Microfinance and the Enhancement of Economic Development in Less Developed Countries

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PREFACE

It is the intention of this study to contribute to further rethinking and innovating in the Microcredit business which stands at a turning point – after nearly 40 years of practice it is endangered to fail as a tool for *economic development* and to become a doubtful finance product with a random scope instead. In fact, the Microfinance sector appears to suffer from a major underlying deficit: there does not exist a coherent and transparent understanding of its meaning and objectives so that MFIs worldwide follow their own approaches of Microfinance which tend to differ considerably from each other.

In this sense the study aims at consolidating the multi-faced and very often confusingly different Microcredit profiles that exist nowadays. Subsequently, the Microfinance spectrum shall be narrowed to a clear-cut objective, in fact away from the mere monetary business transactions to poor people it has gradually been reduced to back towards a tool for economic development as originally envisaged by its pioneers.

Microfinance is a rather sensitive business the great fundamental idea of which is easily corruptible and, additionally, the recipients of which are predestined victims of abuse due to their limited knowledge in finance. It therefore needs to be practiced responsibly, but also according to clear cut definitions of its meaning and objectives all institutions active in the sector should be devoted to comply with. This is especially relevant as the demand for Microfinance services is expected to rise further within the years coming. For example, the recent refugee migration movement towards Europe entails a vast potential for Microfinance to enable these people to make a new start into economic life. This goes to show that Microfinance may no longer mainly be associated with a less developed economic context, but that it will gain importance as a financial instrument in the developed economies, too.

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I. INTRODUCTION

Development aid policy for poor countries is said to have failed to a major extent even though large amounts of money have been made available to promote economic development. The vast majority of the receiving countries, even after decades of development aid, still suffer from severe poverty and lack a sustainable economic framework. In fact, they remain in the status of Less Developed Countries (LDCs). For this reason, research initiatives designed to improve development aid practices continue to present new ways and new ideas to the field. However, putting theory into practice usually is a crucial factor and many well intended approaches end up doing more harm than doing good, as it was, for example, the case for “import substitution”, a development aid tool which was implemented in the 1950s and finally banned in the late 1980s (see KRUGMAN et al. 2012, pp.359-365).

1. Microfinance as a new form of indirect development aid

In 1976 the “Microcredit” term was coined by Muhammad Yunus and the first active lending schemes denoted as Microcredits were launched by him designed as a new means to alleviate poverty. In fact, he set a first example of successful lending to poor, officially not creditworthy individuals in Bangladesh with the aim to help these people help themselves, for example, by investing the capital into an income generating activity. His engagement grew over the years and eventually led to the foundation of Grameen Bank in 1983.

At first, however, Microcredits did not receive a lot of public attention. At the time, global development aid policies for LDCs promoted by organisations such as the World Bank concentrated on other fields, in particular on **direct** forms of intervention into the development process like the donation of goods, money, or services. However, most of the development aid given did not entail a sustainable difference in the development process of the respective countries. It was rather observed that the aid given tended to fragment the economy, to slow down or even prevent domestic efforts to improve the economic situation, and that it created strong dependencies (see McKINNON 1973, pp.170-171; see LIEBRICH 2010, p.30; see GÖBEL 2008, p.58; see VIK 2010, p.293).

In view of these shortcomings, the **indirect** form of development aid associated with Microcredits aiming to help people help themselves attracted more and more followers worldwide. It was jointly assumed that the Microcredit approach would bear an enormous potential and lots of opportunities to help overcome the worst forms of poverty in the world. Many others followed Yunus' example since and, over the years, his small experiment turned into a large Microfinance movement reaching its peak around 30 years later: The year 2005 was declared the UN's year of Microcredit and, a year later, in 2006, Yunus and the Grameen Bank were jointly awarded the Nobel Prize for Peace. On the G-8 summit in Italy in 2009, U.S. President Barack Obama, too, officially pleaded for more help for people to help themselves (see WHITE HOUSE PRESS RELEASE 2009), providing further political support for the Microfinance idea.

In response to the high recognition and promotion of Microcredits both on a social and political level the number of Microcredit providers and transfers increased tremendously and continues to do so. In the year after the Nobel Prize for Yunus, in 2007, Microcredit extension had experienced an extraordinary growth supplying 155 million people all over the world. By 2010, already up to 200 million people have been registered as Microcredit borrowers (see ARMENDÁRIZ and MORDUCH 2010, Preface; see BANERJEE and DUFLO 2011, p.166). But has the principle of Microcredit lending also fulfilled its economic development and poverty alleviation objectives for which it was initially introduced?

2. Institutional success and high repayment rates on the lending side – indicators of positive impact of Microfinance?

So far, most institutions active in the field of Microcredits reported positive results all the way, usually measured in average pay back ratios, e.g. around 98% at Grameen Bank (see, for example, BUSE 2008, p.55). Other institutions were so successful with their Microcredit business in recent years that they were able to attract financial investors, thereby increasing their Microcredit funds and their lending volume, and also their personal wealth to a considerable extent. Prominent examples are the Microcredit organisations Compartamos in Mexico by going public in 2007 or SKS Microfinance in India with their IPO in 2010 (see BANERJEE and DUFLO 2011, p.166; see ARMENDÀRIZ and MORDUCH 2010, p.239). The positive public perception of Microcredits since the Nobel Prize for Yunus combined with the apparent profitability of the business have attracted even more financial investors to the business. In fact, the readiness to invest into the Microcredit market has never been as high before. “Doing Good, while doing well” is the credo that accompanies the Microcredit business in public, and also represents the sentiment that drives most of the individuals and firms investing into Microcredit schemes, as well as their positive reputation in public. However, the question remains whether elevated payback ratios and financial prosperity achieved by the lending side also mean a positive impact in form of poverty alleviation for the borrowing side.

In general, access to finance for poor people alone may not necessarily have a positive effect, but it may also aggravate the situation of the borrower. This can typically be the case if the money from the credit was badly invested, in particular, if the money was spent on consumption goods which do not help generate any income to help repay the credit. So far, such underlying problems of Microfinance remained invisible to outside observers as the high repayment rates were dominating the reports and created an image of success.

However, using high repayment rates as an indicator for success tends to be deceptive in terms of developmental impact. As poor people usually lack collateral in form of land or capital to be seized in case of credit failure alternative credit securitisation methods have been adopted which help compensate the absence of physical collateral. The most common way to replace physical collateral is through the principle of group lending and joint liability, in which all members in a group guarantee for each other’s loan and need to step in for those members who fail the next repayment rate or the credit as a whole. Of course, however, a credit is not considered to have failed as long as the group members have absorbed the credit loss and the money is paid back. This way, the real figure of failures remains generally unknown. And, furthermore, we know little how a group of borrowers was affected by the bankruptcy of one of their members and whether they were able to continue their own projects in the same way after their commitment as bailsmen. Thus, high repayment rates and the financial success of Microfinance providers appear to be insufficient as indicators of the positive impact of Microfinance for the borrowers.

Meanwhile, it was also shown in several recent studies that the majority of the capital granted through Microfinance appears to have been spent, indeed, on consumptive goods rather than invested in some form of productive economic activity. This is why it may also not be surprising that the results of previous studies executed in the sector claiming Microcredits to have a beneficial impact on the respective local economies were revised recently and their results judged as not sufficiently significant (see, for example, DUVENDACK et al. 2011; see MADER 2015).

Therefore, in accordance with more recently executed and published studies, it must be assumed that Microfinance, so far, has not yet had any verifiable positive impact on economic development and on reducing poverty in the respective countries it was introduced to.

3. Inconsistencies in the concept and understanding of Microfinance

The question is thus which may be the root causes for such detrimental development of Microfinance? In fact, as far as the Microcredit schemes as operated in LDCs are concerned significant difficulties and disadvantages became apparent in recent years. For example, reportedly a number of rather abusive and commercially excessive lending practices occurred in several countries such as India and Mexico, whereby the commercial targets of Microcredit lending strongly prevailed over the supportive character as originally envisaged (see, for example, MADER 2010, p.3). It was realised at this moment that the Microcredit schemes operated without sufficient governmental or regulatory control which eventually could have reduced the risk of such abuses. In addition, it became clear that most of the actual Microcredit lending procedures deviated to a substantial extent from the original ideas, e.g. a shift from a borrower oriented to an investor oriented procedure became noticeable putting profitability over development impact. Investors in Microcredits usually insist on being remunerated for their monetary efforts via the payment of interest rates. They would not hesitate to withdraw their money from Microfinance Institutions which cannot provide the right figures. As a consequence of such investor pressure, newly created, and existing Microfinance Institutions appeared to have concentrated their activities in those areas where Microcredit lending was already reported to be successful aiming for the safest and most profitable Microcredit transfers possible and at complying with investor expectations (see HEIN and BERNAU 2011; see BANYAN 2010, pp.55-56). This resulted in undue competition between the lending institutions as well as in an excessive supply of Microcredits and, consequently, in a severe increase of consumptive credit transactions to the detriment of the borrowers who tended to become over indebted instead of getting the help required to make a better living.

All this led to a certain confusion in the perception of Microcredits and caused a loss of profile of the Microcredit concept itself. The only common denominator seems to be that all these institutions officially referred to the name of Nobel Prize winner Muhammad Yunus in the promotion of their concept of Microcredits, yet without implementing his supportive ideas. In fact, the concept of Microfinance seems to have become multi-faced and the understanding of its meaning and objectives to vary strongly within the Microfinance world.

4. A change of perspective is needed to assess the opportunities of economic impact by Microfinance

In view of these shortcomings, this study aims at consolidating the multi-faced and very often confusingly different Microfinance profiles that exist nowadays. In essence, the intrinsic elements and the higher purpose of

Microcredit lending should be put back into focus, namely the aim of generating structural and economic development by such lending as well as the supportive, non-consumptive, but productive aspects which should be incentivised. Further typical characteristics seem to be the absence of collateral as well as the smaller scale of banking compared to traditional banking. As far as the project or rather the object of Microcredit lending is concerned, sustainability should be an implied element.

Hence, the fundamental research question of this study is whether, and under which conditions, Microfinance may attain a positive economic impact leading to an improvement of the living of the poor.

So far, it appears as if impact assessment studies in Microfinance have to a major extent been focussing on analysing microeconomic indicators like, for example, the repayment rates of Microcredits as stated above. This study, however, suggests a change of perspective. In fact, it is argued here that assessing economic impact also requires an analysis of the macroeconomic factors of economic growth in order to retrieve comprehensive insights about the necessary conditions for attaining such objective.

For this purpose, this study utilised a study by Ronald McKinnon published in 1973. In his book “Money and Capital in Economic Development”, McKinnon analysed the role of money and capital in economic development thereby also including the use of “very small credits” as part of a financial growth theory for generating sustainable economic development in Less Developed Countries (LDCs). McKinnon’s study was considered particularly useful for analysing Microfinance from a macroeconomic perspective and for generating valuable insights about the conditions under which Microfinance may be able to attain positive economic impact. In the context of this growth theory, McKinnon took the specific economic conditions prevailing in LDCs into account, which tend to differ considerably from those present in Developed Countries (DCs). A fragmented economy and financial repression present in the domestic capital markets of LDCs may prevent financial development efforts from being successful, especially when applied using traditional growth theories which are usually associated with the economic conditions of DCs and thus may not fit the less developed context. McKinnon's macroeconomic growth approach in turn, even though having been left more or less unnoticed, may be a viable alternative to the traditional growth theories.

With the help of the insights gained, a Microfinance concept shall be elaborated and integrated into an economic growth theory designed to clarify the essential aspects which need to be considered if economic development and thus the improvement of the lives of the poor are the intended objective of Microfinance provision. Thus, this study intends to show that development objectives via Microfinance are not automatically successful once a Microcredit transaction has been completed and the credit been repaid, but that certain conditions need to be fulfilled beyond that. Critical factors for the extension of Microcredits shall therefore be identified complying with the productive aspects needed for economic growth which allow for sufficient return to both borrower as well as lender. Even though it may not be possible to apply the elaborated theoretical concept and framework one to one in practice, the concept may nonetheless be used as a point of reference to identify strengths and weaknesses of the Microcredit system at present and to show where a need for action persists.

5. How the study is structured

In order to tackle the research question, i.e. whether, and under which conditions, Microfinance may attain a positive economic impact leading to an improvement of the living of the poor, the study is divided into five parts.

Following this introduction, in part II, the Microfinance sector will be portrayed and analysed critically. Even though officially perceived as a tool to enhance economic development of the poor, it will be shown that the majority of Microfinance Institutions tends to pursue other primary targets such as financial self-sufficiency. Furthermore, it will be demonstrated that Microfinance, so far, is neither attaining any verifiable economic impact nor does a macroeconomic growth theory supporting this assumption exist. Instead, it will become obvious that the concept of Microfinance is strongly scattered lacking coherence and transparency with asymmetric information being commonplace and without any effective customer protection being in place.

All in all, it will become clear that Microfinance lacks a clear guideline in form of a standard concept comprising a set of fundamental elements and characteristics which need to be respected if an objective like economic impact is being pursued. Such standard concept is considered especially helpful for introducing coherence and transparency as well as to enable customer protection in form of regulatory measures in the market. Hence, in accordance with the original idea of Microfinance, this study seeks to elaborate elements of a standard concept of Microfinance with the objective of enhancing economic development.

In order to identify and retrieve the necessary conditions for attaining economic development, a change to a macroeconomic perspective is undertaken in part III. It endeavours to analyse the macroeconomics of Microfinance with particular reference to the economic context of LDCs for which McKinnon's growth theory from 1973 is utilised and reassessed. The typical financial problems of LDCs, foremost fragmentation and financial repression, will be assessed and explained. It will be shown that capital is very scarce and, in addition, that the domestic capital markets are distorted and thus in an imperfect state. More precisely, different effective prices are paid for capital in the economy and access to the capital market is generally restricted, particularly in the rural, underdeveloped areas where organised finance is merely present. After assessing the financial problems McKinnon's growth approach in this economic context will be introduced. It will be shown that it emphasises on promoting investment under domestic entrepreneurial control, granting access to finance, and attracting capital via high interest rates. Furthermore, it will become obvious that the state of an imperfect capital market makes the prevailing monetary growth theories incompatible. In particular, instead of a substitution effect between money and physical capital associated with perfect capital markets, McKinnon suggests assuming a complementary relation for them in an imperfect capital market. Accordingly, an incentive to save via high interests on the capital markets will not thwart but even promote highly successful investments. This way more capital will be attracted on the capital markets which is at disposition for investments while the high yield required will act as a natural boundary to separate less promising investment opportunities from the best. The latter are considered to be found plentiful in the abandoned rural areas of LDCs where technology is still largely inferior and where thus immense jumps in productivity can be achieved through effective investments by domestic entrepreneurs. Interestingly, it will be shown that McKinnon already considers a small scale of these investments as totally sufficient as long as the gains in productivity are achieved thereby very much reflecting the original idea of Microfinance. Thereafter, McKinnon's suggestions to implement his growth approach are presented at the heart of which lie the liberalisation of the domestic capital market and foreign trade in order to overcome financial repression and fragmentation. Essentially, he is pleading for more neutral intervention policies by the governments like, for example, the Value Added Tax (VAT) instead of single industry support schemes which end up being preferential policies distorting the market. Hence, his aims are directed towards supporting autonomous domestic development via access to supplemental finance accompanied by neutral government policies.

After a review of critical reactions in learned writing to McKinnon's growth approach which proves to have provoked both positive and negative associations, the merits of McKinnon's approach for development economics, and for Microfinance, in particular, are summarised. It will be resumed that his theoretical approach confirms the potential of Microfinance to attain economic impact and development. Furthermore, his study outlines the challenges of intervening financially in LDCs while also providing interesting solutions, foremost by introducing the complementary relation between money and physical capital as a means to improve capital scarcity and the furthering of domestic entrepreneurial investments.

With the help of the insights gained in the previous two parts, the elements and characteristics of a Microfinance concept with the objective to enhance economic development will be elaborated in part IV of this study. Six fundamental elements will be retrieved which together will conceive the new concept of Microfinance. The first three elements represent a firm commitment to provide Microfinance in accordance to the stated objective, namely to pursue economic development of the poor, in general, to extend the services to local entrepreneurs with a promising investment opportunity, only, and to assure productive investment of the extended capital. The fourth element, then, deals with the question how to secure the Microcredits appropriately. In fact, it will be introduced using the selected promising investment opportunities as collateral for the credit services rather than any traditional securities in form of physical capital. First of all because poor borrowers generally do not tend to be endowed with sufficient collateral, and secondly because Microfinance providers will be obliged to focus on finding suitable promising investment opportunities. In the fifth element, a business banking account needs to be provided as well as access to savings and deposits facilities needs to be granted to all borrowers. The former enables capital providers to supervise revenue streams. The latter intends to improve capital accumulation and the availability of disposable capital. Finally, the origin of capital inflows for financial institutions is specified to stem from regular capital markets rather than speculative markets.

Thereafter, the appropriate economic framework for applying the elaborated concept will be examined. In line with McKinnon, the importance of expanding organised finance as well as of generating sufficient disposable capital on the capital markets will be stressed. With neither liberal nor strongly intervening policies having produced favourable results so far, an economic framework leaning on the ordo-liberal approach will be suggested and outlined. Such framework is expected to cope with the needs of a neutral regulation and supervision of market participants as well as to introduce coherence and transparency in the scattered and multi-faced Microfinance sector at present.

In a next step, then, the elaborated Microfinance concept is tested under ideal economic conditions by reinterpreting a famous example story by Yunus. It will be shown that all elements of the elaborated concept have been respected and that the concept is generally representable and maintainable.

In the last chapter of part IV, the findings and the feasibility of the concept in practice will be discussed. It will be shown that the apparently new way of securing Microcredits very much resembles a seed financing mentality which is considered to be numerously available for the Microfinance sector, for example, in form of development foundations, public private partnerships in development and banking, or the general impact investing movement. Together with technological inventions like mobile telephone banking they are expected to be able to bridge the absence of organised finance in the first place. Furthermore, local governments will generally accept these non-political initiatives of capital inflow. However, as far as the ordo-liberal economic organisation of the Microfinance sector is concerned, such framework has not been implemented yet. It will become clear, nevertheless, that the elaborated concept is not depending on such framework but that it could be developed in due course to help providing coherence and transparency. All in all, it will be shown that the newly elaborated concept is feasible and ready for being implemented but depends to a large extend on the willingness of policymakers to radically reassess the Microfinance sector.

This study then concludes in part V by reflecting on the insights gained thereby emphasising the distinctiveness of the fields covered and the research methods used before rounding off with an outlook and some recommendations on future research.

II. CRITICAL ANALYSIS OF THE MICROFINANCE SECTOR AT THE BEGINNING OF THE 21st CENTURY – A MULTIFACED BUSINESS LACKING COHERENCE AND TRANSPARENCY

In the first chapter of this part a critical presentation of the phenomenology of Microcredits at the beginning of the 21st century shall be given. In order to understand the development towards the present status, the transformation process during the past 40 years will be displayed. As the Microcredit sector is nowadays struggling with several profound shortcomings the second chapter will analyse whether any underlying deficits which may have been responsible for these shortcomings can be identified. The third chapter will assess whether researchers and practitioners both define and apply the Microcredit concept according to coherent and transparent standards which would normally help preventing such shortcomings from happening via appropriate regulative measures. Finally, the insights gained from the analysis will be presented.

1. The transformation of Microcredits in the course of the last 40 years

When analysing the present status of Microcredits at the beginning of the 21st century, two characteristic features come to mind: in the 1970s the introduction of Microcredits was generally considered as an experiment the outcome of which was all but clear (see ARMENDÀRIZ and MORDUCH 2010, ch. 1, pp.1-24). In contrast, looking at Microcredits nowadays the experimental phase has been left behind long ago and we have witnessed the emergence of a real Microfinance sector with a growing field of influence and application. Nowadays, there are more than 10.000 Microfinance Institutions active in all parts of the world serving around 200 million clients and mainly offering credits, but at times also savings deposits, Microinsurances and other financial services (see ARMENDÁRIZ and MORDUCH 2010, Preface; see BANERJEE and DUFLO 2011, p.166). This rather surprising development occurred in less than 40 years. However, the development from a small experiment towards a huge industry also brought about substantial change to the market as well as to the market participants, and also to the meaning of Microcredits, in particular. It is thus worth recapitulating and assessing critically the way in which the Microcredit sector has been shaped over the past four decades.

1.1. Yunus and the beginning of active Microcredit lending schemes

Indeed, in Bangladesh, the first renowned examples of Microcredit facilities have been established. In 1976, Muhammad Yunus started an unprecedented initiative to lend money to poor, officially not credit-worthy people which in addition were not able to offer any security in form of collateral. He realised that the poor population, especially in the rural areas, seemed to have no access to regular credit institutions, but were forced to address informal local money lenders instead. Their usury lending practices, particularly the exceptionally high cost for capital, would prevent poor individuals from generating sufficient return with the economic activities they had initialised with the borrowed capital. Poor individuals would thus not able to substantially improve their standard of living by themselves and would remain stuck in poverty. Yunus, at the time working as a professor of economics in Bangladesh, realised that the renowned modern economic theories he had been teaching in class for years were more or less useless when applied within the settings of Bangladesh where severe poverty prevailed (see SPIEGEL 2006, pp.21, 25). On the other hand, he discovered the economic potential which appeared to be concealed by the conditions of poverty. Such poverty could not be overcome unless a new approach allows the poor, mostly rural population to contribute to their own economic development.

Since poor people are typically not in possession of sufficient capital and not considered as credit-worthy by the regular banks due to a general lack of collateral and regular income, this vicious circle needed to be surmounted by finding new ways and principles of money lending. The specific conditions of such new ways of money lending introduced by

Yunus were, first of all, the small sums involved. The first Microcredit lending case reported dealt with 27 US $ which were granted out of the own pocket of Yunus (see YUNUS and FULLER 2003, p.75; ARMENDÁRIZ and MORDUCH 2010, p.12). Furthermore, the project was a rather simple one, the continuous production of bamboo stools. The amount of money was extended to a group of 42 women from a village called Jorba, who needed money to purchase bamboo in order to be able to continue their production. They had reported that they had approached the local money lender before who proposed an interest rate between 10% per week or even per day adding up, in the worst case, to an interest rate of 14200 per cent per year (see SPIEGEL 2006, p.25; see BÖS 2009a, p.C3). It was clear under such conditions the stool production would never become profitable. Furthermore, a deal with the local stool processer, who provided the raw material as a grant before buying the produced stools off them, was no better in the end, as it left the women with tiny revenue margins, barely enough to live on. The negative borrowing cycle would have to go on if they wanted to continue their production. Yunus felt encouraged to help the group of bamboo stool makers by lending them the required amount of 27 US Dollar at no interest rate. To his surprise, the grant was completely repaid in due course and, as far as can be seen, should have left an increased profit to the women nevertheless (see SPIEGEL 2006, pp.23-27; see BÖS 2009a, p.C3). As a result of this successful experiment Yunus developed his vision of Microcredits and started to increase his efforts in the field by lending more money to poor people in need of financial support. Yunus' Microcredits to poor people functioned so well that his concept did not remain unnoticed and many others were to follow his example over the years.

Thirty years later, Yunus' pioneering work for the implementation of Microcredits in the world has been honoured with the award of the Nobel Prize for Peace in 2006 (see Press Release Nobel Peace Prize 2006). Nowadays, Yunus engages not only in Microcredits through his Grameen Bank, but has adopted further policies to encourage people to support fighting poverty. One recent initiative was the furthering of social entrepreneurship that, for example, stands for the provision of basic goods like the one cent yoghurt or the one Dollar shoe for the poor regions of the world for which he was able to attract many big firms, e.g. DANONE, Adidas and BASF (see MECK 2009, p.45; see PINZLER 2010, p.28; see NEIDHART 2009, p.17).

1.2. 1970s and 1980s – Yunus and the Grameen Bank as role model for Microcredits

Essentially, and most important to recall, the idea of Microcredits was born in the 1970s with the primary aim to promote economic activity within the poorest regions of the world which was supposed to *enhance the general economic development* and thus to help alleviate poverty. As stated in the previous section (see chapter 1.1., p.13), it was not the issue that poor individuals did not have any access to capital at all (see also ARMENDÀRIZ and MORDUCH 2010, p. 67). Apart from some informal local credit arrangements between individuals like "Rotating Savings and Credit Associations" (ROSCA) or "Credit Cooperatives" (for a detailed analysis see ARMENDÀRIZ and MORDUCH 2010, ch. 3, pp. 67-96) it was, in particular, local money lenders who would provide those in immediate need with money. However, the conditions under which these individuals were usually supplied with capital did not allow them to make sufficient profits with their activities and to achieve a basic level of self-sustainability which could have helped them advance at an economic level. It was rather observed that the money lenders would make use of their monopolistic position and would tend to exploit their clients to the maximum possible via extremely high interest rates charged for the credits extended (see SENGUPTA and AUBUCHON 2008, pp.16-17; see ARMENDÀRIZ and MORDUCH 2010, p.31). It may thus be assumed that many promising undertakings were prevented from generating sufficient return due to the high cost of capital. Aggravatingly, lacking alternatives, these "small entrepreneurs" were forced to approach the moneylender again for a new borrowing cycle if they wanted to continue their undertaking. In this way, credit takers would not only be entirely dependent on the money lenders' capital, but they would also fail to make any form of economic progress, be it on a productivity, on a technology, or on a growth level. Consequently, the vast majority of them was left stuck in inferior levels of development - a vicious circle of poverty they could not escape despite their efforts to generate an income (see McKINNON 1973, pp.12-16, 69-72).

1.2.1. The rising acceptance of the Microcredit idea and the foundation of the first Microcredit bank in 1983

Microcredits, in their original form as initial funding, should be extended in order to break through this vicious circle of poverty and to help economically active individuals escape it and enter the next stage of economic development (see SENGUPTA and AUBUCHON 2008, p.9). They were supposed to be an effective alternative to the local moneylender in providing poor individuals with more affordable capital to be used for productive, income-generating purposes, e.g. buying bamboo for the production of bamboo stools (see SPIEGEL 2006, pp.23-27), or buying a mobile phone for the installation of a wireless phone booth in a village (see BUSE 2008, pp.54-55). Consumption credits were not (yet) part of the scope of Microcredit lending, as far as can be seen.

Breaking this vicious circle was also the ambition of Yunus when he first extended his Microcredits to poor women in Jorba (see SPIEGEL 2006, 23-27; see also above chapter 1.1., p.16). In fact, during the experimental phase of Microcredit extension in the late 1970s and the beginning of the 1980s, the poor, previously considered “unbankable”, turned out to be highly credit-worthy even though they were not able to provide traditional credit securities in form of collateral. Apparently, nearly all credits extended were successfully repaid. Interestingly, in due course of the experimental phase, women were considered to be more responsible and reliable credit takers than men, in general, and hence credits were preferably extended to women (see SPIEGEL 2006, pp.32-35; see ARMENDÀRIZ and MORDUCH 2010, p.14; see BUSE 2008, pp.55-56). Yunus went on to increase the scale of his Microcredit engagements and continued to report highly successful transactions. Other institutions started to take notice of Yunus’ activities, most of them development agencies or funds, charitable institutions or other non-profit organisations like NGOs (see ARMENDÀRIZ and MORDUCH 2010, p.15; see SPIEGEL

2006, p.61; see MCGUIRE and CONROY 2000, pp.191-192). They began to support Yunus financially or to develop Microcredit schemes of their own.

Meanwhile, Yunus kept on approaching traditional banks with his idea, but reportedly he was not able to convince them to pick up efforts to integrate Microcredits into their lending schemes (see SPIEGEL 2006, pp.27-28). Even though Yunus was able to present payback ratios that were supposedly higher than in conventional banking (see STALLINGS 1999, p.14; see METZGER 2008, p.22), traditional banks would still classify Microcredits as too risky, too costly and not sufficiently lucrative, and would therefore refrain from providing any such programmes themselves (see SPIEGEL 2006, pp.26-28). Although more and more successful cases were later reported from other organisations, too, traditional banks would not change their mind over the years and kept out of the market. Yunus, however, saw the need for an institutionalised extension of Microcredits in order to respond effectively to the apparently vast demand for such transactions within the poor population of Bangladesh. In 1983 then, he finally founded his own bank called “Grameen” (meaning “bank of the village”) specialising in Microcredit lending to the poor only. Grameen Bank has since provided financial support to millions of poor individuals claiming to achieve a payback ratio of around 98%, while reporting positive financial returns which were mainly reinvested in the build-up of new agencies or otherwise distributed as dividends to the bank’s shareholders, which are the borrowers themselves at around 95% and the government at 5% (see Yunus 2011c; see SENGUPTA and AUBUCHON 2008, p.11; see BÖS 2009a, p.C3; see BUSE 2008, p.55; see SPIEGEL 2006, p.28; for more detailed information about Grameen Bank see below chapter 3.3.2., p.75).

1.2.2. Breakthrough and further implementation of the Microcredit idea

In reaction to the success stories reported from Grameen Bank during the 1980s, international development organisations and funds started to largely acknowledge Yunus’ revolutionary approach to provide development aid in an *indirect* way, i.e. a way to help people to help themselves. At the time, development aid practice had focused on *direct* forms of intervention into the development process like the donation of goods, services or money. Each year, a vast amount of money has been injected into suffering economies, yet without creating significant progress in the development process of the respective countries. Its impact was considered being only short term beneficial and creating expectations or rather strong dependencies on such aid within the economies instead (see McKINNON 1973, pp.170-171; see LIEBRICH 2010, p.30; see GÖBEL 2008, p.58; see VIK 2010, p.293). Apparently, some economies were said to have focused their competition more on the distribution of the "costless" development funds rather than on the local markets for goods and services (see GÖBEL 2008, p.58)

Microcredits, on the other hand, would incite individuals in the respective economy to take up efforts of their own and to change their situation by themselves. This indirect form of support was considered having a longer lasting development impact than the previous forms of direct development aid. The fact that the recipients of Microcredits are not simply donated the money, but that they have to be ready to take risks and pay for the money in form of interest rates, would ensure that credit takers were devoted to their investments, would plan them carefully and give their very best to realise them – instead of being confronted with some form of help or donated good they may not have asked for and for which they may not see a personal need, and, thus, to which they would react reluctant or indifferent. For example, in Africa during the 1980s, the direct form of development aid was said to have provided only very limited development effects and resulted in, for example, tractors that remained unused or buildings that were quickly rundown (see GERHARDT 2010).

1.2.3. Microcredits and the prospects of self-sustainable development aid

In the eyes of the numerous development institutions like NGOs or international funds, it was commonly agreed that the extension of Microcredits, as opposed to donations, would more or less assure an efficient assignment of the capital to the benefit of the recipient - at least in a better way than during previous development practices. Additionally, Microcredits would be repaid meaning that the lent sum is at disposition again and ready to serve new credit transactions, while a certain income was generated by the lending institutions through the payment of interest rates. As repayment rates were reported to be exceptionally high, there appeared to be a prospect of financial self-sufficiency of the credit institutions making the funding of the respective financial institution unnecessary at some later stage (see BATEMAN 2010, p.12).

With these prospects in mind, NGOs, international funds, and other non-profit organisations started to comprehensively fund the newly created Microfinance Institutions (MFIs) which rose numerously all over the world, particularly in Less Developed Countries (LDCs) like in Bangladesh, India, Indonesia, Mexico, or Brazil. It soon became obvious that not all of the newly created MFIs would stick to the purely philanthropic approach introduced by Yunus. Inspired by the high repayment rates and by the regular flow of monetary funding they began analysing the opportunities of earning money in the field seeing no contradiction in generating returns while serving the poor at the same time, e.g. the NGO "Association for Social Advancement" (ASA) in Bangladesh (see BUSE 2008, pp.55-56). It may be assumed that such approaches were tolerated by the funding organisations since they supported the efforts towards financial self-sufficiency of the MFIs at some later stage. And, as Microcredits would obviously be doing Good according to Yunus' principle, there would be no objection against "doing well while doing Good".

1.2.4. The successful development from an experiment to a recognised tool for development aid

The experimental phase of Microcredit extension in the late 1970s and beginning of the 1980s was able to prove that credits extended to the poor are in fact repaid to a very large extent and that the poor are bankable to some extent. With that proof at hand, the international development community started to engage in the Microcredit sector by promoting the creation and the funding of new MFIs inspired by Yunus' approach. The continuous high level of repayment of credits reported made the idea of Microcredits become widely accepted and welcomed among developers and was soon introduced by development agencies around the planet (see MCGUIRE and CONROY 2000, pp.192-193). Some of the institutions involved started interpreting the Microcredit business in a different way than Yunus. In their view, generating returns and helping the poor must not be contradictory. A view, however, which Yunus strongly objects in the context of Microcredits (see BUSE 2008, p.55). Nevertheless, the character of the credit would remain within its original meaning for the time being, i.e. to support the poor and help them in an indirect way create a viable existence on their own rather than via direct interventions into their development process.

1.3. 1990s – Commercialisation of the Microcredit sector and the emergence of broader Microfinance services

After years of growing activity in the field of Microcredits, the 1990s brought a major shift to the whole sector and introduced a commercial, "neoliberal" Microcredit approach, as Bateman describes it (see BATEMAN 2010, pp.12-16). Alternatively, the term widely recognised to denote the new approach is the "Financial Systems Approach" (FSA) replacing the previous "Poverty Lending Approach" (see, for example, VIK 2010, pp.300-301).

1.3.1. The introduction of commercial approaches to overcome subsidy dependence and the emergence of broader Microfinance services

MFIs in the late 1980s, even though they reported positive figures concerning the credit repayment behaviour of clients, were said to be strongly depending on subsidies in order to sustain financially. More precisely, they tried keeping interest rates at an affordable level to the benefit of poor credit takers, which, however, did not allow them to cover all the running cost for administration or outstanding loans during the rapid growth phase of Microcredits despite the high repayment level of credits. However, at the time, more and more critics were rising up in the sector disfavouring any form of subsidisation. Generally, highly liberal policies were very much en vogue at the time and economists as well as institutions like the World Bank pushed heavily towards the realisation of liberal economic structures in the world markets considering them best-practice. It was therefore a matter of time until the Microcredit sector would give in to this movement.

Consequently, by the early 1990s, for funding authorities, the time had come for the prospects of self-sustainability of MFIs to be fulfilled. Hence, a subsidy-free system should be implemented into the sector. It resulted in widespread commercialisation and privatisation of MFIs declaring the end of infinite MFI subsidies and the beginning of profit-driven Microcredit extension. The authorities hoped that the need for profitability would incite MFIs to increase their efforts to attract as many new Microcredit clients as possible making Microfinance spread further and reaching even to the remotest areas. Subsidies, on the contrary, would make MFIs complacent and the apparently vast demand for Microcredits would not be met in the mean term (see MCGUIRE and CONROY 2000, pp.119-120; see BATEMAN 2010, pp.12-14). Therefore, many MFIs refrained from the low interest rates schemes for Microcredits, but lifted them up in order to make credits and their organisations profitable. Internally, the workforce had to be activated and given further success incentives, for example, by implementing internal reward systems like bonuses. Furthermore, some Microfinance Institutions extended their financial services to savings and deposits or insurance services designed to secure clients in the event of an unforeseen external shock during a credit business (see BATEMAN 2010, pp.14-16). Hence, broader Microfinance services had evolved.

Interestingly, some MFIs that previously had been unprofitable and dependent on subsidies were observed to start working profitable in the years following the restructuring, e.g. Bank Rakyat Indonesia (BRI) or Banco Sol in Bolivia. In fact, the latter, reportedly, has been the first to convert from a purely non-profit to a for-profit Microfinance organisation. Both banks received assistance by two large institutions supporting the liberal financial systems approach (FSA), the Harvard Institute for

International Development (HIID) as well as the USAID organisation (see BATEMAN 2010, pp.14-16).

1.3.2. The new financial system approach (FSA) of Microfinance is declared best-practice by the leading development authorities

By the mid-1990s, the new approach was said to have been fully established within the Microcredit community and considered best-practice. Following the advice and example of institutions like HIID, USAID and others the World Bank, which were previously doubting the functionality of the Microcredit schemes as operated by Yunus and thus less involved in it, acknowledged the new Microfinance concept, too, making it part of its philosophy to further economic development in developing countries thereby building on the liberal approach. In 1995, the World Bank also founded the Consultative Group to Assist the Poor (CGAP). Their task was denoted as to help increasing donor activities in the Microfinance sector as well as coordinating the flow of donations in compliance with the best-practice approach of financially sustainable MFIs (see BATEMAN 2010, pp.16-17; see MCGUIRE and CONROY 2000, pp.113-114).

Even though the introduction of the new approach led to a general shift within the Microfinance community, the original (subsidised) poverty lending concept introduced by Yunus and represented by his Grameen Bank continued to exist and was still supported, e.g. by philanthropic donors such as the International Fund for Agriculture and Development and the Ford Foundation or by the governments of Bangladesh or Norway (see ARMENDÀRIZ and MORDUCH 2010, p.12). However, the Microfinance world was now divided into two and with the major development authorities supporting the new financial systems approach (FSA) nearly all newly created MFIs were designed around it. Moreover, the new principles of Microcredits had put commercial funders on the plan who observed the market as a possible investment opportunity with good chances for profitable business (see BATEMAN 2010, p.17).

The Microfinance movement reached a peak in 1997, when the first Microcredit Summit was organised taking place in Washington and gathering around 1500 organisations from 137 countries including a number of high level speakers such as Bill Clinton and, of course, Yunus (see BATEMAN 2010, p.20; see MCGUIRE and CONROY 2000, p.113). In the final declaration of the summit the FSA principles of Microfinance were once more confirmed as best practice underlining that Microfinance would enable a win-win situation in the development process – the poor would be given access to finance and would thus be capable to work their way out of poverty by themselves, while the financing of their activities could be achieved under financial sustainability of the credit institutions. Hence, the goal to reach 100 million Microcredit takers within the following nine years was considered realistic and jointly approved by the summit (see MCGUIRE and CONROY 2000, p.113).

Thereafter, more and more programmes undertook the shift from the poverty lending approach towards the financial approach and the source of purely philanthropic Microcredit organisations was expected to run dry and the old principle to become isolated in the international context in the mean term (see BATEMAN 2010, pp.17-18).

1.3.3. Changing the focus from poverty to commercial lending

Altogether, as commercialisation and privatisation of MFIs had started in the 1990s favouring liberal policies and the financial systems approach extending credits at market interest rates, some MFIs previously dependent on subsidisation seemed to become profitable and financially self-sustainable. Such development looked promising in the eyes of development organisations like the World Bank and led to a broad acceptation of the financial systems approach (see BATEMAN 2010, p.16). On the first Microcredit summit held in 1997 it was officially declared to increase tremendously the number of Microcredit clients within the following years, while reducing subsidisation for the sector and furthering financial self-sustainability of MFIs. The movement and the high payback ratios eventually attracted commercial investors which tended to be more interested in the financial success of Microcredit lending than in its economic development impact (see BATEMAN 2010, p.17). The 1990s thus experienced a general change of focus in Microfinance. In the previous two decades, the poor and their economic development were at the centre of attention. Since the 1990s, the financial self-sufficiency of MFIs and financial institutions appeared to be more relevant in Microfinance.

1.4. The new millennium – Microfinance loses its innocence

The first decade of the new millennium was a time of extremes in the Microcredit sector. It started off with a small revolution in that with "Grameen Bank II" the second generation of the bank was established. It replaced the former system introducing major reforms to its Microfinance practice.

1.4.1. Financial success, extraordinary growth, and the Nobel peace prize for Grameen Bank

According to Yunus, innovating Grameen Bank was necessary after 25 years of continuous and unchanged practice. The innovative procedures were mainly derived from the many lessons learnt within that time period (see YUNUS 2002, p.2). For others, like Bateman (2010), these changes simply meant a shift to the new, liberal financial systems approach as promoted during the past years (see BATEMAN 2010, p.18). In fact, a decisive reason for implementing the changes may have been that it had become known that even though Grameen Bank was reporting very high payback ratios and positive returns overall it was nonetheless always in need of a high degree of subsidisation. Between 1985 and 1996, Grameen received around 176 million US Dollars in subsidies, e.g. in form of direct donations or implicit subsidies through equity holdings. Without these subsidies, the bank would not have been working financially self-sufficient (see SENGUPTA and AUBUCHON 2008, p.22; see ARMENDÀRIZ and MORDUCH 2010, p.322). The new Grameen II project was therefore launched in 2001 in order to escape the dependence on subsidies. Several fundamental changes to its principles of Microcredit lending were introduced. First of all, Grameen converted from a non-profit to a for-profit Microfinance Bank with a focus towards market interest rates and financial self-sustainability. Secondly, the bank now put a higher focus on savings. Apparently, while some saving was obligatory during a credit business, usually 2.5 per cent of the lent sum, voluntary savings plans for borrowers to deposit their excess money have also been promoted, generally incited through an elevated interest rate of around 9 per cent. As credits were extended at around 20 per cent interest rate plus the obligatory saving of 2.5 per cent of the lent sum, there was sufficient margin left, while the bank was able to arrange further credit transfers with the deposited capital. Lastly, Grameen Bank softened its principle of group lending or rather joint liability which previously had been a precondition in its Microcredit lending practice (see ARMENDÀRIZ and MORDUCH 2010, p.127; see BATEMAN 2010, pp.18-19). Originally, with no traditional collateral at hand, poor individuals would join in groups and have to mutually supervise each other's loan within the group creating more of a social instead of the usual financial pressure generated by the possible seizure of collateral. In the classical composition, each group would be made of five borrowers, loans would first be extended to two individuals, later on to the next two and finally to the fifth. If no difficulties arose the borrowing cycle may go on. If one member of the group failed, however, then the whole group will not be subject to further loans in the future. Even though not part of the original concept, the other members would, of course, try to settle the debt of the defaulting member in order to escape this penalty or rather not to drop out of the loan schemes. Thus they would act as bailsmen for each other. Meanwhile, this form of joint liability is considered the usual procedure with group members having to sustain both the social and financial pressure in a borrowing cycle, while the simple group lending principle would only be occasionally applied (see ARMENDÀRIZ and MORDUCH 2010, pp.12-13, 100; see SENGUPTA and AUBUCHON 2008, pp.11-12; see KUNDU 2011, p.34). Now, for Grameen II, credit extension to individuals became an option, too, in order to increase the outreach to more clients, but also in order to be able to handle an individual's credit problem without having to punish the whole group of borrowers for the mistake of one member (see ARMENDÀRIZ and MORDUCH 2010, p.127; see SENGUPTA and AUBUCHON 2008, p.14). With the installation of the changes the new Grameen II project began to work successfully: it generated healthy profits, there was no further need for subsidies and, within three years, 2.5 million further clients had been added (see Figure 1 below), savings deposits were three times the amount of 2001, the portfolio of outstanding loans had doubled, and 500 more branches had been opened (see BATEMAN 2010, p.19). Such outcome may be considered what development institutions had hoped for to be attained with the introduction of the liberal financial systems approach in Microfinance. Yunus and his Grameen Bank started to gain worldwide reputation and appreciation.

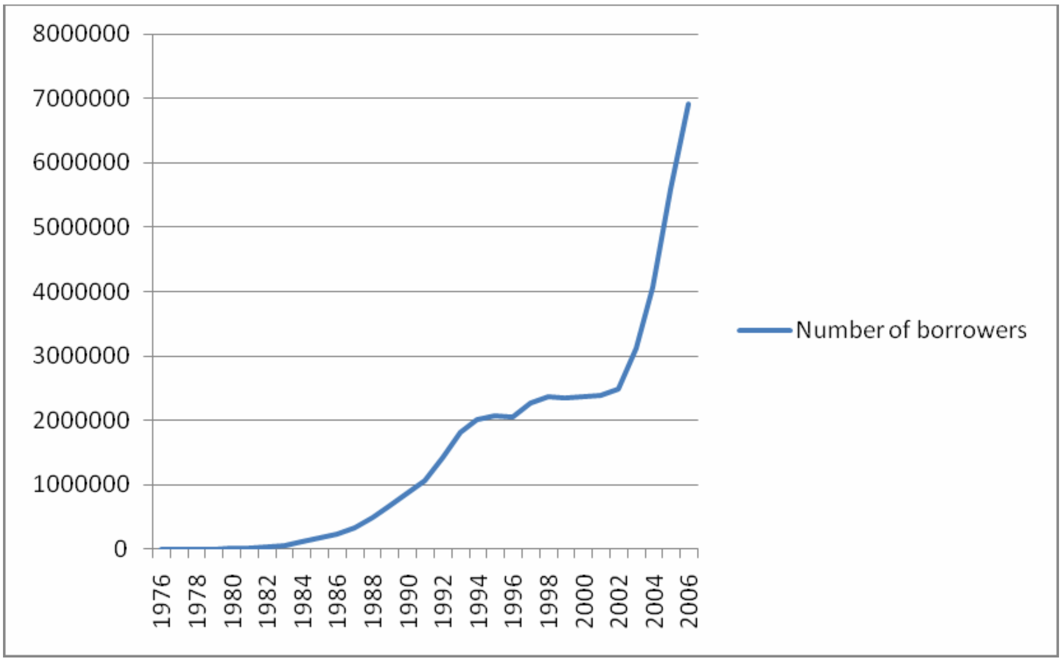

Figure 1: Grameen Bank membership 1976-2006 (Source: Grameen Bank Historical Data from Annual Reports, available at www.grameen-info.org)

Furthermore, with the beginning of the new millennium the rise of commercial funding increased tremendously and Microfinance was established as a viable investment opportunity. Some analysts assume commercial funding to have reached around 30bn Dollars since (see BATEMAN 2010, p.21). Microcredits became so popular at this time that parallel to the commercialisation movement several wealthy philanthropists considering Microcredits as a decisive tool in the fight against poverty started to make extraordinary sums available to the sector, e.g. Bill and Belinda Gates with around 32 billion US $ through their foundation (see BATEMAN 2010, pp. 20-21). Additionally, many big firms have taken up engagements in the Microcredit sector bearing the declared “win-win” situation of the Microcredit principle in mind as well as their reputation in public. Even on a personal level, the web-based firm KIVA (see www.kiva.org) enables an exchange of loans between individuals from industrialised countries and credit seeking individuals from Less Developed Countries. This way they were able to gather several millions of Dollars until today (see BATEMAN 2010, p.21). Along the way, the Microcredit movement is very well accompanied and promoted in public, i.a. with the UN declaring 2005 the year of the Microcredit. In 2006 then, it reached its absolute peak of popularity, when Yunus and his Grameen Bank are jointly awarded the Nobel Prize for Peace to reward their long-lasting commitment

> “to create economic and social development from below” (Press Release Nobel Peace Prize 2006)

with the revolutionary introduction of the Microcredit approach.

1.4.2. Suicides, repayment crises, and financial excess

However, more or less parallel to this seemingly positive development, some dreadful incidents occurred destroying the flawless aura that had previously surrounded the Microfinance movement. In 2004, for example, a suicide wave of more than 400 farmers within only three months, who saw no other way to escape their debt-overload, shocked the Indian state of Andhra Pradesh, an area with an extremely high Microfinance saturation (see BATEMAN 2010, pp.132-133). The number of suicides continued to grow and provoked a Microfinance crisis in the area which could not be properly settled until today, as far as can be seen. In 2006, when more and more complaints about the practices of Microcredit lenders reached the public of Andhra Pradesh, particularly as regards the methods of debt collection, the state government finally intervened by raiding several Microfinance Institutions in order to disclose irregularities within their Microcredit practice and to shut down those institutions involved (see MADER 2010, p.3; see KAZIM 2010a).

Generally, and for some time already, Microfinance had to struggle with various repayment crises, too. In fact, borrowers, like in a domino effect, started stopping their repayments one after the other, often provoked by the urging of opposition politicians like it was the case in Nicaragua, Pakistan and Bolivia (see BAJAJ 2011), or otherwise as a reaction to the conspiratorial spreading of rumour from competitive entities, e.g. about the sudden withdrawal of a Microfinance Institution from the market due to legal prosecution of their leaders as it was the case for the Microfinance Institution “Spandana” in Andhra Pradesh in 2005 (see BANERJEE and DUFLO 2011, p.175).

On an institutional level, e.g. in Mexico, the Microcredit organisation Compartamos, founded in 1990 as a classical Microfinance Institution, went public in April 2007 raising a sum of 313 million Euros (see BUSE 2008, p.58; see BANERJEE and DUFLO 2011, p.166; see ARMENDÀRIZ and MORDUCH 2010, p.239). With the public disclosure of their financial conduct in due course of the IPO, financial excess within the organisation became visible in form of excessive salaries and bonuses for senior managers and directors (see BATEMAN 2010, p.22). Even though Compartamos charges interest rates at 90 per cent and more per year on loans it has been able to attract more than one million Mexican credit takers earning it a 55 per cent return which made it the most profitable bank in Mexico (see BUSE 2008, p.58; see ARMENDÀRIZ and MORDUCH 2010, pp.18, 240-241). The IPO set free a controversial discussion among developers about the legitimacy of a Microfinance model of such kind. Institutions like CGAP were considered as supporters of the IPO, in part at least, as they were close advisers to Compartamos on its way to financial prosperity and because it could be seen as an example in the sector for a successful transformation to financial self-sustainability (see BATEMAN 2010, pp.144-145). Yunus, however, called it a severe setback with bad consequences for Microfinance as it would demonstrate conditions like in usury money lending that were initially meant to be surmounted with the Microcredit approach (see YUNUS 2011a; see ARMENDÁRIZ and MORDUCH 2010, p.240). Just as the discussion started becoming more intensive, it was interrupted by the world financial crisis breaking out in late 2007 (see BATEMAN 2010, p.23). The detrimental business conducts reported from the traditional financial markets overshadowed the problems and discussions arising within the comparably less important Microcredit sector in the aftermath of the Compartamos affair. Hence, the public attention turned away from the Microcredit sector and the newspaper headlines concerned the continuous revelation of new scandals within the traditional financial sector. In the meantime, the Microfinance movement continued to pursue the way it had embarked on, documented by the IPO of SKS Microfinance in 2010 raising 354 million US dollars (see BANERJEE and DUFLO 2011, p.166).

1.4.3. The two sides of an extreme development

The new millennium demonstrated the extreme dimensions the Microfinance sector is moving in, meanwhile. On the one hand, it has reached an incredible outreach when compared to its beginnings in 1976 and appeared to work profitably attracting a tremendous amount of capital. Additionally, the new focus on savings as demonstrated by the Grameen II project may be considered a remarkable extension of Microfinance services providing an additional capital stock to Microfinance Institutions and an alternative productive deposit of excess capital for those individuals and households not yet disposing of investment ideas. Improving capital accumulation efficiency via savings and deposits may help on the way to achieve financial self-sustainability for banking institutions as well as depositors and savers. It may be helpful, too, in the long run, to attain a stable economic development where credit should be mainly financed through real existing disposable capital generated by savings and deposits in order to avoid inflationary pressure (see LECHNER 1988, pp. pp.152-155).

On the other hand, all the promising records from financially successful Microfinance undertakings became questionable once confronted with the happenings reported from, for example, the Indian state of Andhra Pradesh. In the light of these happenings it appeared rather cynical to describe Microfinance as a means to help the poor out of poverty and make a better living.

Meanwhile, the pursuit of financial self-sustainability seems to dominate the thinking of the whole sector and the question arises, whether this sort of Microfinance is capable to respond appropriately to the needs of the underprivileged and poor, especially whether it is capable to incite their economic development as originally conceived.

2. Facing the new reality – Where Microfinance is failing

The practice of Microfinance has changed to a considerable extent over the past 40 years and in such a way that it nowadays seems very different when compared to the original concept. As it was shown in the first chapter of this part (see above chapter 1, p.12), the aim for financial self-sufficiency and institutional independence of subsidies, a promise that the Microfinance movement had made itself for the future, is considered dominating the market by now and, as it seems, has left several fundamental elements of the Microfinance concept fall behind. Indeed, the controversies in today's practice of Microfinance have reached a level that may be counterproductive. This chapter thus endeavours to analyse the major problems persisting and to identify their root causes.

2.1. The declining role and influence of Yunus

The development of Yunus within the Microfinance world may to some extent be seen as symbolic for the general development of the whole sector: After many years of successful and widely accepted professional activity, the most prominent personality of the Microcredit scene has found himself in a completely new situation when he was, for the first time since the difficult beginnings of his Microcredit approach (see SPIEGEL 2006, p.16), confronted with harsh criticism and even accusations. Furthermore, his fundamental ideas were to undergo substantial changes, partially upon his own initiative. These concerned, in particular, the practice of his Grameen Bank and had an immediate impact on his general standing in the business.

Due to his worldwide fame thanks to the Nobel Peace Prize in 2006, the wide spread public opinion tends to connect, and at the same time also to reduce the whole Microfinance sector to Yunus' Grameen Bank and, most importantly, to his purely philanthropic approach with the aim to alleviate poverty from over 25 years ago (see BATEMAN 2010, pp.6-7). Single success stories of his career are repeatedly told and referred to all over the world when advertising the principle of Microcredits. However, the reality of Microfinance, as it was demonstrated in section 4 of the previous chapter (see above chapter 1.4., p.24), may look very different. Furthermore, in the light of the changes of the Microcredit sector, but also the changes Yunus and his bank were to go through, this view in the public seems to be somewhat out-dated and no longer accurate.

2.1.1. Political dispute, legal trials and forced resignation as CEO of Grameen Bank

In fact, on a personal level, Yunus had to resign as head of Grameen Bank in 2011 by decision of the High Court of Bangladesh. Officially, his resignation was explained on grounds of age according to the statutes of the banking sector (see, for example, BARTH 2011; see CLOUSE 2011, p.5). Others assumed that the government feared his political ambitions and power stemming from the more than 7.5 million people who were his clients and therefore insisted on his withdrawal as head of the bank to diminish his influence (see BARTH 2011; see CLOUSE 2011, p.5; see BAJAJ 2011). At the same time, prosecution proceedings were also conducted against him, for example, by the Norwegian government, the reason being that a certain amount of development aid money donated was apparently not spent according to its defined directions (see HEIN and BERNAU 2011, p.45; see KAZIM 2010b). The image of Yunus was badly damaged thereby and suffered a loss of credibility, even though it remained unclear whether these accusations were justified. Eventually, the legal prosecution against him was dropped and the accusations were dismissed as apparently he was able to prove a correct deployment of the donated money in the end (see HEIN and BERNAU 2011, p.45; see BAJAJ 2011; see KAZIM 2010b). Nonetheless, this incident would not easily be forgotten and remained stuck in the public’s mind.

2.1.2. The loss of the defining and inspiring power in Microfinance

In addition, and in view of the development in the Microfinance sector within the past 20 years, it seems that Yunus, despite his outstanding position and pioneering activities in the sector, was not able to convince the majority of competitive Microfinance Institutions to adopt his own model and philosophy. Instead, the majority of competitors were eventually building their own Microfinance systems, thereby following their own ideas which did not necessarily comply with Yunus' approach. Maybe one could argue that the decline of influence of his model could have been counterbalanced by some form of scientific theory Yunus, a professor of economics, could have elaborated on the basis of his vast experience in the Microfinance practice and which could have further explained the basics and limits of Microfinance. Yet his numerous publications, as far as can be seen, focused on presenting his practical Microfinance approach which was characterised by his own philosophy he had followed right from the beginning whenever he was active in the context of Microfinance or Grameen Bank. Such philosophy, however, could not replace a thorough and clear cut scientific analysis which was more and more needed to deeply establish the term and understanding of Microcredits according to his ideas. In fact, Yunus' capacities appeared to have been completely absorbed by being deeply involved in the practice and further development of his Microfinance approach rather than dealing with the scientific aspects of his model which may have made his approach replicable. Moreover, there was perhaps a lack of distance between himself and his model that prevented him from tackling the conceptional side. Clearly, his approach of Microfinance, thanks to the overall positive results of his engagement, became more elaborate with time whereas it was at the same time diluted by the introduction of various other competitive approaches which were also undertaken in the name of Microfinance, but which conceptionally lay very much apart. What may be said is that Yunus, in spite of his outstanding role in the Microfinance market, lost the "defining and inspiring power" which he originally held as pioneer of the Microcredit approach. Thereby, he was forced to give up a certain amount of influence over the

Microfinance market and operations which were no longer oriented towards him alone, but developed their own independent approaches.

