and regional medians for loan losses, weighted by gross loan portfolio.

Figure 4.3.3 Global and Regional Loan Losses as Percentage of GLP, Averages for 2006



Source: Rosenberg et al.2009.

Note that the general rule of thumb in microcredit is that an institution with annual loan loss of more than 5% tends to become unsustainable. Loan collection above this level must be improved substantially and quickly otherwise it will spin out of control. Data on main areas selected for the year 2006 (from figure 4.3.3) show levels far below the 5% limit, except for Africa which is very close to the 5% threshold. A very low percentage of MFIs that have credit losses however can have downsides, as high risk aversion in the selection of borrowers, which precludes access to finance to more poor people, but also a distorted level of the overall profitability of the institution itself. The high average loan loss for Africa (4.9%) is driven by a few outliers (table 4.3.4).

Table 4.3.4 2006 distribution of loan losses, weighted by GLP

Region	5%	25%	Median	75%	95%
Africa	0.3	0.7	2.3	3.9	22.4
EAP	0.1	0.9	0.9	0.9	1.1
ECA	0.3	0.8	1.6	2.0	2.7
LAC	0.8	1.2	2.2	3.6	10.0
MENA	0.0	0.2	1.8	1.8	2.0
SA	0.0	0.4	1.7	2.4	2.7
World	0.2	0.9	1.6	2.7	5.7

Source: Rosenberg et al.2009.

3. Operating Expenses (Costs)

Operating expenses are generally the most important item of expenditure for microfinance institutions. They include the costs of implementing the loan activities, such as personnel compensation (salaries, allowances, taxes bonuses, and social security contributions) and administrative costs (relating to the provision of services to customers, the costs of rent, utilities and depreciation of fixed assets) operating expenses consume the majority of the income of the loan portfolio of most microfinance institutions, especially in developing countries. Thus, this component is the largest determinant of the rate borrowers pay. Due to the high occurrence of these costs on the profitability of organizations, achieving improved levels of efficiency can reduce interest rates on loans to borrowers. MFIs, unlike traditional commercial banks and intermediaries, have low levels of operational efficiency. This is because microcredit is labour intensive. For instance, where MFIs operating expenses reach $15-$20 for every $100 of loan portfolio, an equivalent rate of 15%-20% is charged, while commercial banks will show values between 1.5% and 3%.

The efficiency of microfinance institutions could be affected by elements which can be grouped into two main categories: the target customers served by the Organization and the

peculiarities of the country in which it operates. If the institution caters to a range of customers representing the collection of individuals living below the poverty line, it will be able to grant more amount of loans than another institution that serves the poorest of the poor. Furthermore, the characteristics of the country in which a microfinance organization work is also essential to determine the causes that lead to the achievement of high operational costs. In addition to the quality of infrastructure available, the level of dispersion of clients served is another factor that affects significantly the costs incurred by microfinance institutions. The decrease in operating costs must be accompanied by an improvement in the efficiency of the administrative management and distribution within the microfinance institutions, to ensure the optimization of results in the long run. Another important vehicle could be the increase in competition in the market which forces lenders to develop new distribution systems that are more effective and less costly in economic terms (Rosenberg et al, 2013).

Figure 4.3.4 shows the median operating cost (expense) at 11.4% (represented by the thick horizontal bar) of the gross loan portfolio in 2006. About 90 percent of the values lie between 7.9% and 33.7%. If Africa is excluded, the range would considerably be narrower. Figure 4.3.5 shows the distribution of operating expense ratio of 2006, worldwide and regionally.

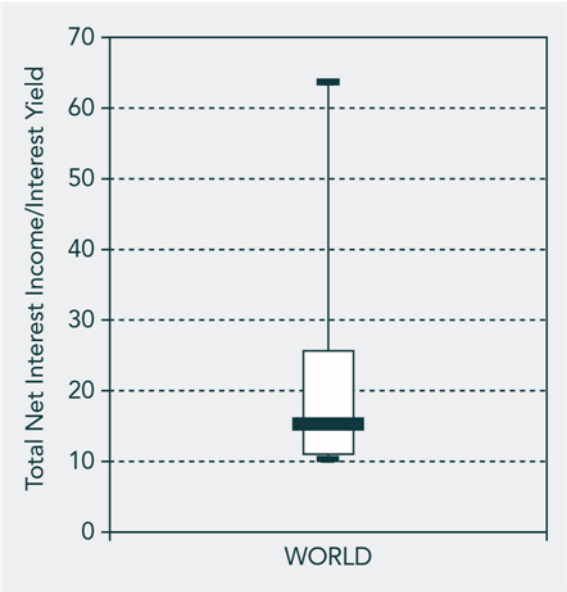
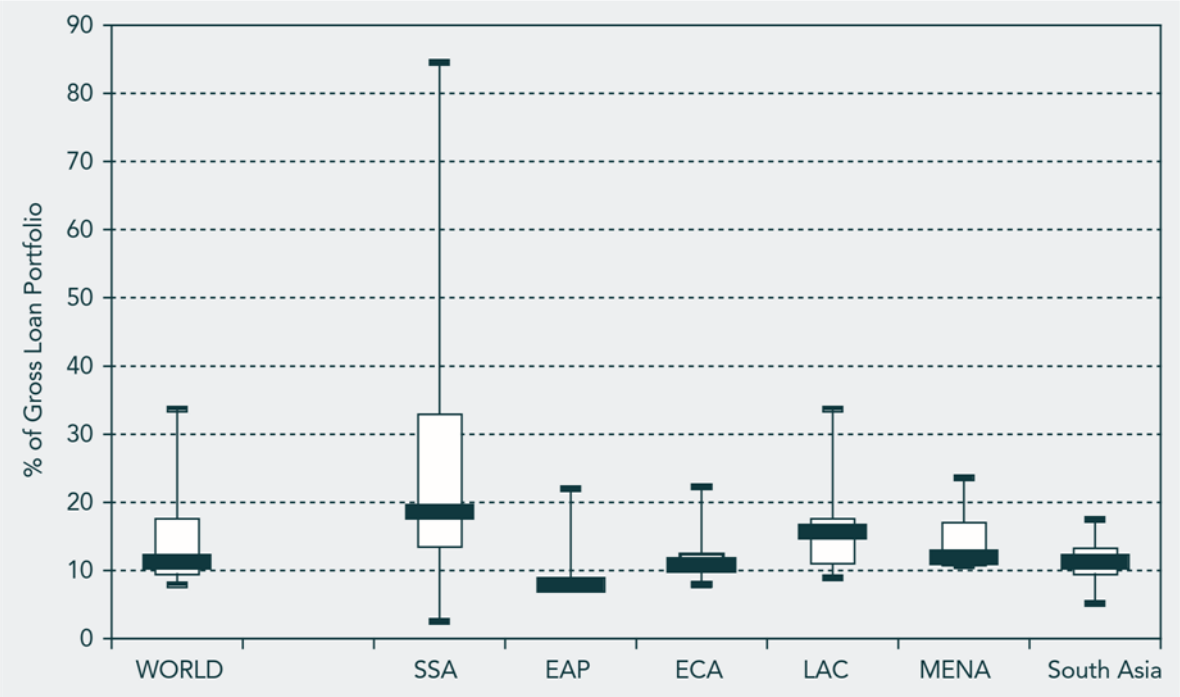


