### Background

This note summarizes findings from a detailed literature review on identifying indirect and direct links of microfinance activity to eradication of poverty. The review highlights the dominant indirect effects that increasing microfinance access has on poverty through establishing a more efficient allocation of resources in the economy. This in turn has a positive impact on job creation and wages. The direct effects on the poor are contingent on several factors including the final recipient of the finance and availability of other financial products for the poor. While most households and individuals are shown to increase consumption with increased availability of micro credit, poor potential entrepreneurs and micro enterprises use this credit to expand. Further, other micro financial products such as savings and insurance may play an equal or more important role in impacting poverty. Finally, in order to expand outreach to poor, several innovative models have emerged among larger commercial banks and cooperatives, which highlight additional ways of providing microfinance beyond the traditional microfinance institutions.

### Objectives

This note summarizes a literature review conducted by IFC on identifying the transmission links of microfinance to poverty and economic growth. This exercise was undertaken as part of IFC’s Poverty Action Plan, to better understand how IFC operations in specific sectors across its investment and advisory operations result in eradicating poverty and boosting shared prosperity.

As of end June 2012, IFC’s microfinance portfolio consists of over 120 microfinance clients, with a committed exposure of $1.5 billion. In FY12 IFC committed $508 million in microfinance, with a focus on East Asia and Eastern Europe (24% each) followed by Sub-Saharan Africa (21% of the total). As of end CY 2011 IFC’s clients had 20 million sub-loans to micro entrepreneurs worth $20 billion.

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1 This note has been summarized from the poverty literature review conducted for IFC by Thorston Beck, Professor of Economics and Chairman of European Banking Center, Tilburg University and CEPR fellow. The note is available on IFC’s poverty webpage: [http://ifcnet.ifc.org/ifcint/deveffectiveness.nsf/Content/home](http://ifcnet.ifc.org/ifcint/deveffectiveness.nsf/Content/home)
This review provides theoretical and empirical evidence for the continued importance of microfinance as an engine of growth, employment creation and poverty reduction.

**Analysis**

**Indirect effects of micro-finance through growth**

*Reallocation of resources to pro-poor sectors*: Existing empirical evidence suggests that expanding microfinance results in financial deepening which in turn can have both a pro-poor and pro-growth effect. For instance, cross-country studies show that countries with higher levels of financial development experience faster reductions in income inequality (as measured through the Gini coefficient and the income share of the poorest quintile) and poverty levels (measured as headcount ratio). Another study shows that financial deepening is associated with a reduction of undernourishment through higher agricultural productivity. This effect flows through an improved allocation of resources, with shifting investment to more pro-poor sectors and a reduced cost of credit. This greater access of credit to the poorer segments of the economy, which are the most constrained for it, can result in occupational shifts from the subsistence sector into the intermediate sector with accompanying changes of wages.

*Demonstration effects*: Finally, the investments in microfinance also spur ‘demonstration effects’ in terms of institutional development, increased competition, and possibly influencing macroeconomic policies that can lead to broader financial deepening by fostering innovation and replication of good practice.

*Changing universe of micro finance sources*: What is more, the type of institutions used for financial deepening may affect the level of poverty impact. For a long time, the focus in microcredit was on traditional MFIs on account of their lower cost base, proximity to clients, and clear pro-poor focus. However, with both technological and institutional innovations, commercial banks and cooperative models have become strong alternative institutions to achieve both pro-poor outreach as well as commercial efficiency. Examples of an innovative alternative is a commercial bank in Ghana offering deposit collection services and providing small traders with a box to store daily revenue that the bank gets collected. Commercial banks are also tying up with cooperatives to deepen their delivery channels. Finally, new delivery channels based on technology has broadened the universe of possible micro credit sources. For example, telecom companies such as Vodaphone have entered the payment service market.

**Direct effects of micro finance**

At the micro-level, the literature on the impacts of access to credit on household welfare is more mixed. Some studies suggest that different household and individual characteristics lead to differential impacts of microfinance. Specifically, factors that seem to matter are whether the micro-finance clients are households or micro enterprises, whether they were existing clients of other MFIs or Banks or not, and whether or not there are other constraints beyond credit that are being faced by small businesses. Overall, the scale effect of pulling people out of poverty may be contingent on other constraints in the business environment which may be more binding.

*Increased consumption by households and individuals*: Studies suggest that large part of the household and individual clients of MFIs use credit for consumption rather than investment purposes. One analysis shows that
only one in five clients in India used the loan to start a business. Others used it for purchase of non-durable goods.
However, to the extent that greater availability of formal credit implies less dependency on access to expensive moneylenders, political connections, microfinance to individuals provides a cheaper and formal source of financing their consumption needs.

*Increased investment and micro entrepreneurship:* One of the most significant direct impacts on poverty comes through availability of cheap credit to those poor individuals who would like to become micro entrepreneurs or those with existing businesses who would like to grow. The IFC Jobs Study on ‘Assessing Private Sector Contribution to Job Creation (‘IFC Jobs Study’) highlights that in South Asia and Sub Saharan Africa, more than 59 percent of MSME’s are unserved. Of the 365 to 445 million MSME’s in developing countries, about 70 percent do not use external finance. For the poorest and smallest enterprises, this implies using alternative sources of more expensive funding, including their own scarce capital.  

Studies show that the expansion of this micro credit disproportionately benefits the small group of poor individuals who without credit could not become entrepreneurs. However, there are also wider effects to the class of workers who benefit through *increased jobs or wages* which comes from the resultant increase in income and business from these micro entrepreneurs. Another study shows that credit expansion following deregulation led to an increase in labor depend, which fell disproportionately on unskilled, lower-income households whose wage rates and working hours increased. Evaluations of microfinance investments in different countries found that the projects resulted in creation of more enterprises, or *higher rates of self-employment.*

However, expanding access has not shown a scale in impacting poverty as expected. Part of the reason could be that there may be other binding constraints for micro entrepreneurs, and that credit may not be the most immediate financial service that the poor need.

*Alternative micro products for the poor:* The literature suggests that there are other products such as micro savings, insurance and payment services (e.g. for business transactions or remittances) that may play an equal if not more important role in impacting poverty. The success of interventions like mPesa mobile phone banking in Kenya or the deposit collection services for small-scale businesses by Oceanic Bank in The Gambia are testaments to this.

**Conclusions and Recommendations**

The above summary could have several potential implications for the IFC. Firstly, given the positive and more pronounced macro-evidence of financial deepening on poverty, investing in enabling environment reforms for microfinance while investing in MFIs are likely to show broader indirect effects on economy-wide financial deepening. Secondly, the types of financial institutions being invested in matters and global examples of financial deepening through commercial banks, mobile banking, and cooperative models should be explored more deeply. Thirdly, evidence suggests that credit alone is not enough – the poor need a more comprehensive package of

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3 A separate note on SME Finance and Poverty looks at the literature on the impacts of IFC’s broader policy interventions in the area of financial deepening (e.g. credit registries).
financial services that includes savings, insurance, and payment mechanisms – that should be part of the support IFC provides in the area of microfinance.