Furthermore, Yunus promoted new ideas and tried to increase his outreach beyond Microfinance, particularly in the field of social entrepreneurship. He thereby added to a certain amount of confusion which nowadays surrounds the sector of Microcredits. For example, he advocated the introduction of low prize yogurt and 1 US $ shoes to be established by foreign enterprises like Danone and Adidas in his country (see PINZLER 2010, p.28; see NEIDHART 2009, p.17; see MECK 2009, p.45) – an approach aiming to change the focus of enterprises from total profit maximisation towards social responsibility (see DUNSCH 2010, p.15; see NEIDHART 2009, p.17), however, which directly contradicts the underlying idea of Microcredits, namely

> “to create economic and social development *from below*” (Press Release Nobel Peace Prize 2006, italics mine)

for which he was awarded the Nobel Prize for Peace.

2.1.3. The permanent need to defend his position

Further changes actively promoted by Yunus concerned the practice of Microcredits through his Grameen Bank. Yunus introduced the Grameen II project in 2001 replacing many of the previous structures and leading to a considerable change of its Microfinance paradigms, particularly as regards the aim for financial self-sustainability which, contrary to the previous system, now became an important target, too (for a presentation of more Grameen II characteristics see above chapter 1.4., p.24; see also below chapter 3.3.2., p.75). Interestingly, the vast majority of the public did not take any notice of these changes within Grameen Bank. In learned writing and for Microfinance specialists, however, these changes did not go unnoticed and led to a fundamental discussion, whether Grameen Bank II was still serving the original purpose of helping the poor. For Bateman (2010), such changes clearly meant a shift to the financial systems approach (FSA) with a new focus towards commercial success instead of help for the poor (see BATEMAN 2010, p.19).

According to Yunus, himself, the main target remained unchanged, namely serving the financial needs of the poor, while ending the dependency on subsidies became a new objective. Therefore, in order to help stabilise the financial structure of the bank, savings and deposits were now strongly promoted. The latter would add considerably to the capital stock which allows extending the business turnover. It is, of course, in the interest of the poor money borrowers to be in the position to deal with financially sustainable Microcredit institutions. Further capital generating measures still had to be introduced in order to obtain comprehensive financial stability. Thus, the Grameen Bank II's portfolio was diversified and now addressed "less poor" individuals, too, i.e. those who supposedly dispose of the financial means to borrow money without suffering a severe decline in their own standard of living, with a more commercial approach in place to earn the revenue needed for financial self-sustainability (see YUNUS 2011c).

In essence, the position of Yunus seems more convincing. In fact, in this case, the aspect of commercialisation should not be overstated, since Yunus did not benefit personally from the new regime of the bank. He avoided any personal enrichment even though the bank was generating healthy profits (see also BATEMAN 2010, p.123). Instead, the newly earned money was mainly reinvested in the opening of new branches of the bank (see BATEMAN 2010, p.19; see BUSE 2008, p.55). The stake holding of the bank remained unchanged, leaving the vast majority of the shares, 95%, with the borrowers and the remaining 5% with the government (see YUNUS 2011c). Unlike in other Microfinance Institutions like, for example, Compartamos in Mexico, no excessive bonuses or disproportionate salaries were granted to bank managers, as far as can be seen, and also the interest rates on loans were kept at a rather low level, i.e. between 20 and 25% per year (see YUNUS 2011c), whereas at Compartamos interest rates up to 90% per year are possible (see BUSE 2008, p.58). This goes to show that despite the changes the bank has continued to follow its own business model the primary goal of which remains to serve the poor.

It goes without saying that a considerable explanation was needed to properly understand the new Grameen II approach and it is therefore not surprising that the perception of these changes led to controversial discussions within the Microfinance community. Yunus has been for many years, and will continue to be, a central figure in the Microfinance world, which means that all his activities will stand in the spotlight and will give rise to discussions, some more controversial than others, whereas competitors may develop their own Microfinance structures and ideas more easily and without critical interference. The permanent need to defend his own position is perhaps the price to be paid for his worldwide reputation in this sector which was mainly shaped by his ideas and activities. With the implementation of Grameen II and all its changes, Yunus will always be confronted with accusations of having abandoned his philanthropic approach and attitude in favour of a for-profit commercial oriented model, irrespective of whether such steps were necessary or not.

2.1.4. The loss of power and influence as a gradual process

All this reflects that his position is no longer undisputed and illustrates the declining role of Yunus in the Microfinance sector. He will continue to be an outstanding representative in the public, yet his immediate influence on the Microfinance practice is diminishing. For example, his objections against the IPO of the Microfinance Institution Compartamos in Mexico in 2007 were heard, but not followed and, subsequently, the IPO was realised (see above chapter 1.4., p.24; see BATEMAN 2010, p.144).

Seen from today's point of view, it seems the declining role and influence of Yunus did not come as a visible development step, but as a creeping process for the past 20 years or so, which at first went unnoticed. Even though Microfinance may be considered for a long time as a "one man show" in the person of Yunus, the multitude of approaches nowadays existing and strongly differing from Yunus' underlying idea show that his influence on the sector and on the practice of Microfinance diminished to a considerable extent.

2.2. Does Microfinance attain any verifiable impact on economic development and poverty reduction to date?

The major reason why Microcredits were, and still are, supported in such a way by the world community is the firm belief that they help the economic development of the poor and the alleviation of poverty. There were plenty of studies executed and published from the late 1990s onwards assessing and confirming the impact of Microfinance on the economy and thus on the reduction of poverty (see DUVENDACK 2010, pp.4, 7).

The study which is most referred to in this context was published by Pitt and Khandker (1998) evaluating that Microfinance would reduce poverty when extended to women, in particular (see ROODMAN and MORDUCH 2012, p.2; see DUVENDACK et al. 2011, p.15; see PITT and KHANDKER 1998, pp.958-996). Further prominent impact assessment studies include, for example, the long term evaluations of SEWA Bank in India, Mibanco in Peru, and Zambuko Trust in Zimbabwe realised by USAID between 1997 and 2000 (see DUVENDACK 2010, p.17; see ARMENDÀRIZ AND MORDUCH 2010, p.268). At SEWA and Mibanco, a positive impact on household incomes was observed together with a few other minor impacts, while retrieving results in terms of entrepreneurial impact proved to be rather difficult as the majority of clients at both institutions were apparently no micro-entrepreneurs, but labourers or sub-contractors instead (see DUVENDACK 2010, p.21; see ARMENDÀRIZ and MORDUCH 2010, p.268). At Zambuko Trust in Zimbabwe, neither an increase nor a decrease in household incomes could be observed, as far as can be seen (see ARMENDÀRIZ and MORDUCH 2010, p.268).

Such studies and the retrieved results may have been serving as basis for policy decisions (see BAUCHET and MORDUCH 2010, p.241) and may thus be considered as important drivers of the Microfinance movement adding considerably to its widespread recognition and growth during the past years.

2.2.1. The lack of evidence of economic impact and poverty reduction by Microfinance in recent evaluations

At this current stage, however, a huge turnaround can be observed as regards the evaluation of impact of Microfinance. In fact, more and more recent studies have come, and apparently there is more research in progress (see DUVENDACK et al. 2011, p.2), to the conclusion that, so far, Microfinance may not have had any notable positive impact on the economic development in the respective countries since its inception, i.e. that it may not have helped reduce poverty (see ARMENDÀRIZ and MORDUCH 2010, pp.5, 267-311; see DUVENDACK et al. 2011, p.74; see DUVENDACK 2010, pp.42-44; see DICHTER 2010, p.19; see BATEMAN 2010, p.23; see PETERSDORFF 2010, p.39). More precisely, the revision of several of the previously executed studies which had assessed a positive impact of Microfinance revealed that the assessments may have been based on data which apparently ignored important factors other than financials and which were thus considered not to be sufficiently significant to justify the conclusion of a positive impact of Microfinance (see BATEMAN 2010, pp.23-24; see DUVENDACK et al. 2011, pp.3-4; see DUVENDACK 2010, p.3; see BAUCHET and MORDUCH 2010, pp.243, 268-269).

For example, Roodman and Morduch (2013) have replicated and reanalysed the famous study by Pitt and Khandker (1998) finding weaknesses in both methodology and selected data resulting in

> "…that the original results on poverty reduction disappear…" (ROODMAN and MORDUCH 2013, Abstract)

and that, even after applying a more adequate methodology,

> "…questions about impact cannot be answered in these data" (ROODMAN and MORDUCH 2013, Abstract).

Karlan and Zinman (2009) have conducted a study in Manila to assess the impact of Microfinance on Microenterprises finding that despite some gains in profit businesses were shrinking, nevertheless (see KARLAN and

ZINMAN 2009, Abstract). Even more surprisingly, they were unable to detect any evidence showing that

> "…increased access to credit improves subjective well-being…; rather we find some evidence of a small *decline* in subjective well-being" (KARLAN and ZINMAN 2009, p.16).

Duvendack et al. (2011) provide the largest assessment and systematic review of Microfinance studies focussing on the question

> "What is the evidence of the impact of Microfinance on the well-being of poor people?" (DUVENDACK et al. 2011, p. 5)

In their assessment they revised the validity of 58 research papers, for example, in terms of economic, social, and/or empowerment outcomes, which previously had concluded a beneficial, or at least potentially beneficial impact of Microfinance (see DUVENDACK et al. 2011,p.3). In almost all of the studies Duvendack et al. (2011) resume that an answer to their fundamental question as stated above cannot be given at this stage, mostly due to methodologic inaccuracy and insignificant data collection in the studies (see DUVENDACK et al. 2011, pp.44, 46-47). In conclusion, after having revised 58 research papers, Duvendack et al. (2011) state that

> "…it remains unclear under what circumstances, and for whom, microfinance has been and could be of real, rather than imagined, benefit to poor people" (DUVENDACK et al. 2011, p.75).

In line with Duvendack et al. 2011, Armendàriz and Morduch have detected two major underlying problems concerning the impact assessments of Microfinance: the problem of selection biases combined with the weakness of impact assessment methodologies. Apparently, there does not yet exist a methodologically robust study capable of assessing Microfinance impact reliably (see ARMENDÀRIZ and MORDUCH 2010, pp.308-309; see DUVENDACK et al. 2011, p.15).

2.2.2. Selection bias – The limited significance of financial and quantitative data analysis for assessing impact

In fact, as far as can be seen, in the majority of the studies that had come to positive impact results the focus during the assessments was laid mainly on the collection and evaluation of financial and/or quantitative data. However, in more and more recent studies conducted by, for example, Duvendack et al. (2011), Morduch and Bauchet (2010), or Vik (2010), the admission of social and/or qualitative indicators in the assessments was considered equally important and led to different results (see DUVENDACK et al. 2011, p.76; see MORDUCH and BAUCHET 2010, p.240; see VIK 2010, pp.292-293). Surprisingly, the claim for including more social rather than purely financial aspects in the investigations is not new. In fact, Woolcock (1999) already warned that the studies conducted at the time were lacking the evaluation of social components in their analyses (see WOOLCOCK 1999, p.19). As Morduch and Bauchet (2010) have observed in their studies, a one sided focus in a study, e.g. on purely financial, but also on purely social aspects, decisively influences the collection of data and thus the final results of a study. As a consequence,

> "*Different answers are thus obtained when asking the same questions with the same variables but with different datasets*" (BAUCHET and MORDUCH 2010, p.241).

A major underlying problem within Microfinance impact assessments to date may thus be that its results were influenced to a large extent by the conceptional focus or rather perspective of the study. As far as can be seen, the older assessments laid the focus mainly on the analysis of financial and quantitative data the results of which, e.g. the elevated credit repayment rates, gave the impression that Microfinance had a positive impact on the reduction of poverty while social and other qualitative aspects, e.g. whether repaying the credit was difficult or not, were more or less ignored. Naturally, it is easier and less costly to retrieve simple quantitative rather than complex qualitative data which may sometimes also be described as "unobservables", e.g.

> “entrepreneurial abilities, access to social networks, risk taking preferences and business skills” (DUVENDACK 2010, p.7).

Therefore, probably due to the commercial pressure in the Microcredit sector, it is little surprising that costly social or rather qualitative indicators are generally underreported, while the record on the operational performance is large and often collected on a day to day basis (see BAUCHET and MORDUCH 2010, p.268; see CHAN, MAKAROV and THOMPSON 2010, p.19). Consequently, due to the one-sidedness towards the selection of financial variables, it has to be assumed that the results obtained in the majority of the Microfinance impact assessments to date have not been sufficiently accurate and may thus not be considered significant. To some, the issue of the one-sided focus in impact assessment also gave rise to the suspicion that the analyses conducted may not have been impartial. Bateman (2010), for example, goes as far as saying that assessment programmes would mostly be used as a means to sustain Microfinance programmes as they too much seek to report the benefits and good parts of Microfinance (see BATEMAN 2010, p.35). Vik (2010), too, concludes that the actual focus of impact measurement on manageability, accountability and institutional performance,

> “derives from the need to legitimize Microfinance as a business and to create an image of success” (VIK 2010, p.323).

Hence, the problem of selection bias, i.e. which variables to include into the assessment survey and which not, supports to a large extent the assumption as stated by Armendàriz and Morduch (2010) and Duvendack et al. (2011) that a robust study overcoming such problem and assessing Microfinance impact reliably may indeed not yet exist (see ARMENDÀRIZ and MORDUCH 2010, pp.308-309; see DUVENDACK et al. 2011, p.15).

2.2.3. The lack of analytical depth of the assessment methods in use

Apart from the use of inappropriate data, some researchers also found that the favoured tools used to assess impact are usually not appropriate to prove Microfinance to work (see BATEMAN 2010, p.34; see DUVENDACK et al. 2011, p.75). This would be particularly the case for the assessment tool “Randomised Control Trials” (RCT), which was derived from the clinical trials of the medical sector and where groups receiving a form of treatment are compared to groups receiving none in order to measure impact (see ARMENDÀRIZ and MORDUCH 2010, p.294). According to Bateman (2010) the measurements suffer from a conceptional flaw as they generally compare individuals receiving Microcredits with individuals receiving no money. In Bateman’s judgement, it is certain that those supplied with money are at first better off than those without. There could not be much derived from that information and it could not be seen as a real proof of the positive power of Microfinance (see BATEMAN 2010, p.34).

One may hold against this that, in the light of the general lack of access to finance present in the poor developing world, comparing an individual receiving a loan with one who does not seems legitimate and may be seen as a possible way to assess the impact of Microfinance, with the latter individual serving as control variable in the evaluation, but also representing the usual situation of those without access to finance. In this context, the underlying question for the impact assessment should be whether the mere supply with finance makes a difference in the individual’s economic life or whether the lack of access to finance denies him this opportunity (see ARMENDÀRIZ and MORDUCH 2010, pp.267-268).

In fact, there is no real conceptional flaw to be found in the assessment method as presented in the book of Armendàriz and Morduch (2010), as far as can be seen. The focus lies on measuring where Microfinance starts to have a first impact and this is indeed the case as soon as Microfinance, with the provision of loans in an area where such services had previously been unavailable, is providing a possibility to change. However, the question is which judgement on the degree of impact can be really derived from the information. In fact, all we know is that, for the moment, the supply with a loan has put the recipient in a financially better position than the other individual who has received nothing. Even though such an assessment method may be flawless as such, it appears to be too superficial, nonetheless, and is thus not convincing for assessing the true impact. In line with Bateman (2010) and Duvendack et al. (2011), the results retrieved are too basic and thus too weak to justify the final statement that such impact may also be beneficial, in general.

2.2.4. No signs of economic impact by Microfinance to date

Therefore, following the evaluations more recent studies have come to (see DUVENDACK et al. 2011; see DUVENDACK 2010; see MORDUCH and BAUCHET 2010; see VIK 2010, pp.292-293) it needs to be assumed that, so far, Microfinance has indeed not had any verifiable impact on economic development and on the reduction of poverty. Furthermore, the assessment methods applied to date do not (yet) seem to be comprehensive enough to allow gathering accurate and significant information on the impact of Microfinance (see also ARMENDÀRIZ and MORDUCH 2010, pp.5, 268-311). In general, they too often lack the inclusion of important qualitative factors which, admittedly, are rather difficult to retrieve and evaluate at the same time. In turn, as most of the revisions of impact assessment studies have shown any poverty reducing impact results to "disappear" (ROODMAN and MORDUCH 2013, Abstract; see also DUVENDACK et al. 2011, p.75) and thus without any proof at hand, it needs to be assumed that, for now, Microfinance was not yet able to attain any sustainable beneficial impact on economic development and poverty reduction.

2.3. The predominance of consumptive Microcredits in the Microfinance market and the general over-indebtment of borrowers

In the original concept of Microfinance the welfare of the poor was supposed to be increased through both the provision of finance for those previously declared unbankable (see ARMENDÀRIZ and MORDUCH 2010, p.3) along with *the assignment of the borrowed capital for investment into small, but highly productive undertakings*, like, for example, the investment in the continuous production of bamboo stools (see SPIEGEL 2006, pp.23-27) or in seed fertiliser to help raise the output of the harvest to a considerable extent (see McKINNON 1973, pp.12-14). In this sense, this section will endeavour to find out whether the Microfinance capital extended to the borrowers has been appropriately deployed, in general, or whether a certain form of mismanagement of Microfinance capital can be observed that may help both explain and understand the rather disappointing impact of Microfinance on reducing poverty to date.

Ideally then, the investments made from Microfinance capital should serve the establishment of new or rather the extension of existing economic activities which are supposed to provide additional income and employment. This is meant to be the ideal impact achieved with Microfinance. The surplus generated from the productive investment may be used either for consumption or otherwise for modest reinvestment or might as well be deposited as savings for future investments. The development would allow the most successful undertakings grow larger and eventually create employment for the very poor or rather for those considered having little personal entrepreneurial capability (see BATEMAN 2010, pp.24-25). Thus, it seems the major focus of Microcredit lending should be lying clearly in assigning the provided capital for *productive investments*.

2.3.1. Evidence on the predominant use of Microcredits for consumption rather than for income generating investment

In reality, however, it seems the majority of the Microcredits have been used for consumption rather than for production purposes, i.e. for

> "consumption spending that cannot be financed out of current income" (BATEMAN 2010, p.29).

In fact, Microfinance is generally said to have been used

> "for a whole range of other private, social and community expenses other than their microenterprises" (VIK 2010, p.296),

e.g. to smoothen losses in times of economic downturn or to treat health problems (see BATEMAN 2010, p.25; see KAZIM 2010b). Furthermore, it appears that the poorest who were originally conceived as the designated recipients of Microfinance tend to more and more lose their status as primary target group of the lending schemes again. With the new financial systems approach (FSA) in place Microfinance has been made available to the less poor class, too, who are considered less risky and more profitable for the extension of loans, especially those for consumption (see BATEMAN 2010, pp.41-42).

The evidence supporting the dominance of consumption credits in the Microfinance sector is overwhelming. Bateman (2010) presents a comprehensive set of example studies which all have come to more or less the same conclusion irrespective of their geographic location (see BATEMAN 2010, pp.29-31, 137):

In a sample study between 1994 and 1995 in a village in Bangladesh, up to 70% of the Microloans extended were not spent on income generating activities as originally conceived (see also RAHMAN 1999, p.106). Similarly, in 2007, another report from Bangladesh by the Goldin Institute found that Microfinance was used primarily to smoothen food shortage, but not for investment purposes (see BATEMAN 2010, pp.29-31, 137) and according to a further study from 2009 the business use of Microloans was not most common, either (see also COLLINS et.al. 2009, ch.6). As far as India is concerned the use of Microcredits for productive means was estimated between one fifth and one third only (see also MILLER 2006). In the African countries Uganda and Tanzania, according to a Finmark trust study, only around 15% of Microloans were used for Microenterprises and expansion. Otherwise, the majority of the capital would preferably be deployed to buy food, pay funerals and school fees as well as medical expenses (see BATEMAN 2010, pp.29-31, 137). In their Microfinance report from 2007, Beck and Ogden even go as far as assuming 90% of Microloans to be generally used for the financing of current consumption rather than for enterprise growth (see also BECK and OGDEN 2007, p. 20).

Bateman (2010) thus summarises that it may be taken for a fact that more than 50 percent of Microloans are nowadays used for consumption, only (see BATEMAN 2010, p.136).

2.3.2. Over-indebtment of borrowers as a result of the dominance of consumer Microcredits

As a consequence, a heavy general debt overload is assumed to persist among most Microcredit borrowers (see BECK and OGDEN 2007, p.20). In fact, meanwhile, in areas where Microfinance is particularly present, the number of individuals and households indebted to a Microfinance Institution is supposedly very high (see POLGREEN and BAJAJ 2010; see BÖS 2009b, p.20). In the case of not having invested the money in any income generating activities and lacking a regular income, poor individuals usually struggle with the capability to pay the interest rates charged as well as the periodical instalments to amortise the credit as a whole. Eventually, they might see no other way than taking up further credits at another Microfinance Institution in order to be able to come up for previous credit commitments (see POLGREEN and BAJAJ 2010; see EPD 2010, p.15; see DICHTER 2010, p.19). This vicious step into the debt trap may, however, ultimately exacerbate the conditions of payment. The gradually increasing repayment pressure may provoke rather bad social dynamics within the borrowing community. For example, in order to escape their debt-overload, individuals have been reported to have tried their luck in gambling the money putting everything in and often losing even more afterwards (see BATEMAN 2010, p.37). Moreover, individuals highly indebted may eventually be left in despair provoking suicidal thoughts, like it happened in the Indian state Andhra Pradesh all along during the past years (see above chapter 1.4., p.24).

2.3.3. The limited opportunities of fuelling the economy via purely debt based consumption

The predominance of consumption credits in the Microfinance sector, and the general debt overload resulting therefrom, may provide a major reason why there was no economic impact or rather alleviation of poverty reached by the provision of Microfinance in the mean term. In the short term, of course, borrowers may benefit from the sudden supply of disposable money and may be in the position to purchase products that may also be urgently needed. However, credits need to be reimbursed and the awareness of the problem usually sets in as soon as the first credit instalments are due, i.e. when the question arises how to pay for something now which was not affordable before. Even if the borrowers concerned manage the situation by cutting on other personal expenses like, for example, food or school fees in order to come up for the credit instalments this still cannot be considered the supposed objective of providing Microfinance. This way, it may rather cause a shift from one problem area to another and would not provide much of an improvement to the borrowers.

It may be noted here again that these circumstances are not accounted for by the basic RCT impact assessment method mentioned in the section above (see chapter 2.2., p.36) – and this further underlines its limited significance. It is too static and short termed as it only observes the moment when an individual is supplied with money compared to another one who is not. The obtained positive results on the impact of Microfinance are not suitable to properly analyse the situation and tend to be rather misleading instead (see also VIK 2010, p.293).

2.4. The heavy increase in commercial excess and abusive behaviour in the Microfinance practice

According to the ideal Microcredit concept the provision of Microfinance is supposed to be an alternative for borrowers which is less costly than approaching informal credit sources like the local moneylender who would normally charge usurious interest rates on the loans extended, thereby preventing the borrowers from generating sufficient return due to the high cost of capital or rather indebting them to a substantial extent. Additionally, Microfinance Institutions in place would generally aim at taking care of their customers and assisting them with a form of sympathetic consulting rather than exploiting them (see BATEMAN 2010, pp.24-25, 29). Microfinance should thus be provided at bearable costs supported by the good service of the lending institutions which are driven by the intention to help the poor.

2.4.1. The predominance of financial self-sustainability over poverty alleviation aspects in Microfinance

As it was shown in the first chapter, however (see above chapter 1, p.12), the Microfinance sector has experienced a heavy shift of focus and a change of its major principles over the years with immediate consequences for the Microfinance practice. Meanwhile, the aim for financial self-sustainability of Microfinance Institutions represents the primary objective to be reached and the Financial Systems Approach (FSA) is dominating the scene having more or less replaced the original Poverty Lending Approach (PLA) (for a more detailed explanation, see above chapter 1.3., p.20). Essentially, as Vik (2010) differentiates,

> "FSA separates itself from the poverty lending approach (PLA) by subordinating objectives of poverty alleviation in favour of financial sustainability" (VIK 2010, p.301).

The prevailing figures which are nowadays promoted in public and thus collected in impact assessments are nearly all oriented towards the manageability, accountability, and institutional performance of the Microfinance Institutions, a change of paradigm that almost certainly came along with the introduction of the FSA, while the furthering of policies concerning the alleviation of poverty fell behind (see VIK 2010, p.323). Due to the aim for financial self-sustainability, Microfinance Institutions are nowadays retrieving their capital to a substantial extent from commercial funds and investors rather than from donors or through other forms of subsidies (see above chapter 1.3., p.20). As a consequence, Microfinance Institutions, in order to be able to remunerate the investors, are obliged to let the borrowed capital work by increasing their loan volume. Additionally, and, most importantly, in order to attract further capital, they are under general pressure to financially succeed and to report attractive institutional numbers (see also YUNUS 2011a). Hence, one of the, supposedly, most important indicators of success of Microfinance, and, simultaneously, the guarantor of continuous capital inflow, is a constantly high average repayment rate of Microcredits reported in the sector. Of course, the expectation of rather safe returns may be considered strongly supporting commercial investors in entrusting their capital into Microfinance, a rather new investment sector which was previously considered high risk and low yield. Without such form of security the investment volume into Microfinance may be expected to be tiny. In the light of these circumstances, many lending institutions were said not to care much about how the money was spent or for what it was used by their clients anymore as long as the credit including interest rate was completely repaid and a high average repayment rate in the institution was achieved overall (see POLGREEN and BAJAJ 2010). This attitude may also be one of the reasons why extending consumptive credits to more or less poor individuals became an option, too (see above chapter 2.3., p.42), as waiting to identify potential micro-entrepreneurial activity normally takes much longer time and could end up in default, nevertheless. Hence, as long as the numbers reported, the repayment rates in particular, remain positive consumption credits might be tolerated.

2.4.2. The misleading interpretation of high repayment rates

The extremely high repayment rates which are reportedly achieved in Microfinance to date are not only persuasive for investors, but also one of the strongest arguments to promote Microfinance in the public. Of course, the saying that Microfinance achieves an average repayment rate higher than in traditional credit markets (see STALLINGS 1999, p.14; see METZGER 2008, p.22) is very convincing from a first glance. It makes believe instantly that the concept should work highly successful in practice and should have a positive impact on the lives of the poor - otherwise they would not be capable to repay their credits at such a rate. At a second glance, however, it appears to be strongly underreported to the public how such high repayment rates were, in fact, achieved. Which, then, are the methods used to secure repayment and responsible for achieving such elevated repayment rates overall?

The most renowned and widely applied method to secure repayment by the poor in the absence of physical collateral which would normally be seized in case of credit default is the principle of group lending or rather joint liability. It was part of the revolutionary inventions along with the introduction of Microcredits to the poor back in the 1970s and is still largely in use nowadays (see also above chapter 1.4., p.24). In short, poor individuals are joining in solidarity groups of borrowers and have to financially guarantee for each other in order to qualify for a Microcredit. Thus they are acting as bailsmen for each other, which is why it is meanwhile also referred to as joint liability, a term which better describes the approach and its implicit regulations rather than the term group lending. Thus, in this procedure, group members have to sustain both a financial and a social (group) pressure in a borrowing cycle (see ARMENDÀRIZ and MORDUCH 2010, pp.12-13, 100; see SENGUPTA and AUBUCHON 2008, pp.11-12; see KUNDU 2011, p.34).

Interestingly, the repayment rate is generally measured at the group level, only, rather than at an individual level. Supposed one group member defaults, then the rules of joint liability force the other group members to jump in and cover the remaining instalments or otherwise the whole group will drop out of the lending schemes. Remarkably, this way, any individual failure will not become visible. Instead, it will most definitely be compensated by the solidarity circle of borrowers which more or less assures a repayment rate close to 100%. In fact, it seems to be hardly ever known, in which way a credit has been repaid, i.e. whether all borrowers had the capacity to repay the whole credit by themselves, or whether the group members had to step in, or whether the borrower's family paid for the debt in the end (see VIK 2010, p.310). Apparently, there do not exist any official records of individual defaults (see VIK 2010, p.319). The only information gathered seems to be whether the group credit has been repaid completely, which is most often the case thanks to the joint liability method.

Hence, high repayment rates in the context of joint liability may not be considered suitable to tell us a lot about the success of Microfinance for borrowers or rather about its real impact. They appear to be a purely institutional element measuring financial performance, instead. Clearly, such information does not provide insights about the difficult social ties which may develop within such solidarity groups and which may provoke rather disadvantageous dynamics among group members, e.g.

threatening or mutual slandering during critical phases of the borrowing cycle, the declared opposite of solidarity that was originally meant to be the basis of group lending. Furthermore, those members who have successfully invested their credits are living under constant pressure as they can only hope that no group member fails so that their generated income, or even their complete investment, is not immediately absorbed by the coverage of other loans. In such a case, which apparently is not unusual, they might end up with empty hands in spite of successful investments of their Micro-capital (see VIK 2010, p.320). Therefore, it may be assumed that the high repayment rates achieved through the joint liability method generally overlook the difficulties arising within such solidarity groups and disguise, in particular, the true number of defaults. From an institutional view, however, the principle of joint liability seems to be very helpful in providing the right figures and numbers to further promote an elevated level of repayment in the public as ultimate indicator of success helping consistently in attracting further investor capital.

As an alternative to joint liability, meanwhile, Microfinance is also made available to individuals. It was shown in section 3 of the first chapter (see above chapter 1.3., p.20) that in due course of the commercialisation movement Microfinance Institutions loosened the condition that Microcredits can only be extended to groups, but may be provided to individuals, too, in order to increase the outreach to as many borrowers as possible. It may be considered a reaction to the increasing pressure on Microfinance Institutions to grow and to attract further investor capital. Naturally, maintaining a high repayment rate of Microcredits as indicator of success remained equally important in individual lending. Thus, in the absence of the more or less “self-regulating” joint liability vehicle, lending institutions had to find other ways to secure both repayment of the credit extended to individuals and to ensure the high repayment rates, overall.

For example, several Microfinance Institutions apparently managed to exaggerate and manipulate important aspects of their operational performance and their impact using specific accounting measures (see BATEMAN 2010, p.35; see WOOLCOCK 1999, p.20). Bateman (2010) even goes as far as assuming that some were able to influence

Microfinance assessments to their favour by channelling people of trust into important projects who would take care that the assessments came to the right conclusions (see BATEMAN 2010, pp.35-36). In cases of default, the Microfinance Institutions reportedly helped to brighten their repayment quotas by taking over the debt themselves and declaring it as flawlessly repaid. This way the official repayment rate would remain within attractive heights and a negative rating that might have endangered the continuous supply with investor capital seemed to have been prevented successfully (see LUYKEN 2011, pp.14-15).

The latter examples, even though being a measure to disguise the real facts and once more stressing the tremendous focus laid on appropriate repayment rates by Microfinance Institutions, appears to be, nevertheless, a rather harmless and borrower-friendly way to react to an increased level of credit defaults. This is particularly the case when comparing them to the ways other Microfinance Institutions tend to treat their clients in order to retrieve their money and to prevent default, as will be shown in the following undersection.

2.4.3. The undisturbed rise of commercial excess and abuse of borrowers

Reportedly, in their desire to grow further and generate higher returns, many Microfinance Institutions are suspected of having implemented aggressive lending practices, e.g. that they would tend to more or less seduce customers into Microcredit contracts and abuse their highly limited knowledge and experience in finance by implementing, for example, usury interest rates or hidden clauses into the contract. Consequently, these forms of abusive, aggressive lending practices would eventually lead to the impoverishment of customers who, even though lacking a regular income, in general, would tend to spend the credit on goods they cannot afford and would eventually be struggling to repay (see DUFLO 2010; see POLGREEN and BAJAJ 2010; see MADER 2010, p.3; see BAJAJ 2011; see HEIN and BERNAU 2011; see BÖS 2010).

Furthermore, in the eagerness to grow their lending portfolio, many Microfinance Institutions were also said to have dismissed checking thoroughly the capacities of their clients to repay. As a consequence, such easy access to finance may have caused many borrowers' over-indebtment as it allowed them taking up fresh credits from one Microfinance Institution to cover previous debts from another one. However, sooner or later, they would find themselves in a similar situation again piling up more and more debts and rising costs over time, until there is no Microfinance Institution left ready granting further credit (see POLGREEN and BAJAJ 2010; see KAZIM 2010a; see BÖS 2010). In some of these cases, reportedly, money collectors were said to have started increasing the pressure on borrowers to retrieve the loan. For some borrowers the pressure was apparently so heavy that they ended up committing suicide when they saw no other way to resolve the situation (see HEIN and BERNAU 2011; see POLGREEN and BAJAJ 2010; see MADER 2010, p.3; see DUFLO 2010; see KAZIM 2010a).

As concerns the rising number of suicides due to over-indebtment in the sector, the commercialisation process is said to have helped two rather perverse incentives to evolve in the Microfinance business, even though certainly not intendedly. First of all, the staff of Microfinance Institutions is usually remunerated by the level of repaid credits, on the average 56% in addition to the basic income (see MADER 2010, p.3; see DUFLO 2010). Secondly, many Microcredits are covered by life insurance, meanwhile, which are very often sold together with a credit and which were designed to protect the borrower's family in case of unexpected decease. Here, Mader (2010) sees a direct connection to the suicides in assuming that, from a money collector's perspective, a dead borrower might be considered more lucrative than a borrower in default (see MADER 2010, p.3).

2.4.4. Inconsistencies of the present with the original ideas of Microfinance

It seems commercial excess and abusive powers have considerably distorted the Microfinance sector since the introduction of the FSA. Certain Microfinance Institutions were aiming at extending their size and profitability as much as possible and regardless of the consequences. The foremost example in this context may be given by the IPO of the Microfinance Institution Compartamos in Mexico in 2007 which provided deep insights into their business conduct which was marked by excessive salaries and bonuses for senior managers and directors, along with usury interest rates at around 90% to 100% per year (see BUSE 2008, p.58; see ARMENDÀRIZ and MORDUCH 2010, pp.18, 240-241; see also above chapter 1.4., p.24).

In general, it appears as if, meanwhile, the business conduct of many active Microfinance Institutions is more or less inconsistent with the original ideas of Microfinance. Starting with the demand for Microcredits, in general, it was generally assumed and promoted in the public that the poor are in desperate need for Microfinance, i.e. that their demand is more or less endless. By now, however, it seems that in some areas borrowers had to be persuaded by Microfinance Institutions to take up a Microcredit rather than applying for one by themselves. It may therefore be assumed that Microfinance in these regions has finally reached a distinct level of over-supply. Yet, while the demand of the poor for Microcredits is starting to slacken the demand of Microfinance Institutions to grow and extend their lending volume is further increasing, nevertheless.

Secondly, in some areas borrowers have to face extremely high costs in Microfinance which are rather similar to what previously the usury local moneylenders charged from them and which were initially intended to be surmounted by Microfinance.

Thirdly, borrowers' limited experience and knowledge in finance is abused through, for example, the integration of bad clauses in MF contracts, abusive repayment patterns, or rather betrayal, in general, instead of receiving the promised form of sympathetic consulting designed to help them develop economically and escape poverty eventually.

Fourthly, Microfinance is sold as a huge success for the poor to the public using indicators like the high repayment rates which, however, only underline institutional and financial success, while at the same time MFIs are incentivised to comply with these indicators by further increasing their portfolios and by rewarding financial success. The needs of the poor borrowers are subordinated which were originally meant to be at the centre of Microfinance and which represented the main reason why extending Microcredits to the poor was seen as legitimate.

Lastly, by now, many poor borrowers lead a life in fear suffering, for example, from threatening and slandering in their social environment, from the violence of money collectors, from having ruined the finances of the family who had to take over their debts, or from the status of overindebtment some of which see no other way out than committing suicide. Originally, Microfinance services were meant to lift the poor out of misery and help them lead a happier life.

All in all, it has to be assumed that the vast majority of the information gathered in Microfinance, like repayment rates or cost effectiveness, does not deal with questions of poverty, but with institutional details, only, and thus does not provide us with any insights on the impact of Microfinance on the welfare of the poor (see VIK 2010, p.301). In view of the predominant commercial thinking in the sector, the rise of excessive practices and the promotion of institutional financial success over poverty aspect, it may be assumed that Microfinance nowadays is mainly to the benefit of the lenders, not of the borrowers (see BATEMAN 2010, pp. 50-51; see also YUNUS 2011a).

2.5. The lack of an effective legal framework and governmental supervision

It became apparent in due course of the analysis that Microfinance has changed its paradigms over the years. With the introduction of liberal policies and the implementation of the Financial Systems Approach (FSA) in the sector in the 1990s various new and also seemingly conflicting approaches of Microfinance practice entered the market and started to each gain ground: commercial versus poverty lending, profit versus non-profit organisations, but also abusive versus supportive business behaviour. Thereby, as demonstrated in the previous section (see above chapter 2.4., p.46), excessive commercial and abusive lending forces in the Microfinance sector have been growing further and further over the years, without considerable resistance as it seems, but with unintended support of the development agencies and governments due to their change of Microfinance policy instead. So far, the liberal FSA does not appear to have been able to self-regulate such detrimental developments, as originally hoped. Indeed, the temptation for lending institutions to apply abusive and excessive behaviour in the market may be seen as generally tremendous: the poor as the designated customers of Microfinance usually dispose of a limited background and experience in finance and may thus have no means to defend themselves against any abusive practices and betrayal. Hence, a suitable regulative power as well as an effective legal framework would be helpful which helps preventing the implementation and dispersion of damaging business conducts while at the same time providing measures to protect its participants. Normally, commercial banks are bound by official regulations of the state supervision of banking. However, many Microfinance Institutions are not operating as duly authorised banks, but as “Non-Bank Financial Companies” (NBFC) which are not subject to the strict banking regulation (see MADER 2010, p.3).

2.5.1. Unsuccessful tries to introduce regulatory measures and their consequences on the market

For a long time, any irregularities taking place in the Microfinance sector seem to have been more or less disregarded by both governments and the public and could hence further infiltrate the market. In 2004, a suicide wave of 400 farmers within only a few months in the Indian state of Andhra Pradesh, all declared due to over-indebtment, caused deep irritations within the Microfinance world which, however, did not provoke any political or rather legal reaction. Apparently, the situation was handled by denying any immediate connection of the suicides to Microfinance in the public, but stating instead that such unfortunate happenings were not uncommon in India and that over-indebtment may have various backgrounds (see BATEMAN 2010, pp.132-133; see MADER 2010, p.3; see BANYAN 2010, p.56). In 2007, however, the highly successful IPO of the Mexican Microfinance Institution Compartamos raised first widespread doubts in the public as well as in some parts of the Microfinance community about the correctness of such business behaviour. The question put forward was whether fighting poverty may at the same time be so profitable and turn its providers into millionaires. The public disclosure of Compartamos' business conduct provided insights of the commercial excess in the institution composed of charging usury interest rates on its loans between 90 and 100% while granting rather elevated salaries to its managers and running extensive reward systems for their employees. Nevertheless, Compartamos reported fast growing numbers of clients and repayment rates close to 100%, while complaints or accusations of the abuse or betrayal of borrowers associated with Compartamos were not reported at the time, as far as can be seen. Therefore, in spite of some critical reactions to the IPO, e.g. by Yunus (see ARMENDÁRIZ and MORDUCH 2010, p.240; see also YUNUS 2011a), Microfinance continued its boom in the following years. It may be assumed that the financial success of Compartamos also made some investors believe, that, if the demand of the poor for Microfinance is so tremendous that they are even willing to pay unreasonable interest rates, then the supply of Microfinance is still too small and should be greatly increased (see also ARMENDÀRIZ and MORDUCH 2010, p.19). Eventually the prices would drop with rising competition and saturation, but until then it might be appropriate to participate in the opportunity to generate high returns (see also ARMENDÀRIZ and MORDUCH 2010, p.240). Thus, the next highly successful IPO took place in 2010, executed by India's largest Microfinance Institution SKS Microfinance, raising 275 million Euros or rather 350 million US Dollars (see MADER 2010, p.3; see HEIN und BERNAU 2011; (see also YUNUS 2011a). Remarkably, the SKS founder sold privately a package of shares worth 8 million Euros (see MADER 2010; see POLGREEN and BAJAJ 2010).

The rate of suicides, however, continued to grow, particularly in India's state Andhra Pradesh. There, it became more and more obvious at some stage that Microfinance may have played a considerable part in them. Previously, according to Mader (2010), it was usually poor farmers highly indebted to local moneylenders who committed suicide. Meanwhile, the majority of suicides were committed by women, the preferred recipients of Microfinance, most of whom were also clearly identified as highly indebted customers of well-known Microfinance Institutions in the area, for example, SKS Microfinance (see MADER 2010, p.3; see also LAKSHMI 2011, p.A12). Eventually, when more and more reports about violent money collectors, cases of pressurising, betrayal as well as usury business models reached the public and were all linked to Microfinance some governments felt compelled to intervene quite rigorously.

The measures undertaken focussed essentially on trying to control the usurious powers active in the market which were meant to be mainly responsible for the over-indebtment of borrowers, but also to penalise those institutions reported to apply inappropriate lending and collecting methods. In India, for example, interest rate ceilings for Microcredits were put into effect (see KAZIM 2010a; see BANYAN 2010, p.56) and laws to regulate how Microfinance Institutions may lend and collect money were passed, thereby restricting the number of loans borrowers may take up from different Microfinance Institutions (see LAKSHMI 2011, p.A12; see POLGREEN and BAJAJ 2010; see MADER 2010, p.3; see HEIN and BERNAU 2011; see HEIN 2010). Further measures were, for example, banning weekly repayment schemes and allowing monthly money collection only, or sanctioning debtors to having to invest the majority of the borrowed sum, yet without specifying which kinds of investments (see HEIN and BERNAU 2011; see HEIN 2010; see BANYAN 2010, p.56).

As soon as the introduction of these policy measures had become official, however, a heavy repayment crisis erupted in the Microfinance sector: with the complaints turning public, in some areas borrowers stopped repaying their credits as a protest against the harassing treatment by the lenders and their unfair lending methods (see LAKSHMI 2011, p.A12), while in other areas some politicians, mostly opposition, aiming at taking advantage of the situation in order to increase their popularity called on all borrowers to refuse repayments to Microfinance Institutions (see BAJAJ 2011; see HEIN 2010; see POLGREEN and BAJAJ 2010; see BANYAN 2010, p.56). Both movements added to the rise of a severe repayment crisis, especially in India, the world's largest Microfinance market (see HEIN 2010), but also in Nicaragua, Bangladesh, Pakistan, Bolivia and other developing countries (see BAJAJ 2011; see BANYAN 2010, p.56).

Repayment rates dropped dramatically, sometimes from close to 100% down to as much as 20% and less (see LAKSHMI 2011, p.A12; see BANYAN 2010, p.56). As a further consequence, India's commercial banks having previously invested around 4 billion US Dollar into the market and now fearing its loss stopped providing new capital for Microfinance Institutions many of which started to run out of liquidity (see BAJAJ 2011; see HEIN 2010; see POLGREEN and BAJAJ 2010).

2.5.2. Regulation – Yes or no?

Naturally, the Microfinance Institutions affected started complaining heavily about the new regulatory restrictions which would not only prevent them from achieving the desired financial inclusion of the poor, but which would even represent a serious threat to the whole industry (see LAKSHMI 2011, p.A12; see MADER 2010, p.3). They would lead to a general decrease in the lending volume as Microfinance Institutions would earn less money which in turn leads to less credit available for the poor, too (see HEIN and BERNAU 2011). Some Microfinance officials also claimed that the figures reported to the public about the general over-indebtment would be exaggerated and that in fact only around

> "20 percent have borrowed more than they can afford and that just 1 percent are in serious trouble" (POLGREEN and BAJAJ 2010).

Therefore, the new regulations, the inherent reduction of investor capital, and the rising mistrust towards Microfinance would also hit Microfinance Institutions situated in regions of India and other parts of the world where, so far, no suicides or harmful lending practices have been reported, e.g. Grameen Financial Services in Bangalore or Share Microfinance in North-Dehli (see BAJAJ 2011; see BÖS 2010). In fact, the latter organisation had to postpone their IPO designed to generate additional capital worth 10 billion Rupees, equalling 162 million Euros, due to the repayment crisis (see HEIN 2010).

On the other side, those in favour of the regulatory steps undertaken would point at the fate of those who were betrayed, ruined, or even harmed by dubious Microfinance providers the business conduct of which could no longer be tolerated and therefore had to be disabled by taking action from a regulatory side (see POLGREEN and BAJAJ 2010).

For those endeavouring to make an impartial analysis of the situation both politicians and Microfinance providers were considered as equally responsible for the crisis (see HEIN and BERNAU 2011; see BAJAJ 2011; see MADER 2010, p.3; see HEIN 2010). They acknowledged that the Microfinance sector has made serious mistakes by, for example, not adopting any self-control mechanisms to prevent abuse (see HEIN and BERNAU 2011; see BAJAJ 2011; see MADER 2010, p.3). However, they found the regulatory measures undertaken as well as the public intervention from a political side were equally inconsiderate and thus further drivers of the crisis (see HEIN 2010; see BAJAJ 2011). The former chief of the International Monetary Fund, the Indian economist Rajan, for example, accused politicians like the Nicaraguan president to have voluntarily aggravated the crisis of the Microfinance sector due to their fear that the Microfinance movement might help the poor become more independent and, eventually, undermine their political sovereignty (see HEIN and BERNAU 2011).

2.5.3. The need for a commonly accepted Microfinance understanding as a base for developing effective regulative measures

All in all, it became apparent that, so far, any aims to regulate the Microfinance sector have proven to be difficult and did not achieve the desired results, as far as can be seen. The Microfinance industry in India's largest state Andhra Pradesh nearly collapsed in the aftermath of the introduction of regulatory measures. However, it remains unclear whether these measures were in fact causing a crisis to break out or whether they were the beginning of a clearing up process of an industry that may have been artificially blown up. Nevertheless, the need for regulation strongly persists in order to protect the market participants, the uneducated borrowers, in particular, and to prevent illegal business behaviour to dwell and develop (see also YUNUS 2011a). First of all, regulation should be supported by comprehensive legislative as well as executive powers like, for example, a credit protection agency or general law enforcement in case of non-compliance. Furthermore and most importantly, however, the regulation itself, in order to be ultimately effective, should be based on a common definition and understanding of Microfinance which is generally accepted and in compliance to which all the necessary regulatory measures are elaborated. Yet the question is whether, so far, such a common understanding exists among the many different Microfinance approaches which have developed in the meantime.

2.6. Excursus: the impact of the world financial crisis on the Microcredit sector

In 2007, the Microfinance community started discussing controversially the worldwide financial crisis and its impact on the sector. Some feared that a possible impact might be an immense cut in donor and commercial activity (see BATEMAN 2010, p.23). Others, however, considered no immediate impact for the Microcredit market arguing that it was working independently of the traditional financial markets and therefore should hardly be affected by the crisis (see POLLGREEN and BAJAJ 2010; see METZGER 2008, p.22). In fact, they believed that Microfinance might even emerge stronger than ever as the crisis would lead to an investment shift towards Microfinance which had emerged as a highly profitable, robust, and secure investment during the last years (see ARMENDÀRIZ and MORDUCH 2010, pp.255-256). In 2008, indeed, Microcredit funds continued to report stable positive results, while the stock markets in developed and Less Developed Countries dropped dramatically, e.g. by 60 per cent in Asia (see BENZ 2009, p.18).

It may therefore be assumed that Microfinance was able to sustain to a major extent as investment vehicle even during the on-going world financial crisis and in spite of the increasing controversial tendencies that were clearly developing within the Microfinance practice. Firstly, because the faith of the majority of the people in Microfinance does not appear to have been shattered – the public rather continued to see Microfinance as a best practice for development aid, as far as can be seen. The abrupt breakout of the financial crisis and its following dominance in the public discussion may have helped restrain the rather newly arising discussions about the disturbing behaviour of some Microfinance models in the market and prevent such news from gaining widespread publicity. Instead, these Microfinance matters were discussed more or less internally, i.e. away from public attention and in the inner circles of the Microfinance movement and the agencies involved. And, secondly, because investments in the Microfinance sector were indeed kept up which was underlined by the highly successful IPO accomplished by India's SKS Microfinance in 2010, i.e. three years after the world financial crisis had begun (see BANERJEE and DUFLO 2011, p.166).

All in all, there has been rather little immediate impact of the world financial crisis on the Microcredit sector, as far as can be made out (see also POLLGREEN and BAJAJ 2010). Due to the shortage of capital and liquidity in the traditional markets as a consequence of the crisis public money which previously had been granted quite generously to the Microfinance sector was strongly decreasing. At the same time, however, the Microcredit sector was considered an area of stability in the middle of the financial crisis leading a number of funds to be invested in Microfinance as an alternative investment. It may be assumed that thereby they were helping to counterbalance the shortage of capital caused by the reduced volume of public and donor money. The question remains, however, whether the increased proportion of commercial investors has further fuelled, or supported at least, the commercial pressure on the Microfinance sector which developed its own crisis later on, namely the so called repayment crisis as described in the section above or, as others describe it, India's version of the subprime crisis (see above chapter 2.5., p.54; see POLLGREEN and BAJAJ 2010; see OEKOM 2009, pp.1, 6).

3. The lack of coherence and transparency in the concept and understanding of Microfinance

The shortcomings in the Microfinance sector described in the previous two chapters are at the same time indicators of fundamental elements a modern concept or rather definition of Microfinance should comprise in order to prevent such shortcomings. The question is whether there exists a Microfinance concept comprising these elements and being generally accepted and coherently applied within Microfinance practice and theory.

3.1. What is Microfinance?

What is Microfinance, *to whom* should it be provided, and which are its *objectives*? These are naturally the three essential questions asked when confronted with the subject for the first time. However, as will become clear in due course of this chapter, a straightforward answer cannot easily be given as of today.

Perhaps, defining what Microfinance is, in general, may be least complicated as the principle approach appears logical, sensible, and easy to explain. McGuire and Conroy (2000), for example, offer a plausible, general definition in seeing Microfinance as

> "…the provision of financial services, primarily savings and credit, to poor households that do not have access to formal financial institutions" (MCGUIRE and CONROY 2000, p.109).

In a more global context, Armendàriz and Morduch (2010) describe Microfinance as a movement:

> "… the global "microfinance" movement [is] dedicated to expanding access to small-scale loans, savings accounts, insurance, and broader financial services in poor and low-income communities." (ARMENDÀRIZ and MORDUCH 2010, p.1)

Providing access to finance, usually for individuals previously excluded from such services, is the most common denominator in defining what Microfinance is. Commonly agreed, too, are the three major financial services of Microfinance: Foremost, the lending of **Microcredits**, i.e. small-scale credits, which are the origin and base of Microfinance. By the time, **Microsavings** were adopted in some service schemes, too. And, finally, proposals of **Microinsurances** were recently developed aiming to save borrowers from external shocks that make repayment of the borrowed sum impossible (see CHAKRABARTI and RAVI 2011, p.127;

see EPSTEIN and YUTHAS 2010, p.35; see GUNJAN, SOUMYADEEP and SRIJIT 2010, p.23).

It is noted here that the author's analysis of Microfinance concentrates on *Microcredits*, in particular, and its underlying principles. Additionally, in an optimum economic context, "absorption deficits" are available to finance "absorption surpluses", i.e. savers and depositors provide the capital stock for those intending to borrow, the banks being primarily in charge for an efficient allocation of capital (see LECHNER 1988, pp.152-155). Moreover, savings and deposits help mobilising more capital in the economy which otherwise may remain unproductively "under the pillow". Furthermore, it increases capital accumulation through the payment of interest rates on savings and deposits. Hence, *Microsavings* are also part of the analysis and considered an indispensable extension to Microcredits needed for the Microfinance system to function sustainably by strengthening the local capital markets. Microinsurances as such are welcomed, in general, but will only be dealt with in passing in this study.

The basic principle of Microfinance should more or less be plausible from what was explained above. However, when it comes to identifying what Microfinance is for, i.e. *to whom* these services should be provided and which *objectives* are meant to be reached through its provision, the Microfinance sector reveals what may be called its major underlying deficit: in fact, there are numerous statements published both by researchers in learned writing as well as by active Microfinance Institutions, which, however, prove to suffer from a distinct lack of coherence and, consequently, also a lack of transparency in their concepts and respective understanding of Microfinance leaving space for further interpretation and showing a certain degree of ambiguity. Interestingly, Yunus himself seems to be aware of the difficulties that have arisen due to the various different and often incompatible approaches of Microfinance existing and circulating in the world. In an official statement on his website from October 2011 he felt urged to clarify what he, in the name of Grameen Bank, understands as Microcredit:

> “Whenever I use the word "microcredit" I actually have in mind Grameen type microcredit or Grameencredit. But if the person I am talking to understands it as some other category of microcredit my arguments will not make any sense to him.” (YUNUS 2011b)

This goes to show that the term Microcredit is no longer self-explanatory – contrary to what the majority of the public assumes it to be and despite its striking simplicity from a first impression.

3.2. The lack of coherence in defining the concept of Microfinance in learned writing

In learned writing, researchers supposedly work independently of any commercial or philanthropic background and execute impartial analyses on the very nature of Microfinance. It will be demonstrated in the following section that, nevertheless, a distinct lack of coherence concerning the definition of the goals and objectives of Microfinance as well as the specification of its primary beneficiaries persists. Interestingly, a research of the EBSCO database revealed that the vast majority of Microfinance or rather Microcredit relevant studies have been published between the years 2000 and today. Around 1500 articles with the key word Microfinance and Microcredit respectively could be found within this time frame. Between 1990 and 2000, only around 300 articles were listed in the results, the majority of which were published after 1996. And lastly, between 1970 and 1990, only a handful of articles appeared including the terms Microfinance or Microcredit. It seems, the Microcredit movement, which began in the late 1970s (for details see above chapter 1.2., p.15,), has entered the scientific debate rather late, but with some vigour, finally.

3.2.1. Chakrabarti and Ravi

To start with, Chakrabarti and Ravi (2011) provide a rather general, and therefore also vague definition of Microfinance:

> “Microfinance… [is] the provision of financial services to those excluded from the formal financial system. It is a process that includes financial intermediation such as supplying credit, savings and insurance products *with a goal towards social intermediation*

> *such as reducing poverty and enabling empowerment*" (CHAKRABARTI and RAVI 2011, p.127, *italics mine*).

While most people believe that Microfinance addresses the fight against poverty in any instance, Chakrabarti and Ravi (2011) seem to leave a door open for other interpretations, too, as they state poverty reduction as one of the possible objectives out of probably many. At least, the objectives of Microfinance should be confined to some form of "social intermediation", in general. The designated recipients of Microfinance are specified as those excluded from formal financial services. Normally, one can assume those without access to formal finance to be poor. But as long as no explicit remark is made in that direction it leaves space for further interpretation. It may therefore be assumed that according to this definition any individual without access to formal finance qualifies as potential recipient of Microfinance as long as a social component persists in the business objective. Interestingly, the requirement of collateral to securitise the credit is not excluded in this definition. It might therefore be conditional for the approval of the credit and a possible heavy barrier for access to finance for poor people not endowed with assets to be used as collateral.

3.2.2. Sharma

Sharma (2011) embarks mainly on the nature of the Microcredit in his definition of Microfinance:

> "Microfinance is the business of disbursing modest, short-tenure *loans without collateral to small borrowers*, *most of them poor*" (SHARMA 2011, p.89, *italics mine*).

Sharma (2011) makes no mention of savings or insurance. According to his view, the Microfinance business consists mainly of Microcredits which are, generally speaking, small loans extended without the requirement of collateral. As regards the designated recipients and objectives of Microfinance, three interesting conclusions can be drawn from this definition. Firstly, the recipients of the loans must not necessarily be poor, even though most of them would be, like he states. Apparently, it is irrelevant whether they had access to financial services before or not, but sufficient if they are *small* borrowers. Thus his concern lies mainly with the size of the credit extended which is “Micro” and i.a. of a “modest” size. Secondly, and building on the first point, Sharma (2011) emphasises that loans extended should be collateral-free and thus do not have to be securitised in this way. This aspect is of importance as poor individuals will most probably not dispose of collateral which is a main reason why they were denied access to formal finance before. Nonetheless, the definition only states that the *loan* itself does not *have* to be securitised by any form collateral. Therefore, poor individuals without collateral qualify as recipients of small loans, but obviously also those individuals with collateral do. Sharma therefore addresses a wider radius of potential Microcredit recipients. Lastly, he does not include any specific objectives in his definition. Microcredits may thus be used for any purpose, e.g. for poverty alleviation or for investment, but also for consumptive spending, as long as the size remains small.

3.2.3. Epstein and Yuthas

Epstein and Yuthas (2010) introduce a further interesting aspect of Microfinance while narrowing the scope of Microfinance to clear objectives:

> “The microfinance industry seeks to promote *economic development* by providing financial services such as loans, savings and insurance to poor clients who are not served by formal financial institutions. Microenterprise lending, the most prevalent form of microfinance, provides financial capital to support business investment and growth“ (EPSTEIN and YUTHAS 2010, p.35, *italics mine*).

