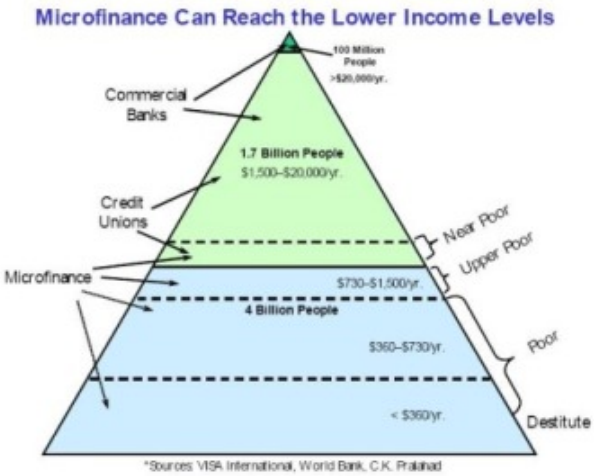
PAMUN XII RESEARCH REPORT—QUESTION OF MICRO-FINANCING IN LESS ECONOMICALLY DEVELOPED COUNTRIES

I. Introduction of Topic:

In the 1970's, Dr. Mohammad Yunus, a professor at Chittagong University, conducted an experiment that would go on to change the world of modern economics. He lent out small sums of money to poverty stricken women in the village of Jobra, Bangladesh. The money was on loan, meaning that Dr. Yunus set a date to pay back the money; surprisingly, almost all of the borrowers repaid their debts, including the interest rates.

This idea- giving financial services (primarily bank loans) to low-income citizens- is known as microfinance. Microfinance represents a bigger concept, though, that individuals are capable of rescuing themselves from the sticky claws of poverty, so long as they are given a few resources.

For example, Dr. Yunus went on to found Grameen Bank, which, statistics estimate, helps 5% of their customers leave poverty each year. The premise of micro financial ventures is that the borrowers find substantial (and regenerative) uses for the money given to them. Due to this, they can pay back the money and the interest to the microfinance institution (MFI) that they borrowed the currency from. As mentioned in Dr. Yunus's initial experiment, micro financed loans come with high-ticket interest rates. However, if the borrower succeeds in paying back the money, their credit is validated, allowing the MFI to trust them more. In some cases, the borrower may even "outgrow" the MFI (which could be anywhere from an NGO to a small bank) and develop new relationships with larger money lending organizations.



The money made off of these initial investments (usually entrepreneurial ventures) allow for a "domino effect" of sorts in their initial communities, putting more money into circulations in places which historically had next to none.

II. Background:

Microfinance, in both practice and concept, is relatively new. As stated before, the birthplace of microfinance was in Bangladesh in the 1970s. In very recent times, though, microfinance has truly started to boom. Catalyzed by the media, it caught on fire with the western world and several non-governmental organizations (NGO's) started to serve as IMF's. At the forefront of this were structures like the United Nations Capital Development Fund (UNCDF)'s. 2005 was even declared "International Microfinance and Microcredit Year". This movement became known as the microcredit revolution.

Microcredit and microfinance's are not omnipotent cure-alls; it will not eradicate poverty. However, it can slowly build to mitigate the long-term effects of living under low economic standards. Aiding this process is micro financers standing in the "lending community"; micro financed loans fall in between the reasonably lower bank rates (which require a credit score to take) and the astronomical fees of a moneylender.

Currently, microfinance plays a crucial role in less economically developed countries (LEDCs)- from India to Mexico to the Philippines to Nepal, just to name a few. It helps borrowers, investors, and their communities (as discussed in section one). Microfinance is especially useful in LEDCs because it serves as a "safety net task" as these states often do not have a social security system.

