Bringing the Poor into the Export Process:
Is Access to Finance the Trigger?

A paper contributed by the
EPRP Team and Vincent Akue

BRINGING THE POOR INTO THE EXPORT PROCESS: IS ACCESS TO FINANCE THE TRIGGER?

1. What is microfinance? Why is it important?

Globalization and trade liberalization present both, new opportunities and challenges for small- and medium-sized enterprises (SMEs). Microentrepreneurs in developing countries can boost growth and reduce poverty by taking advantage of globalization. However, many SMEs in developing and transition economies have been unable to gain from globalization due to pressure from foreign competitors and cheaper imports introduced in their domestic markets.

The term of **Microcredit** refers to the provision of financial services to low-income clients. It involves credits and/or other financial products in small amounts to primarily poor customers, often working in the informal sector, typically self-employed and who usually lack the necessary assets to guarantee their loans. However, some microfinance intermediaries have achieved financial sustainability by using techniques more adapted to microentrepreneurs, charging cost-recovering interest rates, creating new ways of taking guarantees, and thus obtaining high levels of repayment. Microfinance is equally an economic development approach intended to benefit low-income groups. Microcredits include usually small loans for working capital, informal appraisal of borrowers and investments, secure saving products, and insurance and payment service.[1]

There are five main types of **institutions** directly involved in microfinance:

- Governmental;
- Private sector;
- NGOs;
- Cooperative-type institutions;
- Informal lenders.

Group lending is the most common type of micorcredit offered by all financial institutions. This is a breakthrough approach to lending small amounts of money to a large number of poor customers not able to offer collateral. Group lending is therefore based on transferring most of the financial administrative responsibilities onto group members, transferring the risk of non-payment from the institutions to the group through peer pressure and joint liability.[2] Given limited resources, arguments supporting group lending are:

- Group lending reduces costs compared to individual lending since the financial institution provides a large loan to the group, which acts as an intermediary between financial institution and borrowers, instead of dealing with each donor and his or her particular needs;
- Formal group liability and peer pressure to repay loans and interest are supposed to be key factors for risk reduction.[3]

Past experiences and other theories argue that, instead of practical institutional performance focused on financial services, a more poverty reduction targeting and **individualistic approach** would better fulfill microcredit goals like economic growth and development. In the past, problems with group lending have arisen such as:

- Leaving room for defaulting as a result of low levels of cohesion within the group, group coordinator embezzlement, group break-up, members' collusion, and reallocation of loans and responsibilities to other group members creating additional costs for the individual to monitor the other members of the group.[4]
- Institutions providing services to individuals can make a better estimation of the family/businesses needs and possibilities so that they do not get over-indebted,
- Individual lending involves a more personal relationship and an easier channel for monitoring.

---

[1] http://rbapmabs.org/homepage.html
[2] "Integrating a gender perspective in microfinance in PAC countries", European commission, Directorate General VIII, Development, Development Policy, Social Human development, women and development, March 1998
[3] "Critical issues in small and micro business finance", R. H. Schmidt and C.-P. Zeitinger, IPC Working Paper No.1, 1994
[4] www.wikipedia.com

The World Bank estimates that today, about 7,000 micorfinance institutions serve about 16 million poor people in developing countries.[5] The economic units of Microfinancial Institution's (MFIs) customers are usually referred to as micro- and small enterprises that have from 11 to 50 workers, both, from urban and rural areas.[6] These clients often work as traders, street vendors, service providers, small restaurant operators, artisans and small cottage industries. Yet, there is very little evidence that banks, and, microfinance institutions to a lesser extent, know how to work with SMEs and these informal enterprises. In many cases, they have no experience or tools with which to transact with micro entrepreneurs or poor individuals. There is very little information available on this potential market leading to a difficult risk assessment.

Surveys of the **SME sector** in several countries have uncovered surprising factors. The SME sector is very large indeed, employing a substantial part of the working population, especially in rural areas - 68% to 90%. And half to three quarters of households depend on SMEs for at least half of the household's income. SMEs, therefore, open the opportunity for employment in rural areas outside the traditional farming activities.[7] **Access to finance** is one of the major impediments for SME development in transition and developing countries, and particularly for export-led businesses. In recent studies SMEs identify financing, especially medium to long-term finance, as their topmost obstacle to growth and investment.[8]

Up to 80% of people in developing countries derive their income from the informal sector. Thus, the need for good **financial mechanisms** to support wealth creation and financial services in this sector is crucial to promote economic development.