According to Epstein and Yuthas (2010) the enhancement of the economic development of individuals without access to formal finance is considered to be the most common form of Microfinance. They state the creation of Microenterprises through the provision of finance as foremost example of Microcredit employment, where others either make no mention (see SHARMA 2011) or remain relatively vague by mentioning poverty reduction as one possible goal, in general (see CHAKRABARTI and RAVI 2011). It is interesting to note that they set no boundaries to the size of the credit, although the term “Micro” would imply that a rather small proportion of finance will be applied. Nonetheless, it seems the size of the loan does not matter as long as it serves the goals to be reached, i.e. economic development. In line with most other definitions, the recipients are again specified as those individuals which are poor and with no access to formal financial institutions. Surprisingly, the collateral issue is not dealt with by Epstein and Yuthas (2010). Collateral, to be pledged as security like in traditional banking, might remain conditional for a successful loan approval although poor people would generally lack it.

3.2.4. Olsen

Olsen (2010) adds a further point to be respected in the context of Microfinance:

> “…to alleviate poverty and promote development, MFIs provide funds at a *relatively low cost* to poor communities and populations that previously were excluded from credit.” (OLSEN 2010, p.501, *italics mine*)

In accordance with Epstein and Yuthas (2010), Microfinance is to serve specifically the alleviation of poverty as well as the promotion of economic development. Furthermore, Olsen (2010) adds a new aspect to the objectives of Microfinance in that it should be financially bearable. It remains unclear, however, whether the costs should remain bearable for the recipients or for the institution handing out the loan, or for both. Nevertheless, the cost of Microfinance is only rarely reflected in Microfinance definitions, even though it remains a crucial factor. Of course, it would be highly appreciated if the cost of Microfinance is as low as possible. But what may be considered as low cost in the context of Microcredits, or rather which costs are appropriate? This important question will be dealt with in detail in due course of the following part (see below part III., p.106). For Olsen (2010) the designated recipients of Microfinance are, like for Epstein and Yuthas (2010) above, those poor households and communities which have been denied access to formal finance before, but without mentioning whether collateral is necessary, or not, to get the loan approved.

3.2.5. Vik

Even though following a more generalist approach, Vik (2010) provides a further fundamental insight into the essence of Microfinance by stating:

> "Microfinance approaches poverty alleviation through inclusive financial services to combat exclusion and *dependency*" (VIK 2010, p.293, *italics mine*)

As already mentioned in the introduction of this study (see above part I., chapter 1, p.1) Microfinance, from a methodological point of view, aims at providing "indirect" help to poor households as a means to "help them help themselves". This aspect of self-help as an indicator of independence is fundamental to the Microfinance approach and Vik (2010) stresses this point again in her definition of the objectives of Microfinance. Dependency on others, like, for example, the good will of external development aid, should be prevented. Instead, with access to finance poor households should be given the chance to work their way out of poverty by themselves, through their own projects, and in their own responsibility. Apart from the fight against dependency, Vik (2010) states the fight against exclusion, in general, as the other major lever of poverty alleviation which the provision of Microfinance is supposed to combine. Nonetheless, the objectives stated here remain relatively vague. Independence is more of a superordinate goal to be reached, an idealistic state, but less concrete as a means to alleviate poverty than, for example, the promotion of economic development as stated by OLSEN (2010) and EPSTEIN and YUTHAS (2010). The focus seems to lie here in the improvement of the human rights status of poor households, particularly to enable freedom of choice and self-fulfilment, a goal associated with the term Microfinance. As far as the specification of the recipients is concerned, this remains slightly vague, too, though recipients should be part of the poor population as well as those generally excluded, most probably from access to finance. Once again, the collateral issue is not dealt with and remains unclear.

3.2.6. Bateman

The vague objectives envisaged by Vik (2010) in her definition may have been formulated more concisely by Bateman (2010):

> "…Microfinance is the provision of tiny loans to poor individuals who establish or expand a simple income-generating activity, thereby supposedly *facilitating* their eventual escape from poverty." (BATEMAN 2010, p.1, *italics mine*)

In this general definition, Bateman (2010) aims at describing the desired circuit of development to be introduced by Microfinance. The provision of loans is followed by the establishment of productive activities via the investment of the received capital which generates sufficient surpluses that help the borrowing individuals escape from poverty eventually. This seems to be a convincing description of inducing economic development within the poor population as major objective of Microfinance. It thereby underlines the self-help aspect stressed by Vik (2010). The potential recipients are denoted as being poor, yet whether they were excluded from formal finance before is not clear. Bateman (2010) is probably more interested in the true course and influence of Microfinance which may be helpful on the way out of poverty. The reduction to "helpful" might also be interpreted as a clue that he does not think Microfinance to be solely capable to solve all the poverty issues, but that it provides a beginning or rather just a small partition of the whole process. It might be equally important what the Microfinance capital is used for by borrowers, namely for some "income-generating activity" as he states. Once again, the role of collateral for Microfinance is not addressed in this definition.

3.2.7. Calidoni and Fedele

A more detailed response to the collateral issue in the context of Microfinance is provided by Calidoni and Fedele (2009):

> "Microcredit programmes provide financial services to small-scale entrepreneurs who otherwise lack access to capital markets *because they are not endowed with assets to be pledged as collateral*". (CALIDONI and FEDELE 2009, p.330)

According to Calidoni and Fedele (2009) Microfinance is made for small-scale entrepreneurs without collateral who would otherwise not be served by the financial system due to this discrepancy. The objective is to reach entrepreneurs, which implies that the Microfinance service should be extended for productive rather than, for example, consumptive purposes. Economic development might be derived as the overall objective, however, no mention is made about poverty alleviation. Nor do the recipients necessarily have to be poor. Therefore, according to this definition, Microfinance addresses specifically individuals without collateral who use the capital for some form of small-scale entrepreneurial activity.

3.2.8. Gunjan, Soumyadeep and Srijit

Finally, a rather extensive understanding of Microfinance is presented by Gunjan, Soumyadeep and Srijit (2010):

> "Microfinance is an extraordinary effective tool in spreading economic opportunity and fighting against poverty. Wider access to finance helps both the producers as well as ***consumers*** in raising their welfare status. Access to finance allows the poor to use their rich talents or opens avenue for greater opportunities. A composite set of services like credit, savings and insurance protects from the unexpected shocks or fluctuations...the functions and role of finance are essential for technological innovation and economic development" (GUNJAN, SOUMYADEEP and SRIJIT 2010, p.23, *italics mine*).

In this definition, Microfinance is seen as a synonym for enabling economic success for poor borrowers, contrary to what, for example, Bateman (2010) says, who considers Microfinance to play just a smaller part on the road to economic success. The goals are the alleviation of poverty together with the creation of economic opportunity as Microfinance helps exploit the rich talents among poor people previously without access to finance. This sounds so easy, but is it too good to be true?

Indeed, from a first look, this definition accommodates most desirable, or rather idealistic social objectives of Microfinance. However, taking a closer look it becomes apparent that on the way to financial prosperity of each individual access to finance may be granted to both producers AND consumers. This means consequently that access to credit with consumptive rather than productive purposes is also welcomed to support producers even though it remains unclear so far whether the consumptive spending of Microcredits can improve the economic welfare of the borrowers all but in the short run. Should consumption via credit be promoted for people who normally cannot afford it due to their poverty status? Is this sufficient to foster economic development in the long run or is some form of productive activity necessary? These questions are left open by the definition mentioned above. Once again missing in this statement is whether the provision of collateral by poor individuals for loan approval is required. Otherwise, mentioning the highly appreciated impact of finance on economic development in this statement is new. It may be noted here that providing an understanding of the role of finance and the capital market in the context of economic development is an essential objective of this study which will be covered in depth in part III (see below part III., p.106).

3.3. The lack of coherence and transparency in Microfinance practice

As far as Microfinance Institutions are concerned, it is important to note that their background plays an important role for the respective understanding of Microfinance. It may be derived from a purely philanthropic or rather non-profit up to a purely commercial or rather for-profit approach. In order to give an impression of the different kinds of approaches, the following section will present the Microfinance understanding of several selected Microfinance Institutions.

3.3.1. Selecting representative examples of Microfinance institutions

The latest comparing figures of Microfinance Institutions were gathered by the Microfinance Information Exchange (MIX) in December 2009. In their comprehensive assessment, 955 Microfinance Institutions worldwide reaching a total of 72.411.490 borrowers were analysed. The results were presented in a global ranking of Microfinance Institutions available as excel sheet on their website (see THE MIX PUBLICATIONS 2009). Many factors were part of the evaluation and thus influenced the ranking. In addition to the number of borrowers and the general size of the institutions they were also addressing the institutional performance, like, for example, market penetration, outreach or cost per borrower so that the largest Microfinance Institutions were not automatically top-ranked. Though certainly not conclusive the ranking contains analyses of some of the most renowned and largest Microfinance Institutions operating in the world at this stage.

As not all 955 Microfinance Institutions can be portrayed in this study, a selection was made on account of the total number of borrowers served by the institution. The aim was to represent the Microfinance understanding of those Institutions which a considerable part of Microcredit borrowers in the world are dealing with every day. At first then, out of the 955 Microfinance Institutions stated the 15 with the largest number of borrowers were extracted, regardless of their ranking position. These can be viewed alphabetically in Figure 2 below.

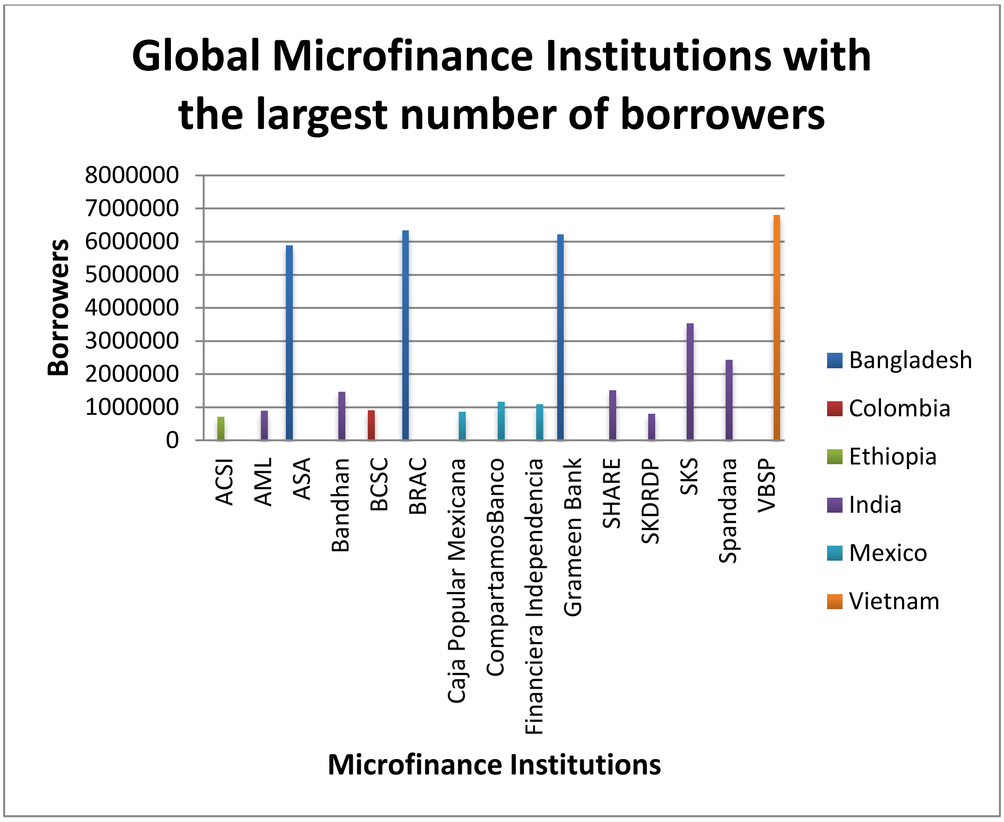

Figure 2: The largest Microfinance Institutions in terms of borrowers worldwide (Figure adapted from the 2009 MIX Global 100 Composite Ranking, source: see THE MIX PUBLICATIONS 2009)

Interestingly, these 15 Microfinance Institutions already serve more than 40 million clients, meaning 56% of the total number of borrowers out of 955 Institutions reviewed in the survey. Figure 3 below provides a further ranking in view of the number of borrowers:

Microfinance Institution	Country	Borrowers
VBSP	Vietnam	6.792.978
BRAC	Bangladesh	6.327.250
Grameen Bank	Bangladesh	6.210.000
ASA	Bangladesh	5.877.480
SKS	India	3.520.826
Spandana	India	2.432.000
SHARE	India	1.502.418
Bandhan	India	1.454.834
Compartamos Banco	Mexico	1.155.850
Financiera Independencia	Mexico	1.085.963
BCSC	Colombia	902.486
AML	India	890.832
Caja Popular Mexicana	Mexico	852.925
SKDRDP	India	801.527
ACSI	Ethiopia	710.576
Borrowers served:		**40.517.945**
Borrowers in total:		**72.411.490**
COVERAGE:		**56%**

Figure 3: Market coverage by the 15 largest MFI in terms of borrowers (Figure adapted from the 2009 MIX Global 100 Composite Ranking, source: see THE MIX PUBLICATIONS 2009)

The ranking shows that the majority of the borrowers live in countries which are known for their long tradition in Microfinance, in particular Bangladesh and India, but also Mexico and Vietnam, whereby Bangladesh and India are said to assemble over 50% of the worldwide borrowers within their territories (see BAJAJ 2011). This is why they may be seen as the pioneering countries in the promotion and implementation of Microfinance systems and have inspired the establishment of many more of such institutions worldwide, so much so, that their understanding of Microfinance may still nowadays be considered as representative for the sector as a whole. Taking into account the number of borrowers as well as the tradition and experience in Microcredit lending, the following institutions and their respective approach and understanding of Microfinance will be portrayed:

- Grameen Bank (Bangladesh)
- SKS Microfinance (India)

- Compartamos Banco (Mexico)
- ASA (Bangladesh)
- Spandana (India)
- VBSP (Vietnam)

3.3.2. Grameen Bank

Grameen Bank, translated meaning “bank of the village”, is the first and therefore oldest Microfinance *bank* established in 1983 in Bangladesh. Its founder is Yunus who, as stated above (see above chapter 1.1., p.13), is seen as the pioneer of Microfinance, in general. When his non-governmental organisation, which had started as a university project, was finally provided with a banking licence, several years of successful Microfinance field work in Bangladesh had preceded. Up to today, a banking licence allowing customers to deposit savings in addition to receiving loans seems to be a privilege which only very few Microfinance Institutions in the world have been granted, as far as can be seen. Grameen’s operations used to follow a purely philanthropic and non-profit approach financed by subsidies and donor capital to a considerable extent, i.e. the primary target was poverty oriented while the commercial performance was of secondary importance. Since 2001, however, Grameen Bank has implemented a system strengthening the commercial aspects of the bank in order to avoid dependence on subsidies. Nevertheless, as reported above (see above chapter 2.1., p.30), Grameen Bank is not known for commercially excessive behaviour, but has rather preserved a moderate business conduct with a strong emphasis on serving the underprivileged (see also YUNUS 2011c; see BATEMAN 2010, p.19).

Due to the different understandings of Microcredits present in the sector which may not be complementary with each other and, in particular, with his own understanding, Yunus felt urged to clarify Grameen Bank’s position (see YUNUS 2011b; see also above chapter 3.1., p.62). Thus, he prepared a rather long list of those features which are supposed to be characteristic for Grameen Bank Microcredit, or rather “Grameencredit” as he calls it, displayed on the Grameen Bank Website (see Grameen-Info.org; see also Attachment 1).

The extensive explanations presented by Yunus in this list provide a deep insight into the Microfinance philosophy of Grameen Bank. Information on the background and philosophy of the institution are presented and answers on the essential questions about Microfinance are given, especially as concerns the *recipients* of such credits and the *objectives* which are meant to be reached. First of all, Yunus sees credit as a “human right” which underlines the supportive character of the Microfinance approach prevailing at Grameen Bank. However, the list also contains elements which clearly show that for-profit programmes are in operation within the confines of Grameen Bank aiming for financial self-sustainability of the bank. Yet, the focus lies in charging interest rates sufficient to achieve programme sustainability rather than in satisfying the expectations of high returns for investors by any means. Furthermore, the designated, supposedly “non-negotiable” recipients of Microfinance are poor households which were previously denied access to finance being considered not creditworthy by traditional banks. Moreover, borrowers do not need to provide collateral to be pledged as security for the credit, unlike in traditional banking. And lastly, the objectives to be reached with the provision of Microfinance are clearly stated: It is designed to help poor people help themselves out of poverty. Thereby, Microcredits must not be provided for consumption purposes, but for assisting the poor in creating self-employment and in pursuing income generating or house building activities. In fact, according to the Grameencredit definition, Grameen Bank’s understanding of providing credits is based on the premise that the poor dispose of an enormous economic potential which can be unleashed with the help of Microfinance helping them to work their way out of poverty by themselves, eventually (see attachment 1 for a detailed overview of Grameencredit definition).

This presentation of Grameen Bank’s Microfinance understanding would be highly satisfactory as it seems to provide a coherent and transparent denomination of the most relevant aspects of Microfinance. The impression, however, is severely shattered when reading the introducing comments by Yunus before he starts outlining the Grameencredit characteristics:

> "Let me list below the distinguishing features of Grameencredit. This is an exhaustive list of such features. ***Not every Grameen type programme has all these features present in the programme. Some programmes are strong in some of the features, while others are strong in some other features***. But on the whole they display a general convergence to some basic features on the basis of which they introduce themselves as Grameen replication programmes or Grameen type programmes." (YUNUS 2011b, *italics mine*)

This statement reveals that not all of the Microfinance programmes operate coherently according to these "guidelines" and it remains unclear which do, at all. Apparently, Yunus himself does not know it, either, and has to remain more than vague in his explanation. The transparency supposedly derived from the "Grameencredit" feature list gets damaged as it cannot be determined which type of Grameen Bank programme follows which approach. It seems Yunus' aim to clarify the Grameen Bank's approach has rather produced more confusion. What can be said, however, is that there may not only exist a lack of coherence between the different concepts of the institutions active in the Microfinance sector, but also *within* the programmes of a single institution itself.

3.3.3. SKS Microfinance

"Swayam Krishi Sangam", in short "SKS", means "Self-help union". The Microfinance Institution SKS was founded in 1998 by Vikram Akula as a classical non-governmental organisation and is now the biggest Microfinance Institution in India with around 1300 branches in the country at the end of 2012 and with around 5.2 billion US Dollars disbursed as Microcredits in total (see sksindia.com; see also attachment 2).

SKS are based in Hyderabad, the capital of the Indian state Andhra Pradesh. In 2005, they converted from a non-profit "organisation" to a for-profit "company" with the intention to become financially self-sustainable and independent of subsidies and donor money, and to have larger access to the capital market. They are now registered as a non-deposit taking Non-Banking Financial Company (NBFC) (see sksindia.com; see also attachment 3). They earned worldwide fame with their spectacular IPO amidst the world financial crisis in 2010 raising capital worth 350 million US Dollars (see BANERJEE and DUFLO 2011, p.166).

Like Grameen Bank above, SKS Microfinance provides comprehensive information about the background and philosophy of their institution on its website, but the approaches differ considerably from each other. First of all, SKS are not acting as a bank, but as NBFC meaning that they do not dispose of savings or deposit accounts from their clients in their portfolio, which is generally interdicted in India (see DUVENDACK 2010, p.15). Furthermore, they openly admit on their website to pursue a purely commercial microfinance model, i.e. their approach focuses on attracting investor capital and remunerating them with a financial return on their investment. Thus they state growth of the company as being equally important to providing financial services to low income households (see also attachment 4). Nevertheless, and despite the strong commercial bias, the declared objectives to be reached with SKS Microfinance appear development oriented. Their declared aim is providing basic capital for poor borrowers to enable them starting or expanding income generating activities (see also attachment 5). Furthermore, SKS declares that the recipients of Microcredits, i.e. the low income households, do not need to provide collateral. Instead, SKS has implemented the joint liability system in order to secure repayment. Their rigorous system, as they call it, appears to work highly successful with repayment rates close to 100 per cent (see also attachment 5).

Obviously, an approach combining the yielding of high returns and supposedly achieving a positive impact on society, like it is presented here by SKS Microfinance, is highly attractive for investors and equally convincing at a first glance. Yet, a closer look reveals some inconsistencies present in the SKS Microfinance model.

Being a commercial Microfinance Institution SKS is, of course, highly sensitive to full credit recovery because of their investors. Yet, as it was shown in the previous chapter (see above chapter 2.4.2., p.48), high repayment rates can be misleading, especially in combination with the joint liability principle. The group may cover the loans successfully as a whole, but it stays uncertain how many members were indeed capable to repay their loan or whether the group or even family members had to absorb the loss in order to keep up the borrowing cycles of the group. Advertising high repayment rates appears more like a financial indicator of success designed to attract investors, who may hope for rather safe financial returns. But it is not able to prove whether SKS has reached his declared objectives of adding value to its borrowers, too.

Furthermore, it is important to note that SKS provides credits and insurance in their service schemes, only, but no savings. Being a NBFC, they have deprived themselves from this additional capital resource in their portfolio. Grameen Bank, on the other hand, is able to attract capital by attracting further savings and deposits. Additionally, at Grameen Bank, savers and depositors, which are actual or future potential borrowers, simultaneously, participate directly in the bank's financial success by being rewarded with interest rates paid on their deposits. At SKS, the institution is owned mainly by external shareholders who benefit from the company's financial success. Furthermore, the capital inflow usually stems from foreign investors, e.g. George Soros and J.P. Morgan (see CHEN et al. 2010, p.8). Eventually, the yielded returns will not stay in the country and the local region will not benefit from any the added value.

The one-sided, purely investor related approach forces SKS to acquire external capital for virtually each new credit arrangement as they cannot benefit from the continuous money flow present in a traditional bank where a considerable part of the credits can be easily financed through savings (see LECHNER 1988, pp.152-155). At the same time, company growth and financial success are indispensable for acquiring new investor capital. SKS claim, however, that company growth and the tapping of capital markets is necessary in order to be able to raise the estimated 50 billion US Dollars needed to cover the Indian Microfinance demand (see IYER

2007). This way they would also assist in fulfilling one of the major Millennium Development Goals (MDGs) with Microfinance, namely to half poverty in the world until 2015 (see also KHAVUL 2010, p.58; see HERMES and LENSINK 2007, p.F1). Another explanation could be that their approach may simply not work if they are not growing sufficiently, as a lack of growth would lead to a lack of return which cannot attract further investors. Altogether, it can be said that SKS represents an excellent example of a Microfinance Institution that has undertaken the complete shift from a pure non-profit to a pure for-profit organisation. Or, in other words, they have successfully changed from an entirely subsidy depending to an entirely investor depending financial institution. The question is whether there remains enough capacity at SKS to ensure added value to its borrowers as proclaimed in their objectives. These reflections come to mind when referring again to the Microfinance excesses that took place in Andhra Pradesh, a core area of SKS activity, which caused a suicide wave of hundreds of over-indebted borrowers – and where SKS employees were said to be involved (see above chapter 2.4.3., p.51; see also MADER 2010, p.3; see BANERJEE and DUFLO 2011, pp.168-169).

3.3.4. Compartamos Banco

Compartamos was founded in 1990 as a classical Microfinance Institution and turned into a commercial bank in 2006. Compartamos means “let us share”. One year later, in April 2007, they were the first Microfinance Bank ever to go public collecting 313 million Euros (see BUSE 2008, p.58; see BANERJEE and DUFLO 2011, p.166; see ARMENDÀRIZ and MORDUCH 2010, p.239: see also above chapter 1.4., p.24). They are now considered to be the largest Microfinance Institution in Latin America.

With the transformation into a commercial bank in 2006, Compartamos Banco has extended their portfolio to a considerable extent adding savings and deposits accounts as well as insurance to the original credit business (see compartamos.com, see also attachment 6). They are since capable to retrieve a substantial part of their capital from customer savings directly. Furthermore, investor capital is strongly emphasised as a means to create economic value and represents another important source of capital, not least shown by their successful IPO in 2007 (see also above chaper 2.4., p.46). The values stated by Compartamos, in general, stress the strong commercial orientation of the bank putting institutional financial success as top priority. Poverty alleviation, on the other hand, which is usually associated with Microfinance as the ultimate objective, does not seem to be the primary issue, even though Compartamos Banco state to be aiming at supporting the economic development of clients in the “lower economic segment” with the provision of finance, in general. Moreover, they have officially devoted themselves to certain social and human values which, however, remain relatively vague: They want to make customers “better people” and reach as many customers in the shortest possible time without specifically addressing poverty alleviation as the objective of their approach (see attachment 6).

Additionally, under these circumstances, it is difficult to clearly identify a specific group of recipients of the Compartamos approach. Addressing the lower economic segment of the population describes a tendency towards poor people, but not necessarily. A closer look at the Compartamos credit portfolio (see also attachment 7) reveals that they accept both borrowers endowed with and without collateral. In general, those without collateral may be considered poorer than those with the capability to provide it. The former are bound to the joint liability lending principle, while the latter qualify for individual loans for which they have to guarantee personally. Nevertheless, and in contrast to Grameen Bank and SKS Microfinance, poverty does not necessarily have to be a condition in order to qualify for a Compartamos Microcredit.

A further distinctive feature of Compartamos is the rather huge size of joint liability groups which may count up to 50 members. In the usual composition, groups are made of five members, only (see ARMENDÀRIZ and MORDUCH 2010, pp.12-13, 100; see above chapter 2.4.2., p.48). Borrowers may benefit from large groups in so far that, in the event of only very few credit failures in the group, their liability amount to be paid can be divided through more members and thus could be more easily affordable. But in terms of transparency it becomes even more difficult to identify who failed his credit repayment and who did not. Moreover, the possibility to derive any significant findings other than institutional financial success from high repayment rates becomes even more difficult in large groups than it already is in small groups (for a detailed explanation of the downturns of the joint liability mechanism see above chapter 2.4.2., p.48).

Lastly, a rather hidden aspect of the Compartamos approach is their interest rate structure. While Grameen Bank and SKS Microfinance appear to openly state on their website the maximum interest rates charged, varying between 20 up to 32 percent per year, Compartamos seems to prefer not directly mentioning it. In fact, in the years after the IPO, Compartamos was considered the most profitable bank in Mexico earning themselves a 55 percent return, while also charging interest rates around 90 percent and more on loans (see BUSE 2008, p.58; see ARMENDÀRIZ and MORDUCH 2010, pp.18, 240-241). There are many, e.g. Yunus, who accused them of applying usury lending methods which were meant to be prevented with Microfinance (see BATEMAN 2010, pp.22-23, p.144; see ARMENDÁRIZ and MORDUCH 2010, p.240; see above chapter 1.4., p.24).

Apparently, Compartamos may have strongly benefitted from the positive Microfinance reputation, so much so that it went more or less unnoticed for a long time that their approach, even though belonging to the Microfinance "family", did not have the ambition to help eradicate poverty, but was designed to generate maximum return by serving the "lower economic segment", a segment which had been underserved by financial institutions before.

3.3.5. ASA Bangladesh

Founded in 1978 in Bangladesh as a non-governmental development organisation providing legal training and aid for underserved rural households ASA, the "Association for Social Advancement", finally decided to specialise in banking services for the poor in rural areas in 1991 (see ARMENDÀRIZ and MORDUCH 2010, p.22).

ASA went through a finding phase for many years and are always open for change. Their approach is said to be cost-efficient and profitable. Since

2001, they managed to become financially self-sufficient accepting neither any donations nor any grants from outside the institution (see asa.org; see also attachment 9). In their portfolio, ASA generally provide two types of loans to its customers, the “Primary Loan” and the “Special Loan”, which are granted according to the fulfilment of certain criteria and dispose of different terms of repayment (see also attachment 10):

The general as well as the specific objectives approach of ASA show that their major focus lies in fighting poverty with economic means: Providing financial services to the poor and underprivileged in order to support substantially their income generating activities and their eventual escape from poverty. The poor borrowers, who can be clearly identified as the major target group of ASA activities according to their website, appear to be in a unique position compared to other MFIs: they neither have to provide any collateral as security nor do they have to join a liability group. Instead, they receive individual loans, only (see also attachment 10).

Even though the fight against poverty seems to be the top priority at ASA, the model is based on making profits, similar to SKS. In fact, without making profits the whole approach would have failed long ago as they have declared not to have accepted any donations or grants from outside the company since 2001 (see also attachment 9). While SKS has continued to rely on outside resources and needs to satisfy investor return expectations, ASA lives on their own resources, as it seems, which consist of their own capital and, additionally, the capital generated from savings and deposits. Despite the profit driven approach, the maximum interest rate charged remains relatively modest reaching 27 percent at the highest (see also attachment 10).

Interestingly, ASA’s legal status is not typical for an institution offering savings and deposits accounts in addition to credits. Normally, only banks are in the position to hold such accounts, like it is the case for Grameen Bank or Compartamos Banco. Others, like SKS Microfinance, are non-deposit taking NBFCs which only extend credits and insurance but do not provide savings or deposits accounts. ASA, as it stands, maintains the legal status of a non-governmental organisation up until today, even though they are offering savings and deposits accounts to their clients. This is possible by circumventing the need for individual customer accounts and thus for a banking license. Instead, each ASA branch has only one bank account of its own, where all supplemental cash is being deposited. Yet, the branch managers are responsible to keep the books up to date on all the individual savings made by its customers. But, altogether, clients only virtually dispose of a banking or rather savings account. In fact, there is only one real banking account per ASA branch (see also attachment 11). Furthermore, ASA claims to be financially independent from any outside grant, but to be able to finance themselves through their own funds (see also attachment 12).

It is interesting to note in this context that there exist, indeed, two entities carrying the name ASA in them, which, however, are very differently organised (see **Fehler! Verweisquelle konnte nicht gefunden werden.** below, p.279). Apart from ASA itself, which represents the entity based in Bangladesh and which was presented here so far, there is also "ASA International" (ASAI) which was formed in 2006. ASAI was established to transport the successful ASA model from Bangladesh into the world. Behind ASA International stands the organisation Catalyst Microfinance Investors (CMI) which is in possession of 100 percent of the ASAI shares. CMI, on the other hand, was founded by ASA Bangladesh and SEQUOIA, a Dutch corporate finance and private equity firm. Together they have gathered and collected capital worth 125 million US Dollars from all sorts of private investors which are made available to ASA International and their affiliates in form of a fund. ASA International is profit oriented und intends to increase commercialisation of the Microfinance sector. Apparently, ASA Bangladesh's direct involvement is limited to providing technical support for ASAI undertakings in Microfinance, only. Nevertheless, it has become clear that ASA Bangladesh is not only independent from outside grants and donations thanks to the own funds sufficiently generated by their successful Microfinance model, but probably also thanks to the additional income generated from the returns of their permanent investment into CMI and ASA International, likewise, adding to their overall own funds (see also attachment 13).

3.3.6. Spandana Sphoorty Financial Limited

In 1998, the non-governmental organisation “Spandana” was established in Hyderabad, India, with the aim to provide Microcredits to low income clients. The name Spandana stands for “responsiveness” and intends to underline their organisational awareness to operate as close to the needs of their clients as possible. Due to the fast growing business and an increasing need for additional capital, subsequently, Spandana converted into a commercial Non-Banking Financial Company (NBFC) in 2004 in order to be more attractive for investors and shareholders. The full title of the organisation is since “Spandana Sphoorty Financial Limited” adding “inspiration”, the meaning of “sphoorty”, to their general credo of responsiveness. Being an NBFC like SKS, Spandana do not offer savings or deposits accounts in their portfolio, but provide credit services, only. They claim to achieve more than 99.5 percent repayment of their loans extended (see spandanaindia.com).

Spandana’s mission and objective are stated as satisfying both their clients and their investors. The former may experience a general improvement in their quality of life thanks to the financial services provided, while the latter may hope for financial convenience due to substantial returns on their investment (see also attachment 14). Spandana is owned by several shareholders. A substantial part belongs to the founding members, while the other parts are owned by several investment funds, like the JM Financial India Fund, which were acquired over the years (see also attachment 15). The real spread of shareholding is not published by Spandana, as far as can be seen.

The major source of capital, however, are public and private banks and other formal financial institutions which grant loans to Spandana at a certain rate of interest, a cost which has to be forwarded to the Spandana clients. This is why it is not surprising that Spandana states that financial costs take over the largest part of the overall costs in a credit to low income households (see also attachment 16).

The Spandana credit portfolio consists of five different types of loans which vary in size and duration and the approval of which appears to depend on the economic development of the recipient (see also attachment 17). In fact, Spandana claims to provide credits at any stage of their borrowers' development, i.e. "up the value chain". The type of credit any customer has to start with and which is, thus, most often extended at Spandana is called the "General Loan", a group lending based credit with a weekly repayment schedule and with an annual effective interest rate around 28 percent. The main objective pursued by Spandana with this form of credit is to achieve financial inclusion of low income households. At this stage it seems they leave it more or less with the borrowers to apply the credit according to their wishes. As the name of the credit, "the general loan", suggests they do not recommend a specific use of the credit. Yet they assume credits to be usually used for "cash-flow smoothening" which they consider to be part of a productive purpose, in general.

As soon as the credit has been successfully repaid by the group, borrowers automatically qualify for the next level, the "Income Generating Loan", another group based credit rather similar to the first, but, as it seems, with a more specified objective, i.e. for income generation. The name is, however, misleading. Indeed, this type of credit is designed for clients who already achieve to generate income with their running business. The main intention of this credit type is to help smoothen the ups and downs in a client's business cycle, e.g. seasonal fluctuations or emergencies, with flexible access to capital. All in all, the income generating credit is supposed to be helping to keep on running a business rather than starting it.

The remaining three credit types, the "Micro-Enterprise Loan", the "Individual Loan", and the "Farm Equipment Loan" are all addressing clients with higher and, in particular, with regular incomes. The "Individual Loan", for example, is preferably given to middle income households. Spandana announces by themselves that at this stage the Micro level has been left behind.

Not surprisingly, the Spandana model is rather different to most other approaches presented up to here. SKS, perhaps, is the most similar

Microfinance Institution to Spandana, being both NBFCs and providing both loans, but no savings. Otherwise, similarities can be made out between Spandana and Compartamos Banco in so far that both have not stated poverty reduction as their ultimate objective. In Spandana's case the main objective, apart from remunerating their investors, is to reach financial inclusion of those usually not served by the formal finance sector. Additionally, it remains rather unclear which use should be made from credits extended by Spandana. Their loans to low income households, particularly the "General Loan" which is the most dominant loan extended in the organisation, do not need to be used for any specific reason nor are they bound to any certain selection criteria, as far as can be seen. According to Padmaja Reddy, founder and CEO of Spandana,

> „access to microfinance is important because it gives the poor a way to map out the future in a way that was not possible for them before, and this is the first step toward a better life. Whether they are buying machines, utensils, or a television for their home, the important difference is that they are working toward a vision of a life that they want, by saving and scrounging and working extra hard when needed, rather than simply drifting along" (BANERJEE and DUFLO 2011, p.170).

Moreover, and once again, like it was the case for SKS and Compartamos, the high repayment levels reached at Spandana can only be seen as financial success factors of Spandana's work, but not as a sign of the positive social impact reached with their Microfinance model. The high repayment rate was achieved with group based lending and the joint liability mechanism which disguise the true number of failures (see above chapter 2.4.2., p.48).

What appears to be rather new at this stage, however, is that Spandana, even though they should dispose of substantial capital generated from investors and from their financially successful business model, continue to depend strongly on external grants, mainly from public and private banks from which they borrow the majority of their funds to be extended as credits to their clients. They even admit these financial costs to take over the largest part in a Microcredit business which is a very different situation compared to most other Microfinance Institutions which claim the client administration to be the most substantial costs and mainly responsible for elevated interest rates charged. Nevertheless, Spandana aim to provide as much transparency as possible by, for example, presenting in the FAQ section of their website how the costs per credit are supposedly distributed in the Microfinance industry (see also attachment 18).

It seems Spandana manages to keep the operating costs rather low so that credit interest rates rarely exceed 30 percent per year despite the high cost of capital (see also attachment 17). It is interesting to note, however, that they claim the majority of capital in Indian Microfinance Institutions to be sourced in form of loans from other banks, in general, even though so far it appears to be mainly their business model which still depends to a substantial extent on external loans.

3.3.7. Vietnam Bank for Social Policies (VBSP)

The Vietnam Bank for Social Policies (VBSP) was established in 2002 by the government and is thus completely state owned. VBSP were able to attract many millions of Vietnamese customers and are now considered being one of the largest Microfinance Institutions in the world. Their early beginnings, however, go back to 1995, when the government implemented a fund to give the poor access to finance, called “Fund for the Poor”. However, it became clear after just a few months that the limited resources of the fund would not suffice to cover the vast demand for credit in the country where, in the early 90s, more than half of the population was considered to live below the poverty line (see BATEMAN 2010, p.191).

Therefore, the government decided to increase their financial support, but also to turn the fund into a bank in order to tap further capital sources, particularly in order to mobilise savings and deposits. The Vietnam Bank for the Poor (VBP) was thus created at the end of 1995 from which VBSP emerged in 2002 (see vbsp.org; see also attachment 19).

VBSP state a clear-cut objective on their website which is to fight poverty with the help of Microfinance and through a non-profit approach (see also attachment 20). Being the only Microfinance Institution active in Vietnam, VBSP provide a wide range of credit products in their portfolio, for example, Poor Household Lending and loans for Job Creation, but also for students, overseas workers or traders in disadvantaged areas and for many more socially driven projects (see also attachment 21).

While the overall objective, i.e. to contribute to reducing poverty, appears to remain conditional for any loan approval, the recipients and the use of their loan may vary from type to type. For example, the “Poor Households Lending” approach is supposed to help the poor develop their businesses, but also to improve their living in terms of electricity, food and education, i.e. either productive or consumptive use is possible. Another example is the “Job Creation” loan directed particularly towards those who already run businesses like farm cooperatives or small and medium enterprises with the aim to create new jobs. In this case, the major objective is the reduction of unemployment for those unable to pursue their own businesses (see also attachment 22).

When looking at the VBSP approach, several features appear to be rather different from what was observed in the other Microfinance Institutions so far. First of all, being a bank fully controlled and possessed by the government is a rather new aspect. Grameen Bank, on the other hand, is almost entirely owned by its clients (see above chapter 3.2.2., p.75) while Compartamos Banco belongs mainly to their investors and shareholders (see above chapter 3.2.4., p.80). Furthermore, throughout their history and thanks to government guaranteed funding, VBSP has maintained the principle of “preferential lending” (see also attachment 19), i.e. borrowers receive cheaper interest rates below the market price for capital, generally between 3.8 and 7.8 percent per year, in exceptional cases even less (see also attachment 23).

Thus, while the vast majority of Microfinance Institutions in the world has put financial self-sufficiency and profitability as their top priority, VBSP not only continue to welcome subsidies, but they also declare to work not-for-profit despite their monopolistic position. These methods instantly appear illegitimate to anyone in favour of the modern market theories, and of the Financial Systems Approach (FSA) of Microfinance implemented in the

1990s, which declared competitive and high yield Microfinance to be best practice (see above chapter 1.3., p.20). Consequently, since the early beginnings, VBSP, and the non-competitive, non-profit Vietnamese policies in the fight against poverty, in general, constantly had to face harsh criticism from all the major development organisations like the World Bank and CGAP. The latter refused to provide them with technical support and funds as long as they did not implement the promoted FSA approach, which they have not done up until today (see BATEMAN 2010, p.196). Surprisingly, the discussions continued, even though Vietnam's efforts to sustainably reduce poverty were extremely successful: between the years 1995 and 2004, poverty was reduced by 40 percent (see BATEMAN 2010, p.191). Bangladesh's economy, on the other hand, has further declined since the implementation of Microcredits (see PETERSDORFF 2010, p.39). According to Bateman (2010), a major reason for Vietnam's success was directing many larger credits into promising investments, especially in structural development and food programmes desperately needed in the regions, e.g. highly efficient rice cultivation which has worked so well that Vietnam is nowadays the third largest rice producer and exporter worldwide (see BATEMAN 2010, pp.194-195).

Nevertheless, the VBSP approach remains perhaps a unique case of successful financial development policy. Reaching economic progress with comprehensive government intervention policies may be described as "heterodox" (BATEMAN 2010, p.198), always accompanied by the question about what happens to the programmes once the government spending declines or stops. However, compared to other countries the Vietnam Microfinance market may have benefitted from another unique circumstance: There is only one single Microfinance understanding existing and represented by VBSP countrywide which is accepted, works under the same terms and conditions for anyone, and which is thus more easily adjustable by regulations. In Vietnam, thus, Microfinance appears as one coherent approach. Elsewhere, Microfinance seems to be merely an umbrella term which enjoys a positive reputation in the public and stands for the social advancement of the poor, in general, but which domesticates a large number of approaches each following their own policy, rules, objectives, and, in particular, their own understanding and definition of Microfinance.

3.4. Consolidating and extracting intrinsic elements for defining a coherent and transparent Microfinance concept

In view of the lack of coherence and transparency as well as the limited comparability of the general concept and understanding of Microfinance which became apparent in the analysis of both Microfinance research and practice in the previous two sections, the question arises which insights which may be retrieved from the information gathered, nevertheless.

3.4.1. Consolidated review of the lack of coherence and transparency in the understanding of Microfinance institutions

When looking at the Microfinance Institutions presented above (see above chapter 3.3., p.71), their practices may be considered the result of the uncontrolled and chaotic expansion of the Microfinance idea over the last decades. They are marked by an individual interpretation of Microfinance and have developed their product portfolio accordingly. Each Institution provides their own set of Microcredit classes, e.g. VBSP in Vietnam has credits to supply poor households or to create jobs, or Compartamos Banco in Mexico offers four different kinds of credits, more or less based on whether they address first-time or more experienced borrowers. However, deriving insights from their credit classes appears difficult, as their fundamental approaches are largely different and thus not comparable: for example, VBSP is completely state-owned and state-financed while Compartamos Banco is privately held and investor financed. VBSP is the only Microfinance provider in Vietnam and no further providers are permitted. Compartamos Banco is one out of many different providers in Mexico and finds itself within strong competition. VBSP provides credits at subsidised interest rates around 8%, Compartamos charges interest rates at up to 90% and more.

All in all, the constitutional background of each Microfinance Institution has strongly influenced their approach of Microfinance and the elaboration of their credit classes likewise. Even though there might be similarities in descriptions and wording, their underlying assumptions within each credit class cannot be clarified and remain non-transparent due to their different business approaches. Hence, what can be said on the practice of Microfinance is that it has developed itself in all sorts of varieties, however, not according to a common fundamental concept and without providing coherence and transparency in their activities from which deeper implications for defining the Microfinance concept could be derived. Figure 4 below provides an overview of the different background and orientation of the Microfinance Institutions presented:

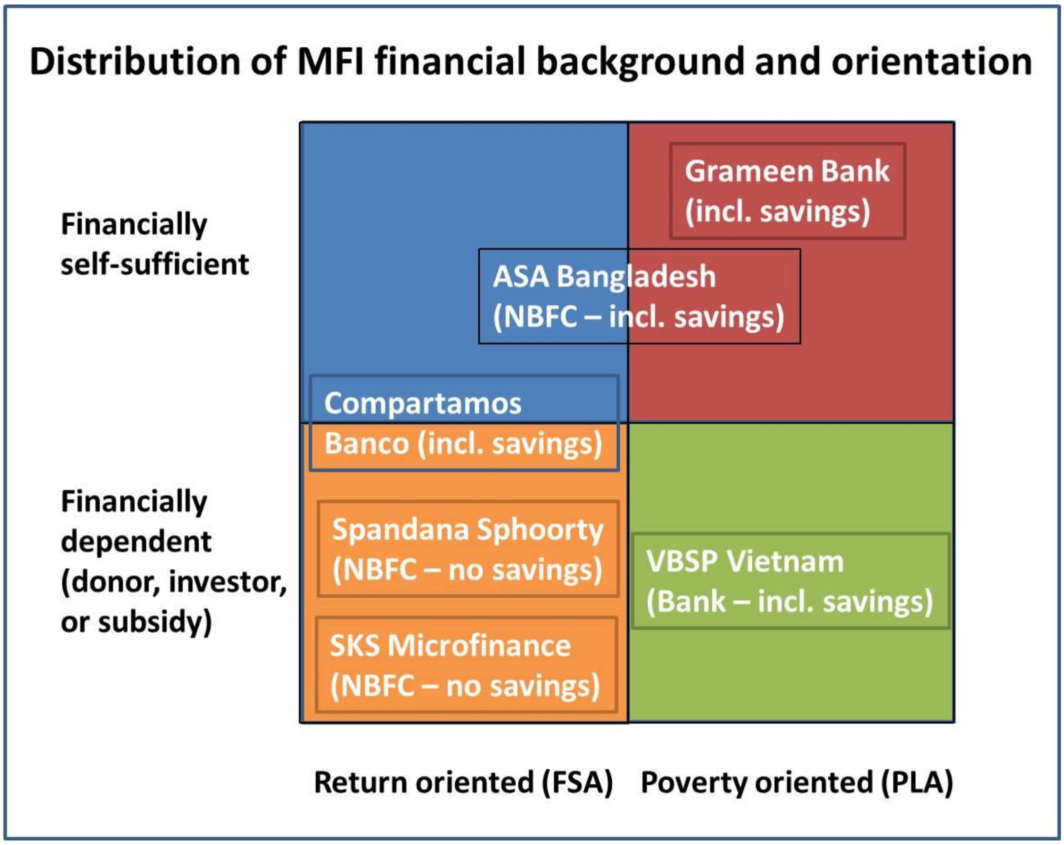

Figure 4: Distribution of MFI financial background and orientation (adapted by the author from the information of the MFIs presented above)

3.4.2. Consolidated review of the lack of coherence in defining the Microfinance concept in learned writing

The analysis of several up to date definitions of Microfinance, too, has revealed distinct differences and discrepancies, some major and some minor, in the respective underlying understandings of the Microfinance concept in learned writing. For example, it has become visible that most of the cited *objectives* vary distinctively from one to the other, either by simply focussing on different aspects (e.g. Vik compared to Epstein and Yuthas, see above chapter 3.2.5, p.68), or by remaining rather vague in outlining the objective (e.g. Chakrabarti and Ravi compared to Epstein and Yuthas, see above chapter 3.2.3., p.66). In either way, none of the definitions provided is able to offer a comprehensive picture of the essential elements addressed with the Microfinance activity. Consequently, these differences and the absence of clarity in the definitions are reflecting the lack of coherence existing in learned writing with reference to defining the Microfinance concept.

3.4.3. An aggregate perspective as a means to extract the intrinsic elements of a coherent and transparent Microfinance concept

However, when looking at the stated definitions and approaches from an aggregate perspective rather than focussing on the differences between them, it goes without saying that, as a whole, they have been able to assemble many topical elements of Microfinance which appear intrinsic for defining comprehensively a coherent and transparent Microfinance concept.

In fact, the majority of the stated definitions and approaches aim at providing answers to the following three fundamental questions:

1. Which overall *objective* is being pursued, e.g. “social intermediation” (CHAKRABARTI and RAVI 2011, p.127), “alleviate poverty” (ASA Bangladesh, see above chapter 3.3.5.,p.82), “economic development” (EPSTEIN and YUTHAS 2010, p.35), or “to combat exclusion and dependency” (VIK 2010, p.293),

2. *To whom* the service should be provided, e.g. “small scale entrepreneurs” (CALIDONI and FEDELE 2010, p.330; see also above Compartamos Banco, chapter 3.3.4., p.80), “those excluded from the formal financial system” (CHAKRABARTI and RAVI 2011, p.127) “small borrowers, most of them poor” (SHARMA 2011, p.89), or “poor women” (SKS Microfinance, see above chapter 3.3.3., p.77),

3. What the Microcredit is used for, e.g. “business investment” (EPSTEIN and YUTHAS 2010, p.35; see also above Compartamos Banco, chapter 3.3.4., p.80), “establish or expand a simple income-generating activity” (BATEMAN 2010, p.1), to create jobs (see VBSP above, chapter 3.3.7., p.88),

Furthermore, the term “Micro” would normally imply that the size of the Microcredit serves as a distinctive feature and needs to be included as typical element in a coherent and transparent concept of Microfinance. Surprisingly, however, the real size of the “Micro-“ credit may be considered less relevant as an element of such concept. Even though some of the authors in learned writing above mention the word “small-scale” with respect to Microfinance, none of them proposes a limit in the amount of money extended. As far as the Microfinance Institutions are concerned, they may indeed provide different credit ranges, yet mostly in order to divide their credit portfolio in several types of credit (see, for example, Compartamos Banco, chapter 3.3.4., p.80). In fact, the true distinctive feature of a Microcredit compared to a traditional credit is not the size, but typically the fact that a Microcredit is *collateral-free*, whereas in formal banking credits are securitised in form of collateral. Hence, Microcredits are typically extended to individuals not endowed with collateral and thus not served by the traditional banking sector (see, for example, CHAKRABARTI and RAVI 2011, p.127; see SHARMA 2011, p.89; see EPSTEIN and YUTHAS 2010, p.35; see above chapter 3.3.2., p.75). As it was shown previously in chapter two of this part (see above chapter 2.4.2., p.48), the group lending and joint liability principle adopted as alternative to traditional collateral in the Microfinance market turned out to be a doubtful practice by disguising the true amount of credit failures and by relieving credit providers to a large extent from their risk. Hence, the task of a new Microfinance concept will be to find a satisfying answer to the question,

4. How a Microcredit is securitised reasonably, if it is collateral-free.

Finally, most of the stated definitions and approaches suggest that Microfinance should provide financial services beyond extending credits, in particular, savings, deposits or insurance services (see, for example, CHAKRABARTI and RAVI 2011, p.127; see EPSTEIN and YUTHAS 2010, p.35; see ASA Bengladesh, chapter 3.3.5., p.82; see Grameen Bank, chapter 3.3.2., p.75). Therefore, the last relevant element for defining a Microfinance concept is:

5. Which services beyond credit need to be comprised in the Microfinance offer.

Summing up, the review of several publications in learned writing and some major Microfinance Institutions revealed and demonstrated a distinct lack of coherence and transparency in defining the Microfinance concept. Nevertheless, by consolidating the results of the review from an aggregate perspective it was possible to extract a set of intrinsic elements as a basis for defining such concept. It should contain answers to five fundamental questions, namely which overall *objective* is being pursued, *to whom* the service should be provided, what the Microcredit is *used* for, how a Microcredit is *securitised* reasonably, and which *services beyond credit* need to be comprised in the Microfinance offerings.

4. Insights gained from analysing the Microfinance sector

Having studied in detail the development of the Microfinance sector, having analysed the challenges it is facing and having successfully identified their root causes the following chapter assembles the major insights gained thereby concluding the first part of the study.

4.1. The vast discrepancy between factual and perceived Microfinance

In this first part of the study, a comprehensive analysis of the Microfinance sector and its development over the past 40 years was conducted. It revealed that by now the original idea, i.e. poverty alleviation, is no longer the primary objective of Microfinance service providers, mainly due to a change in general policies. Instead, the commercial aspects of Microfinance, financial self-sustainability and institutional growth, in particular, are at the core of the so called “Financial Systems Approach” implemented in nearly all Microfinance Institutions active nowadays. Furthermore, it was shown in the analysis that the Microfinance sector is suffering from several major shortcomings:

1. A profound lack of economic impact by Microfinance to date (see above chapter 2.2., p.36)

2. The vast dominance of consumptive instead of productive deployment of Microcredits (see above chapter 2.3., p.42)

3. The heavy increase in commercial excess and abusive behaviour by Microfinance providers (see above chapter 2.4., p.46)

4. The absence of an effective regulative framework within the Microfinance sector (see above chapter 2.5., p.54)

Surprisingly, the public perception of Microfinance is almost opposite to the findings presented. According to the public opinion Microfinance is a driver of economic development and considered to play a major part in eradicating poverty in the world. For example, the UN-millennium goals have been calculated by relying heavily on the positive effects of Microfinance. In fact, however, the Microfinance market has become a place for extremes with heavy discrepancies: Large growing MFIs with an enormous financial power and business success on the one extreme, hardly any verifiable economic impact for the borrowers manifested by the dominance of consumption credits instead of the promised productive investments, and suicide waves of borrowers due to over-indebtment and abusive practices on the other.

What can be said at this stage is that it is very doubtful for Microfinance to ever have a positive economic impact as long as it continues to pursue its actual controversial direction. There are, of course, great examples of Microfinance providers which are devoted to helping poor people to help themselves and which have based their business conducts around it, namely Yunus and his Grameen Bank. However, these positive examples tend to be the exception and they seem to be representing the minority. Grameen Bank and their Microfinance approach, even though reaching an impressive 8 million borrowers by now, are a unique case and they only account for around 4 percent of all Microcredit borrowers in the world. The remaining 192 million Microcredit borrowers are served in a different way.

4.2. A Practice without (scientific) proof – The need for a macroeconomic assessment of Microfinance

While analysing the Microfinance sector, it soon became clear that Microfinance is a pure practice which lacks theoretical foundation. It claims for itself to be a tool for providing beneficial impact to the economy, even though a scientific growth theory proving or confirming this assumption does not exist.

While the early and the leading practitioners of Microfinance, like Yunus, have missed out on the chance to strengthen their Microfinance models by elaborating a fundamental scientific theory (see above chapter 2.1.2., p.32), it is important to recall that in learned writing the vast majority of research on Microfinance has been conducted only from the late 1990s onwards (see above chapter 3.2., p.64), i.e. many years after the beginnings of Microfinance practice and, in fact, at a time when Microfinance was already established and no longer considered an experiment, but a practice that was said to work without any constraints. Therefore, it needs to be assumed that learned writing did not embark on its research by questioning the fundamental aspects of Microfinance, but probably took them for granted. Instead, the research conducted took place on the microeconomic level and was application-oriented: they dwelled largely in field work studies to measure impact and financial sustainability, or they assessed special fields like behavioural economics designed to identify repetitive patterns useful for Microfinance practice. Hence, developing a fundamental macroeconomic growth theory has not been the objective by learned writing, as far as can be seen. Thus, it is perhaps not entirely surprising that, so far, there is hardly any coherence in defining the Microfinance phenomenon in learned writing. However, in view of the serious problems the market is nowadays facing Microfinance needs to undergo such a profound macroeconomic assessment the aim of which should be to find out whether, and under which economic conditions, it is capable to have a beneficial impact on the economies it is applied in.

4.3. A market without customer protection – the need for regulating the Microfinance market to overcome asymmetric information

The analysis of the current Microfinance sector has revealed another dilemma persisting in the market in a distinct form: Heavy asymmetric information among market participants (see also DUVENDACK et al.2011, pp.8-9).

More precisely, the designated customers of Microfinance are to the largest extent individuals with a limited background and experience in finance. Their first contact with finance is either through the local moneylender or through a Microfinance Institution. At this point their information status on finance is considered to be close to zero. Interestingly, many Microfinance Institutions claim to "help" their clients in the beginning by teaching them the basic principles of finance, before lending out to them, for example, SKS Microfinance (see above chapter 3.3.3., p.77). However, more correctly it should be described as teaching them THEIR specific principles of finance, i.e. according to *their* business approach including *their* respective understanding of Microfinance and *their* costs of borrowing. The borrowers lacking alternative offers and comparable information have no choice but to assume the presented form of financial intermediation to be normal. Thus, given their limited knowledge and the lack of comparable options, they are unable to differentiate between supportive or abusive lending practices, in general.

As a consequence of this dilemma, and in view of the increase in abusive and excessive behaviour amongst Microfinance providers, the introduction of customer protection measures may be considered a necessity, without a doubt. Unfortunately, any aims to regulate the Microfinance market have been unsuccessful so far, but have provoked severe crises in the respective regions instead. Consequently, a regulatory authority capable to supervise and control the Microfinance market has not been successfully implemented in any region, too, as far as can be seen.

The difficulty for authorities in implementing regulative measures is that they do not know how to stop abuse and excess without stopping the whole industry. And, aggravatingly, they do not know where to start: the Microfinance practice is tremendously diffuse and scattered. It lacks a commonly accepted basic understanding and definition of the Microfinance concept and its intrinsic elements providing regulatory authorities with an anchor to base their regulative measures upon. For installing effective regulative measures in the Microfinance sector and implementing desperately needed customer protection elaborating such concept would be of critical importance.