III. Relevant International Agreements, Conventions, Organizations and Resolutions:

-**1997**: Microcredit Summit in Washington, DC, where several bilateral and multilateral donors were formed (2900 delegates from 137 countries)

-**1998**: UN resolution A/53/197

-**2003**: UN resolution A/ 58/221

-**2005**: Official UN year of Microfinance as per UN resolution A/58/488

IV. Main Issues:

- **NGO involvement**: The microfinance revolution was spearheaded by various NGO's, for they were the ones who became primary IMF's. Now, though, it is being questioned whether this is the best use of the NGO's resources- both time-wise and fiscally. It is thought that the NGO's could be more productive if they managed the "non-monetary fiscal components" (i.e. various groups capacity building or helping those in need to design loan scheme return plans). This idea has been dubbed a "linkage model", which allows NGO's to still maintain a presence at the grassroots level. This seems to have a huge benefit for the NGO's whose presences now seem to be reduced to banks. However, if this model is implemented, the funding in the near future for microfinance will be jeopardized.

-**IMF's screening**: In truth, microfinance is based on a social obligation that the lender has towards loaner; when employed, this duty is what forces the lender to pay back their borrowed money. In order to ensure that this mechanism is present in the IMF and customer's relationship, IMF's usually screen their followers. The standard of this screening is open to interpretation and tends to not only differ from IMF to IMF, but from branches of these individual organizations. There is no "set" standard other than one's word, for those who utilize micro financial opportunities do not typically have quantitative data or history. Due to this loose screening, possibly caused by a lack of way to identify if a client has a social obligation instilled, has led IMF's to loose a considerable amount of money because clients are not paying back their loans.

-**High interest rates on Small loans**: While microfinance seems to be the happy medium between bank loans and money lending, the interest rates are disproportionately high on smaller loans when compared to larger sums. Essentially, an MFI has to cover three different costs when loaning. The first cost- of money- and the second cost- of loan defaults- are directly proportional to the amount lent. As a quantitative example: if an MFI pays 10% interest for every sum of money it lends, and charges 1% for default expense, on a loan of $100, it will create an additional cost of $11 (likewise, for a loan of $700, it will add $77). The interest rate of 11% holds for any sum of money, but the actual currency owed depends on the amount borrowed. However, a third type of cost comes into play, one that does not change on the amount lent (meaning that whether a person was borrowing thousands or tens

of dollars, they would still be expected to pay a fixed amount, not rate). Transaction costs cover the amount of staff time for meeting with the borrower or the processing costs. These costs are especially harsh because these are the costs that cannot be cut. Using the aforementioned examples, if the transaction costs at a particular IMF was $25 per loan, the same loan of $100 would have $36 of additional bank fees, totaling the interest fee at 36%! On the loan of $700, though, the $25 dollar transaction fee puts the interest rate at around 14.5%. The fact is, though, most people looking at microfinance should only be looking at the $100 type loan, which, by it's nature, creates interest rates that are virtually impossible to pay back.

- **Handout Culture**: Microcredit is a form of subsidized credit, which is increasingly becoming dependant on government loan waivers. The high default rates on payback and the "loan forgiveness" that IMF's practice has actually created a culture of handouts. Thus the entire concept of microcredit is being challenged, critics proclaiming that those IMF's who rely on microcredit should just become handout organizations, rather than hiding under the façade of being an IMF.

V. Web Sites:

The Consultative Group to Assist the Poor (CGAP) strives to give all human beings, especially those in harder economic times, financial resources. Their website contains data on the nature of poverty and those tactics which can be used to alleviate it.
http://cgap.org/

Kiva is a NGO IMF at the forefront of the microfinance revolution.
https://www.kiva.org/

The International Fund of Agricultural Development (IFAD) is a NGO that aims to help the poor overcome poverty. The organization has published many articles on the benefits of microfinance.
https://www.ifad.org

The United Nations Capital Development Fund (UNCDF) has adopted microfinance as a catalyst for capital development.
https://uncdf.org/

The Economist magazine has run several segments and features on the use of microfinance in various LEDC's (especially focused on African and Asian nations).
http://www.economist.com/search/apachesolr_search/microfinance

The official website for the International Year of Microcredit.
http://www.yearofmicrocredit.org/