Figure 4.3.4 Operating expense ratio, 2006

Source: Rosenberg et al.2009.

Figure 4.3.5 Distribution of Operating Expense Ratio, 2006



Source: Rosenberg et al.2009.

Note that the top and bottom of the white box represent the 75th and 25th percentiles respectively and the high and low short bars represent the 95th and 5th percentiles respectively.

4. Profits

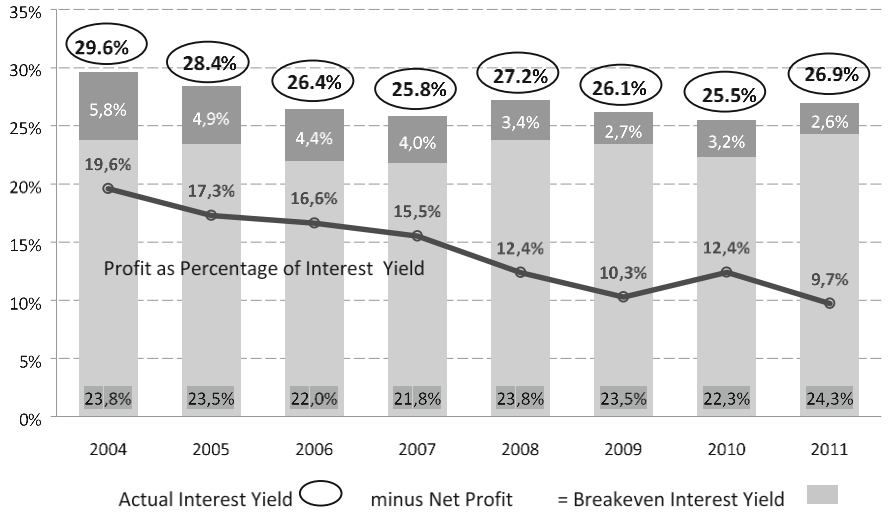
Profit, as we know, is residual and it is defined as the difference between income/revenue and expense/cost. Of all the four components of interest rates in microcredit, profit is the one that is most subject to direct control by the management. There are conflicting currents of thought in respect of the level reached by profits in microfinance institutions. In some cases a high profit is seen as a kind of prevarication against low-income individuals who do not possess a sufficient bargaining power, while in other cases the high returns are considered a useful means to attract more investment and consequently a more rapid expansion of services offered to financially weak subjects (Rosenberg, et al, 2009).

Before we look at the level and the trend of earnings generated by microfinance institutions, let us analyse the impact profit has on the borrower. The determination of the profits generated by the activity of microcredit can easily lead to overestimate the influence they have in defining the overall level of interest rates paid by customers (Rosenberg et al, 2013).

Figure 4.3.5 shows how much microcredit interest rates would drop gradually if MFIs chose to forgo any return on investments regarding the activities of credit supply to its customers.

Profits in relation to the gross loan portfolio decreased significantly over the years, especially in 2009 and 2011. In 2004 the profits generated by organizations weighed for 19.6% on total return; that value has decreased significantly over the years, up to 9.7% in 2011, making it the lowest ever as compared to the 10.3% in 2009 (the crisis year).

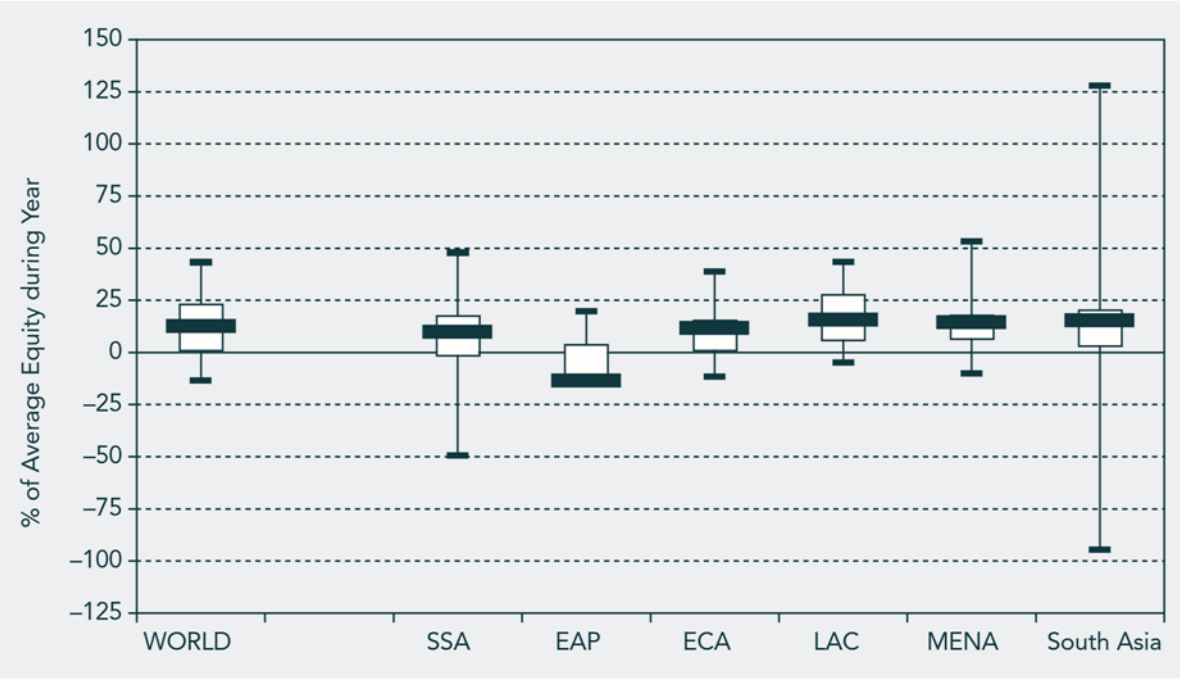
Figure 4.3.5 Impact of profit on global interest rates, 2006