4.4. A principle without guidelines – the need for a coherent Microfinance concept including credit classes providing transparency and enabling effective regulation

After studying the somewhat confusing interpretations of Microfinance circulating in both Microfinance practice and research (see above, chapter 3, p.61), it became clear that Microfinance has become a very elastic term over the last 40 years with more or less each participant adopting their own understanding and definition of Microfinance causing a widespread confusion about its real meaning and its objectives (see also BAHRA 2009, p.50). In fact, a coherent, clear-cut definition of the Microfinance concept which specifies objectives, designated recipients, and other conditional factors has not been provided for. Instead, most of the written contributions in Microfinance prefer remaining in vague descriptions of what Microfinance is, in general.

Nevertheless, a consolidated review from an aggregate perspective of both Microfinance definitions in learned writing and Microfinance approaches in practice has revealed that there are five central aspects to be considered in a coherent and transparent definition of a Microfinance concept (see above chapter 3.4., p.91):

1. A clear general *objective* serving as a guiding line, e.g. to promote economic development or to fulfil consumption desires,
2. *To whom* the Microfinance service is directed, e.g. economically active individuals or consumers,

3. How the capital should be *deployed*, e.g. productive investment or consumption,

4. How the credit should be *secured*, e.g. by some form of collateral or by group lending or otherwise,

5. Which services beyond credit are comprised in the Microfinance offer, e.g. insurance or savings.

Such elements may not only be used as a point of reference for defining a Microfinance concept, but also for creating credit classes in Microfinance which may act as a guideline for Microfinance practice and which may provide the long desired transparency in the market to all participants. In this sense, depending on the respective objective, whether it is the financing of urgently needed medical treatment, or whether educational efforts are being financed this way, or even whether the objective is to support mere consumption, a Microfinance service would have to comply with certain pre-defined requirements based on the five intrinsic elements in order to receive a classification. This way, all participants in the Microfinance market, borrowers, providers, investor, donors and the public, would be able to make the difference between, for example, Microfinance supporting consumption, which at present the vast majority of Microfinance is spent on, or, for example, Microfinance supporting economic development, which at present represents only a rather small proportion of Microfinance.

Furthermore, this form of classification may be used as a starting point for implementing effective regulative measures in the Microfinance market which previously had been impossible due to the incoherent and non-transparent understanding and approaches of the Microfinance principle (see also above chapter 4.3., p.98).

SUMMARY

1. In the course of the last 40 years Microcredits have transformed from an experiment into a large Microfinance industry offering credit, at times also savings and insurance services to many millions of borrowers. The first 20 years of Microcredit lending were marked by subsidised, non-profit business conducts according to the so called Poverty Lending Approach (PLA). This changed in the 1990s, when the major development organisations urged for the introduction of the Financial Systems Approach (FSA) gradually pushing the market towards financial self-sustainability of Microfinance Institutions. The aim was to achieve independence from the limited sources of donations and subsidies, but to tap the apparently endless resources of the financial markets which were supposed to help increase substantially the Microfinance growth and outreach. Investors in Microfinance, however, could only be attracted by considerable returns on their investments. Thus, the Microfinance Institutions started implementing for-profit approaches and more or less the whole sector was commercialised. The original purpose of Microfinance, the alleviation of poverty, became a secondary target. This change of paradigm eventually led to several severe crises in the Microfinance sector in the new millennium. While the majority of MFIs prospered financially and were sometimes able to raise extraordinary sums with IPOs, several reports of suicide waves of Microcredit borrowers due to over-indebtment shocked the Microfinance movement. It became obvious that the Microfinance business did not seem to work as well for its borrowers as it did for its providers.

2. The question is how it was possible that the Microfinance activity, originally designed to help the poor escape poverty, could provoke desperation and hopelessness amongst some of its borrowers instead. For many years, the majority of scientific field studies concluded a beneficial impact of the Microfinance activities on the economy and on poverty reduction. Some of these studies, however, have been revised, meanwhile, and, in accordance with more recently executed studies, it

was finally concluded that Microfinance did *not* have any beneficial impact on the respective economies since its introduction and that it thus has not helped reduce poverty. Previous studies, as it seems, focused on the analysis of short-term financial data, only, which have shown to be insignificant and too one-sided for measuring the economic impact of Microfinance, particularly for borrowers. More recent studies have added further long-term and social values to the assessments and it turned out the economic impact was close to zero.

3. One major reason why Microfinance did not achieve any economic impact, so far, may be that the vast majority of Microcredits has been used for consumption rather than for income generating activities, as recent assessments have shown. Consequently, when borrowers use the credit to purchase goods which they normally cannot afford, they will inevitably struggle with the capability to repay and suffer, hence, from over-indebtment. Consumption alone is not able to fuel economic development, particularly when it is financed with debts rather than with surplus capital generated from economic activity.

4. The rise of consumption in the Microfinance sector may be seen as an immediate by-product of the rise of commercialisation. With the introduction of the Financial System Approach (FSA) the poverty alleviation objectives of Microfinance became secondary to the objective of financial self-sustainability of Microfinance Institutions. In the pursuit of attracting sufficient investor capital and in order to provide the appropriate figures in their balance sheets, meanwhile, Microfinance Institutions were under constant pressure to grow and to be ultimately successful in their business. In order to keep growing, more and more credits had to be extended. As identifying borrowers with productive investments takes much more time and is more complicated, some MFIs tended to disregard what customers used their credits for, as long as they repaid. Logically, this led to a rise of consumption credits invested in food, TV and other non-productive goods. At the same time, using the group lending system was an excellent way to secure repayment and ensure positive financial data, as groups usually recover the loans reliably due to the joint liability obligation. In cases where the group liability system was not in use,

Microfinance Institutions explored different, sometimes rather violent methods to retrieve their interest rates and their money, with terrible consequences for some borrowers, who either committed suicide in despair or were even made to commit suicide, so that their life insurance, which at times is a condition for loan approval and very often also sold by the same MFI, can cover the remaining debt. Furthermore, one was led to believe at several stages that customers did not apply for a credit themselves, but have been more or less seduced to accept a loan even though they did not need it.

5. Altogether, the Microfinance sector experienced a considerable rise of commercial excess and an increasing implementation of abusive lending methods which, unfortunately, remained unnoticed and undisturbed by the state authorities for a long time. There is still no effective regulative power existing capable to control the market which tends to be heavily diverse. Any aims to introduce regulative measures in response to the rising numbers of abuse and commercial excess in the respective markets have led to substantial repayment crises, punishing those, too, who did not apply any abusive patterns in their Microfinance approaches. Naturally, they opposed heavily to any aims to regulate the market, while policy makers insisted on such measures in view of the catastrophes the abuses had caused.

6. Indeed, regulation of the Microfinance market may only work if it is based on a coherent fundamental concept of Microfinance which prevails in the Microfinance practice. The question is whether there exists such a concept or rather definition of Microfinance which is generally accepted and practiced throughout the industry.

The analysis of several publications in learned writing revealed a lack of coherence in defining the concept of Microfinance. Especially when it came to defining to whom the services should be provided and for which objective they should be extended no clear consent existed. In fact, researchers either remained vague in their formulations or they only focused on single aspects instead of being comprehensive.

When looking at the Microfinance practice and at some major Microfinance Institutions active in the field, it goes to show that they work with very different approaches and under different settings. Some work as banks, which may be state owned or private, others as NBFCs and others as NGOs, with an immediate impact on whether they offer credits, only, or savings in addition. Some work purely investor related, others allow their clients to participate in their success. Some depend on subsidies, others on investors. All these influences have shaped considerably the respective understandings and approaches of Microfinance which very often do not have a lot in common and which thus lack transparency.

However, when looking at the stated definitions and approaches from an aggregate perspective, it becomes apparent that both definitions and approaches contain many interesting aspects which provide an important clue about how to approach defining a Microfinance concept. Thus, by consolidating these aspects it was possible to extract five intrinsic elements which may form the basis for defining such concept in a coherent and transparent way. It should include:

- which overall *objective* is being pursued,
- *to whom* the service should be provided,
- what the Microcredit is *used* for,
- how a Microcredit is *securitised* reasonably, and
- which *services other than credit* are comprised in the Microfinance offerings.

7. Overall, the analysis of the Microfinance sector in this part of the study has provided several important insights which may have lacked sufficient attention in the debates about Microfinance, so far. First of all, it must be noted that there is a vast discrepancy between factual and perceived Microfinance. In fact, even though Microfinance has not been able to provide a positive economic impact in 40 years of practice, the public opinion still believes Microfinance to be a decisive tool in fighting poverty. Furthermore, Microfinance has revealed itself as a practice without scientific proof. It is a tool claiming to attain a beneficial impact. However,

it has never been assessed scientifically, whether, and under which circumstances, such objective may eventually be achieved. Thirdly, in view of the heavy increase in abusive and excessive lending practices in the market, the need for regulative measures is evident. This need, however, is extended to a necessity by the fact that Microfinance borrowers usually suffer from a distinct form of asymmetric information: they usually lack any knowledge in finance. They are therefore in a particular need for protection which, unfortunately, the Microfinance sector is unable to provide as of today. Lastly, it has been observed that Microfinance acts like a noble principle, however, without any guidelines to follow. More precisely, Microfinance is merely an umbrella term for a multitude of different understandings and interpretations which are hardly comprehensible. Typical credit classes can neither be identified nor any regulatory measures be effectively implemented this way. Hence, a coherent concept of Microfinance needs to be elaborated providing for a generally accepted and transparent practice of Microfinance, enabling a general breakdown in credit classes and, finally, allowing regulatory measures to anchor in and to be put into effect.

III. THE ROLE OF (SMALL-SCALE) MONEY AND CAPITAL IN THE CONTEXT OF LESS DEVELOPED COUNTRIES – AN ALTERNATIVE APPROACH TO ECONOMIC DEVELOPMENT PROVIDED BY McKINNON

Microfinance is known worldwide as a tool for helping alleviate poverty. More precisely, it is supposed to provide borrowers with the opportunity to start, or invest into, some form of income generating activity. Such investment would increase their wealth eventually and would thus have a beneficial impact on their economic development. However, as demonstrated in the previous part (see above part II., chapter 4.2., p.97), Microfinance lacks a scientific macroeconomic analysis providing proof of its capability to attain economic impact. Such gap needs to be closed urgently, especially because so far it may be resumed that Microfinance was not able to fulfil sufficiently the stated objective of having a beneficial economic impact (see above part II., chapter 2.2., p.36). It therefore needs to be clarified through a macroeconomic analysis whether, and under which conditions, Microfinance is capable to enhance economic development.

In view of the lack of basic research in Microfinance, the following part endeavours to approach such research by changing to a macroeconomic perspective and by assessing fundamentally the role of money and capital for economic development in the context of less developed countries (LDCs) where the vast majority of Microfinance business is happening. The aim is to retrieve fundamental insights on the specific macroeconomic conditions prevailing in these economies and to understand how to successfully enhance economic development with the provision of finance. Consequently, the aim is to draw valuable conclusions for Microfinance therefrom to be processed in the next part of this study, where a Microfinance concept designed to enhance economic development in LDCs shall be elaborated.

Interestingly, in 1973, a rather unknown study on financial economic development in LDCs has been published by McKinnon which appears to be highly useful for attaining the stated objectives, especially in the context of Microfinance: it not only analyses the role of money and capital in the process of economic development in LDCs, thereby including the use of “very small credtis” – nowadays also known as Microcredits. But it also refers to the specific economic conditions present in LDCs which appear quite different from those present in developed economies, in particular as concerns their capital market structure. As a result, McKinnon’s development approach turns out to be fundamentally different from the established growth theories. In view of the lack of success of current development and growth approaches in LDCs, such alternative approach makes McKinnon’s study even though it dates back to 1973 highly topical and thus worth recapitulating and reconsidering from a modern perspective in this part.

1. Background note on McKinnon’s publications

In view of the numerous other publications by McKinnon up to today, the question arises whether a more recent publication than his first book from 1973 exists which may be more suitable for use in this study.

In an email to the author of this study (see also attachment 24), McKinnon named his book “The Order of Economic Liberalisation: Financial Control in the Transition to Market Economy” (2^{nd} edition) from 1993 as the legitimate successor of his first book from 1973. This goes to show that, in his later studies, he was not concerned primarily with deepening the basic questions of economic development within less developed economies, namely in which way, and under which circumstances, money and capital, even if small-scale, may help promoting economic development in LDCs, a question highly relevant for understanding how Microfinance may be able to succeed in the same way. Instead, in his book from 1993, he was focussing specifically on assessing ways for economies to alleviate economic transition and transformation processes towards financial liberalisation. Even though this book provides many valuable insights to the reader, its emphases as regards content are, nevertheless, less relevant for analysing the Microfinance principle than those dealt with in his first book from 1973.

Additionally, McKinnon was not – and perhaps not able to be, at all – aware of a possible interrelation between his first book and Microfinance which may be a reason why he did not further pursue and develop his basic approach. In his email to the author of this study McKinnon confirmed that he had not been thinking about such connection and that his book did not mean to contribute to a theoretical framework for Microfinance in the first place. This is less surprising as, at the time, Microfinance had not been an issue in development politics and practice yet. In fact, Yunus had started his Microfinance experiment three years later, in 1976.

2. Introducing McKinnon's growth theory from 1973

The leading modern theories of market economy, such as the neoclassical concept, Keynesianism and Monetarism, are all based on structural conditions which are usually associated with developed economies. Such conditions comprise, for example, the regular supply of money and capital on the one hand, and a certain mature framework of financial intermediation (services, borrowing, lending) on the other. The question is whether and to what extent the modern theories of market economy also apply to LDCs, i.e. whether in the context of LDCs the same underlying conditions are met. At first glance, the specific economic situation of LDCs seems to be quite different if compared to developed economies. The very concept of LDCs seems to imply a deviation in substance which may be major or minor, just depending on the actual situation of the particular economy at hand.

What can be said in general is that traditionally the concept of LDCs reflects a situation which is characterised by the absence of an *overall* economic development. Furthermore, such development is typically impaired by an apparent *shortage of money and capital* in LDCs. In particular, these countries were supposed to be incapable of generating sufficient capital needed for economic growth. At the same time, injecting large amounts of foreign capital into those economies could only be considered to have short-term beneficial effects. It would not suffice to build a sound and long-term oriented growth rate of the economy.

However, some of the LDCs were able, in recent years, to assemble a large amount of capital which is mainly state controlled and is not accompanied by more liberalised structures in trade, industry, and banking. Their state funds seem to play an increasing role, even in the international field. Other LDCs report a growing economic activity of the elite sectors of the population, yet without a participation of the vast majority of the population.

Interestingly, the relationship between money, capital, and economic development has already been analysed by McKinnon in 1973. In his fundamental study “Money and Capital in Economic Development”, his first book, he examined the vital role of money and capital in the process of economic development in LDCs. Surprisingly, his analysis also referred to the opportunities of economic growth generated by granting “very small credits” – nowadays known as Microcredits – to the poor rural population generally neglected by the capital markets. In fact, he integrated these very small credits as part of a fundamental economic growth theory thereby providing some highly topical insights about the conditions under which money and capital may help enhancing economic development and alleviating poverty. Moreover, he adapted his approach to the specific economic situation prevailing in Less Developed Countries (LDCs), in particular as concerns their capital market structure which differs considerably from that present in developed countries. Hence, analysing his elaborated development approach may allow drawing valuable conclusions for Microfinance and its objective to enhance economic development.

The presentation and analysis of McKinnon’s approach will be displayed in the following steps. In the next chapter, the addressees of his study will be specified, i.e. the LDCs McKinnon is referring to. Thereafter, the typical financial problems occurring in LDCs shall be outlined. In the fifth chapter, McKinnon’s fundamental approach to generate economic development in LDCs will be displayed, followed by a presentation of McKinnon’s suggestions to tackle the prevailing problems in LDCs in order to implement his ideas of economic growth and to build up a stabilising framework of financial market conditions. After discussing some of the critical reactions following the publication of McKinnon's concept, the merits of McKinnon's concept in today's development policies will be presented. Part III of this study then concludes by reflecting on the essential and topical findings from McKinnon's concept for this study.

3. Less developed countries (LDCs) as addressees of McKinnon's concept

When referring to LDCs McKinnon (1973)[1] is primarily dealing with semi-industrial countries, i.e. with

> "those that have made more or less autonomous efforts to industrialise or to develop some commercial agriculture, perhaps with the help of capital inflows from abroad or foreign technical assistance" (McKINNON 1973, p.2).

Judging from the conditions present in the 1970s, McKinnon includes countries like Brazil, Pakistan, Chile, Korea, and Turkey in the circle of LDCs. African economies, however, are not mentioned since they had not reached the status of a semi-industrial country or rather LDC at the time. Socialist economies are not referred to in detail either (see McKINNON 1973, p.2). The list of countries is not conclusive and McKinnon acknowledges the differences of the pace of development which varies from country to country.

It is worth noting at this stage already that nowadays the circle of LDCs has broadened. Some of the socialist economies like China have opened up to the world market and have gained a major influence on it since. At the same time, China is among what is now referred to as the "BRICS-states" comprising **B**razil, **R**ussia, **I**ndia, **C**hina, and **S**outh Africa. Their economies dispose of a vast potential and impress with extraordinary growth rates, yet without having reached the status of a fully developed country due to the lack of an overall economic development with the vast majority of growth taking place in the elite sectors, only. Thus they would count as typical LDCs from McKinnon's angle. Furthermore, South Korea,

[1] From now, whenever McKinnon is referred to in this study, the statements are associated to his book from 1973, only.

Taiwan, Hong Kong, and Singapore, together sometimes named the "Tiger-states", have reached the status of strong LDCs due to an enormous economic development in the 1980s, even though their growth has slackened considerably since the Asian economic crisis in 1997.

Interestingly, Brazil has remained in McKinnon's group of LDCs whereas Russia, India, South Africa and China are important new group members from a modern perspective. Other countries, like Argentina or Chile, have gone through severe economic crises during their development process, which means that it is doubtful nowadays whether they still have the status of an LDC originally accorded to them by McKinnon. As far as Chile is concerned, such doubts seem to be unjustified by now as the country has performed a stable yearly growth rate of 5.5 percent during the past 15 years (KRUGMAN et al. 2012, pp.363-364). In the case of Pakistan, the economic situation is almost similar to that of India. Both countries dispose of atomic weapons, a fact which implies a certain degree of economic development. As a result, Pakistan, although not included in the circle of the BRICS-states, may still be considered as forming part of the group of LDCs as described by McKinnon.

As far as Turkey is concerned, the ambition of joining the European Union is reflecting a continuous process of industrial development which, however, has not entailed a status of full economic development as yet. Hence, Turkey is to be considered as having remained in the group of LDCs as defined by McKinnon. Additionally, some of the former socialist East-European states (e.g. Ukraine, Romania, Bulgaria, Hungary) may nowadays count among LDCs, although some of them have already joined the European Union. The status of the African economies has practically remained unchanged, with the exception of South Africa which is probably the most developed economy of the African continent. Having successfully hosted the Football World Cup in 2010 and being part of the "BRICS"-states as of late, it may be assumed that South Africa has already entered the group of LDCs within the meaning of McKinnon. On the American continent, countries like Mexico and Argentina have also gained the status of LDCs, meanwhile. The same applies to Vietnam and Bangladesh in Asia, which are both disposing of a growing industrial sector well known for their textile production, however, with the majority of the population still working in inferior rural agriculture.

Summing up, it is obvious that the number of countries qualifying for the status of LDCs as styled by McKinnon has increased tremendously. The examples listed here are not conclusive and it may be assumed that since the publication of McKinnon's study in 1973, the number of LDCs has more than doubled. As described by McKinnon, the key characteristic of LDCs may be denoted as the semi-industrial state of their economies, i.e. a strongly growing industrial sector, however, still rather small when compared to the dominant rural agricultural sector. Furthermore, a "fragmented" state of the economy (see below chapter 4.1., p.113) is typical for LDCs usually manifested in an extreme divide between highly developed industrial technologies in a few economic centres and largely backward and inferior technologies in the poor rural regions.

4. The origins of financial problems in less developed countries

Having defined the LDCs McKinnon goes on to lay down the foundations of his concept. He is not primarily concerned with social or humanitarian aspects of LDCs. His point of departure is to look at the problems of LDCs from a financial point of view. In fact:

> "Money and finance, as governed largely by the banking system, are given a degree of importance much greater than that accorded by most authors concerned with development" (McKINNON 1973, p.2).

This financial approach allows McKinnon to shed some light into certain shortcomings which frequently occur in the context of the economic activities of LDCs. An obvious difficulty for most of the LDCs seems to be a general lack of money or rather of available capital serving to finance productive investments. The lack of money and capital, however, is only a symptom of a problem the source of which lies deeper underneath.

For McKinnon, the root of the problem, including the obvious lack of capital but also the lack of an overall economic development in general, is to be found in the malfunctioning of the domestic capital market. In his eyes, the domestic capital market and the way it is influenced by economic policies play a key role in economic development (see McKINNON 1973, pp.2-3).

More precisely, McKinnon defines the general state of the economies of LDCs as suffering from **fragmentation** in the sense that

> "firms and households are so isolated that they face different effective prices for land, labour, capital and produced commodities, and do not have access to the same technologies" (McKINNON 1973, p.5).

According to McKinnon, fragmentation has its origin in colonialism, but has since been reinforced by **financial repression** in the domestic capital market as well as by the **manipulation of the foreign trade sector**. Government intervention, even if well intended, is said to be mainly responsible in so far.

4.1. Fragmentation and its manifestation on the capital market

The fragmented economy, as defined above, is marked by heavy distortions in that way that firms and households face different effective prices for the same commodities, amongst them capital. Taking into account the importance attributed to the capital market for economic development by McKinnon, it will be interesting to get to know into which situation the market for capital has been driven by fragmentation. At first, however, the question arises how LDCs have eventually reached the state of fragmentation and which shape it has taken.

4.1.1. The origin and common manifestations of fragmentation

The state of fragmentation in LDCs has its origin back in colonial times in the sense that at the time the indigenous population was not admitted to participate in any major economic activity. They were deprived of any opportunities to improve their status quo by having no access to capital, no means of acquiring advanced technologies and by lacking skilled labour (see McKINNON 1973, p.6). On the other hand, trade under control of the colonial power which held the primary export enclaves flourished and developed. The soil for fragmentation was hereby set and prepared.

Newly independent governments felt compelled to intervene in order to offset both political and economic colonialism, e.g. by introducing new industrial branches to the country to replace previously imported industrial goods (see McKINNON 1973, p.6).

The intervention policies, however, focused on manipulating commodity prices and on help for some individuals and single sectors, at the expense of the others which did not benefit from government intervention. For example, some industries received high tariff protection whereas most of the others remained unprotected, or an indigenous firm was given an import license, while for others the import of that specific good was prohibited (see McKINNON 1973, p.6).

The results of these policies now mark the economic landscape of LDCs and can be considered as typical manifestations of fragmentation. For instance, small household enterprises are in contrast to large corporate firms which both dispose of a similar range of products, but work with very different factor proportions and a remarkable difference in technological efficiency. Another example is the high and still ongoing mechanisation in farms and in factories while heavy rural and urban unemployment coexist. Excess plants and equipment with underutilised capacities is a sign of shortage of capital in an economy and represents a further typical appearance of fragmentation. As for indigenous firms, they exist marginally, but have to be kept alive with heavy government subsidies and with preferred rights like import licences and tax concessions as well as financial guarantees to investment opportunities (see McKINNON 1973, pp.7-8).

In short, the notion of fragmentation as understood by McKinnon serves to describe the shortcomings involved in an unbalanced economic development process suffering, i.a., from the malfunctioning of the domestic capital market.

4.1.2. The situation on the capital market in LDCs: Costly credit dependence on the usurer on one extreme, cheap state-given credit guarantees on the other

The major concern of McKinnon is directed towards the capital market in which he sees a key role in promoting, or hindering, economic development. The manifestation of fragmentation on the capital market can be derived from McKinnon's definition of fragmentation according to which

> "firms and households face different effective prices for *capital*" (McKINNON 1973, p.5, *italics mine*).

The difference of prices as such is less surprising, since according to Irving Fisher "the effect of risk...is to lower the rate of interest on safe loans, though at the same time...it will raise the rate of interest on unsafe loans..." (FISHER 1930, p.218).

The reality in LDCs is, however, that a huge part of the population has practically *no* access to loans and to the capital market at all (see McKINNON 1973, pp.10-11). The main problem is that financial institutions have not spread throughout the country. Hence organised financial services have not become available to large parts of the population (see McKINNON 1973, p.16). The situation on the capital markets in LDCs can therefore be described as follows (see McKINNON 1973, pp.12-16, 69-72; see also ARMENDÀRIZ and MORDUCH 2010, pp.31-33):

In larger towns with economic centres the financial infrastructure is more or less complete whereas in the poor rural areas bank offices are hardly found. People in the latter areas are dependent on the local moneylender ("usurer") if they are in need of money, e.g. a farmer who wants to buy seeds for the next harvest. The moneylender himself will use his monopolistic position to get the highest return out of the deal by lifting interest rates up to the boundary which goes way beyond what would be the market price reflecting the true economic scarcity of capital. Interest rates may reach up to more than 100 percent and make a long-term money-lending virtually impossible. The return for the farmer then, supposing there is no crop failure, will be sufficient to repay the moneylender, but will leave hardly any gain for himself, perhaps just enough to live on, which obliges him to come up to the moneylender again for the next harvest.

The consequence of this dependency and the abuse of the monopolistic position by the local moneylenders is the stagnancy in rural development. People are not able to modernise their production processes and to improve their productivity by taking up long-term investments.

In contrast, firms and households living in the economic centres have the opportunity to benefit from the existing financial networks. Banks are present and normally capable to give long-term credit to clients with an appropriate investment plan. However, it has become commonplace that specific sectors or firms receive an extra support by the government via subsidies. The aim here is to promote their industry and make them competitive vis-à-vis foreign industries producing an equivalent product. In most cases the supports provided are credit guarantees at low interest rates, not reflecting the true economic scarcity of capital either.

It is in this way that the market for capital is heavily distorted. Some industries have a virtually guaranteed access to capital whereas many others do not even have access to the capital *market*. Additionally, capital in LDCs is scarce and the few preferred industries already consume the majority of the capital available at low rates with no return for the banks. This leaves even less for the unprotected industries to go for and many promising investment opportunities are forgone.

In total, with government intervention the market mechanism has not improved and for some parts even worsened when it has turned into an indicator of social advantage. McKinnon therefore judges modern fragmentation as having been

> "largely the result of government policy that goes beyond the old distinction between the old export enclave and the traditional subsistence sector" (McKINNON 1973, p.6 f.).

The failure of the market mechanism becomes evident in particular when considering that the poor parts of the country remain without access to capital or rather to external financing at an interest rate reflecting its true economic scarcity. Their chances to change their underprivileged situation are reduced to a minimum.

4.2. Financial repression in the domestic capital market

McKinnon considers the situation on the domestic capital market of LDCs, as described above (see chapter 4.1.2., p. 115), to be to a major extent the result of government intervention policies. When such intervention policies lead to organised banking being merely available for certain enclaves like exclusively licensed import activities or for the support of government spending while the rest of the economy must be financed from the inadequate resources of local moneylenders, then McKinnon calls them **financially repressive policies.** Financial repression adds largely to the fragmentation of the capital market (see McKINNON 1973, pp.68-69).

The question is which government policies may be regarded as financially repressive and which influence they have on the processes of the capital market. In this context three characteristics stand up: the implementation of a neo-colonial banking system, the imposition of interest rate ceilings, and the necessity for collateral requirements (see McKINNON 1973, p.69).

4.2.1. Neo-colonial banking system

As for the first characteristic element, financial repression in the capital market has its origin in colonialism, too, just like fragmentation in general. If there were any indigenous entrepreneurs participating in the process of bank intermediation, then they would be depositors rather than borrowers. The funds, however, were mainly controlled by overseas banks and eventually redistributed to those borrowers they knew to have a good reputation or risk-free collaterals. Indigenous entrepreneurship was neglected and left without any financial support (see McKINNON 1973, pp.69-70).

Nowadays, McKinnon goes on to say, with independent governments and newly created central banks in operation, the colonial banks have vanished and have been replaced by a rather similar neo-colonial banking system. In this system, favoured private and official borrowing now absorbs the limited available capital at low interest rates, sometimes below the opportunity cost of scarce capital. Even though many indigenous farmers and industries hold a considerable share of the deposits which are channelled to the favoured enclaves, they again remain financially repressed. The preferred borrowers together with the government use up nearly all of the banks' available resources (see McKINNON 1973, pp.70-71).

4.2.2. Interest rate ceilings

Since the rural population refers to the costly and limited lending opportunities of local moneylenders as stated above (see chapter 4.1.2., p.115), huge interest rate disparities between organised banking and informal rural credit develop where moneylenders tend to abuse their monopolistic position (see McKINNON 1973, pp.71-72).

In reaction, the government often sets up interest rate ceilings on bank loans which, unfortunately, further discourage commercial banks to provide their service to small-scale borrowers. With a maximum interest rate of ten percent they cannot cover the administrative cost of small-scale lending and its inherent risks. The moneylenders' position in the informal sector is thereby strengthened.

4.2.3. Collateral requirements

Interest rate ceilings do not only further restrict bank lending, but also encourage commercial banks to extend their credits to safe borrowers only, whose reputation is known or who dispose of riskless collateral. Even worse, due to the excess demand, the allocation of credit might correspond to the degree of political or establishment connections the potential beneficiary has. Recipients would be most likely importers with exclusive licences or the largest landowners or government agencies (see McKINNON 1973, p.73).

Consequently, as the banks fail to generate sufficient revenue from the low interest rates given to their preferred borrowers, only low rates of return can be granted to depositors. Such rates might as well turn out to be negative if inflation is significant. Naturally, savers react by reducing their holdings of money which in turn leads to a reduction of the overall bank credit (see McKINNON 1973, p.69). Thus, financial repression is an aggravating aspect of fragmentation in the domestic capital market - an insight generated by the financial approach of McKinnon.

4.3. Manipulation of the foreign trade sector

When elaborating his concept of fragmentation McKinnon is also dealing with government intervention in the field of foreign trade designed to circumvent the domestic capital market. This part of his analysis mainly concerns industry and agriculture, and further helps understand the mechanism of fragmentation. In this context, McKinnon classifies seven major categories (see McKINNON 1973, p.22).

4.3.1. Tariff protection for infant industries

In the words of McKinnon, new industries or firms are often said to

> “need protection to cover initial losses, although they will ultimately be profitable at world prices” (McKINNON 1973, p.22).

Such protection is generated by “temporary” tariff or quota restriction on competing goods from abroad, thereby raising the internal price of the domestic product at little immediate political cost. By way of this technique of implementing the import substitution strategy, the surplus is made available to the new industry while it is still in its learning phase, at no specific cost. Obviously, an adequate domestic capital market would provide sufficient funds until maturity is achieved. Under normal circumstances, i.e. without tariff protection, such funds would have to be repaid including interest. Subsidising these industries can only have a short-term effect which may even be detrimental since they will be exposed to real market conditions later on without having had the chance to gain market experience at an earlier stage. Such risks will induce the government to even further extend the tariff protection and to completely deprive the domestic capital market from its function as a financial intermediator in this domain.

4.3.2. Import licences

The next category of foreign trade manipulation centres on import licences granted to a limited number of particular entrepreneurs, in contrast to tariff protection which is non-specific. Usually such import licences are also associated with a low price regime. According to McKinnon the

> "privilege of importing at a low price is another form of subsidy, which, like tariff protection, also increases the wealth or cash flow of producers" (McKINNON 1973, p.23).

Typically, such import licence may enable its holder to obtain external financing more easily as it serves as evidence for the future profitability of his enterprise. However, the social cost of this external financing is the drying out of the domestic capital market. In addition, competition is dampened if the licences are held by a small number of beneficiaries. Should the licences be distributed to a greater number of recipients, then the risk of monopoly building may be reduced while increasing fragmentation of the domestic economy.

4.3.3. Corruption and monopoly privilege

Whether or not the granting of import licences or tariff protection entails a tendency towards corruption, monopoly and a general disequilibrium of the economy is a question which is left open by McKinnon. At a first glance, it may seem likely that the web of privileges could become close to what is generally known as corruption, but there is no evidence in this direction. On the contrary, even McKinnon believes that one might expect corruption not to be more common in LDCs than in appropriately liberalised economies (see McKINNON 1973, pp.24-25).

4.3.4. Cheapening of capital goods

By cheapening of capital goods, McKinnon understands a tendency of the governments of LDCs to foster industrialisation by importing essential goods, whether or not they are licensed, without using the more expensive domestic capital market. This seems to be an inexpensive technique for deploying the economy's surplus toward capital accumulation, but it

> "ignores the need for rationalised inter-temporal and inter-entrepreneur allocations. Of course, it encourages the overuse of imported capital goods" (McKINNON 1973, p.25).

McKinnon acknowledges that this tendency reflects a plausible tenet of the authorities which govern foreign trade policy that imports of "essential" goods should be encouraged while "inessential" ones are kept out if industrialisation is to be promoted. Nonetheless, he is critical about this tenet because it tends to lead to an unbalanced economic development and to fragmentation of the domestic capital market, in contrast to the generally accepted doctrine of uniformly productive capital.

4.3.5. Agriculture's terms of trade

In this paragraph, McKinnon examines the repercussions of government intervention in the terms of trade of agricultural products on the domestic capital market. In fact, if exports of agricultural goods are curtailed in order to secure cheap supplies in urban areas, this will not only devastate rural incomes, but also transfer the rural economic "surplus" to the industrial sector, where investment opportunities are supposed to be more favourable. Thus,

> "the transfer took place through the expropriation of agriculture to provide an unrequited subsidy to industry" (McKINNON 1973, p.26).

At the same time, this policy leads to fragmentation of the capital market within each sector, as well as to their mutual isolation, and the underlying problem, namely the imposed capital constraints and the corresponding imbalance of the economic development, is left unsolved.

4.3.6. Land reform

In the eyes of McKinnon, land reform is another topic suitable to explain the effects of fragmentation of economic sectors. In fact, small landholdings, resulting from inheritance and/or forced-sale patterns, are another example of further fragmentation into tiny parcels. McKinnon observes that land fragmentation, for instance in India, has increased visibly over the past ten years. It is obvious that uncontrolled parcelisation leads to impoverishment and deprives farmers of a sound economic basis for their dwelling. McKinnon advocates

> “that land redistribution should be the principal policy followed in efforts to equalise current and future incomes in agrarian economies” (McKINNON 1973, p.27).

McKinnon goes even further by emphasising that if each farmer had free access to external finance, he could initiate bilateral action to buy contiguous pieces of land from a neighbour without waiting for government action. However, the requisite external finance or internal liquidity is unlikely to be available although land could easily serve as collateral for loans, thereby encouraging agricultural improvements. In a more liberalised environment where the capital market functions efficiently, income redistribution could equalise further agricultural incomes and opportunities (see McKINNON 1973, pp.28-29).

4.3.7. Foreign direct investment and commercial credits

When tackling foreign direct investment and commercial credits, McKinnon deplores the ambivalence of the economic policy of the governments of LDCs. Such direct investment is either welcomed and accompanied by certain privileges or completely abandoned in periods of xenophobia which may include the threat of nationalisation. McKinnon notes that the use of foreign financial services becomes more attractive if the domestic capital is “moribund” (McKINNON 1973, p.29). However,

> “Relying on direct investment from abroad may break the external financial constraint at the cost of relinquishing investment opportunities to foreigners at bargain-basement prices. Domestic entrepreneurial development may thereby be retarded” (McKINNON 1973, p.29).

As a consequence, there is a danger of returning to the “colonial economy” where expatriates operate with access to an external capital market in such a way as to hinder domestic entrepreneurial development.

4.3.8. The downsides of manipulative intervention policies

In this part of his study, McKinnon describes a great variety of examples of manipulation of the foreign trade sector by continuous government intervention. A specific problem lies in that such intervention is ambiguous and contradictory at times. Firms in a particular industry that the government wants to encourage by raising their relative price or by granting them import licenses have their incomes increased regardless of how efficiently they operate. In addition, it has a detrimental influence on the domestic capital market, yet the governments do not seem to be aware of this underlying jeopardy. Interestingly, concerning the topic of foreign direct investment and commercial credits, McKinnon refers in passing to his "fragmentation hypothesis" (McKINNON 1973, p.29) which in this context suggests that domestic entrepreneurs lack financing from outside their own enterprise to exploit their investment opportunities.

5. McKinnon's approach to economic growth and the role assigned to "small credits"

With the financial problems in LDCs having been outlined in detail in the previous chapter (see above chapter 4, p.112), the next step is to present the strategy McKinnon has in mind in order to achieve economic growth, and thus economic development, in LDCs. As it is evident from McKinnon's point of view, money, capital, and the capital market are to play a major role in this process.

In general, McKinnon has detected some **inconsistencies with the prevailing monetary theories** when applied to the economic environment of LDCs. At first, he underlines **the role of money** for individuals in LDCs and how the **monetary system** may aim at price stability, taking inflation into account. Then, in the context of capital accumulation in LDCs, McKinnon is opposed to the prevailing monetary theories which state that capital markets are perfect with a single governing rate of interest. Instead, fragmentation has created an **imperfect capital market** with great dispersions in rates of interest and return (see McKINNON 1973, p.3). This view leads to a different interpretation of the relationship between money and physical capital in LDCs, which McKinnon considers as **complementary** while the prevailing theories define a substitute relationship.

Subsequently, the analysis endeavours to illustrate McKinnon's understanding of **economic development** in LDCs. In underdeveloped economies the accumulation of capital is almost meaningless as rates of return are low and might even turn out to be negative. In the face of great discrepancies in rates of return, McKinnon considers it to be a mistake to regard development simply as the accumulation of homogeneous capital of uniform productivity, as held by most economic theorists. He therefore pledges for the adoption and development of an alternative view of the role of capital in the context of LDCs and hence defines economic development as

> "the reduction of the great dispersions in social rates of return existing and new investments under domestic entrepreneurial control" (McKINNON 1973, p.9).

Economic development in this sense is necessary and suited to generate high rates of saving and investment, to enable the adoption of best-practice technologies, and to further learning by doing.

5.1. Incompatibility of the prevailing monetary theories

The shortcomings detected by McKinnon in the course of his investigation of the specific financial conditions of LDCs lead directly to a fundamental conflict with the leading monetary theories in McKinnon's (1973) view. Indeed, these leading monetary theories, such as Monetarism and Keynesianism, have developed their respective tenets on the basis of certain basic neoclassical assumptions of monetary growth theory. In order to better understand this approach, it is useful to look at the financial structure in LDCs and to clarify the role money and the monetary system may play.

5.1.1. The role of money and of the monetary system in LDCs

McKinnon focuses on the role of the domestic monetary system as regards the improvement of the quality and quantity of capital formation.

He thus takes a closer look at the financial structure prevailing in LDCs. Three characteristics can be observed:

1) "Individual units issue relatively few primary securities as a proportion of saving which indicates a higher reliance placed on self-finance within firms in LDCs than compared to developed countries.
2) Most of this limited flow of primary securities is acquired by financial institutions rather than being placed directly with final savers.
3) The liabilities of the monetary system including the central bank and deposit banks account for about two-thirds of all claims on intermediary financial institutions that are held by the public." (McKINNON 1973, pp.37-38)

There seem to be only few organised markets for primary securities such as bonds, mortgages, or common stock. These curb or traditional capital markets associated with small-scale rural and urban money lending or pawn broking require economies of scale that are generally not present in LDCs. Essentially, there is only little direct contact between primary borrowers and ultimate lenders. Instead, financing or intermediation takes place indirectly through the monetary mechanism, but is generally limited. McKinnon therefore prefers to develop theoretical models for LDCs where money is the only financial asset available to wealth holders. He thereby defines money in a broader sense than usually assumed and includes interest and non-interest bearing deposits of the banking system and currency. Developed economies, on the other hand, have access to a much wider spectrum of financial assets, some of which may be close to being substitutes for money.

Given the circumstances of a limited financial infrastructure in LDCs that suffers from high taxation by inflation or other official policies, where uncertainty about the future severely persists, it is questionable why it should be dominated by the monetary system.

Money is legally designated and generally accepted as the medium of exchange. It is costless to produce and uniquely risk- and default-free for short term transactions. In the underdeveloped world it is hard to market financial instruments other than money as no accepted equivalent can easily be identified. Hence, the role of money as a means of payment, and its sanction by the state, greatly enhance its value as an instrument of private capital accumulation (see McKINNON 1973, p.38).

In order to become a useful instrument for capital accumulation, however, firm-households must be willing to hold money. Holding money over time is never risk-less and its attractiveness depends on how the percentage rate of inflation, the nominal interest rate on deposits and the convenience of holding real money, particularly in form of demand deposits and currency, are combined. The real return on holding real money is given by the difference between the actual nominal rate of interest paid for holding it and expected inflation. It rests in the hands of the individuals to adapt their holdings with respect to the price movements of holding money. Monetary policy, on the other hand, is able to influence the nominal rate of interest on deposits and the rate of expansion of the nominal cash balances. In McKinnon's (1973) view, it is above all the latter that ultimately determines the expected rate of change in price level. If the supply of nominal money exceeds the demand for real balances, then inflation is induced. It therefore remains a policy choice how stable the return on holding money turns out to be and thus, how willing the individuals are to hold money (see McKINNON 1973, pp.38-39).

5.1.2. Money and capital in an imperfect capital market

In the context of the Keynesian or Monetarist theories, the problem arises that individuals might prefer to hold money instead of converting it into physical capital. The assumption of a perfect capital market implies that the demand for real money and the demand for physical capital are in a substitute relationship. McKinnon, however, assumes a complementary relationship as regards LDCs, which means that

> "conditions that make real money attractive to hold enhance rather than inhibit private incentives to accumulate physical capital" (McKINNON 1973, p.40).

The concept of complementarity, to be analysed in the section hereafter, leads to conclusions about inflationary finance and about deposit rates of interest rates accelerating economic development that differ in substance from the generally accepted monetary theories. McKinnon judges that both neoclassical and Keynesian theories were designed for mature economies only, benefiting from a functioning capital market. They may do a lot of harm if applied uncritically to the fragmented economic environment persistent in LDCs.

In the view of McKinnon, there are four neoclassical assumptions which are difficult to maintain in the economic context of LDCs:

1) “Capital markets operate perfectly and costlessly to equate returns on all real and financial assets (other than money) with a single real rate of interest, i.e. the nominal rate that reflects expected inflation accurately.
2) Inputs (including capital) and outputs are perfectly divisible; all firms have access to the same technology and to the same prices in commodity and factor markets.
3) Money is important to meet the transactions demand and to avoid the double coincidence of wants, but not as a means to accumulate capital.
4) Real money balances are socially costless to produce for satisfying the transactions motive. Minting coins and clearing checks are trivial costs relative to the benefits money confers.” (McKINNON 1973, p.43)

From these fundamental assumptions the various authors of growth theories derived their specific ideas, e.g. Milton Friedman in his book “The Optimum Quantity of Money and Other Essays” published in 1969 (see FRIEDMAN 1969), all with approximately similar conclusions about the demand for money. In either case money is treated as a form of wealth that competes with other assets in the portfolios of consumers and producers.

Several problems exist if the neoclassical model is applied to LDCs as regards the four assumptions mentioned above. Following assumption

1), involving the substitution effect, there would be no demand for real money balances if the real return on money is less than the return to physical capital. Automatic credit facilities would take care of the day-to-day, hour to hour exchange of commodities or individuals could carry perfectly divisible physical capital in their pockets, i.e. there would be no need to hold non-interest bearing money as a medium of exchange. Money would retain a role as a numéraire. Therefore, there is full liquidity without money. A determinate for money requires imperfections in the capital market where there are risks of default and the rates of return on physical and financial assets differ. Cash balances are needed to intermediate between income and expenditures, and the demand for money is generally increasing. Since the capital markets are all but perfect in LDCs, a permanent demand for money does exist. Even though imperfections also exist in advanced economies, they still do not occur to such an extent as in LDCs.

As regards assumption 2), in LDCs individuals certainly do face upward-sloping and different supply curves for finance, with indivisibilities in, and restraints on, borrowing. It is obvious, according to McKinnon's (1973) definition of fragmentation, that there is no real divisibility in LDCs, i.e. the firms concerned do not have equal access to money, capital, and technology. Furthermore, contrary to assumption 3), money assumes the role of accumulating capital instead of being invested in physical capital in LDCs. Finally, unlike assumption 4), in the context of LDCs, the production of real money balances is by no means socially costless, since due to frequent government interventions and other constraints on the capital market a high social price in terms of hindering the domestic development of capital markets and the access to technology is being paid.

In conclusion, the merits of this section seem to lie in that McKinnon has endeavoured to distil the general implications of his empirical findings in the light of the leading modern monetary theories. The somewhat surprising result is that four of the underlying assumptions of those theories are apparently not met in the case of LDCs due to the fragmentation of their capital markets and their economy in general. In addition, the neoclassical concept is susceptible to favour inflation which is supposed to help accumulate capital, e.g. due to the substitution effect (see McKINNON 1973, p.51). In LDCs, however, where real cash balances are dominant, it promotes raising revenue for the government via inflation tax and hinders capital accumulation.

5.1.3. Money and capital as complements

The question tackled by McKinnon is, how money enters the process of accumulating physical capital in LDCs. The usual behaviour of individuals can be described in so far that they form expectations about future price movements, which determines their willingness to hold money, while the control of the price level lies within the hands of monetary policies as they are in control of the expansion of the nominal cash balances. The price level is determined by the demand for, and the supply of, nominal money. The major difference in the context of LDCs is that a situation of a fragmented economy prevails. It remains to be seen which further implications fragmentation has on monetary theories and policies (see McKINNON 1973, p.55).

As LDCs lack organised finance, and the various attempts of the governments to substitute financial processes are inadequate (see above chapter 4.3., p.119), McKinnon adapts the fundamental neoclassical assumptions in such a way that they fit the specific economic environment of LDCs (McKINNON 1973, p.56):

1) "Assuming that no distinction can be drawn between savers and investors, all economic units are confined to self-finance. These firm-households do not borrow from, or lend to, each other."
2) "The small size of firm-households implies that indivisibilities in investment are of considerable importance. Typically, indivisible investment is associated with the adoption of markedly improved technologies which bulks large in the eyes of small-scale entrepreneurs." They will be left within the confines of the traditional technology unless they receive external financing which, however, is not commonly found in LDCs (see McKINNON 1973, pp.12-14).
3) "The government does not participate directly in capital accumulation through the tax-expenditure process or by using

> seigniorage from money issue for capital formation. Revenues are used only to finance current government consumption".

McKinnon points out that the first two assumptions reverse those made in the neoclassical model (see above chapter 5.1.2., p.126). Assumption 1) implies that cash balances are the only financial instruments available that can be accumulated or sold freely. Assumption 1) and 2) together imply that

> "restraint on external borrowing inhibits individual enterprises from undertaking discrete investments that embody best-practice technologies. The result is widely dispersed rates of return on physical capital with a melange of firm-households operating at very different levels of efficiency in their use of money, as well as in their use of land and labour" (McKINNON 1973, p.56).

Due to the concept of an entirely imperfect capital market, these assumptions are in fact contrary to the neoclassical approach.

Assumption 3) implies essentially that the government cannot affect aggregate capital accumulation directly, but is limited to influencing the real return on holding money via the control of the money supply and the nominal rate of interest.

McKinnon's aim is to show that the return on holding money encourages private investment as well, i.e. that a complementary relation exists between the two (see McKINNON 1973, pp.57-58).

Suppose an individual "saver-investor", being confined to self-finance, intends to buy physical capital of a kind which is different from his usual own output. His options are either to store inventories of his own output for future sale when he needs the capital for the purchase of the physical capital; or to accumulate cash balances for the same purpose which, however, is dependent on the real return on holding money. The convenience to accumulate cash balances must exceed the convenience to store his output. Thus, the higher the real return on holding money, the more he will use cash balances as a store of value.

Following assumption 2) above, investment in indivisible physical capital implies that a substantial agglomeration of purchasing power is concentrated at the particular point at which the investment is undertaken – e.g. for certain fixed assets like machinery or even seed-fertiliser-pesticide packages for farmers. Whether an individual prefers to consume his income or to save a proportion of it is determined by his propensity to save (or rather invest). The demand for real money balances is therefore strongly influenced by the propensity to save, too. McKinnon derives from this that

> "*if the desired rate of capital accumulation (and hence private saving) increases at any given level of income, the average ratio of real cash balances to income will also increase*" (McKINNON 1973, p.57).

This argument is considered central in the demonstration of the complementarity between money and physical capital. The neoclassical approach assumes that a rise in the average rate of return to physical capital decreases real-cash balance holdings as they compete with each other on account of the substitution effect. For McKinnon, however, a rise in the average rate of return to physical capital increases the desired real cash balance holdings because the rise is associated with an increase in the ratio of investment to income. Essential is the recognition of the accumulation process being so vital in LDCs, which the neoclassical approach ignores. Money should be viewed as a conduit through which accumulation takes place. Likewise, the demand for money rises with the productivity of physical capital.

Therefore,

> "*if the real return on holding money increases, so will self-financed investment over a significant range of investment opportunities*" (McKINNON 1973, p.60).

Holding cash balances reduces the opportunity cost of saving internally for the eventual purchase of physical capital goods from outside the firm-household.

Summing up, this is another striking example of the difference between the approach of McKinnon and the traditional forms of monetary theory.

5.2. How to achieve economic development in LDCs

As was shown in the previous part, circumventing, or intervening directly into, the domestic capital market leads to an aggravated state of fragmentation. The question is how the capital market of an LDC should be exploited in order to relieve, and eventually liberate, it from fragmentation. McKinnon thus hypothesises that

> "unification of the capital market, which sharply increases rates of return to domestic savers by widening exploitable investment opportunities, is essential for eliminating other forms of fragmentation" (McKINNON 1973, p.9).

5.2.1. Investment under domestic entrepreneurial control and Access to external capital resources

The beneficiaries of a unified capital market, following McKinnon's definition of economic development, are supposed to be the domestic entrepreneurs whose investment opportunities shall be greatly increased.

The question is why McKinnon puts the focus on domestic entrepreneurs in particular. Not surprisingly, the answer lies in the fragmented state of the capital market in the underdeveloped economy. Generally, there are no well-defined income categories or any specialised processes of saving and investment as would be found in developed economies. A class structure based on the functional distribution of income among wages, profits, interests, and land rents does not exist, nor can a saving class be distinguished from an investing class. The only characteristic McKinnon is able to identify is that

> "there are many entrepreneurs who provide labour, make technical decisions, consume, save, and invest" (McKINNON 1973, p.10).

McKinnon states that all individuals or families performing these five functions will be denoted as entrepreneurs, wherefrom he derives a model of entrepreneurial behaviour typical for indigenous urban and rural economic life.

This model of entrepreneurial behaviour refers to the work of Irving Fisher in his famous book on “The Theory of Interest” published in 1930 (see FISHER 1930) and is built around his approach to impatience and inter-temporal choice. His approach stresses the individuality of each entrepreneur disposing of his own more or less unique production opportunity. The latter depends on his specialised knowledge and his available factors of production, e.g. family labour, landholdings or structures. The level of his expertise determines his production possibilities and his investment needs in human and physical capital. In LDCs, however, the available skills and talents throughout the urban and rural population cannot be fully exploited as they are often attached to small firm-households and not identified.

Furthermore, capital theory involves decision making over time. As far as the entrepreneur is concerned in that matter, McKinnon refers to three components that influence his inter-temporal decision making and within which he aims at maximising his utility:

1) “His endowment or owned deployable capital.
2) His own peculiar productive or investment opportunity.
3) His market opportunities for external lending or borrowing over time outside his own enterprise.” (McKINNON 1973, p10)

In a fragmented capital market these components are very badly correlated. Either, entrepreneurs with potential production opportunities lack resources of their own and have no access to external financing; or the ones with sufficient endowments lack production opportunities and have only access to “investment outlets” (McKINNON 1973, p.11) that fall short of reflecting the scarcity of capital accurately. The resulting dispersion in rates of return reflects the misallocation of existing capital and represses new accumulation.

As can be seen, endowment does not necessarily correspond to opportunity. McKinnon therefore judges that supplemental financing from outside the individual’s enterprise is of critical importance in determining whether or not productive investments are undertaken. Poverty and the inability to borrow to finance discrete increases in expenditures can be the barriers to the adoption of the simplest and most productive innovations like seed fertiliser packages, on-the-job labour training, equipment purchases, or inventory holding. When it comes to long-term innovative investments, external financing becomes even more crucial as resources will be necessary to finance the time of change and the immediate costs. Otherwise the stagnancy in rural development as described above (see chapter 4.1.2., p.115) will not be overcome as people will remain stuck in the traditional technology (see McKINNON 1973, pp.12-14).

The solution is the provision of an adequate capital market which is able to reshuffle any consumable surplus or available capital generated by any entrepreneur among those who dispose of the best production opportunities. McKinnon emphasises in this context the advantage of this “single allocative mechanism” (McKINNON 1973, p.12).

5.2.2. The importance of high interest rates

Having emphasised the importance of external financing via the capital market, it is now of interest to ascertain, at which cost external financing should be made available to small-scale industry and agriculture. McKinnon states that cheap loans or subsidised credit might be unnecessary and unwise. Instead, high rates of interest for borrowing, as well as saving, will be more successful. The objective is to make entrepreneurs disinvest from inferior processes to permit lending for investment in improved technology. If the rate of saving is above the marginal efficiency of investing in the existing inferior technology, then the entrepreneur will prefer to save its surplus. This way, a higher proportion of net saving will pass through the external capital market which can provide the saving as credits for entrepreneurs with highly productive investment purposes (see McKINNON 1973, p.15). Once the technology upgrade is complete, the repayment flow can be used by another entrepreneur to do the same. McKinnon explains the phenomenon in the following way:

> "Where loans are plentiful, high rates of interest for both lenders and borrowers introduce the dynamism that one wants in development, calling forth new net saving and diverting investment from inferior uses so as to encourage technical improvement" (McKINNON 1973, p.15).

Contrary to what authorities usually assume, McKinnon is convinced that loans to small-scale enterprises will generate sufficient return and might also be more lucrative than giving them to the established enclaves. But, in order to achieve this, it is necessary to desist from the common policy of maintaining low or negative rates of interest on financial assets and from the limited loan availability (see McKINNON 1973, pp.15-16).

As shown in this chapter, the impact of money and capital on the economic development in LDCs is one of the cornerstones in McKinnon's theoretical thinking which differs essentially from the neo-classical theories and the concepts derived therefrom.

6. McKinnon's suggestions to realise his approach

McKinnon does not confine himself to analyse the shortcomings in LDCs resulting from fragmentation, but also attempts to detect ways and methods to remedy the economies suffering from such shortcomings. In particular, he presents a number of measures and tools to implement his strategic approach the goal of which is the **liberalisation of the domestic capital market and of the foreign trade sector**.

Since it is hypothesised that fragmentation in the capital market causes the misuse of labour, land, and suppresses the entrepreneurial development, and also condemns important sectors of the economy to inferior technologies, McKinnon states that an appropriate policy in the domestic capital market that **overcomes financial repression** is the key to general **liberalisation**, and particularly to the withdrawal of unwise public intervention from commodity markets (see McKINNON 1973, p.8). In this context, the successful monetary reforms in the post-war period of Germany and Japan are referred to (see McKINNON 1973, Chapter 8, pp.89-116). However, the specific framework conditions of these two countries, above all their banking tradition and balance of monetary growth and Gross National Product (GNP), only illustrate what a fully developed monetary system might achieve in a rapidly growing economy – in contrast to LDCs where such conditions are absent so far.

Furthermore, successful liberalisation of the domestic capital market would also permit a radical restructuring of tariff, quota, and licensing restraints on foreign trade. As long as the access to foreign trade remains remarkably free, as it has been in the post-war period for instance, such policy lends itself to a successful development by national authorities in LDCs (see McKINNON 1973, pp.2-3). McKinnon thus proposes that fiscal policy, in order to sustain free international trade and liberalised domestic finance, may then replace the existing distorting tax policies by the adoption of a **neutral tax structure**, namely by the introduction of a **Value Added Tax** (VAT).

Subsequently, McKinnon takes the dangers into account that might turn up during the phase of transition to economic liberalisation. Therefore, he presents **measures to stabilise the economy** during this time allowing for a successful transition.

Finally, the **absorption of foreign aid** during the transition process is dealt with. McKinnon strongly advises not to rely on foreign aid during this time as it may provoke dependencies on the donor countries and also prevent the domestic economy from adapting correctly to the real conditions.

