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What is Microfinance?

The term microfinance describes the practice of providing financial services such as loans, credit, savings, and insurance, to people living in poverty.¹ The purpose of microfinance is to increase productivity at the individual level in order to stimulate economic growth “from the bottom up.” While microfinance is generally a charity enterprise, its principles are firmly rooted in market-based economics.

Microfinance alleviates the high barriers to entry into a market by allowing impoverished people to specialize in production of goods or services that they have a relative advantage in (they can produce the same goods for less than anyone else). With a greater degree of specialization, resources such as land, labor (i.e. the previously impoverished individuals shut out of the market), and physical capital are allocated in a more efficient manner. As a result, there is more incentive for individuals to produce what they have a relative advantage in and to procure what they have a relative disadvantage in from someone else, rather than trying to produce everything that they need.

This decision to produce some and barter for the rest is a result of each individual’s cost-benefit calculus. For every choice, an actor will compare the costs of one action with its benefits, then the cost of another action with its benefits, and so on. A rational actor will select the action that maximizes benefit (called utility) for the minimal cost. For our example, individuals have the choice of maintaining current consumption levels versus attempting specialization and production. Without microfinance, the high barriers to entry into the market prevent any actor from choosing to forgo their current income in order to specialize because they will never have enough to overcome the initial startup costs of starting a business.

Microcredit, the facet of microfinance that deals with small loans, provides a solution to this dilemma. Traditional banks make profit from interest on loans and rely on collateral to secure said loans. Because of this, traditional banks have no incentive to deal with impoverished individuals (who in many cases cannot provide any collateral) without charging exorbitant fees to counter the risk of default. These same fees outweigh the borrower’s possible benefits, leaving impoverished people no incentive to deal with traditional banks. As a result, banks do not want to deal with the poor, and the poor do not want to deal with banks. Microcredit institutions attempt to solve this dilemma by granting impoverished persons access to the credit that they need to take advantage of economic opportunities.²

Dr. Muhammad Yunus developed the Grameen Bank, which is the most prominent realization of microfinance today.³ He received the Nobel Peace Prize in 2006⁴ for his success in Bangladesh, which was primarily due to the Grameen Bank’s group-based lending. This system creates collateral for loans to impoverished individuals by using joint liability.⁵ It works like this: a group obtains a loan for an individual, who then invests it as he or she sees fit. If the individual defaults, the group is responsible for the loan repayments and interest.

Microfinance is particular for its dual adherence to market-based principles and to the plight of the poor. It enables impoverished individuals to be active in the market through specialization in production. The principle of microfinance is a movement away from the traditional, restrictive understanding of who has access to financial services by recognizing the

productive potential of even poor people. Microfinance is compatible with a country's existing financial system, and it can exist as a subset of overall financial activity. Microfinance still adheres to the financial principles of sustainability through reinvestment of loan payments with interest, and serving the client's needs, but it broadens the idea those included in the financial network.⁶ Microfinance will not eradicate global poverty on its own, "but it indeed an 'inducer' to a great many actions that can lead to a better quality of life for the low-income groups."⁷

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¹ "Key Principles of Microfinance." The Consultative Group to Assist the Poor.
<http://www.cgap.org/portal/site/CGAP/menuitem.64c03ec40a6d295067808010591010a0/>

² "How Do Financial Services Help the Poor?"
<http://www.cgap.org/portal/site/CGAP/menuitem.07e479bde9789e5067808010591010a0/>

³ Grameen Bank. <http://www.grameen-info.org/>

⁴ The Nobel Peace Prize 2006 http://nobelprize.org/nobel_prizes/peace/laureates/2006/press.html

⁵ "About Microfinance." <http://www.cgap.org/portal/site/CGAP/menuitem.9a218408ac5bc61fae6c6210591010a0/>

⁶ Ibid.

⁷ "The WWW Virtual Library Microcredit and Microfinance." The Global Development Research Center.
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See the following for further reference:

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