Source: Rosenberg et al, 2013

Figure 4.3.6 shows the profits in relation to the gross loan portfolio registered by microfinance institutions in developing countries in the year 2006, for all regions compared worldwide. The overall returns are moderate, at least by commercial standards. Here, the profit levels in the industry vary widely. In 2006, about a quarter of micro lenders earned annual returns greater than 20 percent on shareholders' investment. About 5 percent produced profits higher than 40 percent. Plenty of micro lenders however, lost money, especially in Africa and in South Asia (where some lenders working in Andhra Pradesh had a very bad year).

Figure 4.3.6 Return on average equity 2006, worldwide and region

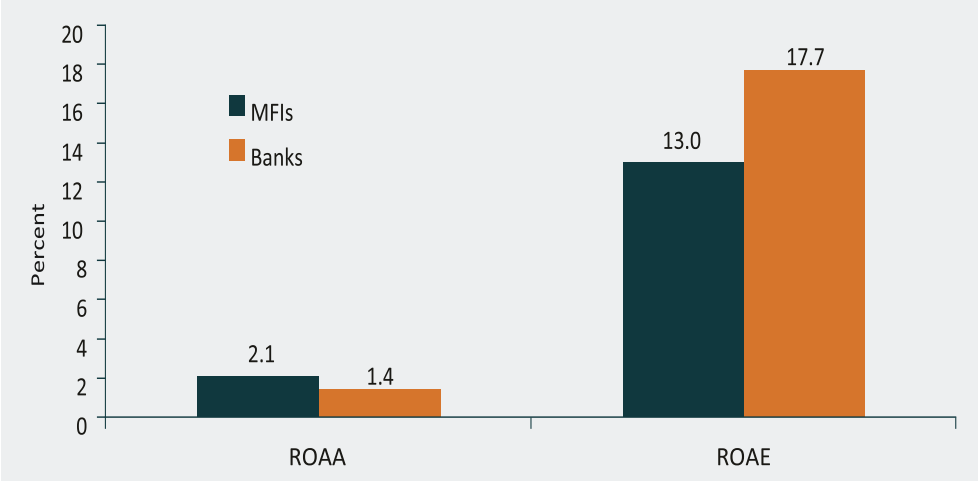


Source: Rosenberg et al.2009.

Note that the top and bottom of the white box represent the 75th and 25th percentiles respectively and the high and low short bars represent the 95th and 5th percentiles respectively.

Figure 4.3.7 compare MFI profitability with commercial bank profitability, measured by both return on average asset and return on average equity. When the profit is measured against assets, it does seem to average higher for MFIs than for banks, with 2.1% to 1.4% respectively. Most of these banks face more competition than MFIs in their countries. The decline in the yields recorded by MFIs has caused a downsizing profitability (figure 4.3.7)

Figure 4.3.7 Profits- MFIs vs Banks return on average asset and equity



Source: Rosenberg et al.2009.

Chapter Five

Poverty Reduction

5.0. Background

Poverty is a universal and meaningful concept in all countries, most especially in developing countries. In recent years, the world has experienced a major economic development and rise in the standard of living (Fishman, 2006; Stiglitz, 2006). However, this development is not evenly distributed around the world in that, the gap between the rich and poor is still large and developing countries, especially in Africa and South Asian countries, still have many people living below the poverty line with low standard of living, and deteriorating economic performance. The significant decline in the standard of living has led to poverty and social conflicts (Cypher & Dietz, 2004). And this has led to the realization that if poverty and the falling standard of living is not addressed, it can lead to more serious problems like political and social conflicts around the world in the long run.

This chapter will focus mainly on poverty and the relevant measures being put in in place to tackle this problem. We shall evaluate the relationship of Small and Medium-Sized Enterprise and Microcredit; what impact and/or contribution they have on the reduction of poverty around the world, most especially in developing countries.

5.1. What is Poverty?

There is no single definition of poverty. Poverty is a multidimensional phenomenon, thus, poverty is easier to describe than to define. A variety of conceptual and empirical approaches has been used to define poverty. Poverty is defined as the lack of basic human needs or items which are needed for proper living; such as food, clothing, shelter and water.

The United Nations defined poverty as “a denial of choices and opportunities, a violation of human dignity. It means not having enough to feed and clothe a family, not having a school or clinic to go to, not having the land on which to grow one-s food or a job to earn one-s living, not having access to credit or not having access to clean water or sanitation” (UN Statement, June 1998-singed by all heads of UN agencies).

At the World Summit on Social Development in Copenhagen (1995), poverty was defined as "a condition characterized by severe deprivation of basic human needs, including food, safe drinking water, sanitary facilities, health, shelter, education and information. It depends not only on income but also on access to social services". When people are unable to get access to these necessities then they are considered to be in poverty irrespective of their income.

The European Commission defined poverty to mean "individuals, families and groups of persons whose resources (material, cultural and social) are so limited as to exclude them from the minimum acceptable way of life in the Member State in which they live" (EEC, 1985).