6.1. Liberalisation of the domestic capital market and of the foreign trade sector

From McKinnon's point of view, there are two aspects which deserve special attention for the economic development of LDCs: Overcoming financial repression in order to liberate the domestic capital market, and the introduction of a neutral tax system replacing the complex structure of tariffs, quotas, and other discriminating levies.

6.1.1. Overcoming financial repression

The striving for a unified capital market means fighting against financial repression with the objective to reduce the great dispersions in rates of return. McKinnon states that various attempts to contain financial repression have been undertaken by the local authorities in LDCs, however, with controversial results (see McKINNON 1973, pp.74-76).

For example, interest rate ceilings were extended on local moneylenders and grain merchants. McKinnon fears that this will aggravate fragmentation even more as the small amount of rural finance will be discontinued altogether. Additionally, it would boost the informal credit market. Even if governments were admitting high rates of interest, they were trying to mitigate any unfortunate social effects. If a farmer pledged his land as collateral and is at some stage incapable to repay the loan, then the moneylender would normally assume control of the farm properties. As this can lead to the rise of a “landless peasantry” (McKINNON 1973, p.75), consequently, authorities often respond by prohibiting the pledging of land or by preventing foreclosure by the moneylender. The problem with these measures is that they make land worthless as collateral, and the access to finance is even more restricted as the demand for collateral will always persist.

Another way to respond to the problem of channelling finance to small farmers was for the government to hold grain inventories and set crop prices. Yet, capital is still scarce and the inventories have to be financed from the exchequer. Furthermore, it has been evident from the past that the authorities come under enormous pressure by the respective interest groups in how high or low prices should be set. This measure does not help the individual farmer either to get his own access to external finance which according to McKinnon is indispensable for improving his situation effectively.

Therefore, in order to overcome financial repression eventually, McKinnon is convinced that there

> “appears to be no economical substitute for expanding the role of organised finance in small-scale lending to indigenous

entrepreneurs in either rural or urban areas" (McKINNON 1973, p.77),

though at the same time he is conscious of the fact that such a course of action will not be costless. The detailed information required from bank loan officers can be expensive in terms of skilled resources. Risk is high, and previously assured collateral might not be available. Generally, it seems to be difficult and costly to replace the services of the well-informed local moneylenders who dispose of detailed knowledge of the borrower's personal and financial circumstances.

The objective should then be that banks charge equilibrium interest rates to rural and other small-scale borrowers which accurately reflect the lending costs. McKinnon suggests that real rates of interest between 15 and 25% for loans in small-scale lending should be charged to be profitable for both banks and borrowers. These rates would suffice to prevent low-yield investment and the diversion of funds to urban enclaves, while they are still far below what would be charged in the traditional local credit markets.

Otherwise, banks may save considerable administrative costs if they worked through traditional institutions such as farm cooperatives. In Ethiopia this has been undertaken with some success. A rural development corporation was set up which received loans from a savings bank at 8 percent. In turn they lent that money to a rural cooperative at 12 percent which extended loans among its members at a rate of 17 percent. Not only were these loans all repaid, there was even a tremendous excess demand for the loans at 17 percent.

Similar to the cooperatives, the moneylenders dispose of valuable inside information of their clients, like the size of their farms, the number of animals they possess, the outstanding debts etc. In order to mobilise the information, McKinnon suggests the governments to seek to legalise their operations by removing usury restrictions and by permitting them to expand their credit base by bank borrowing. If the banking system expands rapidly, the moneylenders' experience could also be exploited by appointing them loan officers. Nevertheless,

> "the main burden of ensuring that there is uniformity in borrowing rates and that competition is broadly based rests with direct bank lending" (McKINNON 1973, p.78).

McKinnon recommends that banks within LDCs should be organised to operate competitively or, at least, to stimulate competitive lending and deposit practices, even if the banking structure remains highly concentrated. This would, however, require a considerable increase in the willingness and ability of banks to purchase primary securities from final investors at rates of interest reflecting the scarcity of capital and the administrative costs for serving each class of borrower. At the same time, the length for which finance is made available must be greatly extended. Loans at high interest rates, but in a higher quantity and at long term will help release the disinvestment in inferior technologies in favour of more modern and productive ones as described above (see chapter 5.2.2., p.134). The policy of cheap bank credits to favoured borrowers would have to be discontinued (see McKINNON 1973, pp.78-79).

There remains the difficulty of high and instable inflation coherent in many LDCs. It appears to be nearly impossible to apply a policy of high interest rates under such circumstances. Inflation reinforces uncertainty and the desire to avoid risk. Nominal interest rates incorporating the expected future price inflation might look too high to borrowers and too low to depositors. The danger persists that inflation could slow down while borrowers are fixed on their anticipated inflation interest rate which makes them pay more than the actual scarcity of capital suggests. In contrast, inflation might speed up even more while lenders are trapped in their low rate of return which might turn out to be negative in the end. In this case, McKinnon sums up, only short term financial commitments could be established.

Otherwise, if inflation as such was accepted, McKinnon considers the possibility of offsetting it via adjustments in nominal rates of interest with the objective to maintain the same real value. This would require indexing of the interest rates by the banking system which according to McKinnon appears to be expensive to fulfil and difficult in that sense that it will be hard to find a suitable commodity numéraire. Still, he considers indexing of interest rates to be better than no protection against unexpected price movement at all. In principle, if inflation is moderate at less than 15 percent a year, nominal rates of interest can be raised by 10 to 15 percent in order to reflect the expected price movements so that depositors and borrowers feel no undue risk. There remains, however, the primary desire to create a situation with credible stability in the price level (see McKINNON 1973, p.79).

6.1.2. Introduction of a neutral tax structure – The Value Added Tax (VAT)

Apart from the domestic capital market, McKinnon's next target is the liberalisation of foreign trade.

As it was shown before (see above chapter 4.3., p.119), government interventions into the foreign trade sector in order to protect or support some favoured domestic industries at the expense of others have contributed to the aggravation of financial repression. In particular, the strategy of industrialising through import substitution has been disappointing and has led to bad prospects for small and medium-sized economies to continue development on an autarkic basis. McKinnon thus pleads for the complete abolishment of the strategy of import substitution (see McKINNON 1973, p.131), a revolutionary advice at the time, but highly visionary as it was eventually followed by authorities in the late 1980s, more than 15 years later (see KRUGMAN et al. 2012, pp.359-365). Instead, it should be acknowledged that

> "a vigorous domestic capital market, centred on the monetary system, can be a more efficient engine of economic development" (McKINNON 1973, p.132).

With a functioning capital market, users of manufactured commodities no longer need to be taxed by tariffs in order to subsidise new domestic producers, but new firms with good investment opportunities will be able to borrow more easily. Likewise, exclusive licenses to import capital goods no longer serve any economic purpose in making it easier for their holders to attract financial capital. In fact, financial liberalisation in LDCs will help eliminate some critical elements of the restraints in foreign trade.

In McKinnon's understanding, the case for free trade is clear as soon as the domestic capital market is working freely, whereby a period of transition is clearly envisaged. Given this situation, the question is which role fiscal policy, in particular concerning the tax structure, assumes in sustaining free international trade and liberalised domestic finance.

The prevailing system of taxation via tariffs, tax concessions or other subsidies has to be replaced by a neutral one that takes account of the limited administrative capacity in LDCs as well as the fact that LDCs raise their revenue rather from indirect taxes in general, and particularly from those on foreign trade. In the focus is also the compatibility of tax neutrality between exporting and import substitution with maintaining high revenue elasticity with respect to a rapidly growing national income. In this context, a weak fiscal policy that forces the government to borrow from the central bank should be avoided. McKinnon's intention is to provide a tax system satisfying both tax neutrality and the elasticity criteria (see McKINNON 1973, pp.132-133).

In general, implicit taxation of export industries is much greater than the visible direct restraints on actual export flows. In fact,

> "the main tax on exports arises from the ways in which tariff and quota restrictions on imports operate through the foreign exchanges to reduce the profitability of exporting. Keeping imports out reduces the effective demand for, and consequently the price of, foreign exchange relative to domestic costs of labour, capital, intermediate inputs, and so on that producers of export products must pay. Since exporters sell in foreign markets at this less favourable "real" exchange rate, they are caught in a profit squeeze, which reduces traditional exports and blocks new export development" (McKINNON 1973, pp.133-134).

In this sense, McKinnon states, a uniform tariff of X percent on all imports is the same as imposing a uniform tax of X percent on all exports. Under either policy, the resources within the domestic economy would be allocated the same way. In most of the LDCs, like the countries of Latin America, but also in India, Pakistan or Turkey, poor export performance records during the 1960s can be linked to extremely strict foreign exchange controls on imports (see McKINNON 1973, pp. 135-137). It therefore seems sensible, at first glance, to advise LDCs to switch their policies from import substitution to export expansion, e.g. by shifting the entirety of fiscal and financial incentives toward exporters. Possible measures are export bonus schemes like they were performed by the government of Pakistan in 1959, or rebates on indirect taxes and tariffs levied at earlier production stages on industrial supplies used by exporters or even exempt them from any direct tax liability (see McKINNON 1973, p.138).

McKinnon considers this to be wrong in that it would leave previous distortions uncorrected. Furthermore, he believes such compensational measures to be unnecessary as well. With the elimination of protective tariffs and quota restrictions on imports the export activities are already freed from an enormous implicit burden and, simultaneously, a more neutral resource allocation will occur (see McKINNON 1973, p.139).

LDCs rely to a major extent on a variety of indirect taxes like sales taxes, turnover taxes or licence fees which are not uniformly applied. In some countries only a third of the tax revenue is generated from direct taxation of income or property (see McKINNON 1973, p.139). Well over half of the revenue from indirect taxation comes from foreign trade, not only in form of customs duties but also from various sales taxes on imported commodities. In the process of his investigation, McKinnon therefore infers that most LDCs depend on indirect taxes, and in particular on those linked to foreign trade.

A consequence of import substitution is that the revenue from indirect taxation becomes less income-elastic, i.e. as the Gross National Product (GNP) grows the revenue from indirect taxation tends to grow less than proportionately. The major reason for this is not the indirect taxation system itself, but its distorted nature resulting from the provision of incentives to support industrialisation in favour of imports.

During industrialisation in many LDCs, some of the tax revenue has been lost merely by accident or through indirection. Tariffs on imports of manufactures that are not or only insignificantly produced in the domestic economy were the main sources of raising revenue. Especially luxury goods were highly taxed. These tariffs had thus no protective but a purely revenue-oriented purpose at this stage. Once industrialisation began, these tariffs obtained automatically a protective nature and started to attract domestic resources into producing equivalent commodities. As a consequence, with rising domestic manufacture, the government loses revenue as imports of final manufactures slacken. Hence, the tax system has become inelastic to the rising income induced via industrialisation (see McKINNON 1973, pp.140-141).

The main loss of revenue, however, has been caused by public policies and their protective purposes in imposing tariffs of more than 200 percent on consumer goods which effectively prohibited their importation. Quota restrictions or prohibitions on imports further reduce the revenue for the government once they are applied to commodities that are normally dutiable. The import base will eventually dry up if prohibitive tariffs are further applied (see McKINNON 1973, p.141).

Contributing to more loss in, and to the inelasticity of, tax revenues are tariff or tax concessions granted to newly protected industries. Some producers are liberated from paying customs duties or other sales taxes on imported goods. Otherwise, those commodities rated very important for domestic industry and industrial development may remain without any import restriction. In Ethiopia, for example, such measures lead in 1970 to a loss of 40 percent of the revenue collected. In Korea, even worse, the revenue lost from liberating certain importers of paying tax or custom duties was greater than the revenue collected from taxing imports (see McKINNON 1973, pp.141-142).

In turn, government expenditure is always elastic to income growth, even if revenues are not. This makes it a lot harder to relieve the problem of financial repression. Growth usually tends to enhance deficit government spending and public saving is mostly incapable to keep up the speed of spending. The traditional reactions by the governments are to impose further non-neutral taxes or to turn to the central bank for financing, the latter leading to inflation eventually. Thus, there is a need for building more revenue elasticity into a reformed tax system if financial repression is to be avoided (see McKINNON 1973, p.142).

In the search for an optimal tax structure, McKinnon is convinced that the first-best solution would be the introduction of a uniform Value Added Tax (VAT) which combines

> "the simplicity of a single *ad valorem* levy on imports with generally neutral taxation of domestic and foreign commodities destined for final consumption" (McKINNON 1973, p.143).

In order to assess how the VAT should be administered, McKinnon looks first at a closed economy, leaving the influence of foreign trade aside. Two ways of determining a tax base can be distinguished. Either, the so called consumption version, where the difference between the gross sales and all supplies gives the sum to be taxed; or the net-product version, where the value of purchased capital assets is not accepted and a depreciation allowance is substituted. McKinnon prefers the former variant as it bears significant administrative advantages. The latter version requires complex accounting services and systems which seem too costly for the rather unsophisticated enterprises predominant in LDCs. Value added tax in the sense of the consumption version means summing up all the wages, salaries, profits, interest, and rents generated within a firm and then tax the sum at the same rate. The taxpayer must provide evidence that he has purchased materials from other firms which have already been taxed. These are to be subtracted from the original tax base (see McKINNON 1973, pp.143-144).

In a situation of an open economy another two ways of applying the VAT are possible – either according to the "origin"-principle or according to the "destination"-principle. In either way, the taxation of imports and exports must be compatible and it is the choice of the border-tax adjustment which distinguishes the two principles. With the origin-principle, authorities could choose to tax all domestic production, including exports, at the factory gate. This requires equally that all imports enter the economy free of taxes. As such, neutrality with respect to foreign trade will be maintained. McKinnon, however, considers this possibility as being less favourable to the context of LDCs. Most LDCs would be hardly capable of taxing anything else than imports in administrative terms. Therefore, the destination-principle might be the better solution. A VAT according to the destination-principle lays down a uniform tax on all imports entering the economy as part of a conceptually neutral tax system. If imports as well as domestic output were to be taxed, it would be required that all exports are exempted from taxation in order to avoid double taxation of foreign trade. This would lead not only to a zero tax on value added by the final exporter, but in fact also to rebates given on taxes that had been paid before when supplies were purchased. In total, the whole product would be exempted. Domestic supplies would be put on the same basis as imports in this respect. This way, no special ad hoc tax adjustments for exporters would be necessary or desirable. If a tariff system was given, then an arrangement for rebating tariffs already paid for imported supplies used by exporters would not be neutral as it creates a bias against using domestic materials, which are subject to other forms of taxation in export activities. All in all, such bias would be avoided if a VAT was introduced instead of applying import duties as a source of revenue and if protective tariffs were eliminated.

Reflecting on possible pressure on authorities to exempt certain vital industrial materials and capital goods that have to be imported from the VAT, McKinnon counters that

> “domestic producers would feel less need to seek exemptions because credit for the VAT levied on imported supplies could be systematically carried forward as an offset against the VAT liability on the firm’s own sales” (McKINNON 1973, p.145).

Thus, McKinnon advises authorities to withstand any pressure for tax concessions in a VAT system.

In summary, the neutrality of a VAT concept can be described in that

1) “differential commodity or multiple taxation is avoided,
2) foreign trade is taxed on a par with domestic value added, and
3) all the primary factors of production bear the same rate of tax” (McKINNON 1973, p.146).

In such a way, the revenue from the VAT raised with a uniform tax rate should be highly elastic to a rising income and help liberalise foreign trade as pressure for exemptions or concessions is reduced by the coherent nature of the tax itself. As the consumption version of VAT excludes capital accumulation from the tax base, incentives for investment arising out of a successful financial liberalisation are augmented.

6.2. Measures to stabilise the economy during the transition phase

McKinnon is aware of the fact that liberalisation measures cannot be introduced straight away, but require a smooth transition phase. In his study, chapter 11 is devoted to this transition process the goal of which is to stabilise the economy on the way to liberalisation. It is especially in this phase that the economy is most vulnerable in terms of inflation due to deficit spending and high imports. In this context, McKinnon pleads for a complete rather than partial liberalisation which in his eyes is supposed to be more likely to be ultimately successful (see McKINNON 1973, p.4). The reason for this insight is derived from a number of practical examples cited by McKinnon in his study. In fact, between the years 1950 and 1970, countries like Chile, Brazil, or Colombia illustrate the devastating effect of a but partial introduction of liberalisation elements such as the lift of import restrictions which had to be abandoned shortly afterwards (see McKINNON 1973, pp.151-152). No clear cut and overall taxation strategy was achieved. On the other hand, McKinnon’s preference for a complete liberalisation leads to the problem of how to design the necessary transition period in order to avoid disruptions such as inflation. McKinnon intends to tackle this problem by what he calls the gliding parity concept which is supposed to be a means to equate the possible shocks the economy of the LDC in question might go through (see McKINNON 1973, pp.166-168). It consists of two interacting forces:

High nominal interest rates in the beginning taking expected inflation into account after the shift to economic liberalisation, which will be reduced in due course as soon as inflation begins to slacken, and depreciation in co-operation with flexible exchange rates. In essence, his concept is related to currency and the foreign exchange.

The goals are to keep domestic money in the country by having interest rates adapting to the inflation rate so that there is no loss for the money holders. They would otherwise deposit their money in a foreign country, a step which might not have been allowed before liberalisation. Additionally, depreciation of the currency from time to time helps keeping the real money value around a more or less constant level.

6.3. Foreign capital and foreign aid during the transition phase

McKinnon ascertains that financial repression restrains domestic saving within LDCs and generates pressure for reliance on foreign capital and/or foreign aid (see McKINNON 1973, p.170). Therefore, foreign capital might prove to be dangerous for a successful liberalisation process and might lift the dangers of inflation. It also provokes dependency on the donor countries and could lead to distortions in that it might not make the market adapt properly to the real conditions at hand. Furthermore, foreign capital is susceptible for returns on investment which may be repatriated by foreigners and may not be balanced by the real economic contribution (see McKINNON 1973, p.171). Governments may even become accustomed to foreign aid and may refrain from taking the necessary measures to install a sound process of reforming the financial infrastructure.

Correspondingly, McKinnon advises that the reliance on foreign direct investment including finance, modern technology and managerial skills, should be curtailed by the LDCs themselves in order to promote a balanced indigenous development. Indeed, the basic theoretical approach of McKinnon's book suggests that distortions in specific markets may cause over-use of foreign sources of finance in a way that may hinder domestic entrepreneurial growth (see McKINNON 1973, pp.22-36, 172).

In McKinnon's view, foreign capital can only be used efficiently if domestic capital can be, which implies that the internal financial machinery is set up and foreign exchanges are liberalised respectively (see McKINNON 1973, p.176).

6.4. The general importance of economic independence and government neutrality

McKinnon has confirmed in this chapter the importance of a liberalised economic environment for the successful realisation of his approach. In particular, the role of an independently working domestic capital market is stressed in this context allowing the government to desist from intervention policies designed to promote or protect preferred industries which enables the lifting of trade barriers in turn. Having studied the benefits of a VAT structure, the introduction of such a system appears to be a sensible solution for governments in LDCs as it is supposed to generate sufficient revenue for the exchequer without distorting trade thanks to its neutral character. Furthermore, pressure from outside the economy is to be avoided during the transition to liberalisation which is why McKinnon rejects any external influence in form of foreign capital or foreign aid in this phase. In the context of McKinnon's stabilising measures during transition it is interesting to note that, in spite of his overall concept of liberalisation, he is in favour of a certain amount of government intervention as far as the parity of the national currency in the period of transition is concerned.

7. Critical assessments of McKinnon's approach in learned writing

This chapter will deal with the critical assessment McKinnon has received in learned writing following the publication of his study. Generally speaking, his study provoked immediate and different reactions in economic literature. Only a limited number of authors fully concurred with McKinnon's idea to achieve real growth in LDCs mainly by providing an efficient capital market and introducing a systematic rise of interest rates. In contrast, none of the critics fully rejected McKinnon's approach. However, the mainstream reaction was to appreciate McKinnon's new approach while pointing at certain weaknesses and inconsistencies, thereby calling for further empirical research to be undertaken.

7.1. Grubel, Waters

Among the authors fully supporting McKinnon's approach is Herbert G. Grubel (see GRUBEL 1974, pp.333-335) who acknowledges McKinnon's merits to have introduced the impact of the financial and monetary sector on the economic development, so far neglected. Grubel believes that McKinnon's book could bring about a fundamental change in the main thrust of theorising about the process of economic development and new policy recommendations to developing nations. He also praises the perceptively simple argumentation, presented in some key models and empirically well documented. In conclusion, Grubel goes as far as saying that McKinnon's study should be mandatory reading for all central bankers and ministers in developing countries.

Alan Rufus Waters (see WATERS 1974, pp.160-162) is also supportive of McKinnon's book. In particular, he is fully in line with McKinnon attacking the neoclassical assumption that money is a form of wealth which substitutes for other portfolio assets and, for the LDCs, replacing it with the assumption of complementarity. Furthermore, foreign aid and capital inflows are rightly questioned on the ground that they are either insufficient or take on neo-colonial patterns. The answer should lie, as pointed out by McKinnon, in the domestic policies of the governments. Therefore, the key to successful economic development is in the hands of the rulers of LDCs, and does not lie with external influences which the more developed nations can manipulate. In Waters' eyes, the analytical development and policy recommendations by McKinnon are realistic and capable of implementation.

7.2. Luders

Rolf Luders (see LUDERS 1974, pp.298-300) is an author who has detected both strengths and weaknesses in McKinnon's book. On the one hand, he finds that McKinnon's conclusion on foreign indebtedness which should be reduced is new and convincing. Foreign resources may relieve bottlenecks in a fragmented economy, but will not cure the economy of its ills. Therefore the development of a domestic financial sector and an adequate export policy are needed. On the other hand, McKinnon's view on complementarity is based upon a model which is far too simple in Luders' view, assuming away all other financial assets except money. Therefore, the validity of McKinnon's theory is dependent on the fact whether an LDC possesses other financial assets apart from money or not.

Nevertheless, Luders believes that McKinnon's book has already had a considerable impact on economic thought among development economists in LDCs, holding that its impact will probably increase as soon as the book has been translated into other languages. Finally, Luders insists that several of the ideas and hypotheses contained in the book should be much further developed and tested before a new theory could emerge.

7.3. Reubens

Edwin P. Reubens (see REUBENS 1974, pp.500-501) does not fully accept McKinnon's interpretation of the effects of high and realistic rates of interest. Though he still agrees on the first effect that if the rates of interest reflect the real scarcity of capital, they will allow for an efficient allocation of resources, he disagrees with the second effect that McKinnon supposes will happen: the efficient mobilisation of resources for real investment. By relying on this interpretation, Reubens predicts many difficulties to turn up in due course like scarcities, bottlenecks, externalities and uncertainty. In this context, as an example, he does not believe that the "typical" citizen of a poor country will be able to actively save money from his income to enable self-finance. It would be doubtful that he will sacrifice 10% of consumption for the benefit of 3% more income in the future. Normally, a rise in his output would be a pre-condition of saving deliberately.

As far as the empirical investigation conducted by McKinnon is concerned, Reubens notes that he heavily relies on the record of the Korean experience in the 1960's which afterwards is "generalised" in order to lay a foundation stone for the approach supposed to be valid for all LDCs. This foundation stone is the suggested complementary relation between money and physical capital, in sheer contrast to the traditional neo-classical approach. Reubens gives several examples to illustrate the inaccurate interpretation of the Korean data. Among them he argues that McKinnon exaggerates the subsequent growth of the real output and overstates the reduction of inflation. It should be noted in passing that for Reubens the Wholesale Price Index (WPI) used by McKinnon is not an appropriate index in this respect. Additionally, in South Korea many credits have been granted at rates far below the nominal interest rate. At the same time, the inflow of foreign capital and aid has been kept up on a high level as well as borrowing from abroad which has financed a major part of the foreign deficit in due course of the industrial boom.

Finally, according to Reubens, the contention that the capital market by itself can make, and has actually made, a great and adequate net increase in capital formation for development remains unproved, both in theory and in experience.

7.4. Engerman

Turning to Stanley L. Engerman (see ENGERMANN 1974, pp.271-273) this author claims that the idea of a complementary relationship between money and physical capital is by no means new, but seems to have already been developed and discussed earlier by writers such as Dornbusch (see DORNBUSCH and FRENKEL 1973, pp.141-156).

Furthermore, Engerman comes to the conclusion that there is no connection specified between inflation and fragmentation, even though McKinnon argues that fragmentation is caused by the applied policies of the government and also by inflation. McKinnon states that holding down inflation rates can spur growth, but does not explain how inflation affects imperfections in the capital market. Additionally, McKinnon neglects the role of financial institutions other than banks denying their contribution of providing for more inter-sectoral flows and external financing by firms and individuals – the so called curb-markets.

He adds to this that the empirical data given by McKinnon are not evident. There has been no investigation of the agricultural sector or of the size of those firms which have enlarged/further spread their investment activities.

As far as interest rates are concerned, Engerman is critical vis-à-vis McKinnon’s understanding of the dispersions in rates of return which may also reflect higher costs of risk and information. More generally, Engerman is reluctant to accept McKinnon’s advocacy of higher real interest rates which he believes are in fact directed against inflationary finance rather than favouring the advantages of intermediaries in transferring funds.

7.5. Wells

Donald A. Wells (see WELLS 1974, p.201) stresses that McKinnon’s theoretical arguments are supported by favourable experiences in countries like Korea, Indonesia, Taiwan, Japan, and Western-Germany, in contrast to those of Argentina, Brazil, and Chile. In Wells’ view, the theoretical arguments establishing the importance of the real return on holding money in countries with imperfect capital markets are excellent. However, he also makes clear that it is unlikely that McKinnon’s book will resolve some of the long-standing arguments which are associated with the neo-structuralists’ view concerning the causes and functions of inflation in LDCs, asserting that more empirical work is required before such solutions may be reached.

7.6. Witcomb

Finally, Roger M. Witcomb (see WITCOMB 1974, pp.422-423) writes that the difficulties in LDCs presented by McKinnon like fragmentation and the lack of financial intermediation are not new. The same would apply to the remedies McKinnon proposes, e.g. ending the favoured position of specific industries or removal of monopoly power of banks and small lenders. However, Witcomb does not provide any sources documenting these statements. Furthermore, in the context of foreign capital, Witcomb interprets that McKinnon wants to discourage the inflow of capital as it seems to have undesirable effects on domestic monetary policy and thus reduces incentives to carry out the necessary reforms. Witcomb judges this to be a case of attacking a symptom and pleads to remember which disastrous measures LDCs have undertaken in the past once foreign aid ran out.

In certain points, he believes, McKinnon has a good understanding of the constraints in LDCs, in some others, however, his proposals look nearly impossible to fulfil, when, for example, suggesting that

> “the government moves to increase saving by raising taxes” (McKINNON 1973, p.159).

Witcomb even considers McKinnon to be naive if he believed that these measures could be so easily undertaken.

Finally, Witcomb stresses the insufficient empirical evidence McKinnon provides to support his hypothesis that an efficient capital market will be essential to get the price level straight. Witcomb assumes that as strong a case could be made for the converse statement.

In conclusion, he judges McKinnon’s book to be full of good intentions, but spoilt by some rather pretentious analysis. His advice is to read it sceptically.

8. The merits of McKinnon’s financial approach for Microfinance and for general economic policy

The comments provided by Grubel, Waters, Luders, Reubens, Engerman, and Wells in the year 1974 stand for the only reaction among US-American economists to the publication of McKinnon's study published in 1973. With the only exception of Witcomb, who taught economics at the British University of Cambridge at the time, there was no reaction in learned writing at all outside the United States, as far as can be made out. This phenomenon does not mean that nowadays McKinnon's concept of a financial approach to economic development in LDCs is only of interest to historians analysing the theories of US-American economists in the second half of the 20th century. On the contrary, the eventual quality of economic thoughts and theories does not depend on the immediate reaction by learned writers at home and abroad.

The pertinent question to be put forward is whether and where the concept of McKinnon is still topical in the present days, whether - and to what extent – his visions have been implemented in LDCs or elsewhere, and whether it has somehow influenced modern theory and practice in the LDCs, thus perhaps deserving more attention in the future.

8.1. Confirming the potential of "small-scale" or rather Microfinance for enhancing economic development in LDCs

Interestingly, the area in McKinnon's concept which could nowadays be said to be the most topical of all is the idea of establishing local institutions granting (micro-) credits to the poor and rural population in LDCs, thereby allowing the individuals concerned to disinvest from inferior technologies in favour of more modern, productive ones. With the revenue gained from the new investment they will be able to repay the credit sums by regular instalments and to afford a degree of saving for further investment in the future. They thus contribute to the economic growth and development of the local economy. This idea of McKinnon's lies at the heart of his financial approach and reflects indeed his social commitment always bearing in mind *la condition humaine* in the respective countries.

8.1.1. Confirming the desired mechanisms of small-scale finance for enhancing economic growth

The investment McKinnon has in mind is small-scale, of course, the idea being that small households which are stuck in inferior technologies dispose of a tremendous potential to improve their productivity right from the tiniest investment schemes. The idea is furthermore that money circulation is not just a country-wide phenomenon but consists of a large number of small units of money-flow at the local level. In addition, the installation of credit facilities provided by what could be called "small banks" benefits from the multiplying effect associated with the very notion of banks as intermediaries in the money-circulating process. This effect is not depending on a minimum size of the banks involved. It is visible as soon as money deposits in (large or small) banks are in operation creating disposable capital and credits granted therefrom make for further capital accumulation (see LECHNER 1988, pp. 152-155).

The underlying idea of McKinnon is to allow the population at large, above all the poor and underprivileged sectors, to realise their small-scale investment needs and to take part in the building up of small but continuous circles of flow of money, thereby entailing a certain economic development which has the advantage of being visible. In this context, it is anticipated that the individual debtors, after having received the credit for some investment, are not only able to repay the loan, but are also in a position to afford a certain regular "saving" from their generated surplus deposited at local banking institutions or rather Microfinance Institutions. The institutions in turn are able to allocate small amounts of money in terms of credits to "investors" who must show a kind of investment plan (e.g. investing in seed fertiliser to improve the output of the harvest) and are subjected to a repayment scheme including interest.

8.1.2. Deriving and articulating the challenges for Microfinance in the economic context of LDCs

By drawing the reader’s attention on the macroeconomic conditions prevailing in the context of LDCs, McKinnon’s study from 1973 provides a comprehensive insight of the challenges any form of financial intermediation has to face when applied within these environments. Such conditions have hardly changed in the past 40 years. In particular, the development of fragmentation and financial repression over many decades in these countries represents one of the most difficult challenges to overcome as they have shaped their economic landscape to an extraordinary extent. It will afford long lasting efforts until these phenomena are eventually withdrawn from LDCs. In this sense, the implementation and extension of organised banking within LDCs appears to be clearly one of the most important issues to be attacked.

Furthermore, with reference to the traditionally known growth theories which have been developed and applied in the economic context of fully developed economies McKinnon has created awareness on their limited practicability in the less developed economies. The latter lack the financial infrastructure necessary for applying such growth theories effectively. In fact, they suffer from imperfect capital markets which make the assumption of substitution effects derived from traditional growth theories like Keynesianism, Monetarism and the neoclassical approach futile. As long as a more or less uniform capital interest rate cannot be guaranteed in LDCs, alternative approaches need to step in. McKinnon provides such alternative by introducing a complementary relation between money and physical capital in LDCs. The aim is to raise interest rates to increase capital accumulation which in turn provides capital for highly productive investments which will be undertaken despite high interest rates for holding money. Hence, rather than a substitution effect between the two, McKinnon assumes increasing interest rates to entail a complementary effect leading to both elevated cash balance holdings as well as rising investment activities in the context of LDCs. Thus, such alternative approach, even though not yet proven empirically, helps sensitising for the prevailing economic conditions in LDCs and the degree of complexity financial intermediation is facing.

8.1.3. The lack of associating McKinnon's approach with Microfinance

Surprisingly, the Microfinance movement which has gained international reputation and was considered an adequate economic development policy is in no ways associated with the name of McKinnon, in spite of the striking similarities with his concept to overcome financial repression and fragmentation and to induce economic growth in the underdeveloped economies. In fact, in his study published in 1973, McKinnon was the first economist, or among the first economists at least, to consider a purely financial approach to economic development taking into account the specific framework conditions of LDCs. In this way, he was led to believe that the best financial contribution to economic development is to set up a balanced money circulation at the local level by way of "Microcredits" allowing for a small-scale yet highly productive economic development. In particular, he insisted that the population in rural areas should be given more opportunities. Furthermore, the successful implementation of the idea of Microcredits, at first by Yunus in Bangladesh and nowadays in many parts of the world, has in fact refuted McKinnon's critics who thought that the population of rural areas could not be expected to afford regular "savings" even of the smallest amounts and that, therefore, McKinnon's idea was but of theoretical importance (see, e.g., REUBENS 1974, at p. 500). Looking at the situation as it stands more than 40 years after the publication of McKinnon's study, the author would probably be pleased to see that in essence, contrary to what the critics had predicted, the concept of "small credits", or rather Microcredits, has become a worldwide movement and continues to be implemented in the lending schemes of several LDCs reaching approximately 200 million poor people.

8.2. Further topical elements of McKinnon's approach in today's economic policy

Several of McKinnon's ideas have materialised meanwhile in both development aid and government economic policy, in general. They may nowadays appear as adaptations to his concept of small-scale or rather Microfinance or they may refer to his policy advice given proving McKinnon's contributions in his book from 1973 to be visionary and his underlying ideas to be sustainable.

8.2.1. Actual development schemes similar to McKinnon and Microfinance

Government institutions have eventually adopted development schemes similar to McKinnon's strategy of small-scale finance or rather Microcredits. In the Russian Federation, a BRICS-state coming nowadays under McKinnon's definition of LDCs, a number of so called "Russia Small Business Funds" (RSBFs) were established during the period of transition following the collapse of the Soviet Regime towards the end of 1991. The concept of the RSBFs was developed in 1994 by the European Bank for Reconstruction and Development (EBRD) which has its seat in London (see EBRD 2007, p.37). The task of the EBRD is to support and enhance the economic development in Eastern Europe by granting loans to private investors and institutions. Originally, it was the EBRD's policy to concentrate on large scale investment and to extend credits of no less than the equivalent of 5 million Euros (see EBRD 2002, p.4). However, there was a lot of demand for small credit arrangements for micro- and small businesses. This led to the setting up of RSBFs in various regions in

Russia, endowed with sufficient capital to grant small-scale credits, also often in cooporation with local banks. The average credit size granted reached about 10.000 Euros in 2007. RSBFs do exercise the typical function of banks; the credits are not subsidies but real and repayable credits. The system of RSBFs has proved to work satisfactorily and has thus been maintained even after the barrier of the minimum credit amount of 5 million Euros was lifted under the presidency of Horst Koehler who later on became president of the International Monetary Fund and thereupon President (Bundespräsident) of Germany. The principle of RSBFs has now been extended to, and is practiced in, 18 countries of Eastern Europe and South East Asia (see EBRD 2007, p.36).

Again, the RSBFs somehow resemble the idea of (micro-) credits elaborated by McKinnon, although in the context of RSBFs no mention is made about the conceptual origins. RSBFs are clearly designed to contribute to the local and regional economic development and thereby to improve money circulation at the local level, just according to what McKinnon had in mind when he described the role of money and capital in the process of economic development. The main difference to the example of Bangladesh lies perhaps in that the credits granted are no longer "micro-credits" in the strict sense of the term but "small credits" in most cases, thereby reflecting the somewhat higher development status even in rural areas of the western parts of the Russian Federation. However, this development of the credit situation might also occur in Bangladesh after a certain lapse of time when the economic development bears fruit. It seems to be an advantage of McKinnon's concept that is has an element of flexibility which allows for a gradual evolvement without losing its conceptual structure.

When the EBRD was founded in 1991, the concept of supporting the economic development in Eastern Europe by way of granting credits which have to be paid back was not entirely new. In fact, the Kreditanstalt für Wiederaufbau (KfW, in English: Credit Institution for Recontruction) in Frankfurt served as a model. The KfW was established in 1948 when the Marshal Plan Funds were also accorded to Germany. As far as can be seen, Germany at the time was the only country to have used the Marshall

Plan Funds as the working capital of a newly created, state-controlled bank, the task of which was to grant credits to investors. Post-war Germany, as mentioned by McKinnon, was in an extremely difficult economic situation somehow similar to that of LDCs, although the banking tradition certainly proved to be helpful (see McKINNON 1973, p.91). In particular, due to the monetary reform of 1948 (introduction of the "Deutsche Mark") the credits handed out by the KfW since that date corresponded to a certain extent to the (micro-) credits styled by McKinnon 25 years later. The initial capital itself did not stem from the urban or rural population of the region but from the US-American Foreign Aid Program, not unlike the micro-credit lending schemes in Bangladesh.

What can be said in general is that the KfW concept was very successful in any respect. It largely contributed to the reconstruction of Germany by providing credit facilities which otherwise would not have been available to the population. Another positive effect was that thanks to the credit arrangements the original Marshall Plan capital, multiplied in the meantime, is still available nowadays where the KfW is supposed to extend credit to what is generally referred to as the “Mittelstand”, i.e. small and medium-sized undertakings. The Marshall Plan Funds were not used as subsidies but converted into small and bankable credits and thus introduced into the money circulation process allowing for an efficient use of the domestic capital market - in keeping with the idea of McKinnon's financial approach of economic development. He largely dwells on the economic situation of post-war Germany in the years 1960 – 1970 (see McKINNON 1973, pp.91-97) and, therefore, does not refer to the lessons which may be drawn from the KfW program set up more than 12 years earlier in the aftermath of the war. In this respect, Engerman and Witcomb, in their critical surveys, are perhaps right in saying that McKinnon's concept is not entirely new (see ENGERMAN 1974, p.271; WITCOMB 1974, p.422). Yet the essential aspect of McKinnon's analysis and concept is to have provided the first *scientific explanation of the economic potential of the supply of small, bankable money and capital* for economic growth in LDCs.

8.2.2. Liberalisation of foreign trade

Another area in which McKinnon's suggestions and proposals have been implemented in the meantime since the publication of his fundamental study to a large extent is certainly his call for the abolition of import substitution and its implicit import restrictions in favour of foreign trade liberalisation. As McKinnon already stated, it is commonly accepted that each policy to reduce imports means reducing exports at the same time (see KRUGMAN et al. 2012, pp.359-365; see above chapter 4.3., p.119).

In the late 1980s the critics against import substitution had become so prevalent among both economists and political decision makers that they lead to a shift of trade policies toward liberalisation of trade in nearly all LDCs. For example, Chile, one of the first LDCs to carry out reforms in their trade policy, removed import restrictions and replaced them by low customs. At first, years of economic crises followed arising partially from the world debt crisis and a dramatic decline of prices for copper on the world market on which the Chilean economy heavily depended at that stage. Eventually, however, the country's economic activity recovered and started to grow impressively. Between 1990 and 2001 the country has a record of averagely 5.5 percent growth per year putting it top of the Latin American countries which, after initial doubts, has led to a profound conviction about the positive effects of trade liberalisation among the population (see KRUGMAN et al. 2012, pp.359-365).

Furthermore, for instance, the European Union which now comprises 28 countries has seen the emerging of the single European Market involving the almost complete abolition of most of the foreign trade barriers, thereby allowing the economies of the former communist member states which have strong similarities with LDCs to benefit largely from the newly acquired export opportunities. In addition, an increasing number of underdeveloped countries are given practically free access to the European Market, e.g. as part of the Lomé-convention. In other areas of the world, new structures of liberalised export schemes have been implemented (CIS-States, NAFTA, etc.). At the worldwide level, the World Trade Organisation (WTO) is devoted to the gradual lowering or even abolition of customs and other barriers restricting foreign trade. McKinnon has mentioned the predecessor organisation General Agreement on Tariffs and Trade (GATT) and its potentially positive impact on the economic development of the countries involved (see McKINNON 1973, p.149). It was his position, precisely, to allow LDCs to fully participate in this organisation. Nowadays, this is the case. The World Bank and the International Monetary Fund are known for their policy of imposing commitments to liberalise the foreign trade sector in connection with a granting of financial or other support.

In the case of China and India, it is acknowledged that their newly acquired role in international trade as exporting nations is based on an apparently liberalised global economy allowing them to export large quantities of their goods and services. Globalisation is in fact a newly coined term expressing a new degree of international trade facilities which at the time of the publication of McKinnon's study did not exist, but were perhaps anticipated by him. Even Pakistan, in spite of its political instability, has been in a position to become one of the powerful LDCs based on the economic power generated i.a. by exports, even if not ranked among the BRIC-states. The Russian Federation, thanks to the enormous surplus stemming from energy exports - oil and gas in particular - has been able to reorganise itself while in transition from a communist economy to a more liberalised albeit still mainly state controlled structure, and to acquire the status of a very powerful economic entity, definitely more powerful in economic terms than at the time of it being a political superpower. Brazil, in turn, nowadays stands for a powerful and stabilised economy the resources of which primarily rely on agriculture (e.g. renewable energy materials, sugar or methanol) and the export facilities associated with them.

However, the success of foreign trade liberalisation for economic development in LDCs and the way it should be introduced are controversially discussed nowadays. Some countries, like Chile, have been able to improve their economic performance to a large extent since the liberalisation of foreign trade, while for others this measure led to economic distress and crises (see AGRAVAL 2004, p.143). Nevertheless, government intervention into and control of the economic activities are commonly considered as being undesirable and harmful to economic development which is why the World Trade Organisation (WTO) and the International Monetary Fund (IMF) still pursue a policy of promoting trade liberalisation instead of the inferior strategy of import substitution and its implicit import restrictions. McKinnon was among the first to criticize import substitution and to call for trade liberalisation, a view which has attracted more and more support over the years and which eventually became so overwhelming that it finally prevailed.

8.2.3. VAT and tax neutrality

Not unexpectedly, the liberalisation of foreign trade is closely linked to the impact of tariffs, tax concessions, and other subsidies which at the time of the publication of McKinnon's study in 1973 played a dominant role in the LDCs. McKinnon, therefore, pleaded for replacing the prevailing tariff and quota scheme by a new system of taxation satisfying both tax neutrality und the elasticity criteria as mentioned in his study (see McKINNON 1973, pp.132-133). Looking at the situation 35 years later, there definitely is a certain progress in the liberalisation of foreign trade as regards the general tax structure at various levels. The European Union, for instance, has reviewed its tariff and quota regulations vis-à-vis third countries, thereby allowing raw materials, industrial and agricultural goods from countries like Argentina, Brazil, Chile, and Mexico to get better access to the European Single Market. These countries, in turn, have reacted by lifting, or imposing less stringent, tariffs and quotas as regards European products. It seems to be obvious that practically all the countries involved are to be considered as LDCs within the meaning of McKinnon's definition presented in his study.

Asian countries qualifying as actual or potential LDCs like China, India, Thailand, Singapore and Pakistan have derived most benefit from the lifting of trade barriers by boosting their world-wide exports which have led to corresponding earnings and income, in particular as far the state treasury is concerned. The building-up of enormous currency reserves have led to the creation of state-funds owned by the government which nowadays have a growing and sometimes even stabilising effect on the international monetary system and the banking sector. For instance, in December 2007, during the world financial crisis, the Singaporean state fund “Government of Singapore Investment Corporation” has helped the Swiss Bank UBS to protect its equity capital base by injecting a loan worth 11 billion francs (see FAZ.NET 2007). However, it is doubtful whether and to what extent the local population can benefit from this type of liberalisation which seems to be largely state-controlled, thereby excluding stable growth at the local level by generating continuous flow of bankable money. This development corresponds less to what McKinnon had envisaged in his study of 1973 since the poor and underprivileged sectors of the population are not really given the chance to participate in the economic development.

Other tax implications impairing the creation of "a vigorous domestic capital market" - to use the words of McKinnon in his study (McKINNON 1973, p.131) - have also been, or are in the process of being, removed in the decades since the publication. For instance, in the field of indirect taxation, there is a general tendency to replace all types of turnover taxes by a modern VAT system in LDCs. The huge advantage of VAT lies in what McKinnon has described as "tax neutrality" (McKINNON 1973, p.143), thereby avoiding prohibitive or other detrimental effects which hinder the building up of efficient and stable capital markets. At the time of the publication of McKinnon's study, the application of VAT was not general standard at all. In Germany, for instance, the turnover tax was abolished as late as 1967 and replaced by the new and modern VAT, standing for the tax neutrality as requested by McKinnon. He strongly advocated the introduction of VAT in LDCs, predicting that its neutrality would help overcome financial repression and fragmentation, and still allow the government to generate sufficient revenue. In this respect, McKinnon's vision has become reality in the meantime. VAT is now generally accepted as a neutral indirect tax, even in LDCs as far as can be seen, but it is, of course, difficult to associate this international development with the merits of McKinnon's study, since the transitional process, as shown above, was already under way when his study was published in 1973.

8.3. McKinnon's terminology - financial repression, fragmentation, and the complementary relation of money and physical capital

In the process of his study McKinnon adopted his own terminology once his position deferred from what was commonly assumed or when his approach entered new fields of research. For instance, the notions of fragmentation and financial repression have been newly introduced in order to describe the economic state of less developed economies and the capital market respectively. Likewise, when McKinnon referred to the complementary relation of money and physical capital in the context of capital accumulation in LDCs, he did not only constitute a new interpretation of the capital accumulation mechanism, but coined a new term, too, disposing of a distinct recognition value.

8.3.1. Fragmentation and financial repression

As for his study in general, not much of his terminology has been picked up and delivered to the language use of learned writing today. For example, the notion of fragmentation has not been brought up again according to the sense McKinnon has assigned it for as far as can be made out.

Yet, out of McKinnon's terminology there is one term that stands out and this is the notion of financial repression which is widely spread nowadays and which has been part of many discussions in economic literature since. It thereby has retained its core statement as assigned by McKinnon. However, just as more and more repressive policies have been identified by now and different ways of financial repression have evolved over the last decades, its meaning has widened and gathers more subjects under its name than in the time when McKinnon wrote his book in 1973. It has been systematically assessed which is visible in recent definitions of financial repression, such as:

> "(...) financial repression can be broadly defined as a set of government legal restrictions, such as interest rate ceilings,

compulsory credit allocations and high reserve requirements, which generally prevent the financial intermediaries from functioning at their full capacity level" (GUPTA 2007, pp.335-336).

Compared to what was learned from McKinnon in 1973, there are now a tremendous number of repressive policies known to economists. In fact, any form of government intervention in the financial sector restricting capital freedom is nowadays referred to as financial repression, for example the setting of interest rates by the government in China (see DORN 2006, p. 231).

Financial repression itself stands for a term that has become so commonly known that in most of the economic literature no need is felt to further explain the origin of the notion or even to associate it with McKinnon. Rather, there seems to be no doubt amongst economists that financial repression, an expression which had been unknown 40 years ago, prevents the efficient allocation of capital and thereby impairs economic growth (see KAMAT and KAMAT 2007, p.5).

8.3.2. The complementarity relation between money and physical capital in LDCs

As regards the complementary relation of money and physical capital, even though there has been some discussion going on in the field, McKinnon's interpretation has not entirely convinced his readers so far. The crucial factor is, similar to the time of the publication of McKinnon's study, that there still exists no fundamental empirical work proving the complementary relation. Indeed, a number of empirical tests have been undertaken since 1973 producing widespread, though all in all negative, results (see FRY 1995, pp.194-196 for a summary of the tests and their conclusions). Interestingly, however, a more recent empirical study of 86 manufacturing firms in Brazil by Natke supports the complementary relation in so far that, at least in Brazil, current liquid asset holdings are indeed influenced by planned investment spending (see NATKE 1999, p.1017). Further empirical work is still necessary, though, to show that the case of Brazil is not unique. Natke in this context pleads for a separate treatment of the Keynesian and McKinnon's understanding of the self-finance motive when applying a test as their theoretical bases vary distinctly (see NATKE 1999, pp.1018-1019). For example, McKinnon's approach of complementarity is based on financially repressed economies in developing countries only. The Keynesian finance motive, on the other hand, is supposed to be applicable to any economic environment regardless of the size of firms or whether they self-finance or not. It is questionable whether the latter approach manages to cope with the specific conditions persisting in an underdeveloped economy. As a matter of fact, Keynes' work does not include any explicit theory on economic development in LDCs, which even the most profound Keynesians have admitted (see THIRWALL 1987, p.6). This goes to show that in the context of LDCs McKinnon's proposal to assume a complementary relation between money and physical – despite being more or less neglected so far – may bear an enormous potential as alternative approach to the established substitutional relation assumed in most other growth theories.

9. Concluding reflections on McKinnon

Summing up, after having analysed and assessed the study of McKinnon, the following concluding comments come to mind.

9.1. McKinnon's pioneering work in assessing the macroeconomics of money and capital for the process of economic development in LDCs

First of all, McKinnon, in his study, has indeed presented one of the first systematic approaches of the relationship between money and capital and the economic development in LDCs, covering a wide area of subjects and fields, yet without elaborating a general or specific development theory carrying his name. It is occasionally that he refers to his "fragmentation hypothesis" (see, e.g., McKINNON 1973, p.29) which is too narrow a notion, reflecting but a certain aspect of the financial problems LDCs are facing. The title of his study "Money and Capital in Economic Development" is rather of a descriptive and analytical nature, and so is the content of his book. McKinnon usually follows a *phenomenological method* with clear descriptive and/or analytical patterns and terms, written in a seductive and comprehensive style that catches the reader's attention at once, although at stages he switches to a level of highly abstract terminology involving mathematics, formulas, and statistics which require an in-depth understanding of economic theories at hand. For instance, the impact of direct and indirect subsidies on the capital markets of LDCs is dealt with in a great variety of cases, not easy to understand, but illustrating the complex relationship between the capital market situation and the degree of economic development in a fragmented environment. With the exception of *financial repression*, the terms coined by McKinnon in his study to describe the shortcomings of the economic development in LDCs are no longer in use, it seems. All this may be one of the reasons why following the reviews all published in 1974 which are mentioned above (see chapter 7, p.148) the findings of McKinnon on the role of money and capital in economic development have not received too much attention in learned writing within the United States of America in the past 35 years, as far as can be seen.

9.2. The limited publicity of McKinnon's study from 1973 in the world

Secondly, at the international level, the study by McKinnon is hardly known after 40 years have lapsed since its publication. For instance, his book is practically not referred to at all in German literature on the subject, even though the leading US-American economists usually exercise a noticeable influence on economists in Germany. One of the reasons why the book has not received sufficient international attention may be found in that apparently it was not translated into many other languages, contrary to what Luders had recommended in his review of the book (see LUDERS 1974, p.300). The only existing translations are Korean (1974), Spanish (1975), Portuguese (1978), and Chinese (1986). Other American post-war economists like Paul Samuelson, Milton Friedman, or John Kenneth Galbraith have become famous and well-known authors throughout the world because most of their books were translated in many languages and re-edited several times. Even if English may nowadays be considered as a kind of working language for economists, the lack of translations certainly constitutes a language-barrier for the public at large.

9.3. The increased topicality of McKinnon's ideas nowadays

Furthermore, there is sufficient and ample evidence nowadays that McKinnon's perception and methodological approach *are more topical than ever and deserve more attention*. This is evident not only because the number of LDCs has dramatically increased in the meantime and will continue to do so in the future, but also because the governments of LDCs would be well advised to consider his suggestions in order to reduce or even avoid the fragmentation of the economy and financial repression as much as possible. For instance, he has shown a very modern and convincing, almost visionary assessment of the implications of a neutral tax system on the foreign trade sector and its liberalisation. What is perhaps more important in this respect is McKinnon's pleading for *economic growth by means of an efficient supply of money and capital through the domestic capital markets in LDCs*. His financial approach consists precisely in the hypothesis that a stable and efficient money allocation is generated by allowing (Micro-) credit schemes to operate, designed to overcome financial repression and fragmentation as well as poverty in the poor, above all rural areas in LDCs eventually. McKinnon stands for a firm social commitment in the context of his financial approach - a standpoint which is of particular importance from the German perspective where the concept of "social market economy" ("Soziale Marktwirtschaft") was strongly advocated, and implemented, in the post-war period. This concept seems to be as topical for LDCs nowadays as it used to be in Germany right after the war when the population suffering from scarcity and depreciation of money was relieved by way of the introduction of a new currency and a new lending scheme designed to heal the war implications.

Therefore, in essence, McKinnon's study may not have received sufficient publicity in the past 40 years but most of the ideas developed in this study are sufficiently topical in LDCs even nowadays that there is a good chance for them to be revived and to gain more attention in the years to come. It is commonplace today that LDCs have their own structural conditions which ought to be taken into account in the context of economic theories. So far, McKinnon does not figure among the first row of the eminent US-American economists of national and/or international reputation and influence. Yet it seems that due to the economic developments in the years since the publication of his study, McKinnon's phenomenological analysis has to a considerable extent been confirmed in economic practice, thereby showing that new concepts which may appear rather secondary or even professorial at first glance may prove to be of primary and consistent quality and to be apt to have a long-term impact on economic theories worldwide.

9.4. McKinnon’s alternative approach as a basis for defining a new Microfinance concept designed to enhance economic development in LDCs

Taking the necessary macroeconomic conditions in LDCs for (Micro-) credit extension into account is one of the outstanding characteristics of McKinnon’s development theory from 1973. Nowadays, in general, Microfinance practice and research tend to be short-term oriented and mainly project and trial based, rather than being conducted according to a long term strategy and certain predefined critical success factors which have been retrieved from scientific analyses thereby taking the present macroeconomic context into account and showing that the models in use are capable to attain a certain beneficial impact or a certain economic objective, at least theoretically. McKinnon, in contrast, provides such comprehensive and long-term strategy and analysis.

Even though there are certainly points in his study which appear outdated from a modern perspective – for example, the gliding parity instrument for stabilising the economy in the transition phase is considered an unorthodox method nowadays – McKinnon’s study is highly topical in the key areas and may nevertheless be seen as important reference model for the Microfinance concept. In particular, McKinnon was able to develop an alternative economic development approach which is independent from the established growth theories. The latter assume perfect capital markets which, however, cannot be provided in LDCs where the fragmented state of the economy has caused imperfect capital markets to be in place.

Under such conditions and due to this fundamental difference, the established growth theories will have severe problems to successfully take effect.

In this context, McKinnon's complementarity approach between money and physical capital, even though still lacking sufficient empirical proof, may be considered a viable alternative to the established substitutional approach. The objective in LDCs should be to improve mobilising and generating more capital within the economy, in particular by helping to increase both savings and investments – an objective which may become feasible by assuming a complementary relation between money and physical capital which promotes both savings and investments.

Hence, it is proposed here to follow the comprehensive analysis of McKinnon from 1973 in the present study for elaborating an economic approach which reflects and forms the basis of a consolidated concept of Microfinance and its intrinsic elements designed to enhance long term economic growth – the original objective assigned to Microfinance by its pioneers, which, up to today, has not been sufficiently fulfilled.

SUMMARY

1. In the third part of this study, a change to a macroeconomic perspective is undertaken. The aim is to analyse and understand the role money and capital may play in the process of economic development and to draw insights for a Microfinance approach designed to enhance economic development therefrom. It is, in fact, a topic McKinnon has already embarked on in 1973 in his book “Money and Capital in Economic Development”. In his study he develops seminal ideas to further the process of economic development in “Less Developed Countries” (LDCs) from a financial perspective thereby including the provision of “very small credits” or rather Microcredits as a means to promote economic development. Apart from a small number of book reviews published in 1974, his ideas, however, have not experienced a great deal of attention in learned writing and his financial approach to economic development is hardly known, even though his work from 40 years ago contains many highly topical elements of development policy today. The idea is thus to pick up his approach and to reconsider it from a modern perspective thereby aiming at generating valuable insights for Microfinance designed to enhance economic development.

2. McKinnon’s approach emphasises the role of a strong domestic capital market allowing for a successful economic development in LDCs. Most of these countries do not dispose of a stable and functioning capital market, but tend to practice development policy in other ways, e.g. by promoting the domestic industries via import substitution. The problem with the latter policy is that the newly created industries are in need of heavy government protection as well as long-lasting government aid if they are to establish a competitive position. Such measures of government protection and aid comprise, for example, the unlimited provision of cheap credit and the restriction or even suppression of imports of competitive goods via tariffs, quotas and other trade barriers. As a consequence, the domestic economy for which a low general economic performance is already characteristic starts suffering from an overall restricted trade and also

loses most of its scarce capital resources to the few preferred industries and sectors. Additionally, and aggravatingly, the assigned cheap credits often mean a loss for the exchequer as interest rates are kept low deliberately.