The **collateral guarantees** requirement is another barrier to entrepreneurs wanting to receive commercial loans. In general, collateral serves to reduce the risk of default by MFIs. But, in developing countries, limited wealth, lacking or unclear property rights and poorly functioning legal systems reduce the availability of collaterals. In fact, other mechanisms have been found for people who cannot afford collateral, like social sanctions and credit denial.[9] Fortunately, in the last few years, banks and other financial institutions understood that they couldn't request mortgages or guarantors like normal banks do. Instead, they have been relaying more on pledge assets of "psychological values" that would be difficult to replace if seized like, for example, household's furniture and machinery. Other types of guarantees: TV and difficult to replace items, cattle for farmers, and peer pressure from group lending.[10]

Finally, support initiatives to increase **savings** can also have a positive impact on microfinancing institutions and SMEs. Some financial institutions not linked to the financial system, like Non Governmental Organizations (NGOs), may find difficulties to refinance the loans. Thus, attracting savings from members of the middle class, outside investors and even the same SMEs will be beneficial for the sustainability of the institution as a fund provider. In addition, creating saving accounts for microentrepreneurs will help them to learn how to manage their money and may even serve as collateral for future loans.

2. Microfinance History

After WWII, the most popular policy for development finance was transferring funds to poor countries in order to fill up the gap of structural capital formation. At that time, almost all the funds targeted macroeconomic goals by financing industrial and infrastructure projects, whose effects were believed

---

[5] Ayyagari, Meghana, Thorsten Beck, Alsi Demirguc-Kunt (2003), "Small and Medium Enterprises across the Globe", World Bank Paper 3127, August, Washington D.C.
[6] "Integrating a gender perspective in microfinance in PAC countries"
[7] idem
[8] Ayyagari, Meghana, Thorsten Beck, Alsi Demirguc-Kunt (2003), "Small and Medium Enterprises. Across the Globe", World Bank Paper 3127, August, Washington D.C.
[9] Collateral substitutes in microfinance Philip Bond and Ashok Rai (www.cid.harvard.edu/cidpublications/limits-july2.pdf)
[10] "Critical issues in small and micro business finance", R. H. Schmidt and C.-P. Zeitinger, IPC Working Paper No.1, 1994

to trickle down benefits to the poor. The fact that the desired effect was not accomplished, lead to a shift in donors' policy orientation to reach the poor.

In the 70s, the concept of "**target group orientation**" was brought up with the intention of focusing on specific community groups to reduce poverty. When it came to financing, donors provided funds for selected projects in order to make credit available for the poor. Also, the creation of special banks and small loans available for small producers and businesses was a new form of targeting the most disadvantaged. But, at the end most of these practices failed. Some people argue it was due to the fact that the government owned these enterprises and others blame adverse financial sector conditions at the time.

In the 80s, the new trend was creating credit programs outside of both, the banking system and government's reach, provided by NGOs and self-help groups. The new advantage for success was their ability to reach the most needed, usually small businesses and low-income households. Despite their apparent early success providing equity and boosting growth, these projects failed as a result of high costs by having to deal with a large number of risky clients, bad and low credit recuperation, lack of refinancing mechanisms to generate new sustainable credit and new financial institutions. At the end, high costs lead to a significant reduction in the number of beneficiaries.

After all these attempts to provide access to capital for small enterprises, experts were divided into two schools; those who advocated specific "group targeting" and those who believed in a "more liberalized" and "market oriented" financial sector.

During the 90s, economists reached a consensus regarding microfinancing for small businesses. Experts believed there were three main areas that should be improved in microcredit financing: **institution building**, a **more commercial approach**, and a better **financial system orientation**. Thus, new financial institutions were established in order to create a sustainable channel of fund provision for the poor. A more commercial approach seemed also necessary in order to cover costs and being able to provide good services to clients. Finally, all financial institutions providing access to funds for the poor should be able to survive and compete in a country's entire financial system.[11]

3. Microfinance Lending Practices

Until now, most of the sector's interventions have focused on **supply side services,** which provide credit to cover both, fixed and variable costs such as invest on new machinery and buying extra inputs to increase production and sales. Microcredit is usually not provided for **consumption** purposes since SMEs are lent a credit to generate additional profits to be able to pay back the loans and to increase their income.