This, 'officially' is the definition of poverty that is used in the European Union (EU) for all 25 member states. Poverty can also be statistically defined and measured in various ways, two most simple ways are: absolute poverty measurement and relative poverty measurement. These are mainly based on income and consumption values.

1. **Relative Poverty**

Relative poverty measures the simplest way to determine the extent at which poverty is spread in individual countries. This is based on the country's income distribution; thus, the entire population is classified in order of income per capita. Relative poverty could be good for country-wide measurements but not for global-wise. If for example, if a country set a 10% relative poverty measurement (it could be even more depending on whatever percentage the government chooses), then any percentage less than this is considered 'poor or impoverish'. On the other hand, if the same 10% is set globally, it will then seem that both an industrialised (developed) country such as Italy, and a non-industrialised Sub-Saharan African country such as Sierra Leone (where, about 60% of the population live in abject poverty), had the same 10% poverty rate.

2. **Absolute Poverty Measurement**

This is also referred to as extreme poverty, and it measures poverty in relation to the amount of income/money necessary to meet basic needs such as food, clothing, and shelter. It set a 'poverty line' of purchasing power (or command over material resources) based on the estimated values of these needs. The poverty line is the minimum level at which a person's income can reach in order to meet basic needs. A person is considered to be poor if his/her income level falls below this minimum line. For example, if a particular country sets a

minimum poverty line (based on consumption) of $5 a day per person, then anyone consuming goods that have monetary value less than $1860 per year would be considered poverty.

Poverty lines may vary from region to region and from country to country, depending on how economically developed the region or country is. A poverty line of $1.90 per day was set by the World Bank in 1990. This line was set/created during the publishing of the World Development Report by the World Bank in 1990, there, the World Bank found that most developing countries set their poverty lines at $1.90 a day. An income $2 per day was also set mainly for developing countries who exhibit better income levels as compared to their $1 a day counterparts. As mentioned before, poverty lines vary thus, more developed countries are allowed to set their own poverty lines as they chooses, this is because it could seem inappropriate (or silly more precisely) to assume that people in a well-developed country like Italy (compared with Sierra Leone) will make less $1 a day, even though it is obvious that they have many people living in poverty. Countries such as the UK, Japan and the U.S who are highly industrialised have an absolute poverty line set that is usually higher (for example a $14.40 line was set in past). As of 2005, the United States has set a $26.19 poverty for a single individual living in the U.S.

5.2 World Bank Goals on Poverty Reduction

The World Bank, whose core mission is 'a world free of poverty', as of 20th April 2013 has adopted two ambitious goals: end extreme poverty globally and promote shared prosperity in every country in a sustainable way.

The progress towards ending global extreme poverty is measured by monitoring the rate of extreme poverty using the international poverty standard. The World Bank has set a target in reducing the poverty headcount ratio from 12.4% in 2012 (See table 5.2) to 3.0% by 2030. In order to avoid overreliance on efforts towards the end of the period, the organization set has set an interim target of 9.0 percent by 2020, consistent with annual reduction in global poverty extreme poverty of a half percentage point over 2012 to 2020.

The promotion of shared prosperity in every country in a sustainable way is not globally defined, but tracks progress at individual country levels. The shared prosperity goal is universal despite not providing a single global target, this is because it includes developed countries that do not contribute the global poverty count but are still monitored in terms of shared prosperity.

5.2.1. Global Poverty and Headcount Ratios

Poverty has been decreasing over the years that is, the share of people living in less than $1.90 a day has declined steadily over the decades but not in Sub-Saharan Africa. Based on the recent (2013) comprehensive data on global poverty, it is evident that the progressive global decline in extreme poverty rates over the years has been uneven, this is mainly at the expense of Sub-Saharan Africa.

As of 2013, an estimate of 767 million people worldwide are found to be living below the global poverty line of $1.90 per person per day. From this, Sub-Saharan Africa has the largest amount of people living below the international poverty line, at 389 million people and with a poverty gap of 15.9%, which triples that of its regional counterparts. East Asia and Pacific (EAP) have a poverty headcount ratio of 3.5% and a poverty gap of 0.7%, and Eastern Europe and Central Asia (ECA), Latin America and the Caribbean (LAC), South Asia (SA) respectively having a poverty headcount ratio of 2.3%, 5.4%, 15.1% and poverty gap of 0.6%, 2.6%, and 2.8% respectively.

Table 5.1substatiates this statement, showing world and regional poverty estimates as of 2013. In every 100 people living in the world, almost 11 or 10.7% of the global population were considered poor by this standard (that is, at $1.90 a day). This is a 1.7% decrease from the 2012 global poverty headcount ratio (table 5.2). This decline can mainly be explained by two regions, South Asia and East Asia and Pacific, which shows significant cuts by lower number of extreme poor between 2012 and 2013, with 37 million fewer poor and 71 million fewer poor respectively (table 5.3). The lower estimates in East Asia and Pacific mainly depend on lower estimates from China and Indonesia while the large cut in South Asia is as a result of India's growth.

Table 5.1 World and Regional Poverty Estimates, 2013

Region	Headcount ratio (%)	Poverty gap (%)	Squared poverty gap (%)	Poor (millions)
East Asia & Pacific	3.5	0.7	0.2	71.0
Eastern Europe and Central Asia	2.3	0.6	0.3	10.8
Latin America and the Caribbean	5.4	2.6	1.8	33.6
Middle East and North Africa	-	-	-	-
South Asia	15.1	2.8	0.8	256.2
Sub-Saharan Africa	41.0	15.9	8.4	388.7
World	**10.7**	**3.2**	**1.5**	**766.6**

Source: Most recent estimates based on 2013 data using PovcalNet (an online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/
Note: where (-) for MENA = not available