3. In the eyes of McKinnon these forms of intervention policy have prevented and still prevent the banking system in LDCs from spreading around the country. In many places, particularly in the rural areas, no banks are present. The majority of the rural population has thus no access to the capital market. The only way for them to borrow urgently needed money is to address the local moneylender who will not hesitate to abuse his monopolistic position. The resulting usury credits granted at interest rates of more than 100% are in no relation to the cheap credits extended to the preferred sectors and prevent the rural population from taking up long-term investments. In this context McKinnon refers to the consequences of “financial repression”. He believes, though, that in the rural areas the highest productivity gains may be realised as their technical progress is generally still far behind the usual standards.

4. According to McKinnon it is already sufficient to provide “very small credits” to domestic entrepreneurs which, for example, allow for the purchase of seed fertiliser and help to raise the output by a lot. The interest rate charged for such credits should adequately reflect the real scarcity of capital as well as cover the costs for the credit institution. Credit takers should thus be capable to repay the credit and even gain a surplus which may be deposited at the bank and eventually serve further investment purposes. Interestingly, such approach resembles in an extraordinary way the general Microfinance idea which, however, was started only three years after McKinnon published his book, i.e. in 1976 when Yunus’ first Microcredit experiment was carried out. Hence, the term Microfinance was not yet coined at the time of McKinnon’s publication and thus could not be used by him in his study.

5. The objective of McKinnon’s approach is to liberalise trade and to unify the “imperfect” capital markets in LDCs which are distorted by the vast differences in interest rates charged. Access to the capital market is

scarce and should be made available to anyone. Promising investment activities would then be selected and realised in a natural way. Therefore, governments should entirely desist from their intervention and preference policies.

6. As far as capital accumulation in LDCs is concerned, McKinnon believes that by taking the specific economic situation prevailing in these countries into account real money and physical capital can be seen in a complementary relation to each other, i.e. rising real money balances come along with a rise of investment in physical capital. With this interpretation McKinnon is heavily opposed to the established monetary growth theories like Keynesianism or Monetarism which define a substitute relationship. Yet they fail to consider the specific framework present in LDCs. In these countries, in particular in the poor rural regions, capital accumulation means little to the population as no access to the capital market is granted and often inflation prevails in such a way that there remains no incentive to save. In McKinnon's view, however, the incentive to save may be revived by granting access to the capital market, by keeping prices at a stable level, and by providing attractive interest rates on savings which will fuel highly profitable investments, nevertheless.

7. Nowadays, McKinnon's thoughts have gained even more importance as the number of LDCs has expanded considerably. Furthermore, some of his ideas proved to be visionary as regards, in particular, the provision of Microcredits which are extended to people in many parts of the world today. Likewise, his perception on the liberalisation of foreign trade has been largely confirmed. Nowadays, the implementation of neutral tax structures (Value Added Tax) he pleaded for has been largely realised and is generally accepted as a taxation measure.

8. Being a pioneer in analysing the role of money and capital for the process of economic development in LDCs it is astonishing that McKinnon's study has been left unnoticed for all these years and, furthermore, that it has not been associated with Microfinance despite the striking similarities. What can be said, in general, after studying his book in detail, is that it has been confirmed that McKinnon's study, even though it

dates back to 1973, contains many highly topical elements for economic development strategies today. His strongest achievements for this study may be considered developing a Microfinance related development approach thereby assessing and taking the macroeconomic conditions of LDCs, in particular the financial challenges persisting which are most relevant for Microfinance, into account. Hence, McKinnon’s development approach will be taken as a reference in this study and will form the basis for a Microfinance concept designed to enhance economic development in LDCs – in accordance with the original idea of Microfinance.

IV. TOWARDS A CONSOLIDATED MICROFINANCE CONCEPT DESIGNED TO ENHANCE ECONOMIC DEVELOPMENT IN LDCs AND ITS PLACEMENT INTO A SUITABLE ECONOMIC FRAMEWORK

It became evident in the second part of this study that Microfinance to date may have failed to achieve any significant impact on the economic development in the respective countries it was introduced to (see above part II, chapter 2.2., p.36). In the course of the analysis, some of the symptomatic shortcomings which may be considered mainly responsible for this overall failure were identified, for example, the dominance of consumption over production credits in the sector and the commercially excessive behaviour and abusive lending practices by certain Microfinance Institutions (see above part II., chapter 2.3., p.42, and chapter 2.4., p.46). The *roots* of these shortcomings, however, were eventually found in the general lack of coherence and transparency in the Microfinance concept occurring both in research and practice (see above part II., chapter 2.5., p.54, and chapter 3, p.61). In fact, numerous Microfinance approaches have evolved over the years and are all based on different interpretations of the Microfinance concept while working under the same name. For Microfinance Institutions, in particular, such concept is depending to a large extent on their backgrounds as, for example, banks, NGOs or NBFCs (see above part II., chapter 3.3., p.71). Furthermore, this state of confusion surrounding the Microfinance concept may be considered the major reason why, so far, any attempts to regulate the market have failed, too. In fact, it is more or less impossible to successfully regulate a highly heterogeneous market which lacks a commonly practiced and accepted concept which might be serving as base for a comprehensive regulation. Any randomly applied regulation so far has caused problems to the whole market (see above part II., chapter 2.5., p.54).

Under the present circumstances, particularly due to the incoherent or rather random application of the Microfinance idea, it is little surprising that

Microfinance has not yet had any verified positive impact on economic development and, consequently, on the reduction of poverty. In fact, almost 40 years after its introduction the whole Microfinance idea is endangered to fail as a tool for *economic development* and to become a doubtful finance product with a random scope instead.

Hence, it is the aim in this part of the study to take steps towards more coherence and transparency in the Microfinance concept. Thus, in the following chapters, the **elements** of a Microcredit concept will be elaborated which coherently pursues one objective: *furthering the economic development of borrowers via Microcredits to help alleviate poverty* – an objective which happens to fully comply with the original intentions of the Microfinance pioneers, e.g. McKinnon and Yunus. Built on these elements, the ideal economic framework for successful Microcredit lending designed to enhance economic development in the context of LDCs will be elaborated. Thereafter, the growth mechanisms of the elaborated Microfinance concept will be run through under ideal conditions. Finally, the insights gained as well as the feasibility of the concept in practice will be discussed.

1. The task to avoid ambiguities in the field of Microfinance

Even though it may definitely be considered a historical progress that nowadays finance is made available to those parts of the population which were previously considered “unbankable”, Microfinance, so far, has achieved disappointing results in terms of fighting poverty. As recent research results have shown, Microfinance has not yet had any verifiable impact at all on the economic development of the respective countries and areas it was introduced to.

The major underlying problem in Microfinance is that different and sometimes even contradictory concepts of Microfinance are practiced under the same name. While Yunus and the Grameen Bank have been jointly awarded the Nobel Peace Prize for their Microfinance approach of creating “economic and social development from below” (Press Release Nobel Peace Prize 2006), other ruthlessly profit oriented approaches were responsible for the suicide of hundreds of over-indebted Microcredit borrowers like it happened in India during the past years (see above part II., chapter 1.4.2., p.27). In fact, the notion of Microfinance, as it stands today, may be described as rather ambiguous. In the public, Microfinance still enjoys wide recognition as a tool for economic development to help the poor escape poverty. In reality, however, only a few institutions are still dedicated to this objective, e.g. Grameen Bank in Bangladesh. Others, like Compartamos Banco in Mexico, do not set themselves such objectives, but have placed financial success of their institution as primary target by serving the so far underserved sector of the poor population. Most of the institutions active in the field of Microfinance simply avoid making clear statements as regards the objectives to be reached with their credit schemes, but leave this issue open (see above part II., chapter 3.3., p.71). At the same time, all these institutions take tremendous benefit from the marvellous public recognition of the Microfinance idea, no matter which interests they pursue and whatever their methods applied to reach their goals may be. In fact, the extension of Microcredits for random consumption rather than for income generating investments is said to be dominating the Microfinance sector by now, perhaps helpful to solve short term desires, but inappropriate to achieve economic impact in the long run. In particular, it is highly important to understand in this context that debt-based consumption by the poor which cannot be financed due to a lack of current and/or regular income will cause tremendous problems later on, as soon as the individual realises that no means for repayment are at disposition, at least not without heavy sacrifices in vital living areas like, for example, food supply. Despite the knowledge that the majority of Microfinance services more or less inhibits rather than promotes economic development by now, it is somehow still received as a successful and effective tool for fighting poverty in the public (see above part II., chapter 4.1., p.95).

The presence of such ambiguities in the field of Microfinance stands at the core for the lack of coherence and transparency in the Microfinance market. Both lack of coherence and transparency are considered mainly responsible for the failure of Microfinance to attain a positive impact to date. In the present state of the sector, it is very difficult for both market participants and observers to clearly differentiate between the manifold and diverse approaches of Microfinance in use and to direct their borrowing or investing decisions accordingly. Such ability to clearly differentiate would, however, be necessary in order to put an end to ambiguous comportment in the application of the concept of Microfinance. Therefore, supposed the concept of Microfinance were split into certain classes, for example, if there existed a class of Microfinance which explicitly pursued the objective of furthering economic development of borrowers and nothing else, while another class only provides solutions to short term financial needs of borrowers with no further long term interests, then anybody involved, e.g. investors or potential borrowers, but also the general public, could consciously take decisions in favour or against one respective class of Microfinance or another. In general, any actual or potential participant in the Microfinance market should get the possibility to distinguish between the different types of Microfinance services existing and to have the chance to get comprehensive information about the opportunities and challenges deriving therefrom. This study aims to make a first step towards a "classification" of Microfinance by providing a clear cut concept of a Microfinance service which exclusively aims at supporting the economic development of the borrowers and their eventual escape from poverty.

2. Determining the fundamental elements and characteristics of a Microfinance concept designed to help promote economic development

The following chapter aims at determining the underlying elements of a Microfinance concept designed to promote economic development. The elaboration of these specific elements represents the most important cornerstone in the overall consolidation process of the various ideas and interpretations of Microfinance which have evolved in the past four decades. In view of the multiple and strongly differing Microfinance approaches existing to date and due to the general confusion surrounding the Microfinance concept by now, a coherent concept for the furthering of economic development may be a first step towards more transparency in the provision of Microfinance services, in general, and, moreover, towards reaching positive impact with Microfinance, at last.

In fact, the elements are retrieved to a large extent by combining the insights gained from the critical analysis of the Microcredit sector (see above part II., chapter 4, p.95) with the knowledge generated from McKinnon's alternative financial development approach (see above part III., chapter 9, p.166). In line with the extracted intrinsic elements in part II (see above part II., chapter 3.4., p.91), a coherent and transparent Microfinance concept is provided when it unambiguously clarifies

- which **objective** is pursued,
- which **recipients** suit best to reach that target,
- in which fashion the Microcapital should be **deployed**,
- how **repayment** should be secured and
- which **further services** are needed apart from access credit to enable the fulfilment of the stated objective.

2.1. Element 1: Furthering economic development of poor clients as the ultimate objective of Microfinance

There are many famous success stories of Microfinance circulating in the world helping the Microfinance idea gain worldwide recognition. The most renowned story deals with Yunus and the very beginnings of Microcredits in 1976 (see above part II., chapter 1.1., p.13). Yunus met 42 women who manufactured bamboo stools, but were not able to generate sufficient return due to the extremely high cost of capital which they had to borrow from a usury informal lending source in order to buy the raw material in advance. When Yunus provided them with an alternative financing in form of a credit without interest rate, they were not only capable to repay the credit, but to increase considerably their income as well. In another famous example a creative borrower had the idea to use the Microcredit to buy a mobile phone and to open the first local phone booth which was badly needed as it turned out (see above part II., chapter 1.2.1., p.16). For example, day workers were now able to call construction sites and ask for available employment before going there in vain. The undertaking was so successful that the borrower was able to grow and diversify her business activities and nowadays owns a kiosk and a little Bed and Breakfast, too. The children are going to school and will probably take up studies at university level later on (see BUSE 2008, pp.54-55).

These famous stories about successful Microcredit deals all have one specific characteristic in common: The credits helped the borrowers to improve their lives by helping them advance on an *economic level*. In fact, the capital was *invested* to support some form of economic and income generating activity. In contrast, the well-known stories are not about poor individuals who were finally able to afford a TV or other consumer goods thanks to Microfinance, as far as can be seen. Nevertheless, the vast majority of Microcredits worldwide go directly into consumption rather than being invested to help the economic development of the borrower (see above part II., chapter 2.3., p.42). In general, consumption spending is an indicator of wealth which is normally not sufficiently present among the poor. They would first have to build up a certain level of wealth before they could be in a position to afford consumption spending. It is therefore assumed that allowing borrowers to use their credits for mere consumption will eventually force them to make sacrifices in fundamental supply areas like food, health care or school services (see also KARLAN and ZINMAN 2009, Abstract). It is rather doubtful whether this helps borrowers to fundamentally improve their lives or rather to alleviate their poverty status in the mean term. It is more likely that it will increase their problems instead.

Thus, supporting the economic development of borrowers should clearly be considered the preferred objective of Microfinance as economic progress helps the building up of wealth which naturally alleviates the poverty status and may probably allow consumption at a later stage. Thanks to McKinnon’s in depth analysis of the use of money and capital in economic development of LDCs from 1973, it can also be explained in a larger and scientifically assessed context how the furthering of economic development via Microfinance may work.

In his definition of economic development, McKinnon includes

> "the reduction of the great dispersions in social rates of return existing…" (McKINNON 1973, p.9)

as one of the key objectives to be reached. As it was explained in part III above (see part III., chapter 4, p.112), the economic landscape of LDCs is marked by heavy inequalities. McKinnon describes them as fragmented and financially repressed economies. Typical LDCs like, for example, Brazil, China, or Russia dispose of a vast economic power within the elite sectors, yet without participation of the majority of the population, especially the rural areas, which suffer from severe poverty and general economic underdevelopment. The great dispersions in social rates of return clearly address the tremendous inequalities existing in many of the LDCs. These inequalities may have increased further since the 1970s as many more countries qualifying for the status as LDC have emerged in the meantime. In countries like Brazil and Turkey which are counting among the so called "founding members" of LDCs as described by McKinnon, the gap between poor and rich might even have aggravated since. In 2014, in these two countries, people have imposingly expressed their deep dissatisfaction with the present status by organising large and on-going demonstrations in the streets. They complained heavily about the misuse of scarce capital and the corruption persisting in the administrative bodies of the government. In Brazil, in particular, incomprehension prevailed about the investment of large sums into prestige building projects like, for example, for the World Cup 2014 while at the same time prices for public transport increased and while the education sector was said to be notoriously underfinanced (see LICHTERBECK 2013).

These differences in social rates of return, where some sectors benefit from preferred policies while others are excluded, represent McKinnon's major reason why these countries have not been able to advance further in economic terms. In particular, the capital markets were distorted and fragmented due to preferential lending policies to certain industries using up the scarce capital present in these countries and resulting in the financial repression of the majority of the population. The latter either lack access to external capital, at all, or they are not granted access to capital under market conditions, but through usury informal lending sources, only. The high cost of capital to be paid for these sources hinders them to realise even the simplest investment opportunities while the preferred sectors of the economy have unlimited access to cheap credit resources. Consequently, the financially underserved parts of the population, the poor rural areas, in particular, continue to suffer from underdevelopment and stagnancy despite their efforts to advance through their daily work (see also above part III., chapter 4, p.112).

Interestingly, however, the state of underdevelopment generally entails a massive economic potential and lots of opportunities to improve with very basic, but highly productive investments. The sensible and effective exploitation of such potential would turn these underdeveloped regions into major drivers in reducing the great dispersions in social rates of return. McKinnon suggests that such investments could sensibly and sufficiently be financed with “very small” credits, or rather Microcredits, which enable, for example, the purchase of seed fertiliser which helps increase the borrower’s output and return to a considerable extent (see above part III., chapter 5, p.123). The generated return should normally be distinctively higher than before, so much so that the individual should not only be able to repay the credit, but also to gain a surplus which allows regular savings, perhaps designed for future investments or to finance school for the children. Furthermore, both the lent capital and the generated surplus, if deposited at the bank, are at disposition for the banking institutions again and will be available to serve further credit arrangements with other individuals, establishing a multiplying effect of money at the local level and creating an independent local capital market under equal conditions in the mean term, thus making a start towards unifying the distorted and fragmented capital markets present in LDCs (see also above part III., chapter 5.2., p.132).

Microcredits are thus particularly useful to help *the economic development* of the poor as the provision of these small credits may enable immense jumps in productivity and output in a highly underdeveloped environment. With the installation of banking and saving facilities and a regular supply with money through the local capital market the volume of investment will grow over time, and, consequently, so will the economic power in that region. Thus, if the alleviation of poverty shall be reached with the provision of Microfinance, then nothing but the enhancement of the economic development of the borrowers must be declared the ultimate objective of these services.

2.2. Element 2: (Potential) entrepreneurs with promising investment opportunities as the designated recipients of Microfinance

Having determined economic development as the ultimate objective of Microfinance the question arises who should receive these services, i.e. which types of recipients are best capable to achieve the objective of economic development.

Recalling the well-known success stories of Microfinance again, it may be observed that credits in these cases were always granted to poor people who were *economically active* and used the capital for *investment*. With the help of the borrowed capital they were able to establish or extend successfully an income generating or rather *entrepreneurial* activity. Thus, from a first glance, it may be assumed that Microcredits are particularly well designed for economically active individuals who are eager to increase the output and return of their economic activities, rather than to individuals who consume the borrowed capital on non-productive consumer goods. It cannot be expected that the latter will generate any return later on and thus does not comply with the objective to create economic progress.

In his definition of economic development in the context of LDCs McKinnon confirms this important aspect and provides an elaborate answer to the question who should be the designated recipients of Microfinance. Apart from reducing the great dispersions in social rates of return existing he considers equally important

> "…new investments under domestic **entrepreneurial** control" (McKINNON 1973, p.9).

McKinnon is aware of the difficult economic conditions present in LDCs and aims at corresponding to them in his analysis. As it was explained above in the third part of this study (see part III., chapter 5.2.1, p.132), LDCs lack any well-defined income categories or specialised processes of saving and investing as they would exist in developed economies. Generally, a class structure based on the functional distribution of income among wages, profits, interests, and land rents does not exist, nor can a saving class be distinguished from an investing class. The only "class" which can clearly be identified consists of

> "entrepreneurs who provide labour, make technical decisions, consume, save, and invest" (McKINNON 1973, p.10).

Thus, all those individuals or families performing these five functions can be denoted as entrepreneurs. They are the designated recipients of Microcredits as their characteristics comply with the requirements to enhance economic development with their activities.

In this context, however, two fundamental questions arise. First of all, how many individuals may qualify as entrepreneurs, or rather, can any individual be a successful entrepreneur? And secondly, considering the difficult economic context of LDCs, which sectors appear to be promising for these entrepreneurs to be successfully investing in?

Yunus, for example, sees an entrepreneur in almost anyone as soon as he or she is given access to finance (see DUFLO 2010; see YUNUS 2011b). However, it remains doubtful whether this approach is a realistic way to identify suitable recipients capable to achieve the desired economic progress. On the contrary, this view may wrongly imply that extending a Microcredit to poor borrowers will automatically turn them into entrepreneurs disposing of all the qualifications determined by McKinnon's definition of entrepreneurs. The assessment of Microfinance activity to date, however, has indicated that this approach resulted in the majority of Microcredits being used for consumption rather than for the realisation of entrepreneurial ambition (see above part II., chapter 2.3., p.42). Such careless extension of *consumptive* Microcredits may neither help the borrowers nor the economy as a whole to develop substantially. In fact, reportedly, such carelessness has sometimes even ruined the finances and lives of complete families when they were unable to repay the credit, or even worse, when they committed suicide in despair (see above part II., chapter 1.4., p.24).

A better way to respond to the first question is that ***potentially*** any individual may be an entrepreneur and granted access to Microfinance. ***Effectively***, however, only those who are capable to fulfil the requirements demanded from an entrepreneur as described by McKinnon. As a result, it must be assumed that the effective number of entrepreneurs present in LDCs is generally limited.

Furthermore, and turning to the second question, it should also not be the quantity of extended Microcredits which matters, but the ***quality*** of investment that is supposed to be supported by the access to supplemental finance. As far as the investment opportunities in LDCs are concerned, even though they may be considered to be plentifully present, the focus should lie on the most promising forms. In fact, ideal deployment opportunities for “less developed” entrepreneurs may be found specifically in the services as well as in the production sector. The demand for services would typically be given in the more developed economic centres of LDCs like big cities where a need for small scale support persists, for example, in form of messenger or transportation services, food supply for employees via mobile soup kitchen, or gardening services for sophisticated households. Each of these services affords small scale or rather Microinvestments into the needed facilities like a mowing machine, a transportation vehicle and/or cooking device. In the production sector, the largest opportunities may be found for growing producers in the remote, economically abandoned areas of LDCs, in particular in farming and manufacturing for which constant investment into the improvement of the working process and productivity is needed, e.g. machinery, tools, seeds, or fertiliser.

Interestingly, a more successful way to find potential entrepreneurs in LDCs is to identify economically active individuals which already produce certain commodities or provide services, i.e. which dispose of a certain set of skills and business infrastructure, so that they are most likely to comply with the requirements of an entrepreneur as laid out by McKinnon, like, for example, the 42 women from Jorba producing bamboo stools mentioned above (see above part II., chapter 1.1., p.13). Then, the focus can be laid on finding out whether there exist promising investment opportunities within these small enterprises. In the stool maker example, the business success and productive development were inhibited especially due to the exaggerated cost of capital charged by usury lending sources thereby preventing sufficient return to be generated from an otherwise well-running business. Hence providing more affordable capital was key in turning the business into profitability and in assuring repayment of the lent sum.

All in all, however, it must be assumed that not only the effective number of entrepreneurs present in LDCs is generally limited, but that simultaneously only a limited number may be expected to be successful with their investment opportunity in the challenging economic context of LDCs, i.e. that the number of promising investment opportunities is also limited, in general.

Consequently, if the Microfinance sector strictly pursued the objective of identifying potential entrepreneurs with promising investment opportunities, then the number of Microcredits extended in the world would be expected to decrease tremendously.

Nevertheless, if the objective of reaching economic development with the distribution of Microcredits shall be pursued consistently, then Microcredits should be extended to those capable to achieve economic progress, only, i.e. to potential entrepreneurs who dispose of a promising production opportunity.

2.3. Element 3: Productive investment as a non-negotiable pre-condition for Microcredit extension

Having specified economic development as the major objective and potential entrepreneurs with promising investment opportunities as the designated recipients of Microfinance the following fundamental element of Microfinance addresses the character of the credit itself. The major question is in which way the capital from the credits should be deployed.

In general, credits may either be invested productively or they can be spent non-productively via consumption. As it was explained by McKinnon, entrepreneurs perform several important functions in the economy including both consumption and investment. However, in order to achieve economic development according to McKinnon's definition it is necessary to enhance, in particular,

> "…new **investments** under domestic entrepreneurial control" (McKINNON 1973, p.9).

It is interesting to note here already that the consumptive use of Microcredits is not even mentioned by McKinnon as a possible way to deploy Microcredit capital showing that such unproductive use of scarce capital was not even considered a possible alternative to productive investment. In fact, using the credit for non-productive consumption is not considered an investment and, furthermore, would be counterproductive for the objective of reaching economic development. Due to their state of poverty and their lack of a regular income the approval of such consumption credits may cause over-indebtment of borrowers.

Instead, the credits should preferably be used for *productive investments*. Such productive investments may be extensively outlined, however, simplified, it means that the capital should be deployed *in a market oriented or rather in a product oriented way by multi-periodical personal partnerships*. The objectives are to create value and to generate income allowing repayment of the loan and leaving a surplus for the investor. It is argued here that the smoothening of consumption needs may, for the first time, become an option for the entrepreneur and her/his affiliates once a generated surplus is at disposition. Such opportunity to consume would be covered by an income as a result of value creating work rather than being debt financed.

Nevertheless, whether capital has been deployed productively or non-productively may sometimes be difficult to judge. In most cases an increase in productivity can *directly* be explained by the impact of an investment, but there are others, where a connection persists *indirectly,* only, and hence its productive impact is more difficult to explain. On the one hand, for example, the purchase of seed fertiliser with the borrowed capital has a *direct impact* on increasing the output of the harvest and improving the overall productivity, i.e. the investment itself in form of the seed fertiliser is the vehicle for improvement. On the other hand, an impact on increasing the productivity may sometimes be reached *indirectly*, for example, through consumption spending, too, even though such deployment of capital appears to be non-productive from a first impression. It is decisive in this regard whether the positive impact of such consumption spending can sensibly be explained and related to the objective of improving the productivity and/or efficiency of an economic activity. For example, the purchase of a warm coat seems at first like an investment in the improvement of the personal quality of life rather than in the improvement of the individual's entrepreneurial activity. If, however, the coat allows for an increase in working hours in the cold and prevents possible sickness which would otherwise cause non-productive time, then it may be considered a productive investment as it *indirectly* supports an increase in productivity and thus in output. Therefore, the investment itself in form of the coat may not be the vehicle for improving the productivity - it still is the individual's hard work which remains decisive for increasing the output in the end. Yet, the coat obtains an indirect, but no less important role as it enables extra shifts in the cold necessary to reach an increase in output and productivity overall.

All in all, it may be noted that the most important characteristic of a Microcredit with the objective of reaching economic development should be its productive deployment, i.e. its market or rather product oriented use, in form of a direct or indirect investment by multi-periodical personal partnerships. Interestingly, there may exist cases where initial consumption may indeed be considered a productive investment, too. It is, of course, a sensible "price-earnings" ratio which finally legitimates the approval of a credit for such an investment. In the example given, the question would then be on how many days of the year the wearing of a warm coat is necessary and whether these days are decisive for substantially increasing the productivity so that an elevated return can be generated, sufficient, at least, to repay the credit for the coat. In contrast to the seed fertiliser mentioned before which is used up after the first application, the coat represents a durable investment, which may be expected to endure several seasons in a row. Thus, both potential investor and lending institution are responsible for keeping the price-earnings ratio in the appropriate proportion. Most importantly, however, their decision to approve or decline a credit transaction should always be based on whether such a transaction serves the ultimate goals of supporting entrepreneurial activity and reaching economic development.

2.4. Element 4: Using promising investment opportunities as collateral

Usually, the chance to get a credit approval is a lot higher - and the cost of capital substantially lower - if it can be securitised with collateral which can be seized in the event of credit failure. Typical forms of collateral are physical property, e.g. buildings or owned land, a regular income or other financial guarantees by third persons like close relatives.

The difficulty for potential Microcredit borrowers is that they typically lack any of these forms of traditional collateral due to their state of poverty. With no collateral at hand, the credit will either be neglected or it will be classified as a high risk transfer leading to strongly elevated costs of capital for the borrower, which, in turn, will reduce the chances to become profitable with the planned investment.

On the other hand, the group of poor borrowers possessing some land and/or a small house, e.g. those working in agriculture, risk losing everything they have if they use it as collateral during their investment. Therefore, in this study, it is suggested that the insertion of such collateral during a credit transfer is only permitted if the survival of the family is secured, i.e. if a minimum subsistence level can be guaranteed for the family despite the seizing of house and land as collateral. Consequently, by assuming that the vast majority of these households cannot afford losing house and land, they may be counted among those having no collateral to offer, too.

Hence, the question is how Microcredits for poor borrowers can alternatively be securitised.

During the past 40 years, new approaches to circumvent or rather replace the traditional requirements for physical collateral have been developed (see above part II., chapter 2.4.2., p.48). The most renowned and widest spread approach is the principle of group lending where a credit is extended to a group of borrowers and each group member acts as guarantor for the others. Formally, this approach has indeed produced exceptionally high repayment rates for many years in the Microcredit sector. However, a look behind the scenery has revealed that the real number of failures is generally disguised by this principle because any failure of a member is absorbed by the group and does not appear in the balance sheets of the lending institutions (see above part II., chapter 2.4.2., p.48). Additionally, the group members have to sustain an extraordinary social pressure during the borrowing phase. Failing the credit repayment will not only cause denial of any further credits in the future, but, even worse, it will most probably also damage their social ties or leave them socially isolated.

Having set the furthering of economic development as the ultimate objective of Microfinance by means of extending these services to potential entrepreneurs for productive investment, this study suggests a new approach on how Microcredits could be collateralised. As it was explained above (see above part III., chapter 5.2.1., p.132), McKinnon has identified three decisive components which influence the inter-temporal decision making of an entrepreneur in an underdeveloped world, i.e. whether or not he or she will decide to become economically active or to increase an economic activity:

1) “His endowment or owned deployable capital.
2) His own peculiar productive or investment opportunity.
3) His market opportunities for external lending or borrowing over time outside his own enterprise.” (McKINNON 1973, p.10)

In a fragmented economy which is typical for LDCs these components are very badly correlated. For example, entrepreneurs with potential production or rather investment opportunities lack resources of their own and/or have no access to external financing. As poor people generally lack sufficient endowment or deployable capital, the access to supplemental external financing is, consequently, of critical importance if any promising investment opportunities shall be realised. Nowadays, with the Microfinance movement having started to implement financial services for the poor without endowment in many parts of the world (see above part I., chapter 2, p.2), external borrowing has become a realistic opportunity for domestic entrepreneurs. In the absence of endowment, but in the presence of increasing access to external financing the identification of productive entrepreneurial investment opportunities thus attains a key role in making entrepreneurial activity happen and, hence, in helping promote the economic development in the underdeveloped areas.

Coincidently, as it was explained above (see above chapter 2.2., p.183), the state of underdevelopment, even though certainly not desirable, entails a massive potential for development, nevertheless. In fact, in underdeveloped areas the opportunities to enhance and further economic development are plentiful and can very often be realised in small, but highly productive steps, e.g. by the simple use of seed fertiliser which will increase both output and return to a considerable extent. Essentially, a poor farmer intending to realise such a promising investment opportunity would only be in need of some extra capital in order to be able to make the necessary purchases. Naturally, such extra capital needed will be provided through a Microcredit and, thanks to the strongly elevated income generating prospects of the investment, it is highly probable that this credit will successfully be repaid. Hence, the best collateral for a Microcredit in an underdeveloped economy may indeed be considered the *promising investment opportunity itself,* which can be found plentifully in these areas.

Furthermore, using the investment opportunity as collateral for Microcredits more or less assures the deployment of capital to the most sensible and thus truly promising investments for which a strong and on-going demand persists. It may indeed serve as “collateral” for the economy in so far that it prevents the market from being flooded by products which may be easy to produce, however, for which no real demand exists (see LECHNER 1988, pp.9-10). Nowadays, for example, out of the minority of Microcredits extended to date which may be considered productively invested an elevated number is preferably used for either the purchase of sewing machines or the establishments of kiosks. Consequently, there is an oversize supply of second hand bags or clothes in these regions. In fact, the real demand for these products is tiny, especially bags, as their purchase does not cover any basic needs and is thus of limited interest for potential buyers in an area that suffers from overall poverty. In many cases, the eventual buyers of these perhaps beautiful but rather useless products are charitable institutions from abroad intending to help the producers, however, creating an artificial market the continuation of which depends entirely on the capability of the institutions to convince further buyers rather than on the continuous real demand for the product (see also BATEMAN 2010, p.53). The same applies to the number of small kiosks existing nowadays. In some areas, kiosk owners struggle with an immense competition for the few buyers of their products (see BATEMAN 2010, p.2, pp.66-73). Food, on the other hand, is generally scarce in poor regions and represents a basic need for which a continuous high demand persists. Furthering the local agriculture and food production may thus be considered an example for a sector disposing of numerous highly promising investment opportunities which may be adequate to serve as collateral at the same time.

The remaining question to be discussed in this context is which kinds of financial providers would be ready to accept promising investment opportunities as collateral? In fact, it cannot be assumed that there exist any traditional banks which are fully informed and riskless, and which would thus be open to implementing such securitisation approach.

However, it may be assumed that the following constellations allow implementing promising investment opportunities as collateral:

1. *Altruistic and social institutions* which do not pursue profit maximisation, however which aim at conserving the capital granted, i.e. which are *risk neutral*, for example, crowd-funders using the platform “kiva.org” (see also above part II., chapter 1.4.1., p.24).

2. Financing provided by *government institutions* which are *risk-averse*, i.e. which cap the inherent risks, e.g. state funds like the Norwegian pension fund or the European Fund for South-East Europe (EFSE).

3. Implementing the use of promising investment opportunities as a *criterion for granting a banking licence* to finance institutions intending to invest in Microfinance (which may be cross-subsidised by the government). Furthermore, the alternative use of property based and/or group based securities as collateral is explicitly prohibited.

4. By leaning on to *Islamic banking* principles where no interests on capital are allowed, but where any return generated is shared between capital provider and capital seeker. In fact, the external capital is used as equity in the company balance so that both provider and seeker *share the inherent risks* of an investment: bankers will only provide capital if they are fully convinced by the project. In this sense, the banker acts as finance director of the company, like it is, for example, the case for private equity funds, Venture Capitalists or Business Angels.

2.5. Element 5: Indispensable services accompanying Microcredit extension – Access to business banking accounts and access to saving and deposit accounts

Having primarily specified the characteristics for enhancing economic development with regard to Microcredit extension, so far, the attention is now drawn to the requirements beyond mere credit supply which should accompany any Microcredit transaction designed to enhance economic development. Hence, the opportunities of granting access to banking accounts to credit takers, and to business banking accounts, in particular, will be explained and implemented as an indispensable part of the Microfinance concept presented.

Most importantly, for capital providers, such business banking accounts can be used as a control opportunity by giving them insights of the revenues and expenditures streams taking place during an investment.

They would then be able to verify whether the planned cash flows are being realised, or not. Moreover, it would enable them to take steps and intervene at an early stage if they observe deviations in the business conducts of their clients. In general, it may be assumed that such controlling ability by the financial institutions would greatly support the viability of using promising investment opportunities as collateral as stated in the previous section (see above chapter 2.4., p.189). Hence, whenever a credit is supplied, financial institutions should be obliged to provide their clients with a business banking account, too.

For credit takers, on the other hand, such access to banking accounts would enable them to organise their cash flows, while also providing them with an opportunity to save and deposit some of their generated revenues earning them an interest rate, rather than leaving the surplus unproductively "under the pillow" at home. Hence, any entrepreneur aiming for financial self-sufficiency should not only get access to costly external finance and credit accounts, but should also have the opportunity to accumulate some capital via savings and deposits accounts and, in particular, via the interest rates paid on them by the banking institutions. With the accumulated capital further promising investments may be undertaken at a later stage or other future expected expenditures may be compensated.

Until then, the capital from the savings may serve the financing of credits for other individuals allocated by the banking institutions. These institutions, too, are considered to benefit strongly from attracting savings and deposits and the inherent multiplying effect of money on their way towards financial self-sustainability. More precisely, by attracting savings and deposits from their customers they could be in the position to start relieving themselves from the pressure of having to rely entirely on the inflow of external or foreign capital, thus providing themselves with a substantial alternative capital source by building up their own equity base. In fact, they would be able to retrieve a considerable amount of their deployable capital out of the regular flow of money typical for a functioning capital market rather than being dependent on external capital injections for virtually each new credit arrangement (see above part III., chapter 8.1., p.154; see also McKINNON 1973, p.170). Furthermore, a capital market with a growing savings and credit volume indicates the creation of real value in the economy.

In general, any financially well-developed and stable economy benefits from a more or less equal proportion of credits and savings which keep the price level at a steady level. In fact, they dispose of a functioning capital market. Banks are responsible for the efficient allocation of present “absorption deficits” to the financing of “absorption surpluses”. The former originate from savings and deposits at the banks by individuals and households, i.e. their accumulated capital, while the latter represent individuals or enterprises ready for investment, but in need of supplemental capital due to a lack of sufficient resources of their own. Ideally, their need for credit can be financed by using the capital at disposition from the savings and deposits (see LECHNER 1988, pp.152-155; see also above part II., chapter 3.1., p.62). Thus, a further important aspect of attracting savings and deposits in an economy is that they help mobilising disposable capital, eventually serving the financing of further absorption surpluses or rather credit arrangements instead of being hoarded at home and left unproductive. The establishment and furthering of an adequate local capital market may thus be the key towards efficient allocation of disposable capital towards the best investment and production opportunities at hand (see above part III., chapter 5.2., p.132).

In the context of LDCs, however, McKinnon has shown that the existing capital markets are fragmented and financially repressed, and that, so far, capital accumulation plays an insignificant role. In most cases, banks offering savings are not present or interest rates on savings are low and with inflation present the return from savings might turn out to be negative (see above part III., chapter 4, p.112). Therefore, in order to overcome fragmentation and financial repression in the capital markets eventually, it is worth repeating McKinnon’s quote here stating that there

> “appears to be no economical substitute for *expanding the role of organised finance* in small-scale lending to indigenous entrepreneurs in either rural or urban areas”

(McKINNON 1973, p.77, italics mine; see also above part III., chapter 6.1.1., p.137).

“Organised finance” normally deals with the management of money which includes the management of debts and liabilities, e.g. credits or, in this case, “small-scale lending”, but also the management of equity holdings and assets, e.g. savings and deposits. Thus, the provision of savings and deposits accounts may be considered an indispensable part of organised finance. Unfortunately, the majority of Microfinance Institutions nowadays does not offer savings in their service schemes, as far as can be seen (see above part II., chapter 3.3., p.71), even though households, entrepreneurs, and financial institutions should all have a strong interest in the availability of capital from savings and deposits.

For McKinnon, the key to attracting savings from individuals and entrepreneurs is granting a sufficiently high interest rate which should increase the general propensity to save (see above part III., chapter 5.2.2., p.134). Essentially, in the specific economic surrounding of LDCs, where a wide range of investment and production opportunities persist, McKinnon aims at creating a dynamism which promotes only the best of these opportunities. He would prefer if economically active individuals saved their capital rather than invested it in inferior processes and technologies which keep their economic development at a low level. Hence the high returns of attractive saving schemes would make them desist from continuing inefficient low level productions and investments which generate less return than savings. Instead they would start accumulating capital to be invested at a time, when significant improvements can be achieved. Meanwhile, their saved capital is at disposition for current promising investment opportunities.

On the other hand, as far as the banking institutions are concerned, paying elevated interest rates on savings may at first seem like an unnecessary supplemental cost driver for them they may not agree with. However, apart from the structural advantage of being able to build up their own, manageable capital base with the help of customer savings accounts, additionally, the demand for credit should remain unbowed and continues to be plentiful despite attractive interest rates on savings. It has been shown that the economic potential present in LDCs provides many promising investment opportunities the return of which will exceed considerably the return gained from the elevated interest rates on savings, so much so that entrepreneurs will decide to invest rather than to save. Hence, rather than to depend on acquiring costly external capital from investors, these investments can be financed to a large extent by the higher proportion of savings present on the capital market (see also above part III., chapter 5.2.2., p.134).

At the same time, the interest rates charged for credits are much higher than the interest rates paid on savings and deposits by the banking institutions. The cost of credit may adequately reflect the inherent cost of lending while also leaving a substantial benefit to the banking institutions. McKinnon, for example, has estimated interest rates between 15 and 25 per cent to be adequate (see above part III, chapter 5.2.2., p.134). Hence the credit transactions may provide for a steady income enabling banking institutions to provide means for paying both employees and interest rates on savings while also generating a surplus which may be used, for example, for further expansion of the banking activities.

Thus, contrary to the initial assumption, it goes to show that banking institutions, if they want to achieve financial self-sufficiency themselves, would have to promote savings and deposits of their customers. If not, weal and woe of their business may continue to depend on the goodwill of financial investors and foreign capital, in general, the provision of which in turn is dependent on the financial success of the institution the latter depending on the ability of customers to succeed. It rests uncertain, however, whether customers, deprived of the opportunity to accumulate capital due to the absence of access to savings and deposits accounts, are able, at all, to be continuously successful with their investments and thus susceptible for further credits and increasing investment activities. The vast majority of them would keep up investing their limited capital in inferior economic activities and processes rather than saving it to wait for larger and better investment opportunities. In fact, for most of them the level of development would most probably continue to stagnate at a low level and repayment of credits would remain a tremendous struggle. Therefore, savings need to be promoted and attracted so as to gain the banking institutions a solid equity base with which they can steer the efficient allocation of disposable capital while generating them the needed revenue. Hence, a positive investment climate resulting from improved build up and use of disposable capital will not only increase the standard of living of customers, but also both revenue and capital stock of banking institutions in the mean term.

What can be said overall is that, first of all, credit takers should be provided with a business banking account in order to organise their revenue and expenditure streams, but also in order to provide banking institutions with a controlling ability of these streams which increases their influence and hence also the chances of using promising investment opportunities as collateral. Secondly, for the furthering of financial self-sufficiency of both borrowers and lenders access to savings and deposits accounts should be promoted, in general, while the provision of such accounts should become compulsory once a credit is being extended, in particular. As the interest rates for borrowing are typically high in Microfinance, banking institutions should be able to afford paying elevated interest rates for savings and deposits, too, reflecting accurately the cost of capital. Higher interest rates attract more savers and, furthermore, make them refrain from investing in inferior technologies and inefficient working processes, while helping them accumulate capital in anticipation of better investment or production opportunities. Interestingly, the approach to increase the attractiveness of savings and deposits via higher interest rates has worked rather well for Grameen Bank II. They were not only able to increase the Savings and Deposits portfolio to an extraordinary extent thanks to an elevated interest rate at 9 per cent. Additionally, the number of credit extension went into new heights with interest rates charged between 20 and 25 percent – as assumed by McKinnon – earning Grameen Bank II a healthy profit and making it independent from donor and investor capital for the first time (see above part II., chapter 2.1.3., p.33, and chapter 3.2.2., p.75). It seems, under such conditions, assuming a complementary relation between money and physical capital as suggested by McKinnon may indeed become feasible in the context of LDCs, as the Grameen Bank II experience has shown (see above part III., chapter 5.1.3., p.129, and chapter 9.4., p.169).

2.6. Element 6: The origin and non-speculative character of Microfinance capital

The remaining field to be clarified is the origin and character of the capital resources provided for a Microfinance concept designed to enhance economic development.

In fact, it may be generally assumed that the capital is distributed by regular Microfinance banks which are served by the regular capital market, however, not by the speculative market. The latter may be excluded as any transaction conducted in the presented context is not considered to be subject to speculative decision making in a limited time frame, but designed as a long term investment in an economic environment with extraordinary development potential expected to achieve steady economic progress, growth and to generate returns, hence making the investment attractive for traditional, non-speculative capital providers (see also above chapter 2.4., p.189). In fact, the speculative elements in this context are considered to be more or less equal to the usual microeconomic risks inherent in any usual business investment cycle. Hence, the level of risk and uncertainty usually associated with a speculative context is not given here.

Microfinance banks in operation may be organised in various ways. They may be privately or state owned, but also organised as a public-private partnership (PPP). Another interesting type of organisation would be credit cooperatives as a self-help organisation among private households where any speculation is formally excluded. Indispensable characteristics of these banks need to be the ability to create bank and savings accounts as prescribed by the fifth element above (see chapter 2.5., p.193).

On the capital market itself a wide range of capital providers can be found, for example, state or private funds, foundations, venture capitalists, business angels, seed-financers, but also the interbank market, from which the proposed Microfinance banks are able to receive sufficient capital.

3. Elaborating the appropriate economic framework for Microfinance to enhance economic development in the context of LDCs

Having set forth the elements and characteristics of a Microfinance concept designed to attain the objective of enhancing economic development the question arises which economic framework would be appropriate for the concept to be successfully applied in.

In general, LDCs dispose of a tremendous development potential as a result of their state of underdevelopment, but they often lack a mature financial infrastructure to exploit the opportunities given. Hence, and in accordance to McKinnon (see above part III., chapter 6.1.1., p.137; see also above chapter 2.5., p.193), the role of **organised finance** needs to be greatly expanded and improved so that the vast economic potential can finally be exploited.

In their current situation, LDCs continue to suffer from low economic growth combined with a substantial scarcity of capital. In fact, the drivers of growth, **capital accumulation and successful entrepreneurship**, may only take place in a few highly developed economic centres, but are absent in most parts of the economy (see above part III., chapter 4.1., p.113). Hence, the main focus of monetary and fiscal policies should lie in helping promote capital accumulation and entrepreneurship which are desperately needed to enhance economic development in LDCs.

As it was explained by McKinnon (see above part III., chapter 5.1., p.124; see also part III., chapter 2, p.108), it is doubtful whether **the leading monetary growth theories**, like Kenynesianism or Monetarism, can be applied to the context of LDCs. In particular, the assumption of perfect capital markets may not fit the economic background of LDCs, where capital is scarce and where the capital markets are usually heavily distorted and fragmented. Their state may rather be described as imperfect. Under these circumstances, applying the policies of modern economic growth theories may do more harm than they may help.

Furthermore, aggressive, though certainly well intended government intervention and preference policies aiming to protect and promote domestic producers are aggravating the state of fragmentation and lead to financial repression (see above part III., chapter 4, p.112). They need to be discontinued and replaced by more neutral policies. McKinnon suggested complete liberalisation of the capital markets and of foreign trade as a suitable measure for relief (see above part III., chapter 6.1., p.136). It remains questionable, however, whether complete liberalisation leads to overall positive results, too. Nevertheless, applying an appropriate and efficient competition policy in the context of LDCs appears indispensable for supporting economic growth in these regions.

Hence, finally, an alternative method to organise competition via ordo-liberal structures will be elaborated and presented. It is considered the most adequate framework for the extension of the Microfinance concept developed in this study and may be used as a basis for providing coherent and transparent Microfinance services.

3.1. The importance to expand the structures of organised finance in LDCs in order to exploit efficiently the capital resources and the large development potential persisting

It is interesting to note that DCs, in contrast to LDCs, benefit from an extended network of banking facilities and a long lasting banking tradition, in general, yet their development potential via small scale finance appears rather limited due to their overall high development level. Nevertheless, the demand for Microfinance in DCs is increasing rapidly, and sometimes even too fast. In 2008, for example, Germany had to leave more than 200.000 requests for Microfinance unfulfilled, representing a considerable loss of employment opportunities in a country, where around 3.3 million people were unemployed at the time (see BILEN 2009, p.28). Nowadays, ith the massive inflow of refugee migrants to Germany, the demand for Microfinance is expected to rise even more. This goes to show that even in highly developed environments numerous small scale investment opportunities can be identified, even though not all of them may be considered feasible, of course, with respect to the difficulties of identifying promising small-scale investment opportunities. In turn, it provides an impression of the enormous dimensions of the economic potential which may be expected to prevail in the underdeveloped environments and which is waiting to be exploited. This, however, may only be achieved efficiently in the presence of a large and well-organised financial infrastructure. As it was explained by McKinnon, a functioning capital market with a large banking system governing money and finance may effectively exploit the economic potential existing and is thus considered indispensable for enhancing economic development, particularly in LDCs (see above part III, chapter 4, p.112). However, organised finance in LDCs is scarce and its expansion has been restricted by certain shortcomings in the economy, namely due to the malfunctioning of the domestic capital market which is said to have been distorted by fragmentation and financial repression. As a result, access to the capital market is rarely given and an overall scarcity of capital persists (see above part III, chapter 4, p.112).

Hence, the only way to unify the capital market, and thus the primary task of government policy, is to actively help expanding organised finance in LDCs throughout the country by any means and to enable an overall access to finance, technology, and skilled labour to small-scale entrepreneurs and the population, in general, providing the structural requirements for the successful exploitation of economic development potential (see above part III., chapter 6.1.1., p.137).

Indeed, compared to 1973, the time of the publication of McKinnon's book, the state of the domestic capital markets of LDCs has certainly changed to a considerable extent. At the time, access to finance was even scarcer and access to the regular capital market was rarely given. This situation has certainly improved nowadays, as the Microfinance movement has brought financial services to some of the remotest areas in the world serving as alternative to the local moneylender and other informal credit institutions and thus increasing the overall access to finance in these regions. More than 200 million Microcredit takers have been recorded and the number is increasing rapidly (see ARMENDÁRIZ and MORDUCH

2010, Preface; BANERJEE and DUFLO 2011, p.166; see also above part I., chapter 3, p.4). Nevertheless, the Microfinance capital market is still not working as efficiently as it should be and dispersions in the social rates of return persist. In some areas, interest rates charged by Microfinance Institutions, e.g. Compartamos Banco in Mexico, resemble very much those previously charged by usury informal sources, like, for example, the local moneylenders (see above part II., chapter 2.4., p.46; see also part II., chapter 3.3.4., p.80). In other areas, customer savings are still not offered in addition to credits by Microfinance Institutions, e.g. SKS Microfinance in India (see above part II., chapter 3.3.3., p.77). The efficient exploitation of capital resources and a process of capital accumulation are thereby restricted the importance of which will be explained in the following section.

3.2. Economic policy and the importance to promote the generation of disposable capital and to avoid inflation

The main objective of any economic policy, in general, is to achieve full employment of all production factors in the economy, even though it remains unclear whether and to which extent such objective may ever be reached (see LECHNER 1988, pp.7-9). Indeed, capital accumulation and the presence of a large entrepreneur class are considered among the most important strategic factors on the way to full employment (see LECHNER 1988, p.248).

In order to promote capital accumulation, enterprises, households and individuals need to be provided with disposable capital to finance their investment opportunities. Ideally, disposable capital is available, if absorption deficits, in particular in form of savings, have been generated in previous periods, ready to finance absorption surpluses, in particular investments, in the actual period (see LECHNER 1988, p.152-155). Without sufficient disposable capital at hand, any unbacked creation of money by the central banks, the so called “easy money policy”, will most likely lead to inflation. In fact, due to the raised availability of cash the demand for goods increases. However, while the supply with cash can be increased in the short term by lowering the capital interest rate on the capital markets leading to the availability of cheaper credits the supply with goods remains constant for the actual period as they can only adapt the production for the next period. As a result, goods become scarcer in relation to the increased demand so that suppliers will react by lifting prices, giving rise to inflation, and thus to a rise in overall cost. Furthermore, there will be less disposable capital available in the next periods as the generation of absorption deficits, i.e. savings, has been less attractive than producing absorption surpluses. Eventually, the interest rate will rise again as a means to stop inflation, but prices remain constant at the elevated level and credits for the financing of investment will be more expensive again, while disposable capital is scarce as savings are yet to rise again (see LECHNER 1988, p.163). Hence, in the mean term, such policy rather leads to a general loss of capital than to its accumulation and will not help to further entrepreneurship so that the objective of full employment is threatened. Consequently, it has been understood that in order to sustainably promote capital accumulation and entrepreneurial investments, absorption surpluses should generally be backed up by disposable capital generated from absorption deficits in previous periods, or, in other words, any credit should be backed up by capital generated from savings.

In LDCs, a general scarcity of disposable capital can be observed due to a lack of an overall saving class (see above part III., chapter 5.2.1., p.132). Thus, fuelling investments by entrepreneurs with backed-up capital is limited so that monetary policy is often tempted to apply easy money policy as a relief in the short term, the result of which may be, however, that more value is destroyed rather than created in the mean term. Nevertheless, the financing of entrepreneurial activity and the enhancement of economic growth remain vital for capital accumulation, even though they appear rather difficult to attain in the economic context of LDCs. It has become clear, however, that the focus of economic policies in LDCs should primarily lie in helping to increase greatly the attractiveness and the amount of savings in order to generate a stock of disposable capital which can back up the financing of entrepreneurial activity without giving rise to inflation, but leading to an enlargement of the entrepreneurial class, thus to economic growth and to capital accumulation.

3.3. The limited field of application of the leading economic growth theories in the context of LDCs

According to the assumptions of leading monetary theories, like Keynesianism and Monetarism, capital markets are perfect with individuals and households facing the more or less same effective price for capital. In LDCs, however, capital markets are distorted and fragmented so that highly different prices for capital need to be paid, i.e. their capital markets may be considered imperfect (see above part III., chapter 5.1.2., p.126). This underlying difference has an immediate impact on the effect of applying such theories in the context of LDCs.

In fact, the notion of a perfect capital market implies that real money and physical capital are in a substitute relationship, i.e. the return on holding money is held against the return on investing in physical capital where a decision taken in favour of one option, only. For monetary politicians in support of the leading monetary theories holding money is not desirable and equally considered a shortfall in demand (see LECHNER 1988, pp.196-200). They prefer it to be productively converted into physical capital and employment as a means to accumulate wealth and thus to enhance economic development. The so called “easy money policy”, as explained in the section before (see above chapter 3.2., p.203; see also LECHNER 1988, p.163), is widely spread and acknowledged as a means to fuel the economic performance in the short term. The capital rate of interest is lowered so that credits become cheaper and savings less attractive. This way the demand for investments into physical capital is greatly increased and thus the substitution effect sets in (see above part III., chapter 5.1.2., p.126; see LECHNER 1988, p.163).

According to McKinnon, however, in the financial structure of an underdeveloped environment, money is more or less the only financial instrument which can be identified. Furthermore, and unlike in DCs, money is also the only financial asset available for wealth holders and thus represents an important factor for the accumulation of wealth in these areas. The imperfect capital market structure, together with financial repression and the inability to borrow at market prices, prevent them from "substituting" real money for physical capital. Hence, contrary to the situation prevailing in DCs, the ability to hold money, in particular as savings, turns out to be highly important in LDCs and the impact of the monetary system is decisive for efficient capital accumulation to take place (see above part III., chapter 5.1.1., p.124; see also McKINNON 1973, p.38). Thus, applying uncritically the methods of the leading monetary theories from DCs to further economic growth to the context of LDCs may do a lot of harm. In particular, "easy money policy" and the process of lowering the capital interest rate making holding money less attractive negatively affects capital accumulators in LDCs where holding real cash balances represents more or less the only means to accumulate wealth.

Furthermore, as it was explained above (see above chapter 3.2., p.203), inflation will most probably set in as an immediate consequence of "easy money policy". For wealth holders in LDCs, i.e. real cash holders, such inflationary policy leads to inflation taxes paid by the households and individuals on their savings thereby reducing considerably their accumulated wealth (see above part III., chapter 5.1.2., p.126). In total, easy money policy not only reduces the attractiveness of holding money, it also reduces its value due to inflation. Hence, as there exists no alternative for accumulating wealth in LDCs than via holding money, monetary and fiscal policies should by any means make holding money attractive and avoid policy decisions which give rise to inflation.

McKinnon therefore adapts to the economic situation prevailing in LDCs. In fact, he believes that, in these specific economic surroundings, the substitute relationship between money and physical capital does not apply, but that rather a complementary relation may exist between them:

> "conditions that make real money attractive to hold enhance rather than inhibit private incentives to accumulate physical capital" (McKINNON 1973, p.40).

Thus, complementarity of real money and physical capital implies that an increase in money holdings in form of savings will further physical capital accumulation through investments nevertheless. This approach is contrary to the assumptions of traditional monetary concepts, where attracting and extending the holding of real cash balances is considered as inhibitor of economic progress (see above part III., chapter 5.1., p.124; see LECHNER 1988, p.163)

It seems the complementarity approach by McKinnon fits perfectly in the context of LDCs. Capital accumulation lies idle, in general, and money is the only financial asset to accumulate capital. Therefore it appears appropriate for monetary policies to increase the attractiveness of savings to mobilise savings and to enable an efficient capital accumulation process. At the same time, the development potential present in LDCs provides numerous small scale investment opportunities the returns of which are expected to exceed substantially those generated from savings and holding money. Hence, despite attractive savings opportunities economic development will still be furthered due to more attractive investment opportunities present. Promoting savings will help mobilising capital which creates further disposable capital designed for financing these investments.

Unfortunately, there exists, as far as can be seen, only one quantitative survey from Brazil supporting that the complementarity relation suggested and developed by McKinnon is working to a certain extent (see above part III., chapter 8.3.2., p.165; see also NATKE 1999). McKinnon's complementary approach has thus not been sufficiently tested in order to assure that it is the appropriate alternative monetary theory in the context of LDCs. On the other hand, McKinnon has provided sufficient proof that modern economic theories like Keynes and Monetarism should not be applied to the economic context of LDCs (see above part III., chapter 5.1., p.124; see above part III., chapter 8.3.2., p.165). What may be confirmed after all, however, is the premise that monetary theories in the context of LDCs should focus primarily on supporting the expansion of the role of organised finance, in particular to enable the accumulation of capital via savings, and on furthering entrepreneurship via small-scale or rather Microcredit lending as the most important drivers for helping sustainably the economic development in LDCs to improve. The complementarity approach by McKinnon is a way supporting both aspects and, with no alternative at hand, will be assumed in this study as a basis according to which monetary and fiscal policies should take their decisions.

3.4. A critique of liberal and intervening competition policies in the Microfinance sector

Apart from capital accumulation, another vital factor for achieving full employment is applying an efficient competition policy (see LECHNER 1988, p.248).