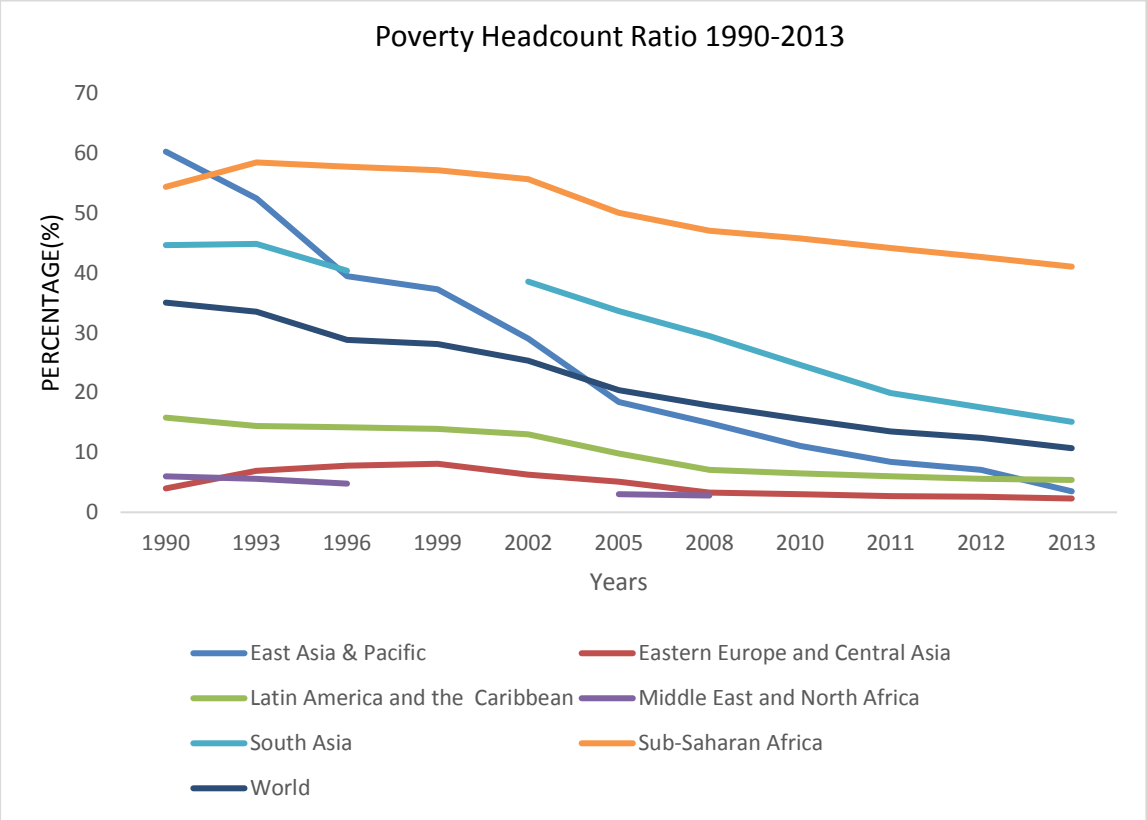
Table 5.2 and figure 5.1 shows the historical trend of world and regional poverty headcount ratios (2011 purchasing power parity) through the years 1990 to 2013. Indeed, Sub-Saharan Africa made little or no progress in the reduction of extreme poverty over the years and still has the highest poverty headcount ratio at 41.0% as of 2013 and houses the largest number of the poor at 389 million. This is an extreme shift as compared to East Asia and Pacific which had the highest poverty headcount ratio in 1990 at 60.2%, and has made a reduction progress to 3.5% as of 2013. The poverty headcount ratio for Eastern Europe and Central Asia decreased by a quarter of percentage (0.3%) between 2012 and 2013; while the headcount ratio for Latin America and the Caribbean declined by 0.2% , that is from 5.6 percent in 2012 to 5.4 percent in 2013.

Table 5.2 Regional Poverty Headcount Ratios, 1990-2013

Region	1990	1993	1996	1999	2002	2005	2008	2010	2011	2012	2013
East Asia & Pacific	60.2	52.4	39.4	37.2	29	18.4	14.9	11.1	8.4	7.1	3.5
Eastern Europe and Central Asia	4.0	6.9	7.8	8.1	6.3	5.1	3.3	3	2.7	2.6	2.3
Latin America and the Caribbean	15.8	14.4	14.2	13.9	13.0	9.8	7.1	6.5	6.0	5.6	5.4
Middle East and North Africa	6.0	5.6	4.8	-	-	3.0	2.8	-	-	-	-
South Asia	44.6	44.8	40.3	-	38.5	33.6	29.4	24.6	19.9	17.5	15.1
Sub-Saharan Africa	54.3	58.4	57.7	57.1	55.6	50.0	47.0	45.7	44.1	42.6	41.0
World	**35.0**	**33.5**	**28.8**	**28.1**	**25.3**	**20.4**	**17.8**	**15.6**	**13.5**	**12.4**	**10.7**

Source: Most recent estimates based on 2013 data using PovcalNet (an online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/

Figure 5.1. Poverty Headcount Ratio 1990-2013



Source: Most recent estimates based on 2013 data using PovcalNet (an online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/