As it was demonstrated by McKinnon in detail (see above part III., chapter 4, p.112), competition policy in LDCs was, and continues to be, dominated by a rather aggressive intervention policy by the government aiming to protect and promote local industries. These policies, however, turned out to become unfair preference policies towards some selected industries leading to a state of fragmentation in the economy and to financial repression of the vast majority of the population. In fact, the scarcity of capital already persisting in less developed economies was aggravated due to preferential lending methods at interest rates below the market price for capital. In fact, with government intervention the scarce capital was consumed to a large extent leaving other industries in need of capital unserved, or rather financially repressed (see above part III., chapter 4.1., p.113, and chapter 4.2., p.117). In addition, measures to enhance the local production by manipulating foreign trade via, for example, tariff protection and import licences on certain goods turned out to be hidden subsidies and had the same negative effects on the local economy all the way, i.e. fragmentation and financial repression, especially on the local capital market (see above part III., chapter 4.3., p.119).

Normally, it is the task of a functioning capital market to allocate available finance efficiently to the most promising investment opportunities. In view of the distorted and fragmented state of the capital market in LDCs, McKinnon suggested to liberalise both the capital market as well as foreign trade in order to relieve the economy. In particular, he recommended governments to refrain from any intervention policies (see above part III., chapter 6, p.135). Instead, the ideal way for governments to unify the capital market and end financial repression would be to focus on expanding

> "the role of organised finance in small-scale lending to indigenous entrepreneurs in either rural or urban areas" (McKINNON 1973, p.77).

In this way, his idea of enhancing economic development in LDCs would take shape, namely to reduce

> "the great dispersions in social rates of return existing and new investments under domestic entrepreneurial control" (McKINNON 1973, p.9).

Indeed, as far as small scale lending, or rather Microfinance is concerned, development authorities which had subsidised Microfinance Institutions for a long time started to introduce liberal policies to the Microfinance sector at the end of the 1980s. The objective was to reach financial self-sufficiency of the institutions. The idea behind was that independence from subsidies and the new pressure to be financially successful would help increase the outreach of Microfinance to even the remotest areas not yet supplied with finance. Subsequently, numerous privatisations of Microfinance Institutions were conducted and a general commercialisation of Microfinance lending could be observed starting to take over the Microcredit sector in the following years and becoming the dominant practice, eventually (see above part II., chapter 1.3., p.20; see also BATEMAN 2010, p.14).

Even though such measures looked promising at first, with some Microfinance Institutions starting to generate healthy profits, they turned out to be a detrimental incentive for the whole sector in the mean term. In fact, the focus of Microcredit lending switched from the socially well-intended "poverty lending approach" towards the return and institutional growth oriented "Financial Systems Approach" so that from then on the financial performance of Microfinance Institutions was given highest priority (see above part II., chapter 1.3., p.20, and chapter 2.4.1., p.47).

The results of the introduction of liberal structures to the Microcredit sector were not only an overall lack of economic impact and poverty reduction by Microfinance to date (see above part II., chapter 2.2., p.36), but also a dramatic increase of over-indebted borrowers due to the careless extension of consumer Microcredits (see above part II., chapter 2.3., p.42), and a considerable rise in abusive and commercially excessive lending practices (see above part II., chapter 2.4., p.46). When the authorities in LDCs finally realised that the Microfinance market went out of control, they returned to the intervention policies leading immediately to several substantial repayment crises which nearly caused a collapse of the sector in some regions (see above part II., chapter 2.5., p.54).

Obviously, both liberal and intervening policies may not stand for the appropriate competition policy to be applied in the context of LDCs, in particular, for the practice of Microfinance. Liberalisation may help in mobilising extra capital, especially from investors, but it has turned out that the liberal forces on the capital market were not capable to allocate the money efficiently so that economic development was attained. Furthermore, chaotic conditions persist nowadays in an uncontrolled, non-regulated market with a multitude of different approaches and interpretations of Microfinance in place, each following and applying their own idea leading to an overall lack of coherence and transparency of the Microfinance concept (see above, part II., chapter 3., p.61).

3.5. Towards an ordo-liberal economic organisation and the introduction of the "EconDev Microfinance" concept

In view of the failures caused by applying both liberal and intervention policies in the Microfinance sector alternative competition policies need to be developed. Ideally, such policy would be capable to help organise the Microfinance sector in such a way that a coherent and transparent practice may be enforced so that the proclaimed objectives, like, for example, economic development and poverty reduction, may be finally achieved.

In fact, it is suggested here to lean on the approach of an "ordo-liberal" economic organisation of the Microfinance market. Typically, in this policy form, an economic framework is provided in which all market participants can operate freely, but need to comply with specific rules and regulations which apply equally to any market participant. The government, or another specified agency, will be in charge of supervising and assuring that all market participants operate in line with the predetermined rules. Market participants, in turn, are free to take decisions, but must take over full responsibility of their operations and shall be held liable for any offence of the rules (see also ENGELKAMP and SELL 2013, pp.457-460; see also WILDMANN 2014, pp.96-98).

In the Microfinance concept developed in this study the enhancement of economic development has been declared the ultimate objective. Economic development is the driver of sustainable capital accumulation which leads to increased wealth. This way, Microfinance can effectively contribute to poverty reduction (see above chapter 2.1., p.179). Thus, a framework with a set of rules to host this concept shall be set up. The provision of Microfinance within this framework and according to these rules shall be named "EconDev Microfinance". Hence, any market participant aiming to qualify as provider or recipient of "EconDev Microfinance" will need to apply Microfinance according to the following rules:

1. The overall objective of "EconDev Microfinance" is to enhance the economic development of its borrowers and suppliers of such services need to devote themselves to this objective (see above chapter 2.1., p.179)

2. Microcredits have to be extended to entrepreneurs, or to potential entrepreneurs at least, with a promising investment or production opportunity (see above chapter 2.2., p.183).

3. Microcredits must be invested productively. By no means they may be used for mere consumption, unless an indirect connection can be confirmed which effectively and sufficiently provides an increase in the productivity or efficiency of an income generating activity (see above chapter 2.3., p.186).

4. Microcredits do not require any collateral, in general. Alternative methods to secure repayment, like, for example, group lending or

joint liability, which are not related to the investment itself, should not be applied. Instead, repayment is secured by selecting the best investment opportunities available which are most likely to succeed and which can numerously be identified in the underdeveloped world, and which hence act as collateral (see above chapter 2.4., p.189).

5. Credit providers must provide business banking accounts to credit takers. Furthermore, the latter must be given access to savings and deposit facilities in order to be able to improve capital accumulation efficiency in the short term, to become financially self-sufficient in the mean term and to achieve economic stability in the long term. As banking institutions themselves benefit equally from the generation of disposable capital, interest rates on savings should be adequately high in order to attract as many savers and depositors as possible (see above chapter 2.5., p.193).

6. The capital deployed must originate from regular business investment providers present on the capital market. “EconDev Microfinance” is not subject to short term speculative capital (see above chapter 2.6., p.199).

In order to assure that market participants abide to the rules, a supervision agency needs to be installed by the government and provided with the legal authority to enforce the rules. Any investor or donor providing money explicitly for the extension of “EconDev Microfinance” can be assured that the money is deployed coherently according to the rules set.

It is important to note here that such a framework does not have to be confined to the extension of “EconDev Microfinance”, only. It may be developed for any field of application of Microfinance. In fact, a framework for the extension of consumption Microcredits with a set of rules in accordance may function equally providing for a classification of the different ways to deploy consumption credits, for example, for the purchase of food, for education, for health improvement, or for the purchase of mere consumer goods. This way, coherence and transparency would be provided in the Microfinance market and it could be assured that the means provided by investors or donors are deployed according to their investment wishes. In any case, it would help to show that Microfinance may be used for a number of purposes some of which may be active drivers of improving the living standard of borrowers, e.g. “EconDev Microfinance”, while others may be used for enabling a different organisation and distribution of the routine household expenses, like food supply. Finally, some may incorporate a high risk for credit takers of aggravating their current status, e.g. mere consumption credits which cannot be financed due to a lack of current income. It remains, of course, within the hands and the will of borrowers for which Microcredit product they finally opt. The responsibility for making this choice, however, also lies in the hands of those providing the respective Microfinance products, i.e. the Microfinance Institutions and banks, as well as those willing to contribute financially to their provision, e.g. the investors.

4. Ideal growth mechanisms of the elaborated concept of Microfinance and institutional support by reference to the stool makers from Jorba

In this chapter, the growth mechanisms of the elaborated “EconDev Microfinance” concept shall be demonstrated with reference to a renowned example of successful Microcredit extension from the past. In fact, it refers to the stool makers from Jorba, i.e. the 42 women which had been provided with credit by Yunus in 1976 (see above part II., chapter 1.1., p.13) – a non-speculative capital resource as Yunus did not even charge an interest rate, but relied on the capacity of the women to repay (see above chapter 2.6., p.199). Choosing this example for demonstrating the effects of the “EconDev Microfinance” has the advantage of dealing with a real rather than fictional case.

Furthermore, ideal structural conditions will be assumed so that access to organised finance persists and is dedicated to providing both attractive savings and credit facilities to the population. The economy is assumed to suffer from underdevelopment, yet bringing forth an enormous economic potential waiting to be exploited. Government policies have legally enforced the rules of “EconDev Microfinance” and have set up a supervision agency to assure compliance with the rules, thus providing a regular economic framework for a market designed for the extension of Microfinance to enhance economic development. Market participants may operate freely within this framework, but need to respect the rules applying for the extension of “EconDev Microfinance” and will be held responsible for any offence (see above chapter 3, p.200).

4.1. From productive microcredit extension to successful repayment and savings

Ideally, costly but affordable Microcredits will be extended by the banking institutions – which are supplied by non-speculative capital resources on the capital market (see above chapter 2.6., p.199) – to the best production and investment opportunities persisting. The capital is not spent on mere consumption, but invested productively aiming to create and add value to the economic activity of an individual. In due course, the successful economic activity will allow the individual to earn sufficient return to repay the credit including interest rates. This way, the borrowed sum is at disposition for the banking institutions again, ready to serve further productive investments for other individuals. Moreover, despite the payment of credit instalments the individual is left with a surplus generated from the economic activities which may serve the financing of personal needs or which may be saved, for example, as a basis for the next investment. Banking institutions, on the other hand, are rewarded with the revenue gained from the credit transactions. The installation of savings accounts adds to the overall capital stock ready to be productively employed. As a result, the accumulation of wealth has begun providing a first prospect of financial self-sufficiency for both lender and borrower in the future (see also above part II., chapter 2.3, p.42, and chapter 2.4., p.46; see BATEMAN 2010, pp.24-25).

4.1.1. Identification of potential entrepreneurs with promising investment opportunities

Before any capital is extended by means of a credit, of course, the first rule for extending “EconDev Microfinance” requires suppliers to devote themselves to the objective of enhancing economic development with their service and, secondly, to identify potential entrepreneurs which dispose of a promising investment or production opportunity, accordingly (see above chapter 3.5., p.210 ; see also chapter 2.1., p.179, and chapter 2.2., p.183). In the example from Jorba, the women had been pursuing an income generating activity by producing stools made from bamboo (see above part II., chapter 1.1., p.13). This situation may be considered an excellent condition for successfully identifying entrepreneurs, at first. As it has been explained above, the women's economic activity of producing stools shows that they dispose of a certain set of skills qualifying them as entrepreneurs within the meaning of the second fundamental element elaborated (see above chapter 2.2., p.183).

Having identified the women as suitable entrepreneurs, now, the focus of the research process needs to be placed on identifying whether the entrepreneurs dispose of a promising investment or production opportunity and whether any financial involvement provides for a substantial increase in productivity or efficiency, thereby generating an elevated return to the investor allowing the repayment of the borrowed capital and leaving a considerable surplus, nevertheless. As far as the demand for stools is concerned, a sufficient turnover could be assured by the local stool merchant who, as far as can be seen, purchased them all on a regular basis and sold them on (see above part II., chapter 1.1., p.13). Hence, the production opportunity may be considered promising in so far that a general demand for stools persists (see above chapter 2.2., p.183).

Nevertheless, the women from Jorba, for eventually producing the stools, were in need to purchase the raw material in advance. However, as they were not endowed with capital they had to borrow the sum needed to realise the purchases. So far, a lack of access to alternative sources forced them to approach usury moneylenders leading to a tremendous cost of borrowing which left them with hardly any return and inhibited any advances in productivity and efficiency. In fact, the women from Jorba were prevented from doing better due to a lack of access to affordable credits. Thus, providing the women with capital at market prices should already suffice to help them generate an elevated income from their activities while being in the position to afford repayment of the credit including interest rates. Hence, the production opportunity may be considered most promising, indeed (see above chapter 2.2., p.183).

Consequently, after having chosen “EconDev Microfinance” as a concept and hence complying with the first rule, the crucial phase for financial institutions of identifying entrepreneurs with a promising investment opportunity according to the second rule of the “EconDev Microfinance” has successfully been completed.

4.1.2. Productive capital deployment, intangible collateral and the requirement of “sympathetic” client consulting

The word “credit” can be derived from the Latin word “credere” meaning “to trust” or “entrust”. Hence, in any credit transaction, capital is virtually “entrusted” to borrowers with the firm belief that they are capable to repay. As a first measure, banking institutions in the Microfinance sector need to assure that their entrusted capital is used productively by the entrepreneurs with the promising investment opportunities, in order to comply with the third rule of the “EconDev Microfinance”, i.e. that the capital is not used to smoothen non-productive consumption (see above chapter 3.5., p.210; see also above chapter 2.3., p.186). Hence, a distinct form of sympathetic client consulting is required, explaining to the borrowers the risks inherent in the misuse of capital and convincing them that any deployment other than for productive investment in their promising production or investment opportunity will cause severe setbacks in their finances and lives as repayment will not be secured or may be impossible. In the case of the women in Jorba, a productive investment of the borrowed sum into nothing else but the raw material needed to be assured. Yunus trusted them and relied on their promise to use the capital for the purchase of the raw material which they finally held. Alternatively, Yunus could have taken over the purchase of bamboo himself in order to secure a correct deployment of the money.

Furthermore, the banking institutions, in general, are eager to select those options available on the market which have the highest chance to be successful bearing in mind that no collateral in physical form is provided but that the qualities of the entrepreneur and the investment opportunity have to suffice acting more or less as “intangible” collateral. Thus, quality of the choice of the entrepreneur and the investment is most important as they are the only collateral at disposition for banking institutions according to the fourth rule of “EconDev Microfinance” (see above chapter 3.5., p.210; see also chapter 2.4., p.189). Such form of collateral, however, also assures a more or less continuous sympathetic client consulting by the financial institutions. The borrowers are to a large extent depending on such “sympathetic” form of consulting as they may be considered low educated in terms of finance, in general, and are thus in need of protection. Referring to the example of the stool makers from Jorba, it was highly important that Yunus analysed the situation in depth together with the 42 women before taking any further steps. Only this way it became clear where problems persisted and where opportunities to improve the situation via Microfinance could be found. Hence, the obligation for sympathetic client consulting may assure that borrower and lender develop all aspects of the investment together, including a careful plan of investment, repayment and saving. Such joint analysis of potential production or investment opportunities may be considered indispensable to find out whether financial furthering is, at all, suitable to increase the income considerably on the one hand, and whether affordable conditions for borrowing can be supplied on the other, allowing the borrower to generate a surplus in the end. Only this way capital accumulation and an improvement of the overall economic situation as prescribed by “EconDev Microfinance” may be achieved.

4.1.3. Completion of credit repayment, surplus generation and savings

Finally, the women from Jorba were able to repay the credit in a rather short time. Even though Yunus’ story ends here, i.e. with the successful repayment of the sum, it may be assumed that the women have been left with a substantial surplus generated due to the strongly reduced costs of borrowing. In fact, in accordance with the sixth rule of “EconDev Microfinance” (see above chapter 2.6., p.199) Yunus took the form of what would nowadays be considered a (non-speculative) business angel and did not charge any interest rates on this specific loan to the women from Jorba. It was his first experiment with Microfinance and he wanted to find out, first, whether these poor women, so far considered “unbankable” in traditional finance, were trustworthy. It may be assumed, however, that charging interest rates at market prices would not have thwarted the prospects of repayment and of a considerable surplus for the women as the interest rates would still have been substantially lower than before.

Once the repayment is complete and a surplus at hand, the question arises how to handle the extra capital generated. In line with the fifth rule of the “EconDev Microfinance” concept the first option should be to deposit the capital as savings, in particular as long as it remains unclear how to deploy it, so that further income from the interest rates paid on savings can be generated and so that capital accumulation can take place effectively (see above chapter 3.5., p.210; see chapter 2.5., p.193). For the stool makers, it would be particularly sensible to save a considerable amount in view of the next purchase of raw material which lies ahead at a certain point. With some equity at hand, future credits are rated safer and will become considerably cheaper. From a future investment perspective, another good option for the stool makers would be to save all surplus for paying the complete amount due for the raw material next time, sparing them the total cost of credit, thus generating even more return in the future, however, leaving them with little for the moment. Of course, consumption spending now becomes an option for the first time, too, as it represents remuneration for hard work. Another reason to save the money is to be prepared for unforeseen events and monetary bottlenecks or emergencies in their private households. Whatever the decision may be, it is highly important that individuals consult closely with their banking institution which option suits best in the respective situation. Banking institutions continue their sympathetic consulting approach and will try to convince borrowers to save or invest as much as possible so that capital accumulation takes place effectively.

4.1.4. The symptoms of economic growth: Money circulation, disposable capital and capital accumulation via increases in efficiency and productivity

From the perspective of banking institutions, several beneficial effects may set in after the Microcredits have been repaid and a surplus been generated by their customers. First of all, the lent sum is at disposition again – including a substantial amount of profit generated from the interest rates charged – meaning not only that it may serve further financing of investments again, but meaning also that during its circulation in the economy it has helped create and add value in form of the stools produced from mere bamboo by the women and of the revenue generated from the sale, a factor which stands representative for the successful enhancement of economic development. In addition to the renewed availability of capital from previous credit transactions, the increased amount of savings from the generated surplus adds further to the capital stock providing for the banks' own disposable capital urgently needed to back up credit supply, rather than being dependent on the inflow of external disposable capital from, for example, investors.

Looking back on the experiences of the stool makers form Jorba during the Microcredit borrowing cycle, it may be resumed that their stool production has experienced a fundamental increase in efficiency and return which was achieved by substantially reducing the costs of borrowing leading to the generation of a distinct surplus thanks to the financial intermediation via "EconDev Microfinance". In fact, the women have put themselves in an economically better position, created by their own hands and supported by finance which provided them with a higher return than in previous periods leading to an increase in their overall wealth. It may hence be concluded that a substantial progress in their economic development has been achieved after this first borrowing cycle so that the prospects of "EconDev Microfinance", namely to enhance economic development, have been fulfilled.

4.2. Outlook and the importance of follow up financing to continue the economic growth process

The successful Microfinancing of the stool makers from Jorba, even though it has not been reported what happened to them in the aftermath of Yunus' experiment, may be considered only the beginning of a development process. If possible, it should be assisted by providing more or, at least, a continuous level of Microfinance so that the women can constantly build up wealth in the following periods with their stool production. At the same time, the continuation of these services would allow for a further increase in income for the banks, too. In fact, both participants would benefit largely from any productively employed capital which the financing of the stool makers has proven to be. Moreover, after a successful first investment cycle, any thoughts on extending and diversifying the product portfolio may be further developed and put in concrete terms in consultation with the banks. As a consequence, increasing product portfolios and investments may fuel regional economic growth and its beneficial impact may finally reach those considered "less entrepreneurial", too, by providing them with new employment opportunities. At some stage, the degree of development might eventually require the provision of larger scale financing, when the capital demand of small and medium size enterprises (SME) needs to be financed.

4.2.1. Ideas on the possible prospects of further investment activities by the stool makers from Jorba: Optimising workflow, product diversification, enterprise growth and the creation of new employment opportunities for the less entrepreneurial

With a successful first investment cycle and an increased income at hand, the stool makers from Jorba have not only proven to be reliable credit takers, but also to dispose, indeed, of a promising production opportunity which, from the banking institutions' perspective, should make them even more attractive for future financial services. The initiated investment cycle should be further pursued so that both stool makers and banking institutions may continue to benefit from the successful business.

In terms of enhancing more economic growth and in order to further increase revenue, however, further development steps may be taken. For example, it is suggested here to enlarge the scale and product portfolio of the stool makers over time. Having improved the overall efficiency by reducing the cost of capital, now, attempts to improve the overall productivity of the stool makers could be undertaken to exploit their capacities to the full. In fact, an efficient deployment of the previously earned revenue may allow the stool makers to purchase, with the support of credit, if necessary, new and more modern working tools or to enlarge their manufacturing site, for example. The objective would be to increase both quality and output of their production. Furthermore, assuming that at some point the working capacities of the present stool makers are at their limit, new workers can be employed and trained on the job. Hence, those individuals considered “less entrepreneurial” would be finally included in the overall development process.

Another opportunity would be to diversify the product portfolio in order to avoid dependence on a single product where any negative fluctuations in demand may cause immediate setbacks to the overall turnover of the small stool maker “enterprise”. In fact, there are many products which could be conceived and produced with bamboo and which are similar to the construction method of stools, for example, benches, tables or beds, i.e. which may only require marginal changes in the working process and working technique. At some stage, the stool makers may also be able to financially afford further training in more sophisticated construction techniques and in the use of different material, for example, plain wood or even iron.

Even though there do not exist any records on the further development of the women from Jorba, the previous outlining of their possible economic dwelling may give an impression of the vast opportunities for further development which have been brought forth by the simple provision of small-scale finance in an underdeveloped area.

4.2.2. Potential regional economic growth towards SMEs and the provision of follow up finance

In order to exploit and further enhance the economic development potential prevailing, it may be considered desirable to provide the initiated development process with follow up financing enabling follow up investments. Follow up financing, in general, may attain critical importance on the way towards reaching comprehensive regional growth.

In the beginnings, it may be expected that the beneficial impact of the general increase in investments and economic output will affect the Microenterprises, only. They should be able to increase their efficiency and productivity and to improve their overall income generation. Eventually, however, their existing capacities are expected to be fully occupied so that they would have to grow further in size, if they intend to further grow revenues. Consequently, this would finally result in the creation of employment opportunities leading to an inclusion of the less entrepreneurial and less educated for the first time in the development process.

Moreover, it may be assumed that an increase in turnover and employment entails more pleasing effect on the region and its economic growth. Suppliers of bamboo, for example, would experience a considerable increase in turnover and in income, too, whereas the stool merchant would be able to sell more stools himself. Newly employed individuals would be able to afford consumption spending based on a regular income.

All in all, it has become obvious that such economic development may well lead to an overall increase of wealth in the region leading to a reduction of poverty. Follow up finance to exploit the tremendous opportunities for economic growth via follow up investments may hence be considered indispensable for enhancing sustainably the process of economic development in the mean term. The long term objective would be to develop and establish small and medium size enterprises (SME) in the region which require a larger amount of finance and capital. In general, banking institutions would then have to adapt to the increasing capital needs of growing enterprises. The term “Micro” might eventually disappear from the finance schemes for these enterprises.

5. Discussing the insights gained from the elaborated concept of Microfinance and its feasibility

Having retrieved the fundamental, yet still general requirements of a coherent and transparent Microfinance concept in parts II and III of this study, the objective of this part IV was to elaborate in detail a Microfinance concept designed to enhance economic development while also placing it into a suitable economic framework. In the previous four chapters of part IV, such concept has been outlined in detail and tested under ideal conditions. Now, in the following concluding chapter, the insights gained from the elaborated “EconDev Microfinance” concept will be discussed. Particularly, in view of the concept being of theoretical nature so far, questions will be put forward on how, and to which extent, such concept might become feasible in practice in the future.

What can already be said at this stage is that, when looking at the fundamental elements of the “EconDev Microfinance” concept and its prescribed requirements, it may be contemplated that some of them appear more easily convertible in practice than others, from a first glance. The same applies to the suggested economic policies and the framework conditions. There are, however, forces present in the financial markets, especially from the private wealth and equity sector, which may be of fundamental importance in bridging initial starting problems.

5.1. Elements 1-3: Allowing Microfinance classification via commitment

For instance, complying with the overall objective from element 1, namely to enhance economic development with the provision of Microfinance (see above chapter 2.1., p.179), means more or less agreeing to a guiding principle which requires no immediate action. However, providing this information already serves as an important commitment and as an indicator which specific type of financial service is being offered and which general purpose is aimed at. It is thus a first measure of separating the financial service product from others. Likewise, if the stated objective were to enable the fulfilment of consumption needs, a different setup of the financial service would instantly be expected. In other words, such element lays the foundation for a general credit classification providing for transparency urgently needed in the Microfinance sector.

Thereafter, the second and third elements entail deeper implications for both credit provider as well as borrower. They further specify the targeted clientele of “EvonDev Microfinance”, namely towards (potential) entrepreneurs with a promising investment opportunity (see above chapter 2.2., p.183), and confine the deployment of the extended capital to productive or rather investment use, only (see above chapter 2.3., p.186). Like for any productive investment in any bank or financial institution in the world, a credit approval depends entirely on the analysis, what the credit is used for, i.e. whether the investment makes sense, and whether the credit taker has the capacity of fulfilling the proposed investment plan. Such analysis appears hence to be part of a normal selection process when preparing an investment where identifying the most expedient options is the declared objective.

However, in the economic context of LDCs several difficulties arise. Even though entrepreneurs are considered the only common class to be identified according to McKinnon (see above part III., chapter 5.2.1., p.132), actively searching and finding suitable entrepreneurs with promising investment opportunities seems like a time consuming and costly procedure. Even more, when considering that the targeted persons in Microfinance tend to be completely uneducated in finance so that the level of insecurity and risk is high and requires an individual treatment. At the same time, the investments in mind are small-scale and might entail little profit compared to the costs they may provoke. Under such conditions, the demand for providing such banking services appears to be rather unattractive for traditional financial services and therefore little feasible in practice, from a first glance.

On the other side, it has become known that a tremendous development potential persists in LDCs waiting to be exploited. The investment schemes considered are very basic, like the purchase of seed fertiliser, and hence the feasibility threshold is much lower than compared to large and complex investments leading to less time spent on each case. Furthermore, it has become clear that many individuals actively seek access to external finance themselves in their efforts to escape their inferior levels of technology or to improve both quality and efficiency of their output, in general. In the absence of alternatives, they even went to approach the usury local moneylenders for costly credit in order to attain their objectives (see, for example, above part II., chapter 1.1., p.13, and chapter 1.2., p.15). Certainly, it must be taken into account that their willingness to get supplemental finance is not always accompanied by the wish to improve their economic activity, but may also be the consequence of financial hardships. Nevertheless, this goes to show that finding suitable entrepreneurs does not necessarily imply active search for them in the field by the credit institutions. Entrepreneurs may themselves be on the search for external finance as well and the only measure for institutions to undertake is to provide alternative sources and offers for them to the usury local moneylender and to select their financing either according to the principles of enhancing economic development or, if not targeted, according to other types of financing.

All in all, the discussion has shown that finding and selecting appropriate entrepreneurs and promising investment opportunities to enhance economic development in Microfinance is by no means a simple but rather a challenging and complex process. This is, however, little surprising because, in fact, providers of finance face the same difficulties in the large and medium scale financial segment. Consequently, there is no apparent reason why this should change for the small scale financial segment.

Hence, providing finance designed to enhance economic development according to the “EconDev Microfinance” concept may not be seen as a mass product – even though the process of selection may certainly be constantly optimised by accumulating experience over time – but is assumed here as a general commitment of credit institutions to this objective and to its underlying features which the first three elements of the “EconDev Microfinance” concept exemplify. Credit institutions are thus free to choose following these principles. Not complying with them, however, implies that their financial services are not designed to enhance economic development, but have other objectives in mind, and hence they should also not be declared as services enhancing economic development.

5.2. Investment opportunities as collateral and non-speculative capital – a typical seed-financing mentality

When looking at the fourth intrinsic element of the "EconDev Microfinance" concept (see above chapter 3.5., p.210; see also chapter 2.4., p.189), using the investment opportunities of entrepreneurs as collateral appears like a radically new thinking in securitising Microcredits, at first, and perhaps like a somewhat far-fetched idea. By taking a closer look, though, such impression can be relativized.

So far, Microfinance providers were most concerned with developing new methods assuring repayment of their capital by poor clients not endowed with collateral, and thus initially considered "unbankable", much more than with assuring its appropriate deployment, as it seems. They focussed on developing their repayment schemes accordingly, namely the well-known group lending and joint liability principle (see above part II., chapter 2.4.2., p.48). They were thus able to shift the majority of risk to their clients who were not only endangered of failing repayment, but also of losing their social ties if their group co-members needed to step in financially for them.

At this point, it needs to be remembered that the adopted group lending method is, in fact, the extraordinary way of securing repayment and has been a radically new invention. It is hard to imagine such lending to happen without distress amongst borrowers anywhere within the developed countries – unless, of course, it is a group which has united for a joint investment, i.e. which shares the same investment objectives and wants to fulfil them together. This is usually not given in LDCs. Most of the success stories told about Microfinance are about individual investments which, however, were secured by a group with various other investment interests. An exception is the group lending of the stool makers from Jorba mentioned above who all wanted cheaper capital for the purchase of raw material for their stool production (see above part II., chapter 1.1., p.13). Nevertheless, Microfinance Institutions officially praise their assortment of homogenous groups of friends and neighbours in a Microfinance liability circle. These groups, however, usually work with largely heterogeneous investment objectives, a situation which entails tremendous social problems if something goes wrong. Financial institutions, on the other hand, benefit greatly from this kind of self-observation and control by the borrowers.

Using promising investment opportunities as collateral provides a more even spread of the risk of financing to the parties involved. Financial institutions are required to select their clients more carefully according to their investment plans. Borrowers only receive credit approval in case they propose a sufficiently promising investment opportunity. Moreover, financing a promising investment opportunity is a much more familiar and usual way of financial engagement than arranging a secure way of financing a group of borrowers with different spending objectives.

In fact, in the particular case of Microfinance, where no traditional collateral can usually be provided as security, the financing of poor individuals with an investment opportunity may to a large extent relate to the seed-financing of start-up companies: potential founders have nothing but their idea and their knowledge to offer, which, nevertheless, appears so promising that venture capitalists, Business Angels or other types of seed-investors may invest at an early stage thereby taking possible initial losses into account while expecting returns at a later stage due to a large development potential. It is the conviction that the investment will eventually succeed and pay off which makes such investors supply capital. Moreover, during the development and growing phase of a start-up, seed-investors serve as direct consulting partners, thereby introducing the aspect of sympathetic client consulting desperately needed in the Microfinance sector to support the borrowers which may be expected to be little experienced in finance and in need of entrepreneurial experience (see BRAUN 2013, p. 4; see SCHWEEN 2012, pp.14-16; see GAIDA 2011, pp.30-35; see WELPE 2004, pp.17-19; see RHEIßIG-THUST 2003, pp.22-30; see also above chapter 2.4., p.189).

In this context, providing business banking accounts to credit takers of the "EconDev Microfinance" concept is considered a supporting feature for the implementation of using promising investment opportunities as collateral as it enables providers to take over a certain amount of influence with the revenue and expenditure streams being visible for them (see above chapter 2.5., p.193). Hence, providing business banking accounts to their clients should be easily convertible by financial institutions.

It is interesting to note here that the provision of Microinsurance services which are at the brink of gaining larger influence in the market, is a further possibility of spreading the risk in this phase. They may be especially valuable in securing the loan repayment in case of any unforeseen incidents or external shocks, like flooding or other natural catastrophes (see HINTZE 2008, p.50).

As far as the origin of capital is concerned, and hence the sixth intrinsic element of "EconDev Microfinance" (see above chapter 2.6., p.189), it goes hand in hand with the question of collateral that the typical target group of investors in the "EconDev Microfinance" concept is assumed to be largely based on non-speculative capital providers with a seed-financing mentality like, for example, capital from private equity, venture capital, business angels, Islamic banking or other forms of domestic or foreign direct investments. They are not as much concerned with traditional forms of collateral, but more with the actual development potential of both investment opportunity and those working for it, namely the entrepreneurs. Such seed-financing resources are considered to be plentiful and can be provided by a wide range of organisations, e.g. from large specialised venture capital institutions, from private Business Angels, but also from individuals providing small loans to other individuals in need of capital, e.g. by using the platform KIVA.org (see also above part II., chapter 1.4.1., p.24; see also above chapter 2.4., p.189). At the same time, the provision of a business banking account under their supervision enables them to take influence during the investment cycle whenever considered adequate.

5.3. Increasing access to savings and deposits accounts – how technological innovation may support

Capital accumulation, in general, is an indicator of economic growth and at the same time, if deposited at a banking institution, generator of disposable capital which can be further allocated to finance so called absorption surpluses, i.e. investment opportunities (see LECHNER 1988, pp.152-155). Savers are remunerated in form of interest rates for lending their capital out to banks by depositing it in their bank accounts. Yet, both efficient capital accumulation and disposable capital are, as it was demonstrated (see above part III., chapter 5.2.2., p.134; see also above chapter 2.5., p.193, and chapter 3.1., p.201), notoriously rare in the economic surroundings of LDCs due to the absence of access to savings and deposits in the vast parts of the respective countries. Overcoming this structural problem is of major importance in order to enable sustainable economic growth in the respective economies which is why access to savings and deposits for borrowers are included as indispensable element of the "EconDev Microfinance" concept (see above chapter 2.5., p.193).

Even though Microfinance has spread into many areas of the world it has not been able to make a difference and to provide sufficient capital accumulation opportunities to its clients in form of savings and deposits. A major underlying problem is that too many Microfinance Institutions are registered as NBFCs, i.e. not as regular banks. They are not obliged, and sometimes also not allowed like it is, for example, the case in India (see DUVENDACK 2010, p.15), to offer regular savings in their service schemes (see, for example, above part II., chapter 3.3.3., p.77, and chapter 3.3.6., p.85). Savings and deposits are, however, indispensable for accumulating capital and wealth effectively among households in LDCs and to provide disposable capital for economic growth.

Interestingly, the exploitation of technological opportunities within the mobile telephone industry has been able to provide some basic relief for this underlying problem. For example, the UK based company "Millicom" developed digital cellular products and services for more than 45 million households in the emerging markets (see Millicom Website at www.millicom.com). Depending on the mobile phone penetration in the respective country, mobile phone accounts are nowadays often used to deposit money. At the same time they can be used for cashless payment. They may, in fact, act like a banking account to a certain extent. Even though many MFIs have already adopted mobile banking in their service schemes by implementing the appropriate information technologies and by developing functional software, it is still far from being comprehensive (see KUMAR et al. 2010, pp.1-16). Nevertheless, it is a promising future opportunity for many poor households willing to put surplus money aside in the absence of alternative depositing facilities, yet very often without interest rates paid. It may, at this stage, be considered a way to bridge the absence of local access to savings and deposits to a certain extent.

In view of the large success of, for example, Grameen Bank in offering savings accounts (see above part II., chapter 3.3.2., p.75), or of ASA Bangladesh, an NGO accepting savings and having reached financial independency from both investors and donors (see above part II., chapter 3.3.5., p.82), this additional source of capital provides financial institutions with an important alternative and is thus assumed an attractive asset for Microfinance Institutions to have in their portfolio. Yet, despite mobile banking bridging the gap to a certain extent, there remains no alternative than to expand comprehensively the structures of organised finance within LDCs. It remains conditional for allowing all borrowers to have access to savings and deposits serving the accumulation of capital.

5.4. Expanding organised finance – The tremendous role of private wealth and impact investing as providers of bridge and seed financing

The question is how organised finance may eventually spread further into LDCs and provide individuals and households with comprehensive access to finance and savings facilities allowing efficient capital accumulation and allocation to take place. The major problem in this context persisting in LDCs is the general scarcity of capital preventing comprehensive financial support in the neglected, mostly rural areas of the respective economies from being realised.

Therefore, as local governments are usually restricted in generating sufficient capital due to inflationary danger (see above chapter 3.3., p.205), other capital providers need to step in. The objective is to bridge the actual lack of both capital and organised finance until a basic financial infrastructure with local capital markets is established which will incite organised banking to join in and, if necessary, to take over eventually.

Fortunately, such objective has become a realistic opportunity during the past years. First of all, several government institutions like EBRD, USAID or KFW Germany have provided vast amounts of capital to LDCs aiming to alleviate their capital constraints and to further economic development (see above part III., chapter 8.2.1., p.157). Furthermore, some of the wealthiest individuals and private organisations in the world have decided to make large parts of their fortunes available for investment in the less privileged areas in the world thereby supplying them with desperately needed capital for improving health, education, economic development and other issues (see BALANDINA-JAQUIER 2011, p.5). The investments they have in mind are supposed to make a beneficial impact, but providers also expect the deployed capital to be preserved, at least, or to achieve some returns, in order to prevent the capital from being used up eventually. Such form of investment is defined as "impact investing", a rather newly coined term which may be defined as

> "Investing with the specific objective of achieving positive social and/or environmental impact as well as financial return" (BALANDINA-JAQUIER 2011, p.5).

Investing in this context is understood in a broad way meaning that

> "capital is deployed in form of debt or equity investments, cash deposits, guarantees etc." (BALANDINA-JAQUIER 2011, p.20).

The specific objective lies in promoting

> "ventures (companies, projects or fund managers) that are designed with the intention of making a positive impact" (BALANDINA-JAQUIER 2011, p.20).

Positive impact should be part of the venture strategy. At the same time, impact should preferably be measurable and the results published as a reference, while the returns expected range from mere preservation of initial capital up to full financial returns showing that any form of (less productive) donation is not intended in impact investing (see BALANDINA-JAQUIER 2011, p.20).

Numerous wealthy families and their family offices have joint initiatives like the impact investing movement by now in search of alternatives to the traditional charity donations and have made enormous sums available. For example, the Bill and Melinda Gates alone have injected around 32 billion dollars into their foundation designed to help fighting poverty (see BATEMAN 2010, pp.20-21). Microfinance is considered such alternative and plays an important part in the impact investing schemes (see BALANDINA-JAQUIER 2011, p.23). Furthermore, the impact investing approach of venturing investment opportunities to achieve positive impact provides exactly the desired seed-financing mentality for the Microfinance sector on its way to achieve economic development.

The ways in which private wealth owners usually make their capital available focusses mostly on creating funds, e.g. the Acumen Fund by Jaqueline Novogratz (see also COSTER 2011, pp.66-75), or on foundations, e.g. the Bill and Melinda Gates Foundation or the Ford Foundation. From there, the capital is channelled to the impact investing projects which, in the case of Microfinance, reach financial institutions which should provide borrowers with needed capital thereby offering the desired form of sympathetic client consulting (see above chapter 5.2., p.226).

In fact, the Microfinance sector has already been able to benefit from several investments stemming from such resources. Private funds or foundations united with governmental institutions and development advisory companies to form a conglomerate equipped with sufficient capital and disposing of all the necessary factors to achieve the objective of making an impact including political, financial and impact investing know-how and experience. For example, “AccessBank” in Azerbaijan is a bank providing loans to the SME sector and is owned by six international financial institutions, namely

- The Black Sea Trade and Development Bank (BSTDB)
- The European Bank of Reconstruction and Development (EBRD)
- The International Finance Corporation (IFC)
- The KFW Development Bank
- The Access Microfinance Holding AG
- LFS Financial Systems GmbH

Interestingly, the non-governmental financial institutions among them, the BSTDB and Access Microfinance Holding, have been funded by several private and/or public investors (see ACCESSBANK Website).

Another successful example is the international cooperative “Oikocredit” which has devoted itself to ethical investments in the emerging markets to promoting development. They have attracted capital for their investments from more than 50.000 investors. The collected capital is channelled to selected local institutions for investment according to the stated objectives, for example in Microfinance projects. The organisation consists of several regional private associations, churches and other partner organisations like companies or banks (see OIKOCREDIT Website at www.oikocredit.org).

Hence, it goes to show that the incentives by private wealth owners as well as institutions may not only be fully capable of bridging the persisting gap in organised finance in LDCs due to the enormous capital resources available, but that they are also generally willing to do so with the aim to achieve positive impact.

Thus, it is assumed here that the implementation and spreading of organised finance providing both credit and savings in the remote and unserved areas of LDCs will be bridged with the help of private impact investors at the initial stage providing the first basic financial infrastructure, either directly by founding and implementing appropriate financial institutions, or indirectly by channelling their capital to existing financial institutions. Furthermore, due to the supportive character of these capital initiatives such assumption implies that the supportive seed-financing mentality as described above (see above chapter 5.2., p.226) and needed to realise investments according to the “EconDev Microfinance” concept will be assured.

5.5. Are government policies in LDCs sufficiently stable and policymakers willing?

The preceding discussion has shown that the majority of private investment in LDCs may most probably stem from wealth holders situated in DCs rather than in the domestic markets. The question is thus whether governments and policymakers in LDCs are able to attract these forms of foreign direct investment by, for example, providing sufficient economic and political stability, and whether they are willing to do so at all.

As far as the stability of LDCs is concerned, it should be noted here again that the circle of countries being part of the general LDC concept has been confined to semi-industrial countries, i.e. those that have made

> “autonomous efforts to industrialise or to develop some commercial agriculture, perhaps with the help of capital inflows from abroad or foreign technical assistance” (McKINNON 1973, p.2; see also above part III., chapter 3, p.110).

Hence, countries definitely included are the BRICS-states and the Tiger-states, but also several others like Bangladesh, Vietnam, Chile, Turkey, Romania, Bulgaria, or Hungary (see above part III., chapter 3, p.110). Their status as LDCs implies a certain degree of development which is also visible in a stable political situation, in a rising industrial sector, as well as in a more or less stable price level. Such conditions are strongly required if foreign direct investments shall be attracted providing the initialisation of investments in form of “EconDev Microfinance”.

In contrast, countries not disposing of such economic and political conditions cannot be expected to attract foreign direct investments sufficiently. For example, in the African state of Somalia the political situation may not yet be considered stable enough due to ongoing civil war and terrorism through the Al-Shabaab militia. Even though the situation has improved compared to previous years, the country remains under constant distress allowing neither any political nor economic stability to gain ground (see HAHN 2015). The same applies to other countries shattered by civil war, like, for example, Afghanistan, Syria, Libya, or Iraq.

Difficulties arise, too, in non-democratic countries in the hands of dictatorship and/or marked by overwhelming corruption in the political elite, for example, in countries like North Korea, Cuba, or Iran where politicians might hinder foreign direct investments to be placed freely. In these countries, therefore, the “EconDev Microfinance” concept is rather unlikely to be applied successfully.

Nevertheless, in general, it may be assumed that the majority of LDCs are nowadays running in a sufficiently stable economic and political environment. Of course, they continue to suffer from the stated underlying structural problems (see above part III., chapter 3, p.110, and chapter 4, p.112), yet they may be considered to be widely open for foreign direct investments as a means to improve the situation. Additionally, in the case of private investors which act independently of any political background political decision makers should be even more willing to grant access to their economy. At the same time, as these private investors bring in their own stock of capital, politicians are relieved to a certain extent from the difficult task to generate disposable capital in their economies in which capital is scarce and in which any form of “easy money policy” leads to severe forms of inflation destroying the rest of disposable capital present.

It is therefore assumed that policy makers in LDCs will generally welcome any of these investor initiatives from abroad, in particular from private impact investing initiatives disposing of the desired seed-financing mentality (see above chapter 5.2., p.226, and chapter 5.4., p.230), and will thus not hinder them to take up their activities in the economy, but will provide widespread support to them by desisting from any inflationary economic policies and by trying to keep the price level stable. The lack of organised finance should thus be overcome eventually, as soon as a basic financial infrastructure has been built up by these initiatives. Nevertheless, local authorities should look for domestic banks to follow up so that they will benefit themselves from the new creation of disposable capital in the economy while also assuring that the local economy does not become entirely dependent on private or foreign capital investments.

5.6. The chances for implementing an ordo-liberal competition policy helping to regulate an independent Microfinance sector

As it was shown in the previous other sections, all the necessary pre-conditions for supplying the "EconDev Microfinance" concept, namely sufficient capital resources for the furthering of economic impact, organisations providing access to savings and deposits, and policies in favour of these investments could be available and would be more or less waiting to be exploited effectively. The question is, however, how local competition policies may support such effective exploitation and to help organise and regulate the Microfinance sector.

As it was demonstrated before (see above chapter 3.4., p.208), neither purely liberal nor strongly intervening competition policies may be considered as having achieved a coherent organisation and practice of Microfinance services granting sufficient customer protection via regulative measures. Instead, these services continue to be extended in a chaotic and directionless way lacking, as far as can be seen, any positive impact on the respective economies (see above part II., chapter 2.2., p.36). Hence, with the elaboration of the "EconDev Microfinance" concept in this study, the requirements for extending Microfinance with the objective to enhance economic development in a coherent and transparent way have been specified. It now rests with the appropriate choice of competition policies to allow such concept to be realised effectively.

It was proposed here to lean on an ordo-liberal Microfinance market organisation allowing participants to operate freely within a protected economic environment equipped with fundamental rules which anyone active in the market needs to abide with (see above chapter 3.5., p.210). Such framework may facilitate the necessary coherence and transparency in the application and practice of Microfinance while also allowing supervision of market participants which entails the ability to regulate the market. In the particular case of “EconDev Microfinance”, the rules for participants would be to commit themselves to its underlying principles designed to enhance economic development. It is important to differentiate here that there is no provider of Microfinance services generally obliged to practice the “EconDev Microfinance” concept. However, if they intend, and also officially claim, to support economic development with their services, then it would be made compulsory for them to comply with the rules of the “EconDev Microfinance” concept. The latter clearly prescribes which fundamental aspects need to be respected and fulfilled if such objective is to be reached realistically. Of course, it is almost certain that not all the services in a Microfinance Institution are destined to enhance economic development. Yet, in order to provide transparency, the Microfinance Institutions will have to declare officially which of their credit services is factually designed for such objective. In view of the lack of economic impact to date and the vast dominance of consumer Microcredits in the market, it would not be surprising to see that the proportion of Microfinance services actually designed to enhance economic development is rather small.

It appears reasonable in this context that a restructuring of the Microfinance market into an ordo-liberal organisation would be extremely helpful for enforcing the suggested “EconDev Microfinance” concept granting, at last, some coherence and transparency to the market. Without such organisational support, it may continue to be tremendously difficult to assess whether enhancing economic development continues to be a vague promise or becomes a realistic option for Microfinance. The remaining question, however, is whether such reorganisation has already been implemented in any LDCs or how likely such implementation would be?

As far as can be seen, an ordo-liberal organisation within any country supplying Microfinance services is not in place. It appears to be even the contrary, when, for example, looking at Grameen Bank in Bangladesh which provides a highly successful and socially well intended Microfinance service, however, which at the same time is left more or less unsupported by the government (see above part II., chapter 2.1., p.30). As a consequence, their approach was not considered best practice for the local Microfinance concept and not used as a reference for unifying the domestic Microfinance market, but instead many different approaches with different objectives and interpretations of Microfinance have been developed in the meantime which all need to be treated individually. Overall, it appears as if each of these Microfinance Institutions has defined their own understanding of market organisation and structure. Hence, it seems more or less impossible for state authorities to intervene by means of regulation as no collective reference point is given.

There are, however, examples for the other extreme to be observed in the market, too. In Vietnam, the Microfinance sector is completely state controlled. In fact, there is only one bank in the country granted with the permission to extend Microfinance services, the VBSP (see above part II., chapter 3.3.7., p.88). Nevertheless, and much different to Bangladesh and other countries, a coherent and transparent form of Microfinance services could be guaranteed this way as any market participant is confronted with a uniform and clearly defined Microfinance programme with the same set of credit products, without differences in the interest rates for the same products, and with the same ways of service provision supervised by the state authorities anywhere in the country.

Of course, despite the obvious advantages, the conditions in Vietnam are far from being perfect. The interest rates are subsidised and kept artificially low, the whole sector is depending on government financing, and the degree of state control exceeds by far the form of an ordo-liberal organisation. It remains questionable whether they will be capable to keep up providing sufficient capital resources to the sector in view of the general scarcity of capital and, simultaneously, of the rising demand for such cheap credits. Nevertheless, Vietnam has been highly successful with their poverty reduction programme so far for which Microfinance played an important role. By reducing poverty by 40 percent since 1995 they have produced by far more success with the help of Microfinance services than all other countries (see above part II., chapter 3.3.7., p.88).

Summing up, it may be stated that there does not seem to be a market organisation present in LDCs which sufficiently relates to the ordo-liberal framework as suggested in this study, as far as can be seen. Nevertheless, it may be assumed that policymakers will greatly improve their efforts to help implement similar structures, at least, in order to help reorganise the Microfinance market so that they are finally able to protect market participants and to regain some control over the activities on the Microfinance market. Such reorganisation appears feasible as the Microfinance sector, to date, acts independent from all other financial sectors. Hence reorganisation would not concern the whole financial sector but would be confined to the Microfinance sector, only. The "EconDev Microfinance" concept shall serve as a first reference point with the help of which policymakers may be able to identify those activities within the market which are in favour of promoting domestic economic development, and those who are not – or those falsely claiming to do so.

5.7. EconDev Microfinance – a feasible concept in need of widespread support

Having discussed the insights gained from the elaborated "EconDev Microfinance" concept it has turned out that, even though most of its implications are but of theoretical nature, such concept is assumed to be feasible in practice, nevertheless. What can be said, after all, is that, in fact, all the necessary conditions for actively implementing the "EconDev Microfinance" concept can be met and all the necessary resources would be at hand, in general.

The only aspect which is missing, but which was recommended in the "EconDev Microfinance" concept, is the presence of an ordo-liberal competition policy designed to structure and to control the Microfinance market in the respective countries. The markets are either too much in disorder, like, for example, in Bangladesh or India, or otherwise too strongly controlled, like, for example, in Vietnam, to allow any policy similar to the ordo-liberal approach to be implemented.

Fortunately, however, such competition policy is not absolutely needed as the implementation of the "EconDev Microfinance" concept is not depending on such policy to be already in place. It may rather be used as a reference for further developing the necessary modalities leading eventually to a competition policy similar to the ordo-liberal principles.

All that remains to be done is to provoke the readiness and willingness among decision makers in Microfinance politics to radically reassess and restructure the Microfinance sector with the help of the “EconDev Microfinance” concept. Moreover, to allow judgment on the accomplishments reached with actual Microfinance projects which most likely will turn out to be negative as the amount of Microfinance services actually designed to attain economic development may be considered very low which is also reflected by most of the recent studies carried out in the field supposing zero economic impact of Microfinance. Such willingness, however, is expected to be rather low as it may be assumed that such reassessment and restructuring will manifest the prevailing challenges of Microfinance in the public. Many previous investors will be disappointed as they will have to recognise that their capital has not been used for making a beneficial economic impact in the less developed societies as initially designed. They might also be endangered to be deemed as investors who have made money out of the poor without letting them participate. This might consequently lead to a considerable capital outflow from the Microfinance sector.

Nevertheless, it should not be neglected that Microfinance can be helpful in many ways, i.e. not only in enhancing economic development, but also in fostering healthcare, education, and even to allow controlled consumption. Therefore, Microfinance must not be condemned just because not all of its services supplied enable economic development and the alleviation of (financial) poverty. Poverty has many faces which may be treated by different Microfinance services. Such services, however, need to be transparently classified and their approaches coherently specified so that finance can be channelled to them accordingly and intendedly. By introducing the “EconDev Microfinance” concept and by using its intrinsic elements as a reference, a first step towards classifying Microfinance designed to enhance economic development would be taken.

SUMMARY

1. It has become evident in the first two parts of this study that the Microfinance sector suffers from a lack of coherence and transparency as it is dominated by a rather ambiguous practice. The latter is trial-based and randomly conducted rather than being based on a scientifically assessed and clear cut concept taking the macroeconomic conditions prevailing into account. This directionless action may be considered the main reason why Microfinance, so far, was unable to provide any beneficial impact for the economies it was introduced to. This study hence endeavours to develop a coherent and transparent Microfinance concept designed to enhance nothing but the economic development in Less Developed Countries (LDCs). Furthermore, an appropriate economic framework shall be elaborated for such concept to be effectively placed in. The fundamental elements of this concept are retrieved by consolidating the insights gained from the analysis of almost 40 years of Microfinance practice and from McKinnon’s scientific analysis on the role of money in the process of economic development in LDCs. Thus, coherence and transparency are provided when the Microfinance concept unambiguously clarifies which objective is pursued, which kinds of recipients are suitable for reaching that target, in which fashion the Microcapital needs to be deployed, how repayment can be secured, and which services are needed apart from access to credit to assure the fulfilment of the stated objective.

2. Hence, in the first fundamental element the overall objective of the Microfinance concept is defined, namely to enhance economic development. In fact, it could be observed that all the famous and successful examples of Microfinance to date reported cases where the provision of Microfinance helped individuals to advance on an economic level. Usually, they invested the capital in the establishment or the improvement of income generating activities rather than consuming it non-productively leading to an overall increase in income and economic development. McKinnon, too, considers the provision of finance as ideal tool to enhance economic development in LDCs. In his study, he dwells on

the enormous economic potential present in LDCs which may only be exploited by using efficient domestic capital markets capable to provide small scale or rather Micro-Finance enabling tiny, but highly productive jumps in productivity and efficiency among the poor population. Hence, supporting economic development is considered the most reasonable objective for the extension of Microfinance and all further elements are subordinate to this objective.

3. The second element clarifies the designated recipients of Microfinance: entrepreneurs with promising investment opportunities. Again, the successful cases of Microfinance to date referred entirely to individuals who were economically active, i.e. who were pursuing an income generating activity, and needed the capital for further investment into that activity. McKinnon, too, stated the furthering of “investment under *domestic entrepreneurial* control” as one of the cornerstones for reaching economic development in LDCs. In addition, entrepreneurs are also the only common class which can be identified throughout the fragmented state of LDCs. Thus, the best way to enhance economic development with Microfinance is providing it to domestic entrepreneurs which dispose of a promising investment opportunity.

Nevertheless, not anyone may qualify as entrepreneur. Unlike most authorities and institutions in the Microfinance field which assume that any individual has a right for credit, this study pursues the approach that *potentially* any individual may be susceptible for credit, however, only if he or she complies with the requirements of an entrepreneur with a promising investment opportunity. Consequently, the number of recipients of Microfinance capable to enhance economic development is generally limited.

4. The third element addresses the character of the credit, i.e. in which way the capital from the credit should be deployed. In order to enhance economic development, credits need to be invested productively, only, rather than spent non-productively, i.e. market or product oriented by multi periodical personal partnerships. McKinnon does not even include consumption spending in his thoughts underlining the irrelevance of such

deployment of capital for the process of economic development. Nevertheless, consumptive use of Microcapital is dominating nowadays.

5. The fourth element deals with the question how to secure credit repayment by the poor where physical collateral to be seized in the event of credit failure is either absent or inappropriate to be used as such as it would ruin their existence. In fact, previous alternative approaches like group lending and joint liability which have been established in the past 40 years are considered inappropriate. They may provide high repayment rates, but tend to disguise the real number of failures which are usually absorbed by the group. This form of securitisation prevents banking institutions from making sure that they identified suitable entrepreneurs with promising investment opportunities. Therefore, using the promising investment opportunities themselves as collateral appears more suitable in this context. As entrepreneurs in LDCs lack endowment, their promising investment opportunities are everything they can offer. In underdeveloped areas, where a tremendous development potential persists which is also rather easily convertible, the promising investment opportunities themselves are considered to serve best as collateral. This way, banking institutions, for example risk neutral altruistic, social institutions or risk-averse state funds, take over more responsibility and need to aim for the most sensible deployment of their capital towards the most promising investment opportunities which may be found plentiful in LDCs.

6. The requirement to provide access to business banking accounts, savings and deposits facilities represents the fifth fundamental element of the new Microcredit concept. Business banking accounts act as a means to control revenue streams by providers. Saving facilities enable the generation of disposable capital on the capital market enabling backed-up credit extension needed to keep the price level stable. For individuals, households and entrepreneurs, they represent an important and efficient tool to accumulate capital and wealth, particularly in LDCs. For banking institutions, the provision of savings and deposits entails an additional and valuable capital source which reduces their dependence on externally acquired capital. Hence, both have an elevated interest in the presence of savings and deposit facilities which must be provided along with credit.

However, capital accumulation in LDCs plays an insignificant role as organised finance is unavailable in most areas and otherwise little attractive for savers due to interest rates beneath the current inflation rate. McKinnon stresses the importance to expand distinctively the role of organized finance in LDCs and recommends the granting of high interest rates to attract savers. With the numerous promising investment opportunities available in underdeveloped surroundings banks will not fall short of revenue, but will benefit from increasing credit transactions despite paying elevated interest rates on savings. In recent years, the adoption of savings into the Microfinance service schemes has produced excellent results. Grameen Bank II, for example, has experienced an extraordinary increase in credit extension while also attracting savings in a similar proportion earning it substantial revenue. They are now independent of donor and investor capital.

The final element of the Microfinance concept clarifies the origin and character of capital resources which are considered to be provided by regular Microfinance banks served by the capital market. On the capital market, several non-speculative providers such as venture capitalists, business angels are present. Capital can also be retrieved from the interbank market. Microfinance in the proposed long term investment context is thus not subject to any speculative markets.

7. After having defined the fundamental elements needed for a Microfinance concept designed to enhance economic development, now, the attention is drawn to analysing the structural requirements and the appropriate economic framework for a successful application of the new concept within the imperfect economic environment of LDCs.

8. First of all, the role of organised finance needs to be expanded greatly in LDCs so that the structural requirements for successful exploitation of the development potential present are fulfilled. On the one hand, the Microfinance movement has tremendously increased access to finance during the past 40 years and hence greatly improved the availability of organised finance. On the other hand, however, the capital markets in LDCs are still distorted, for example, due to heavy dispersions in the cost

of borrowing and a limited access to savings and deposits for customers. The capital accumulation process is thereby restricted while the economic potential cannot be exploited efficiently.

9. With organised finance in place, it rests mainly with economic policy decisions whether economic development is hindered or promoted. In LDCs, the foremost task of economic policy is to support the generation of disposable capital in the economy serving the alimentation of investments without giving rise to inflation. “Easy money policy”, for example, causes inflationary pressure and is hence considered inappropriate, in particular in the context of LDCs. Moreover, the leading monetary growth theories, like Keynesianism and Monetarism, are considered inappropriate for the application in the less developed context. They assume perfect capital markets in the economy with more or less one single capital interest rate leading to a substitute relationship of real money and physical capital. Such conditions may only prevail in fully developed economies. In LDCs, fragmentation and distortion of the economy gave rise to imperfect capital markets, where different effective prices for capital are paid. Even though there is no empirical proof, McKinnon’s approach to assume a complementary relation between money and physical capital appears more reasonable. In view of the need to generate disposable capital and to establish a saving class in LDCs, McKinnon’s growth theory should help increasing the attractiveness of savings via high interest rates. At the same time, as many promising investment opportunities can be detected in the underdeveloped environments, the accumulation of physical capital will occur via highly productive investments, nevertheless.

10. When analysing the competition policies applied to date in LDCs, it becomes evident that they have caused severe damage to the respective economies. At first, economic growth in LDCs was prevented by an aggressive intervention policy by the government, well intended for the protection of local industries, but leading to fragmentation and financial repression in the economy and on the capital market. Rural development, in particular, was more or less neglected and suffered from stagnancy in inferior levels of development. With the implementation of strongly liberal competition policies at the end of the 1980s, intervention policies were

discontinued. In the Microfinance market, Microfinance institutions were privatised and had to become financially self-sufficient. This led to the adoption of commercial lending approaches putting the original poverty lending approach aside. As a result of liberal policies, the Microfinance sector still has failed to achieve any positive economic impact to date, consumption spending of Microcredit is dominating the market by now, and commercial excess as well as abusive practices are in operation in many places. Any tries to newly intervene and regulate the market ended in severe crises in the respective areas. Hence, both intervention and liberal competition policies are considered inappropriate to help enhance economic development in LDCs.

11. A better way to structure and organise the Microfinance market may be an ordo-liberal competition policy. Such policy allows market participants to operate freely but there are certain rules which need to be respected by anyone. The government’s main field of intervention is the supervision of the compliance with these rules by installing suitable authorities. In this ordo-liberal economic framework, the elaborated concept of Microfinance can easily be integrated. In fact, the rules applying to each market participant in this framework are derived directly and completely from the fundamental elements of the concept. This way a transparent and coherent practice of Microfinance designed to enhance economic development has been provided for. The provision of Microfinance within this framework and according to these rules shall be named “EconDev Microfinance”.

12. Having classified a Microfinance concept for enhancing economic development in this study, it can be noted here that such classification may also be applied in further vital areas where Microfinance can be of critical importance. For example, Microfinance concepts for promoting education, improving healthcare, or for classifying consumption spending may be helpful in providing comprehensive coherence and transparency in the whole sector.

13. In order to test and demonstrate the growth mechanisms of the elaborated concept, a famous example study of successful Microfinance is

referred to and reinterpreted, namely the stool makers from Jorba, which had been supplied with credit by Yunus in his first Microcredit experiment. It turned out in the demonstration process that the financing of these women and their economic activity incorporated of all the characteristics required by the “EconDev Microfinance” concept. Its underlying assumptions were thereby confirmed. It remains to be assured that promising investment opportunities like the financial furthering of the stool makers from Jorba receive continuous follow-up financial services so that economic development and growth is able to establish and to spread further into the region. The objective is to integrate those considered less entrepreneurial as fast as possible into the development process by providing them with employment opportunities from the growing entities established with Microfinance.

14. When discussing the insights gained from the elaborated Microfinance concept it was possible to confirm that the underlying characteristics of the “EconDev Microfinance” concept described in six elements form the basis of a transparent and coherent approach designed to enhance economic development. While the first three elements stand for a general commitment to comply with the economic, entrepreneurial and productive aspects necessary to achieve this objective, the other ones imply deeper implications. They may be seen as separating those providers merely seeking to enhance economic development in LDCs from those seriously implementing the necessary steps, thereby assuming them to take over an appropriate proportion of risk and responsibility in the selection process of investment opportunities considered as the only collateral and by granting savings and deposit facilities to help borrowers accumulate capital more efficiently and to create disposable capital needed for economic growth. Predestined providers of such services may be found in the seed-investing business which are non-speculative capital resources and which are specialised in investing in promising business opportunities while also offering the professional help to entrepreneurs during the investment cycle.

15. When referring to the economic framework conditions needed for the Microfinance concept to be applied effectively, it could be observed that

despite structural deficits persisting in LDCs private wealth und impact investors have been detected as ideal alternative capital suppliers which are not only capable to bridge the structural financial deficits at first, but which are currently also willing to do so by making large partitions of their wealth available for impact investments. At the same time they incorporate the necessary seed-financing mentality needed for the "EconDev Microfinance" concept to be applied. Governments, too, due to their limited ability to generate additional capital in their economies, are considered to warmly welcome any of such initiatives in their domestic markets supplying them with fresh capital without giving rise to inflation. Private services are particularly attractive for governments as they are provided by institutions without political background, but rather with the ambition to make a positive impact in the world.

16. After all, a problem was detected when analysing the chances for implementing the suggested ordo-liberal economic competition policy within these countries. As far as can be seen, an equivalent does not yet exist and the lack of coherence and transparency in the Microfinance concept has hindered any structured interference into the market aiming for a reorganisation of the Microfinance market according to ordo-liberal principles and allowing comprehensive regulation of the activities. Nevertheless, the proposed "EconDev Microfinance" concept may be considered a starting point and may be used as a reference for implementing such structures, in particular, in order to be able to differentiate between Microfinance services designed to enhance economic development and those not doing so. This goes to show that the implementation of such concept is not entirely dependent on the presence of a well-regulated and controlled Microfinance market, but that it may help in further developing the necessary modalities for it leading eventually to a competition policy similar to the ordo-liberal principles.

17. What can be said, after all, is that, in fact, all the necessary conditions for actively implementing the "EconDev Microfinance" concept seem to be met and all the necessary resources available, in general. All that remains to be done is to provoke the readiness and willingness among Microfinance decision makers to radically reassess and restructure the

Microfinance sector. Such willingness is expected to be rather low as it may be assumed that such reassessment and restructuring will lead to overall disappointment about Microfinance success and might entail large capital outflows at first. By using the “EconDev Microfinance” concept as a reference it may be expected to become evident that most of the Microfinance services provided are not confined to enhancing economic development and (financial) poverty alleviation. Nevertheless, it needs to be remembered that there are many facets of poverty not all of which are denoted as being of financial nature. There are many more areas to be tackled with Microfinance like fostering education, health, or to allow smooth consumption spending. However, if financed through credit, such services need to be defined and classified coherently so that they may be applied transparently and capital can be channelled to them accordingly and intentionally. By introducing the “EconDev Microfinance” concept and by using its intrinsic elements as a reference, a first step towards classifying Microfinance would be taken.

V. CONCLUSION

Summing up, after having completed the analysis, the following concluding comments come to mind.

1. Summarising the insights gained in this study

The objective of this study was to elaborate a distinct Microfinance concept the aim of which is to enhance economic development in less developed economies. Therefore, the necessary characteristics of such concept had to be defined and, additionally, an appropriate economic framework within which such concept might operate effectively and sustainably had to be specified.

1.1. Why the study was carried out

The necessity for elaborating such concept became evident in part II of this study which analysed in depth the actual state of the Microfinance sector. It not only revealed the symptomatic problems persisting, e.g. the lack of economic impact of Microfinance to date or the dominance of consumption credits as opposed to productive investment (see above part II., chapter 2, p.30), but it also identified the major underlying deficits in the extension of Microfinance services. These are marked by a general lack of coherence and transparency surrounding the Microfinance concept meaning that a multitude of completely different Microfinance approaches are currently applied in the sector serving different objectives and following different underlying assumptions about what Microfinance precisely is (see above part II, chapter 3, p.61). At the same time, Microfinance is officially perceived as a tool to alleviate poverty even though it has not yet been able to achieve this objective (see above part II., chapter 4.1., p.95). All in all, the necessity for elaborating a new concept of Microfinance was based on the following insights gained from the analysis of the sector (see above part II., chapter 4, p.95):

1. Microfinance services, in their actual state, are considered very unlikely to ever reach their self-imposed objective of reducing poverty,

2. Microfinance practice lacks any scientific proof of being capable to achieve such objective at all,

3. The Microfinance market operates without any control, i.e. it cannot be regulated and/or provide sufficient customer protection in its present form

4. The Microfinance principle lacks any guidelines in form of pre-defined credit classes

Consequently, developing a new Microfinance concept would help encompassing possible solutions to the stated problems, namely to provide a scientifically assessed Microfinance concept approved to be able to enhance economic development, enabling regulation and providing coherence and transparency in form of guidelines.

1.2. Which steps were undertaken to solve the difficulties detected and which methods have been used

As a first measure, various definitions of Microfinance published in both learned writing and by Microfinance practice were reassessed from an aggregate perspective in order to retrieve a set of intrinsic elements which should form a first reference for elaborating a coherent and transparent Microfinance concept. Hence, it turned out that such concept would require specifications about

- which **objective** is pursued,

- which **recipients** suit best to reach that target,

- in which fashion the Microcapital should be **deployed**,

- how **repayment** should be secured and

- which **further services** are needed apart from access to credit to enable the fulfilment of the stated objective (see above part II., chapter 3.4., p.91).

By analysing the role of small-scale finance in the process of economic development from a macroeconomic perspective in part III of this study (see above part III., p.106), it was possible to retrieve comprehensive insights about the conditions under which a positive impact on economic development via small scale finance may be realised, particularly with reference to the conditions prevailing in Less Developed Countries (LDCs). Such scientific analysis was vital in providing a back-up on how to approach elaborating a Microfinance concept in the context of LDCs the objective of which is to enhance economic development (see above part III., chapter 8.1., p.154).

It is important to note here, that these insights were adopted from a macroeconomic study by McKinnon dating back to 1973, in which the role of money and capital in the process of economic development was scientifically assessed. In fact, it became apparent that, so far, the leading Microfinance practitioners had missed out on the opportunity to develop by themselves a fundamental Microfinance approach the impact of which was academically assessed. Likewise, modern research has not been focussing on providing fundamental research, too, but almost entirely on providing applied field research without questioning the basics of Microfinance (see above part II., chapter 4.2, p.97).

McKinnon's study, on the other hand, assessed economic development from a financial perspective including the extension of very small credits and hence turned out to be very relevant for assessing the opportunities of enhancing economic development via Microfinance. In particular, his approach adapted to the specific economic conditions of LDCs including the presence of fragmentation and financial repression leading to imperfect capital markets. Consequently, such adaptation led him to an alternative and highly interesting interpretation of how growth within these surroundings may be incited beyond what is known from the traditional monetary growth theories which are usually associated with the perfect capital markets of developed economies. Therefore, even though dating back to 1973, McKinnon's approach was considered well worth recapitulating and reassessing from a modern perspective and being integrated in this study as a basic part of conceiving a Microfinance concept designed to enhance economic development within the difficult financial surroundings of LDCs (see above part III., chapter 9.4, p.169).

1.3. Which solutions were elaborated and whether they are feasible

Finally, after having retrieved the fundamental requirements for elaborating the stated Microfinance concept in parts II and III, elaborating such concept in detail was carried out in part IV introducing the "EconDev Microfinance" concept designed to enhance economic development in LDCs (see above part IV., chapter 2, p.178, chapter 3.5., p.210, and chapter 4, p.213). It comprises the following six characteristics:

1. The overall objective of "EconDev Microfinance" is to enhance the economic development of its borrowers and suppliers of such services need to devote themselves to this objective (see also above chapter 2.1., p.179)

2. It is designed for entrepreneurs, or to potential entrepreneurs at least, with a promising investment or production opportunity (see also above chapter 2.2., p.183).

3. Capital from "EconDev Microfinance" must be invested productively rather than spent on non-productive consumption (see above chapter 2.3., p.186).

4. Repayment is secured by using the best investment opportunities available as collateral (see also above chapter 2.4., p.189).

5. Credit takers must be provided with a business banking account. Furthermore, they must be given access to savings and deposit facilities in order to be able to start accumulating capital (see also above chapter 2.5., p.193).

6. Capital must be retrieved from the regular capital markets, but not from speculative markets (see above chapter 2.6., p.199)

Furthermore, favourable economic framework conditions were specified for such concept to be applied in thereby taking the economic context of LDCs into account (see above part IV., chapter 3, p.200).

As a result, it was possible to show that the Microfinance market already disposes sufficiently of nearly all requirements necessary to allow the elaborated “EconDev Microfinance” concept to be implemented and to open the way for enhancing sustainably economic development via Microfinance (see above part IV., chapter 5, p.223). In particular, sufficient non-speculative capital resources, mainly from abroad, would be available, sufficient willingness to make a contribution among capital providers, mainly private wealth holders who have devoted themselves to the so called “impact investing” principles designed to support economic impact, was considered to be given, and governments in the receiving countries would also be expected to warmly welcome such initiatives. In fact, the only challenge remaining would be to convince and encourage decision makers in Microfinance politics to actually enforce and help implementing such concept and to support reassessing and restructuring the Microfinance market. Nevertheless, the elaborated concept was considered feasible and would be ready to be tested in practice. In the long term, however, it would be apt for further political and institutional support in order to be able to be implemented consistently.

2. Distinctiveness of the fields covered and of the research methods used

As far as the fields covered and the research methods used in this study are concerned, four distinct characteristics can be made out.

2.1. Focussing on enhancing economic development

Firstly, the principle of Microfinance was interpreted and approached from an economic perspective, yet strictly according to its original idea and according to what the vast majority of the public believes it to be, namely to *fight poverty in financial terms*. More precisely, the reduction of poverty via Microfinance is associated with its capability to achieve *positive economic impact*. Such impact may be reached when the provision of Microfinance enables an advance in *economic development* of borrowers, e.g. by an increase in income or in the accumulation of physical capital. Such approach has been chosen for two reasons. It should demonstrate clearly that, apart from a few single success stories told, Microfinance in its present state has not proven to reach this target – contrary to what is generally assumed in the public – and, moreover, that the parameters for reaching such a target have not yet been consistently defined and need to be clarified, in both research and practice. This study is supposed to lay a foundation by elaborating such a definition (see also above part II., chapter 4, p.95).

Consequently, this study did not cover any aspects which go beyond the narrow interpretation of Microfinance designed to enhance economic development and to alleviate (financial) poverty. There are, of course, other highly important topics to be tackled with Microfinance, for example, financing education, health, or consumption. However, they would all be part of a different analysis. Hence, in this study, enhancing economic development with Microfinance is the only aspect treated and all analyses have been carried out accordingly.

2.2. Taking the macroeconomic context of LDCs into account

Secondly, this study was putting a strong effort on analysing the macroeconomic conditions necessary for successful Microfinance transactions. This is particularly relevant as Microfinance services are almost entirely extended in the so called "Less Developed Countries" (LDCs) where the economic infrastructure is considered incomplete. It is thus evident that they are not only confronted with a general lack of overall capital when compared to "Developed Countries" (DCs), but that they also suffer from a fragmented economy lacking organised finance to allocate capital efficiently, that they have to deal with financial repression, with inflationary pressure due to a lack of private capital accumulation, and very often with an inappropriate economic policy as well as an ineffective competition policy. Such conditions may prevent even the best concept from having a positive economic impact, in particular, when the approach is based on using financial services like it is the case for Microfinance. The macroeconomic conditions need to be addressed equally when discussing the opportunities of Microfinance of having a beneficial economic impact, an insight which is provided for in this study and which is also taken into account during the elaboration of the presented Microfinance concept (see also above part III., chapter 8.1.2., p.155; see also above part IV., chapter 3, p.200)

2.3. Assessing Microfinance from a macroeconomic perspective as opposed to single case analyses

Thirdly, in order to retrieve a holistic impression of the present state of the Microfinance sector the study aimed at reviewing and analysing the development of the *entire* sector rather than picking out single cases or focusing on specific geographic areas or other single aspects which usually is the case in Microfinance research, but which would have entailed a danger of being too one-sided in the analyses. Thanks to this holistic approach it was possible to shed light on the vast discrepancies and distortions existing within Microfinance practice worldwide – and to identify its major underlying deficits which this study endeavoured to resolve (see also above part II., chapter 2, p.30, and chapter 3, p.61).

2.4. Providing basic research for a practice without scientific proof

Lastly, on an aggregate level, this study has been conducted as a *basic research* on Microfinance, an area which still has a lot of fundamental questions to be solved despite 40 years of experience. In fact, the most basic question, i.e. what is Microfinance, could not be answered clearly to date. There exists neither a fundamental scientific theory of Microfinance nor a genuinely accepted definition, as far as can be made out (see above part II., chapter 3, p.61). On the contrary, there is a huge amount of confusion surrounding the notion of Microfinance. Individuals confronted with the topic for the first time are confused because they read about different opinions on Microfinance in each publication. But confusion persists equally among professionals, like, for example, Yunus who felt constrained to declare his personal interpretation of Microfinance on the Grameen Bank's website (see above part II., chapter 3.1., p.62). In addition, even though it is often based on differing assumptions, the vast majority of research in Microfinance is conducted as *applied research*. Many villages and communities in all parts of the world have been analysed individually in terms of their economic behaviour in handling the

Microfinance services, in a great variety, at a tremendous length of time, in remarkable detail, and with the help of highly sophisticated empirical methods. When put together and compared, however, only very few similarities or significant correlations could be identified (see also above part II., chapter 2.2., p.36). Perhaps such research results would become more significant if the studies were conducted in areas where the same kind of Microfinance practice is being carried out giving them the same basis to depart their research on? This study provides a beginning by introducing a type of Microcredit which is clearly defined according to the objective of enhancing economic development.

3. Outlook and recommendations

It has become obvious in this study that the Microfinance sector would benefit from undergoing a comprehensive restructuring and reorganising process. If it continues to pursue its current way, it may be endangered to fail as a tool for enhancing economic development in the less developed economies for which it was originally conceived. The expectations in Microfinance in the aftermath of the UN year of Microfinance and the Nobel Peace Prize for Yunus and his Grameen Bank have been overwhelmingly high. The market has grown at an exceptional speed since and, as a consequence, appears to have lost control over its powers in the meantime. Such control needs to be regained by introducing new concepts to the market, like the proposed "EconDev Microfinance" concept, which allow for new coherence and transparency enabling supervision and control. This would be particularly needed in view that the demand for Microfinance as alternative financing of economic growth is expected to rise considerably in the years coming, not only in LDCs, but also in DCs. Germany, for example, experienced a massive inflow of immigrants with a refugee background in 2015 who dispose of a large variety of skills and backgrounds but will most probably need to start from scratch into their business life. Microfinance could prove to be crucial in enabling them to start their businesses.

At the same time, research in Microfinance has failed, so far, to question the basic mechanisms active in practice and to provide any fundamental approaches helpful for gaining deeper insights about the decisive factors which drive Microfinance to attain certain objectives. It is rather astonishing that the author of this study had to go back to 1973 in order to find a suitable growth theory which not only provides academic insight information on the role of small scale capital for the process of economic development, but which also takes the economic conditions present in LDCs into account of his analysis. It is hoped for that this study represents only a beginning of a series of fundamental research being conducted in Microfinance. At this stage, it can be observed that, at least, a rising number of comprehensive research studies is being carried out assessing the Microfinance impact critically and identifying the need for alternative market approaches in Microfinance, like, for example, Mader in a very recent comprehensive survey (see HARTMANN 2014; see also MADER 2015). However, more research is needed which also focusses on *supplying* viable alternative approaches which help reorganising and restructuring the market to achieve better results with Microfinance in the future.

Despite the apparent weaknesses of Microfinance, its great fundamental idea of providing indirect help for people to help themselves is considered a highly promising form of supplying development support, nevertheless. It should thus continue to be absolutely inspiring for researchers in development economics to engage in further developing and rethinking the Microfinance idea.

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ATTACHMENTS

Attachment 1: The Definition of Grameencredit (Source: Grameen Bank Website, see http://www.grameen-info.org/index.php?option=com_content&task=view&id=28&Itemid=108 accessed 30 April 2013)

General features of Grameencredit are :

a) It promotes credit as a human right.

b) Its mission is to help the poor families to help themselves to overcome poverty. It is targeted to the poor, particularly poor women.

c) Most distinctive feature of Grameencredit is that it is not based on any collateral, or legally enforceable contracts. It is based on "trust", not on legal procedures and system.

d) It is offered for creating self-employment for income-generating activities and housing for the poor, as opposed to consumption.

e) It was initiated as a challenge to the conventional banking which rejected the poor by classifying them to be "not creditworthy". As a result it rejected the basic methodology of the conventional banking and created its own methodology.

f) It provides service at the door-step of the poor based on the principle that the people should not go to the bank, bank should go to the people.

g) In order to obtain loans a borrower must join a group of borrowers.

h) Loans can be received in a continuous sequence. New loan becomes available to a borrower if her previous loan is repaid.

i) All loans are to be paid back in instalments (weekly, or bi-weekly).

j) Simultaneously more than one loan can be received by a borrower.

k) It comes with both obligatory and voluntary savings programmes for the borrowers.

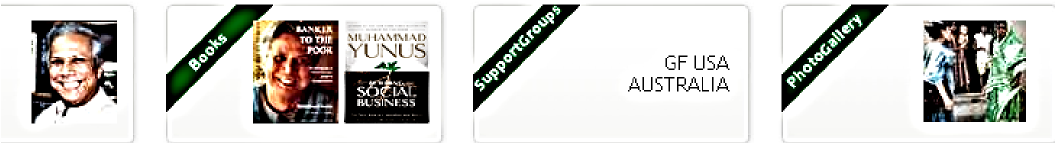
l) Generally these loans are given through non-profit organizations or through institutions owned primarily by the borrowers. If it is done through for-profit institutions not owned by the borrowers, efforts are made to keep the interest rate at a level which is close to a level commensurate with sustainability of the programme rather than bringing attractive return for the investors. Grameencredit's thumb-rule is to keep the interest rate as close to the market rate, prevailing in the commercial banking sector, as possible, without sacrificing sustain-ability. In fixing the interest rate market interest rate is taken as the reference rate, rather than the moneylenders' rate. Reaching the poor is its non-negotiable mission. Reaching sustainability is a directional goal. It must reach sustainability as soon as possible, so that it can expand its outreach without fund constraints.

m) Grameencredit gives high priority on building social capital. It is promoted through formation of groups and centres, developing leadership quality through annual election of group and centre leaders, electing board members when the institution is owned by the borrowers. To develop a social agenda owned by the borrowers, something similar to the "sixteen decisions", it undertakes a process of intensive discussion among the borrowers, and encourage them to take these decisions seriously and implement them. It gives special emphasis on the formation of human capital and concern for protecting environment. It monitors children's education, provides scholarships and student loans for higher education. For formation of human capital it makes efforts to bring technology, like mobile phones, solar power, and promote mechanical power to replace manual power.

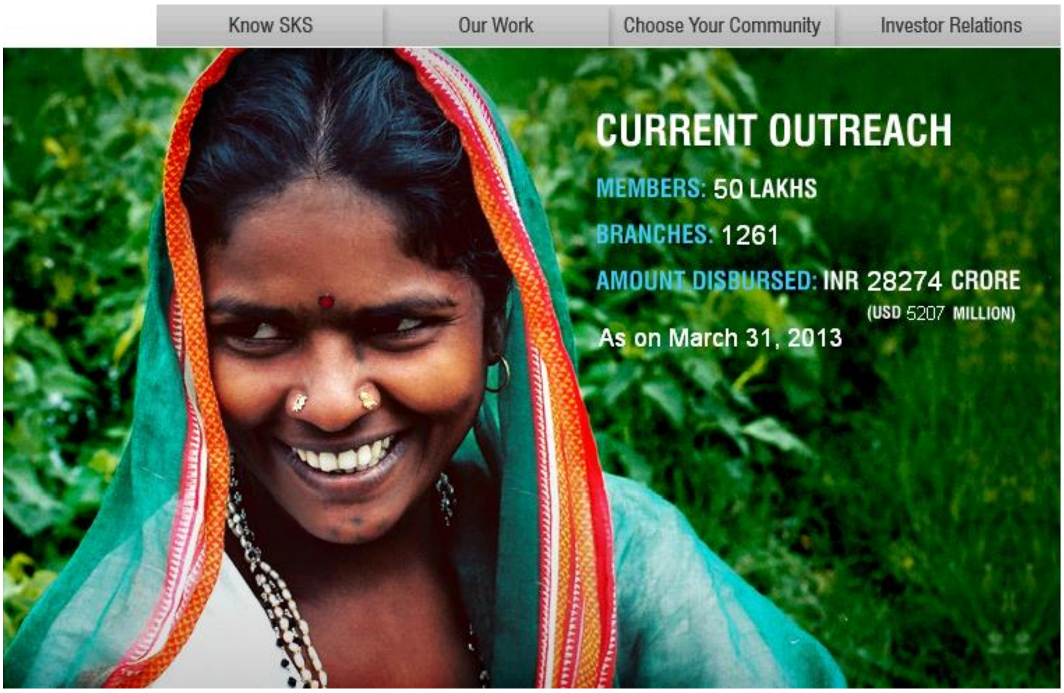
Grameencredit is based on the premise that the poor have skills which remain unutilised or under-utilised. It is definitely not the lack of skills which make poor people poor. Grameen believes that the poverty is not created by the poor, it is created by the institutions and policies which surround them. In order to eliminate poverty all we need to do is to make appropriate changes in the institutions and policies, and/or create new ones. Grameen believes that charity is not an answer to poverty. It only helps poverty to continue. It creates dependency and takes away individual's initiative to break through the wall of poverty. Unleashing of energy and creativity in each human being is the answer to poverty.

Grameen brought credit to the poor, women, the illiterate, the people who pleaded that they did not know how to invest money and earn an income. Grameen created a methodology and an institution around the financial needs of the poor, and created access to credit on reasonable term enabling the poor to build on their existing skill to earn a better income in each cycle of loans.

If donors can frame category wise micro credit policies they may overcome some of their discomforts. General policy for microcredit in its wider sense, is bound to be devoid of focus and sharpness.



Attachment 2: SKS Outreach (Source: SKS Website, see http://www.sksindia.com/, accessed on 21 may 2013)



Attachment 3: SKS For-Profit Approach (Source: SKS Website, see http://www.sksindia.com/how_we_do.php, accessed on 21 May 2013)

Capital

Many believe that microfinance should be a "social business", meaning investors should get their investment back but no profits. SKS has a different view. If the microfinance industry is going to provide the estimated INR 2,399.35 billion (USD 51.4 billion) of credit needed by the poor, it must tap commercial capital markets – and that means structuring microfinance so that investors can expect a return on their investment. That is why SKS converted from a non-profit NGO to a –profit Non-Banking Financial Company (NBFC) – regulated by the Reserve Bank of India – in 2005.

Attachment 4: SKS Microfinance Mission and Vision (Source: SKS Website, see http://www.sksindia.com/philosophy.php, accessed on 30 April 2013)

Our Mission

Our mission is to provide financial services to low-income households.

Our Vision

Our vision is to serve 50 million households across India and other parts of the world and also to create a commercial microfinance model that delivers high value to our customers.

Attachment 5: SKS Microfinance Approach (Source: SKS Website, see http://www.sksindia.com/know_sks.php, accessed 30 April 2013)

Home ▸ Know SKS

Microfinance is an effective tool that can help reduce poverty and spread economic opportunity by giving poor people access to financial services, such as credit and insurance. SKS distributes small loans that begin at Rs. 2,000 to Rs. 12,000 (about $44-$260) to poor women so they can start and expand simple businesses and increase their incomes. Their micro-enterprises range from raising cows and goats in order to sell their milk, to opening a village tea stall.

SKS uses the group lending model where poor women guarantee each other's loans. Borrowers undergo financial literacy training and must pass a test before they are allowed to take out loans. Weekly meetings with borrowers follow a highly disciplined approach. Re-payment rates on our collateral-free loans are more than 99% because of this systematic process. SKS also offers micro-insurance to the poor as well as financing for other goods and services that can help them combat poverty.

Attachment 6: Compartamos Banco Microfinance Approach (Source: Compartamos Website, see http://www.compartamos.com/wps/portal/AboutCompartamosBanco/OurValues; accessed 26 April 2013)

Home > About Compartamos Banco > Our values >

We are the bank that generates social, economic and human value through an efficient business model; we are the largest microfinance institution in Latin America due to the number of clients* , and we have more than 18 years of experience granting micro credit.
Our essence at Compartamos Banco is to generate development opportunities by giving access to financial services offering them to people in the lower economic segments.
Our main interest is the person; this is why we innovate our financial products and services that permit long term personal and family development of our clients.

We have a deep knowledge of our market; this allows us to attend to it via social networks and a business model that generates social, economic and human value.

Social Value
Promoting development by providing financial services to the greatest number of people in the shortest possible time.

Economic Value
We have created a profitable and strong institution, in which private capital may participate, making the industry more attractive for others to compete.

Human Value

We trust people, we trust in their word, their willingness to succed and their ability to develop their skills. This is why we promote means that offer clients and employees the opportunity to become better people.

***Source:** *Mix Market*

Datos al 31 de octubre de 2012

Attachment 7: Compartamos Banco Credit Types (Source: Compartamos Website, see http://www.compartamos.com/wps/portal/ProductsServices/Credit, accessed 30 April 2013)

Tu Crédito Mujer	(Women Credit) A credit granted personally to women in groups from 10 to 50 members, with solidarity guarantee, for investment in their business.
Tu Crédito Comerciante	(Merchant Credit) A group credit granted to groups of 4 to 20 entrepreneur men and/or women with solidarity guarantee.
Crédito Individual	(Individual Credit), this grants a greater financing for men and/or women who need to make a stronger investment in their business, with a personal guarantee.
Crédito Mejora tu Casa	This funding is directed to Crédito Mujer clients and will allows them to grow their business and/or make home improvements.

Attachment 8: ASA Vision, Mission and Objective (Source: ASA Website, see http://asa.org.bd/?page_id=29, accessed on 1 May 2013)

Vision of ASA

The vision of ASA is to establish a poverty free society.

Institutional Mission of ASA

The institutional mission of ASA is to support and strengthen the economy at the bottom of the socio-economic pyramid by facilitating access to financial services for the poor, marginalized and disadvantaged.

Objectives of ASA

The overarching objectives of ASA are to alleviate poverty and improve the quality of lives of the landless and assetless rural poor by providing them with access to financial services.

Attachment 9: ASA Approach Elements and Objectives (Source: ASA Website, see http://asa.org.bd/?page_id=33, accessed on 1 May 2013)

The main elements of ASA approach are:

- savings and credit for income generation in a cost-effective manner
- Member Security Fund (Mini Life Insurance) to shield member from unforeseen hardship

The main objectives of this phase are:

- alleviate poverty and improve the quality of life of the landless rural poor by providing them with appropriate and affordable financial services
- reduce the dependence of the poor on the local moneylenders
- facilitate additional income earning at micro level for improving the economic status of the women
- empower the landless and disadvantaged people

In 2001, ASA became financially self-sufficient and does not accept any grants or donations from outside sources since then.

Attachment 10: ASA Loan Products (Source: ASA Website, see http://asa.org.bd/?page_id=96, accessed 1 May 2013)

The loan products of the organization have been re-categorized into two segments in 2011, one is 'Primary Loan' & another is 'Special Loan'

Primary Loan has a maximum tenure of 12 months with a loan ceiling of BDT 50,000; Where Special Loan has a maximum tenure of 24 months and provides with ranging from BDT 51,000 to BDT 500,000. Both of loan products have flexibility in terms of repayment and require neither any kind of collateral nor group guarantees.

Category	Eligible Criteria	Initial Maximum Loan Size	Interest Rate	Loan term	Repayment Mode	Incremental Increase of Loan Size
Primary Loan	Economically active poor to undertake or strengthen income generating activities (IGAs).	BDT 8,000-20,000 or US$ 105-265 depending on the economic potential of area and client's capacity as well, but entreneurs and traders can be provided maximum BDT 50,000 or US$650 at first loan cycle.	Maximum 27% declining	4, 6 or 12 months based on nature of IGAs	Generally weekly or monthly for all term loan. But repayment can be made in one installment at maturoty of 4 or 6 months trem loan.	BDT 10,000 or US$130 (Maximum) in each loan cycle.
Special Loan	Informal or formal small/micro enterprises or entrepreneurs and traders to promote and scale up production, business activity and employment generation.	BDT 51,000-500,000 or US$ 662-6500 depending on the economic potential of area and client's capacity.	Maximum 27% declining	12, 18, 24 or 30 months based on nature of enterprises	Weekly or monthly	Any amount within limit depending on the economic potential of area and client's capacity.

Attachment 11: ASA Branch Composition (Source: ASA Website, see http://asa.org.bd/?page_id=36, accessed on 1 May 2013)

Each branch has one Branch Manager (BM), one Assistant Branch Manager (ABM) and 4 Loan Officers (LO) on average.

Each LO is responsible for overseeing between 18 and 24 groups comprising of 360 – 550 members.

Depending on the number of LOs working in a branch, each branch can have between 72 and 120 groups totaling between 1,440 to 2,750 members.

Branch Offices do not have Accountants or Cashiers. LOs are responsible for maintaining daily accounts and rotate to perform the job of cashier. Branch Accounting and transactional accounts are maintained by the Branch Manager.

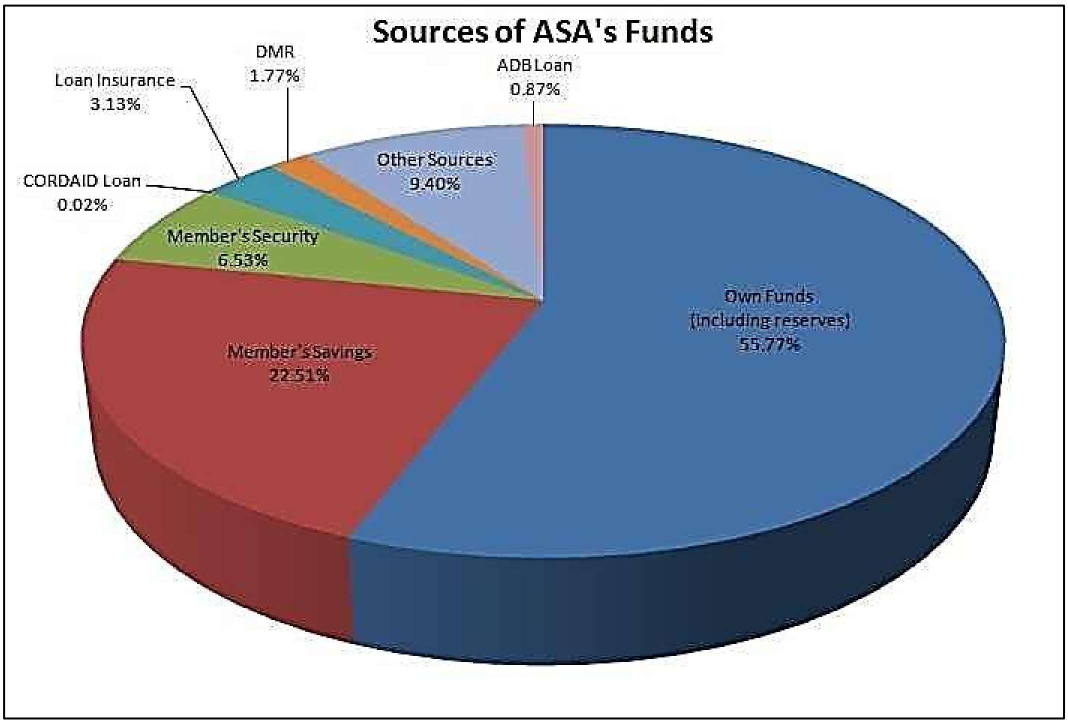
All activities of ASA branches can be done and approved by the branch office itself, as long as it conforms to the ceilings identified by the working manual, which changes each year to keep up with all relevant variables.

Each branch prepares its own annual work plan with fiscal targets and cash flow projection. After money comes in from daily collections (savings, insurance premiums and loan installments; at approximately noon each day), the branch calculates how much it needs for daily accounts or expenditures and then deposits the rest in the bank.

The bank acts as a "security guard", because ASA branches do not have its own security. When a branch needs more money – for example when collection is not enough – it draws money from its bank account. If the branch cannot cover all its payments from its own receipts, it can then request money from headquarters.

Money may also come from other branches in the district, depending on which has surplus. Thus, funds are distributed evenly through the entire ASA structure.

Attachment 12: ASA Sources of Funds (Source: ASA Website, see http://asa.org.bd/?page_id=59, accessed 1 May 2013)



Attachment 13: ASA Catalyst Microfinance Investors and ASA International (Source: ASA Website, see http://asa.org.bd/?page_id=25, accessed 1 May 2013)

Catalyst Microfinance Investors (CMI)

Catalyst Microfinance Investors (CMI) (www.catalyst-microfinance.com) was established by ASA and Sequoia, a Dutch corporate finance and private equity firm, in 2006. CMI received capital commitments of US$ 125 million from leading international institutional and private investors such as, amongst others, the Dutch pension fund, ABP, the US investor financial services organization, TIAA-CREF, the government owned fund CDC Group, established microfinance funds like Gray Ghost Microfinance Fund as well as a number of private investors from mainly Europe and the United States.CMI intends to apply the majority of its funds for the rapid establishment and growth of ASA International in many of the largest microfinance markets in Asia and Africa. CMI's objective is to accelerate the growth of the MFIs it invests in by strengthening their financial resources and providing them with the ASA expertise needed to expand and optimize their operational efficiency. Ultimately, access to this large pool of capital is required to answer the financial needs of the poor.
CMI is the 100% ***shareholder*** of ASA International.

ASA International (ASAI)

ASA of Bangladesh ("ASA") in collaboration with international microfinance investors established an international microfinance organization to overcome such challenges for low income entrepreneurs. This organization, ASA International, is the first truly international microfinance holding company ("ASA International"). ASA is providing technical support to each subsidiary of ASA International (www.asa-international.com) and is responsible for the implementation of the proven ASA Model of Microfinance in the different countries in Asia and Africa. ASA International is primarily funded by Catalyst Microfinance Investors ("CMI"), USD 125 million microfinance investment fund, as well as a number of well-established debt providers.
ASA International initiated "Greenfield" operations in India, Nigeria, Pakistan, The Philippines, Sri Lanka and Ghana and is looking to establish operations in Indonesia and China. Each of the organizations was build from the ground up with the support of ASA. In some of these markets ASA International is still an early entrant and should enjoy certain advantages as a result, as well as contribute to the creation of healthy microfinance environment in such country.
Each of the ASA International operations is strictly following the highly efficient ASA model – adjusted to meet local conditions and requirements – and is ideally suited to address the unique needs of the people in those markets, mainly low income women. Unlike some other microfinance institutions ("MFIs"), ASA International is a for-profit organization hoping to bring further "commercialization" to the microfinance sector. The ASA microfinance model introduces efficient operating procedures and credit methodologies that adequately address the risks associated with commercial banking to the poor.
Experienced staff from ASA has been seconded to these institutions to train local staff and design the various policies and procedures. It is expected that each of these MFIs will, over time, emerge as the market leader in terms of efficiency and scale in each of these countries. This should promote competition and encourage other MFIs to reduce their operating expenses and thereby reduce the costs of borrowing for the clients.

Attachment 14: Spandana Mission (Source: Spandana Website, see http://www.spandanaindia.com/brand_identity.html, accessed 7 May 2013)

Mission

We want to be one of the most significant microfinance service provider by offering a range of financial and non financial products and services to low income households and individuals to improve the quality of life. We constantly endeavour to deliver quality services to our clients and remunerative returns to our Investors by maintaining highest levels of transparency and integrity. We strive to be the most preferred Employer in the Industry.

Attachment 15: Spandana Shareholders (Source: Spandana Website, see http://www.spandanaindia.com/investors.html, accessed on 7 May 2013)

Promoter Group

Promoter Mrs. G Padmaja Reddy holds a substantive stake along with the rest of the promoter group

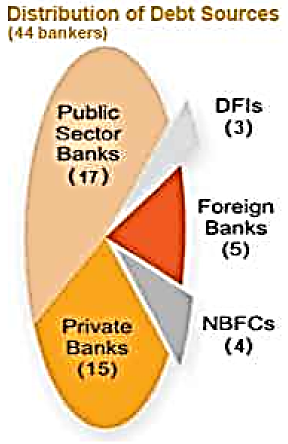
Investors

Spandana has the benefit of value additions done by its investors who joined in at different stages to facilitate growth of outreach to larger number of low-income clients. Key institutional shareholders are:

JM Financial India Fund (JMF)

The JM Financial India Fund (JMF) is a US$225 million private equity fund which invests in fast growing, unlisted companies in India. It is a broad based, multi-sector fund that provides growth capital to companies to leverage the Indian domestic consumption story combined with global outsourcing opportunities. The Fund is sponsored by JM Financial Group – a leading financial services firm with over three decades of experience in advising and managing Indian businesses. The lead investor in the fund is Old Lane Partners LP, a US$4.5 billion global-proprietary firm.

Attachment 16: Spandana Debt Sources (Source: Spandana Website, see http://www.spandanaindia.com/bankers.html, accessed on 7 May 2013)



Overview: Financial cost is the largest cost component in the loans offered by Spandana to its low-income clients. Spandana focuses on diversified fund sources so that the cost of borrowing is reduced. The major sources for the funds are Term Loans, Portfolio Sales (bilateral assignments and Securitisation), Capital Markets (NCDs) and Money Market (CPs) products.

Humble Beginnings: When Spandana started operations as an NGO, sourcing commercial funds was a big challenge – Convincing Bankers to give loans for a segment with which bankers experience was not very good required immense passion, drive and demonstrated performance.

Initial Support: The first term loan was given by Friends of Women's World Banking (FWWB) to Spandana and after that, there has been no looking back. Small Industrial Development Bank of India (SIDBI) under its SFMC project funded by IFAD and the ICICI Bank Partnership model helped us fuel the provision of credit to larger number of clients.

Current Status: After transitioning into an NBFC in 2004-05, Spandana has now been raising funds from diversified sources – Development Financial Institutions, Public Sector Banks, Private Sector Banks, Foreign Banks, and other NBFCs besides the capital and money markets.

Attachment 17: Spandana Loan Portfolio (Source: Spandana Website, see http://www.spandanaindia.com/products_services.html, accessed on 8 May 2013)

General Loan (Abhilasha)

Abhilasha stands for "Aspiration". This loan is designed for economically active low-income households who have an aspiration to improve their economic well-being. The loan is offered in a group mechanism.

This is the most dominant loan product helping in driving financial inclusion of low-income clients, predominantly women. Option of weekly repayments ensure that the clients can save a little from their daily cash-flows and do not face repayment stress. Loans are used for cash flow smoothening, predominantly for productive purposes.

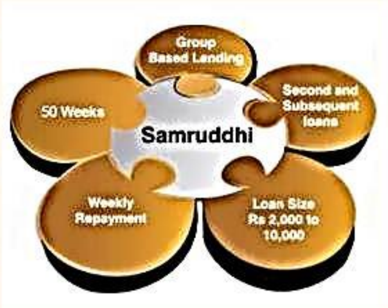
The interest rates for this product is 13.2% flat, this translates into approximately 26% on annual declining basis. An additional 1% is charged upfront that makes the annual effective charges as 28.2%. The effective rate would vary slightly depending upon the tenor and frequency of repayment chosen by the borrower.

Income Generating Loan (Samruddhi)

Samruddhi stands for "prosperity". For all group clients who have gainfully employed, Abhilasha loan provides higher amount of funds to meet working capital needs, emergency needs unbudgeted requirements particularly in case of seasonal bussinesses.

This loan offers an avenue to our microfinance clients to get flexibility of an interim loan. This loan is also useful for temporary cash requirements like education, health emergencies etc.

The interest rates for this product is 13.2% flat, this translates into approximately 26% on annual declining basis. An additional 1% is charged upfront that makes the annual effective charges as 28.2%. The effective rate would vary slightly depending upon the tenor and frequency of repayment chosen by the borrower.



Micro Enterprise Loan (Pragathi)

Pragathi stands for "Progress". This product is offered to those microfinance clients who have slightly higher economic well-being and have stable monthly cash-flows.

This helps the clients to avoid spending time on weekly meetings while at the same time enjoy the benefits of sustained credit supply by virtue of peer pressure based repayment discipline.

The interest rates for this product is 26% on annual declining basis. An additional 1% is charged upfront that makes the annual effective charges as 28%. The effective rate would vary slightly depending upon the tenor and frequency of repayment chosen by the borrower.

Individual Loan (Sphoorty)

Sphoorty stands for "Inspiration". This loan is offered to low/lower-middle-income people running micro-enterprises or having any other stable income source. This loan is delivered to individuals. This loan is given primarily to borrowers who graduate to higher ticket sizes from group loans.

This loan product helps us go up the value chain and also to provide support to our existing clients who have moved up the economic ladder.

This is a non micro finance loan given to middle income households. The interest rates for this product is 26% on annual declining basis. An additional 1% is charged upfront that makes the annual effective charges as 28%. The effective rate would vary slightly depending upon the tenor and frequency of repayment chosen by the borrower.

Farm Equipment Loan (Karshak)

Farm Equipment loans are offered to clients who want to finance purchase of Farm Equipments either for cultivation or for transport. Farm Equipment is hypothecated for the tenure of the loan.

Farm Equipment loan helps us increase the overall microfinance market pie by reaching out to new client segments while leveraging on the existing distribution channel.

The interest rates for this product is 19-25% on annual declining basis. Rates charged for used equipment is higher while it is lower for new equipment. An additional 1-2% is charged upfront. The effective rate ranges to about 29% but varies depending upon the used/ new equipment, loan tenor and frequency of repayment chosen by the borrower.

Attachment 18: Spandana Distribution of Cost per Credit (Source: Spandana Website, see http://www.spandanaindia.com/faqs.html#five, accessed on 8 May 2013)

Q5. Why are microcredit interest rates so high?

This should be looked at from MFIs' perspective as well as from clients' perspective. MFI Perspective – MFIs like any service provider need to offer financially viable services so that these can be sustainable unless these are subsidized. This involves cost of delivery of service to the customer doorstep such that the opportunity cost of customers on account of time is saved. The opportunity cost is the time they can use for improving their income, provide labour, get wages etc. From cost plus pricing standpoint, following are the three broad costs involved –

Operating cost [6 to 18%] :Depending on the operational efficiency levels of different MFIs, the range for operating cost is about 6% on the lower side for most efficient MFIs like Spandana – to– Industry average of 12% while some of the MFIs have operating cost as high as 18%. Micro-financing involves large volume of small value transactions. Therefore the transaction costs are relatively high. Most of the Operating cost is the salaries of the field staff.

Cost of funds [10 to 14%] : Most of the money raised by Indian MFIs for lending is sourced from Banks in terms of loans. The industry average cost of funds is about 12%

Risk charge [1 to 2%] : To write-off bad debts and to provision against future delinquencies and any other risk, MFIs need to provide a charge into their Profit and Loss accounts

Considering the above costs, the average costs come at about 26%. MFIs typically add their margins to it and price their loans accordingly. However, Interest rate is not the only cost for borrowers – the other costs are also relevant, e.g if somebody is charging a high processing fee or any other fee should also be accounted. What is essential is to disclose all charges to the customers in a transparent and ethical manner.

Hypothetically, if the cost of funds from Banks goes down by 5%, MFIs can pass on all the 5% interest rate benefit to the customers – all other things remaining the same - and still maintain their service quality and profitability.

MFIs need to make margins to comply with the Capital Adequacy norms prescribed by the regulators and also to have enough accruals to support growth and reach out to larger number of clients who need similar services.

Attachment 19: VBP Background (Source: VBSP Website, see http://www.vbsp.org.vn/evbsp/view_detail.php?mtt=117&mamm=10, accessed 14 May 2013)

II. Bank for the poor:

1. Background

1.1 From the operational experience as well as to overcome disadvantages of the Fund for the Poor, VBARD suggested and gained the agreement of SBV's Governor to submit to the Government on the necessity of establishing a state credit institution with appropriate policy system to support production loans for poor households. Accordingly, the idea of replacing the Fund for the Poor with a bank is formed and becomes a premise of establishing a state credit institution which provides preferential credit for poor households.

Attachment 20: VBSP Mission Statement (Source: VBSP Website, see http://www.vbsp.org.vn/evbsp/view_content.php?mamm=12, accessed on 14 May 2013)

MISSION

VBSP is not for profit and implement policy lending to the poor and other policy beneficiaries. VBSP is a state-owned bank operating as a tool of the Vietnamese Government to fight against poverty. VBSP contributes to:

- Provide microfinance to the poor and policy beneficiaries
- Reduce poverty sustainably in Vietnam
- Remain social stability
- Protect environment.

Attachment 21: Examples of VBSP Loan Schemes (Source: VBSP Website, see http://www.vbsp.org.vn/evbsp/view_maincontent.php?mamm=4, accessed on 15 May 2013)

LOAN SCHEMES

POOR HOUSEHOLDS LENDING

To implement the Government task in process of poverty reduction, VBSP conducts the policy credit channels for poverty alleviation such as the credit program for poor households. >>>

DISADVANTAGED STUDENTS

To perform the task mandated by the Government, VBSP implements lending to disadvantaged students for purpose of social equality and access to good education service >>>

JOB CREATION

To implement the Government task in poverty reduction and employment generation, VBSP conducts the credit program for job creation. >>>

OVERSEAS WORKERS LENDING

To implement the Government task in the course of poverty reduction and job generation, VBSP conducts the credit program for overseas workers >>>

TRADERS IN DISADVANTAGED AREAS

To implement the Government task in poverty reduction and employment generation, VBSP conducts ending to traders in disadvantaged areas >>>

BUSINESS & PRODUCTION HOUSEHOLDS IN DISADVANTAGED AREAS

To implement the Government task in poverty reduction and job creation, VBSP conducts the credit program for business & production households in disadvantaged areas. >>>

Attachment 22: VBSP Poverty versus Employment Loans (Source: VBSP Website, see http://www.vbsp.org.vn/evbsp/view_maincontent.php?mamm=4, accessed 15 May 2013)

LENDING TO THE POOR *No one left behind*	LENDING FOR JOB CREATION *Everyone can have a job*
Lending to poor households In compliance with Document No. 316/NHCS-KH dated May 02, 2003 providing guidance on lending to poor households.	**Lending for job creation owners**
*** Lending purposes:**	*** Lending purposes:**
- VBSP provides loans to poor households for the purposes of business production, life improvement which contributes to the implementation of National Target Program on Hunger Elimination, Poverty Alleviation and Employment.	- To create jobs, reduce unemployement rate and change labor structure ect,.
*** Loan utilization:**	*** Target clients:**
- Poor households shall use the loan for business, production and services to generate income, and escape poverty. - For payment of expenses as: electricity, clean water, house repairment, and some of essential needs for education.	- Sole proprietorship households, production combinations, cooperratives, the disabled enterprises, small and medium enterprises, farm owners, Labor-social education centres. - Households.

Attachment 23: VBSP Interest Rates Poor Household Lending and Job Creation Lending (Source: VBSP Website, see http://www.vbsp.org.vn/evbsp/view_maincontent.php?mamm=4, accessed on 15 May 2013)

LENDING TO THE POOR *No one left behind*	LENDING FOR JOB CREATION *Everyone can have a job*
*** Lending interest rate:**	*** Lending interest rate:**
- Loans taken before 1/5/2009 are charged at the interest rate of 7,8%/year Overdue debt interest rates = 130% of lending interest rate. According to Decision No 579/QD-TTg dated May 6th 2009 of the Prime Minister on supporting interest rates policy, loans taken from 1/5/2009 to 31/12/2011 shall be charged at the interest rate of 3,8%/year.	- Loans taken before 1st/05/2009 are charged with the interest rate of 7,8%/year excepting for enterprises employing workers with disabilities (over 51 % of total workers) which receive 50% reduce from normal interest rate . From 1st/05/2009 to 31st/12/2011 the interest rate is 3,8%/year, for enterprise using workers with disabilities (over 51%), the interest rate is 0%.

Attachment 24: Email correspondence of the author with Ronald McKinnon

Betreff: Re: Study about your Book "Money and Capital in Economic Development"

Von: Ronald McKinnon (mckinnon@stanford.edu)

An: maximilianschroth@yahoo.de;

Datum: 22:14 Donnerstag, 22.März 2012

Dear Mr Schroth:

Thank you for your Masters Thesis. Maybe you understood my 1973 book better than I did! Anyway, I am flattered by all the attention.

You noted that there was no 2nd edition. I would like to refer you to my book *The Order of Economic Liberalization* : *Financial Control in the*

Transition to a Market Economy, 2nd edition, 1993 Johns Hopkins University Press. In many ways , it is the 2nd edition for my 1973 book.

You mentioned that you were now to proceeding to work on micro finance. I have long felt that the Grameen model was too one sided in emphasizing loans over deposits--with every body going into debt. Better to (also) encourage wealth accumulation on the deposit side. Here Bank Rakyat in Indonesia might be a better model.

Best wishes for your future research

Ronald McKinnon

At 10:29 AM 3/22/2012, you wrote:

Dear Prof. McKinnon

My name is Maximilian Schroth, a Ph.D. student in Economics at University of Potsdam and University of Technology Berlin, Germany. My research focuses on the concept of Micro-Credits and economic development.

I am writing to you as a “fan” of your first book “Money and Capital in Economic Development”. In fact, my decision to embark on a Ph.D. thesis was largely due to the analysis of your book as part of my Master Thesis in 2008. It was recommended to me by my supervisor, Prof. Dr. Hans H. Lechner, Professor at the Department of International Relations at University of Technology in Berlin. In particular, your understanding of *productive* small scale credits is very convincing and highly relevant for the Micro-Credit business today. Nowadays, consumptive Micro-Credits are dominating the sector achieving little economic impact in the respective countries or even none at all, as recent reports have shown. The concept of Micro-credits thus needs to be modernized which is the aim of my studies.

I have attached my Master Thesis from 2008 to this email and hope it will arouse your interest.

Many regards from Berlin,

Yours sincerely

Maximilian Schroth

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Eidesstattliche Erklärung

Ich versichere an Eides statt, dass meine hinsichtlich der früheren Teilnahme an Promotionsverfahren gemachten Angaben richtig sind und, dass die eingereichte Arbeit in keinem anderen Verfahren zur Erlangung eines akademischen Grades vorgelegt worden ist. Ich versichere darüber hinaus, dass bei der Anfertigung der Dissertation die Grundsätze zur Sicherung guter wissenschaftlicher Praxis der DFG eingehalten wurden, die Dissertation selbständig und ohne fremde Hilfe verfasst wurde, andere als die von mir angegebenen Quellen und Hilfsmittel nicht benutzt worden sind und die den benutzten Werken wörtlich oder sinngemäß entnommenen Stellen als solche kenntlich gemacht wurden.