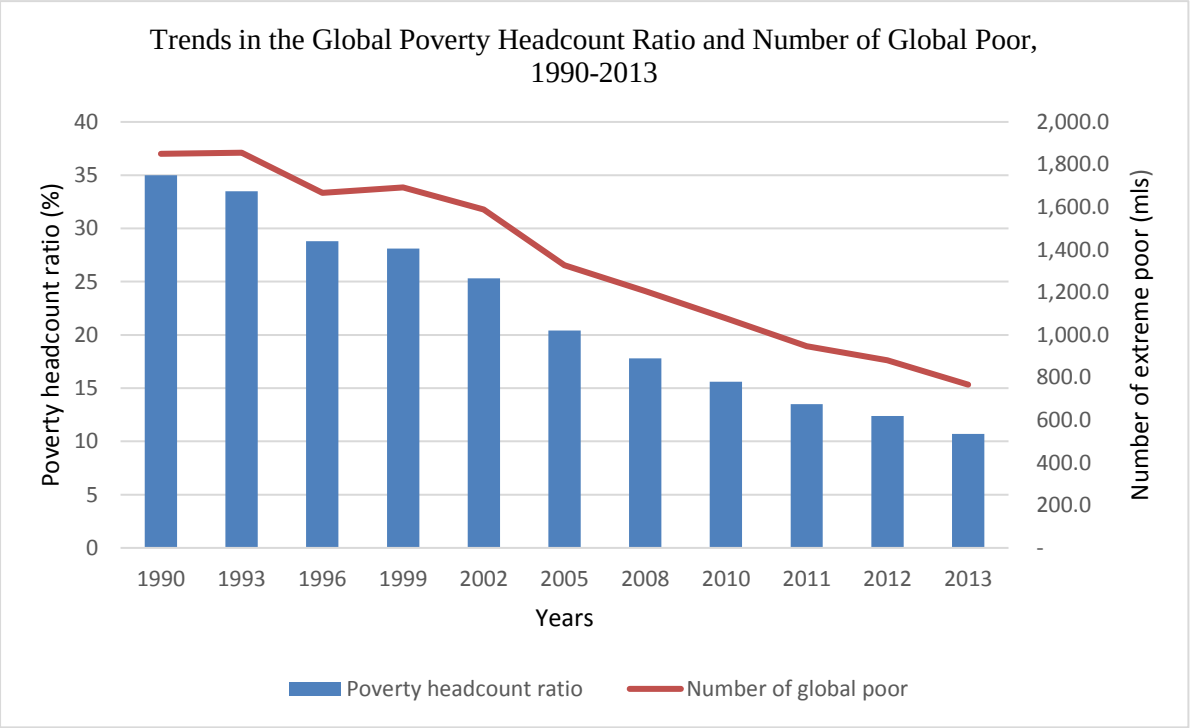
Both the total number of extreme poor (globally) and the global poverty headcount ratio have been declining steadily over the years. Since the year 1990 to 2013, the world has had 1.1 billion fewer poor**.** Table 5.3 shows the historical trends in the numbers of extreme poor by region from 1990 to 2013 and figure 5.2 shows the trends in the global poverty headcount ratio and the Number of global poor, 1990-2013.

Table 5.3 Historical Trends, Number of Extreme Poor, by Region, 1990-2013 (millions)

Region	1990	1993	1996	1999	2002	2005	2008	2010	2011	2012	2013
East Asia & Pacific	965.9	876.8	683.8	669.0	535.1	349.2	288.2	218.2	166.9	141.8	71.0
Eastern Europe and Central Asia	18.2	32.2	36.3	37.8	29.3	23.8	15.5	14.2	13.0	12.2	10.8
Latin America and the Caribbean	71.2	68.3	70.7	72.2	70.6	55.6	41.9	38.8	36.4	34.1	33.6
Middle East and North Africa	13.7	13.6				9.2	6.7				
South Asia	505.0	541.5	517.0		552.4	508.3	464.7	400.3	327.9	293.3	256.2
Sub-Saharan Africa	276.1	323.1	346.1	371.3	391.3	381.5	389.1	399.1	395.7	393.1	388.7
World	**1,850.1**	**1,855.4**	**1,666.3**	**1,692.9**	**1,588.1**	**1,327.5**	**1,205.6**	**1,077.5**	**946.3**	**880.9**	**766.6**

Source: Most recent estimates based on 2013 data using PovcalNet (an online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/

Figure 5.2. Trends in the Global Poverty Headcount Ratio and the Number of Global Poor, 1990-2013

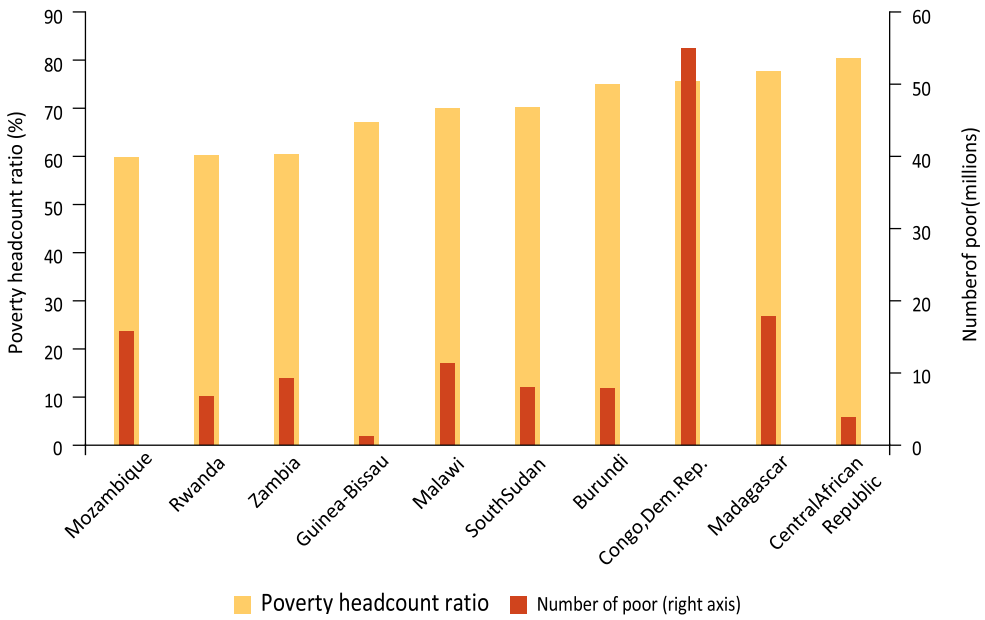


Source: Most recent estimates based on 2013 data using PovcalNet (an online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/

Figures 5.3 and 5.4 respectively shows the poverty headcount ratio and the number of poor for the top ten (10) countries. It can be seen that the countries with the highest poverty headcount ratios are not the same as those with the largest number of poor people. The countries with the highest poverty headcount ratio are mainly in Sub-Saharan Africa. However, countries like Mozambique, the Democratic Republic of Congo and Madagascar appear among the top ten countries with the highest number of poor. In figure 5.3, among the countries with highest headcount ratio, the red bars shows the number of poor people living in a particular country. The Democratic Republic of Congo has the largest number of poor people (that is, people living below $1.90 a day) at 57% and has an extrem.ly high poverty rate at 75.9%. Madagascar and Mozambique also have high poverty headcount ration at 78.0% and 60.0% respectively, this result in lower absolute poverty numbers, 17.9 million and 15.9 million respectively, because of the smaller population of these countries.

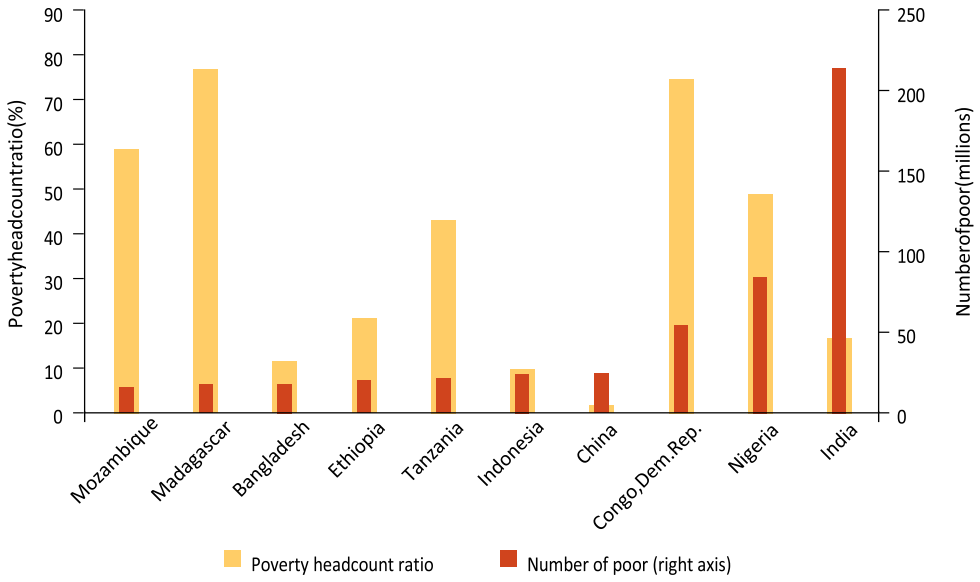
Furthermore, even though over half of the world's poor live in Sub-Saharan Africa, four of the top 10 countries by the number of poor namely, Bangladesh, China, India, and Indonesia (see figure 2.7, where the red bars show the number of the poor) are not in this region. This is because, despite the relatively low headcount ratios, these four countries have large populations. India is by far the country with the largest number of people living under the international poverty line of $1.90 a day; 224 million more than 2.5 times as many as the 86 million in Nigeria, which has the second-largest population of the poor worldwide. Thus, Sub-Saharan Africa has one in two of the poor worldwide, while India accounts for one in three (see table 5.1).

Figure 5.3 Poverty Headcount Ratio, Top 10 Countries, 2013.



Source: Most recent estimates based on 2013 data using PovcalNet (an online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/

Figure 5.4 Number of Poor, Top 10 Countries, 2013



Source: Most recent estimates based on 2013 data using PovcalNet (an online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/

5.3. The Eradication of Poverty in Developing Countries

Poverty in all of its forms and sharps has become a global concern. Thus, its eradication in all dimensions has become 'the greatest global challenge' and an indispensable requirement for sustainable development since the United Nation's World Summit on Social Development in Copenhagen (1995). The wide spread of poverty especially in developing countries has become a target for its eradication by international bodies who have come together to put measures in place to help in reduction if not eradication of poverty by 2030. To begin with, the First United Nations Decade for the Eradication of Poverty (1997-2006), which was proclaimed by the General Assembly in its resolution 50/107 is "to achieve the goal of eradicating absolute poverty through national action and international cooperation". It is broadly accepted that strong economic growth that is labour-intensive and equitable, combine with larger outlays of social expenditures, especially directed towards the poor (now estimated 767 million people as of 2013), are winning combination in the fight against poverty.

However, in spite the passage of time poverty still continues to be a significant challenge for many developing countries especially in Sub-Saran Africa (see table 5.3). International have examined some policies and strategies for the eradication poverty:

1. **The Economic Growth Approach**

There have been some beliefs amongst experts that growth is the principal means of reducing poverty and improving quality of life (WDR, 1990). The idea of poverty reduction by market-led economic growth was introduced by Adam Smith in the 1770s and this idea is based on the argument that the richer a country, the lower its poverty levels the higher its improvement in education and human capital (WDR, 2001). Hence, economic growth is viewed as a powerful force for poverty reduction.

2. **Good Governance**

According to the African Commission Report (2005), growth contributes more rapidly to poverty reduction if the poor are capable of participating in the society and economy. However, in the growth literature, the ability of growth to reduce poverty depends on favourable policies such as macroeconomic stability, a good governance system, and pro-poor and pro-development trade policies (Collier and Dollar, 2001). For instance, developing a good governance regime in the African context should not ignore the quality of governors. So far, all interventions on developing a good governance regime in Africa have focused almost exclusively on establishing institutions and systems and improving technical training for the governors. Yet, to achieve a sustainable good governance in Africa, it is necessary to understand and incorporate Africa's socio-cultural values into any intervention.

3. **Poverty Reduction Strategy Paper**

One important initiative of the World Bank and the International Monetary Fund (IMF) approach in the 1990s, was the Poverty Reduction Strategy Paper approach (PRSP) later called the Poverty Reduction Strategies (PRS). This was tied to debt reduction. The PRSP came as a result of increasing concerns and attention regarding the need to improve aid effectiveness and poverty reduction. In reacting to the concept, the World Bank and the IMF adopted the Poverty Reduction Strategy Paper's approach in a bid to provide development assistance to low income countries (IMF and IDA, 2002). The process requires the preparation of a Poverty Reduction Strategy so as to enable a country to remain worthy for Bank-Fund assistance (Mahmud, 2006).

The PRSP is very much focused on African countries and on countries which are:

i. at the poorer end of the spectrum of countries eligible for concessional lending;

ii. at the more aid-dependent end of the same spectrum; and
iii. predominantly African (Piron and Evans, 2005:3)

4. Millennium Development Goals' (MDG) Approach

The MGDs (which is already expired) was an international approach to poverty reduction. It all began in September 2000, when 147 heads of state and governments, and 189 nations converged at the United Nations to make the Millennium Declaration [A/RES/55/2]. The Millennium Declaration was to be guided by a strategic plan composed of eight (8) goals and sixteen (16) targets to be achieved by 2015. The eight were:

I. Halving extreme poverty and hunger;
II. achieving universal primary education;
III. promoting gender equality;
IV. reducing infant (under-fives) mortality by two-thirds;
V. reducing maternal mortality by three-quarters;
VI. reversing the spread of HIV/AIDS, malaria and Tuberculosis (TB);
VII. ensuring environmental sustainability; and
VIII. developing a global partnership for development, with targets for aid, trade and debt relief.

In a nutshell, the MDG is a comprehensive agreement which represents an unprecedented commitment to the reduction of poverty and ill-health, to gender equality, education, access to clean water and clean environment.

5.3.1. Microcredit as a Poverty Reduction Tool

Microcredit is a well-known and effective tool for the reduction of poverty and its role in reducing poverty is now well recognized all over the world. Microcredit is in fact considered an effective tool that helps the poor to get out from the 'poverty web' by providing them with collateral-free loans and ensuring access to finance where traditional financial institutions are not able to serve or not adequate. In its 1997 resolution, the General Assembly noted that microcredit programs in many countries, especially in developing countries, have demonstrated

to be an effective tool in reduction of poverty by helping to free people from extreme poverty and have helped to increase their involvement in the economic and political process in the society.

Microcredit programs, as have been discussed earlier in chapter three, are poverty focused and they provide financial and business services to very poor people for the generation of self-employment and income. Credit is a powerful instrument to fight poverty. These factors have led an increasing interest by governments, donors, development agencies, banks, universities, consultants, philanthropists and others, in microcredit in promoting growth with greater equity.

The question of whether or not credit alone is needed for poverty reduction has been an on-going debate so far. There are views that credit alone on its own is inadequate to fight poverty. The need for other services is also important in this respect. Such views, although, do not negate the role of credit, fail to appreciate the role of credit on its own merit. Most of the practitioners believe that credit plays a vital role as an instrument of intervention for a poor person to discover her potential and to stride for better living.

Muhammad Yunus, founder of the Grameen Bank believes, and advocates that Credit is a human right and once this right is established, the entitlement to other rights for leading a dignified life becomes easier. It empowers to break the vicious cycle of poverty by instantaneously creating self-employment and generating income. According to Muhammad Yunus (2003:171), "microcredit is not a miracle cure that can eliminate poverty in one fell swoop. But it can end for many and reduce its severity for others. Combined with other innovative programs that unleash people's potential, microcredit is an essential tool in our search for a poverty-free world".

5.3.2 SMEs as Poverty Reduction Tool

Small and medium-sized enterprises like microcredit have also played a vital role in the reduction of poverty most especially in developing countries. SMEs have enormously contributed towards the growth and development of both developed and developing countries. They are normally referred to as "the engine of growth" and "catalyst for socio-economic transformation of any country". Gebremariam et al. (2004) noted in their study that "an increase in the percentage share of SMEs' employment has a positive impact on economic

growth, thereby reducing poverty". SMEs' potential to reduce poverty lies mainly in their abilities to create jobs and enhancing economic growth.

Furthermore, SMEs do not only provide jobs or enhance economic development but also creates "the prideful sense of being independent" (Pradhan, 1989:157). In developing countries, the SME sector accounts for more than 90 percent of all sectors outside the agricultural sector, and contributes to employment and generates significant domestic and export earnings and these benefits are directly relevant to any effort of eradicating poverty, most especially in Africa.

Conclusion

This thesis has presented the two main alternative strategies (SMEs and microcredit) that have played a pivotal role in the economic development of transitioning and developing countries.

This study of SMEs in developing countries confirms that many SMEs are heavily reliant on internal funding resources for both start-up and business expansion. External financing still remain beyond the reach of many smaller-sized SMEs, making lower profits, with business expansion desires but financially constrained and operating in less developed economies. Moreover, the size of SME and the stage of the country development, reflecting financial market conditions, affects the choice of financial institutions and financial products.

With regards to microcredit and poverty reduction, there are many questions to answer and strategies to put in place regarding the eradication of poverty. Regarding microcredit, the question (s) that this study has tried to address (in chapter four) is whether microcredit borrowers are being exploited by high interest rates.

The level of interest rates is a subject of primary importance regarding the results and social performance of microfinance institutions. The application of high interest rates is likely to generate incompatibility between the cost of services to the target population and the real ability of customers to cope with the obligations assumed. The most important indicators used for the definition of the interest rates applied to customers are the annual percentage rate and the effective interest rate. The difference between the two signals is the way they compute the interest rate in that year; the effective interest rate, unlike the annual percentage rate, is financially more correct because it uses the compounded interest rate.

In the microfinance sector there are two main techniques of determining the interest that the client must pay before being granted the loan. The “declining balance method”, commonly known as the French depreciation in equal instalments. It calculates interest based on the remaining balance of loan, taking into account the actual loan amount held by the borrower at the moment.

The “flat” method is a special case of the American style build up in two shares depreciation rates, where the interest at which quotes are capitalized is zero. This method, in contrast to the “declining balance”, calculates the odds interest payable to the lender considering the amount of the original loan for the duration of the period of repayment, rather than the amount actually available to the borrower.

The main components of microcredit interest rates are represented by cost of funds, loan losses, operational and management expenses, and finally by the profit margin. Microfinance institutions use net interest income to cover the costs, and the difference between income and expenses incurred determines the profit or loss obtained from management. A decrease in the rate of interest requires therefore lowering of at least one of the four components mentioned above.

Poverty, on the other hand, should be conceptualized after understanding the poor as well as the rich.

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