Competition among developing countries for international market access, foreign investment, and resources has become more intense. A **supply chain approach** is a strategy for partnering with strategic international investors. For example, multinational enterprises looking for entering new markets and investing opportunities might give capable SMEs the chance to join global value chains through subcontracting linkages.

In institutional economics a **cluster** of small enterprises is considered a way of industrial organizations to embrace both, geographical and sectoral specialization, competing with medium and large enterprises.[12] Clusters can be a powerful tool for these small businesses to assess and manage risks collectively. The integration of small and informal enterprises into the market, the joint use of assets, the development of external markets through business support services, and the adoption of trade standards and protocols among trading partners (small and large) are some of the ways in which

[11] Ayyagari, Meghana, Thorsten Beck, Alsi Demirguc-Kunt (2003), "Small and Medium Enterprises. Across the Globe", World Bank Paper 3127, August, Washington D.C.
[12] Enterprise Clusters and Networks in Developing Countries, by Maine Pieter van Dijk and Roberta Rabellotti, Frank Cass-London, in association with the European Association of Development Research and training Institutes (EADI), Geneva, 1997.

clusters and collaboration can reduce transaction costs, improve market access, and enhance competitiveness.

Other types of credit lending are credit unions, village banking and self-help groups. **Credit unions** are cooperative institutions, which started operating in the 1950's, and are represented worldwide. They collect savings and provide short-term credit. In developing countries credit unions have 9 million members, 60% of which are in Africa and the Caribbean. It is estimated that credit unions provide 860,000 SME customers with an average loan of US$176.[13] **Village banking** was developed during the 80s as an alternative to rural credit in Bolivia, based on the assumption that village communities would make the best managers of their own banking system. Village banks can invest their savings in local business ventures or community development projects, lend them out, or deposit them in commercial interest-bearing bank accounts. Some village banks allow members to borrow for personal consumption as well as business purposes. Loans range from US$25 to US$500, but most are in the $50 to $100 range. **Self-help groups** are predominantly female organizations that save usually very small amounts and can borrow these savings on a rotary basis.[14]

4. Banks and Financial Institutions

Microfinance practices targeting the lower end of the market have made a significant breakthrough in the last decade providing financial services for millions of poor entrepreneurs. However, statistics show that only 5% of potential clients are actually reached as a result of a "one-size fits-all" approach.[15] Not all clients and poor communities have the same problems and needs. Thus, providing the same type of services for all may not suite all clients, reducing the impact microcredit could have on development and poverty reduction.

In order to increase the outreach of microfinance institutions, some literatures and studies suggest magnifying the resources available for microfinance institutions. For instance, for the creation of a pool of funds in Ethiopia (*Rural Financial Intermediation Programme)*, IFAD, and the ADB have jointly mobilized more than US $65 million in the last 12 years to support microfinance institutions and projects. Furthermore, other promising experiences are leading the way for commercial microfinance. In addition, a recent paper called "A billion to gain?"[16] explains how quite a number of international financial institutions are taking their first steps into the area of microfinance.

Information Technology (IT) has entered the microfinance industry. The use of **smart cards** with an embedded chip to keep accounts and transaction records, remote transaction systems and biometric technologies to identify borrowers and improve security among customers in Africa, Latin America, and Asia has opened new avenues.[17] These tools have proven to be a powerful catalyst in increasing productivity making possible for microfinance institutions to improve their services and provide low cost services to remote communities. This advent of new technology also has the potential of reducing asymmetry in market information, which is a source of market inefficiencies.

But MFIs alone are not the answer to credit accessibility. **Banks** and **other financial institutions**, domestic and international, have far greater resources to take up the challenge and come up with innovative financing schemes. On average, the typical commercial banker is negatively pre-disposed towards micro entrepreneurs, who often work in the informal sector, in semi-legal, low-productivity, and family-based activities that are difficult to quantify or assess. This is also due to the fact that they have minimal assets and therefore minimal collateral of microentrepreneurs.

[13] Integrating a gender perspective in microfinance in PAC countries
European commission, Directorate General VIII, Development, Development Policy, Social human development, women and development, March 1998
[14] idem
[15] CGAP and IFAD
[16] ING Releases Study on Financial Access, Role of Banks in Microfinance
[17] http://digitaldividend.org/case/case.htm

5. The real challenges

The three main constrains that SMEs face are related to market access and lack of both, financial resources and inputs. Overall, most of SMEs face at least one of the following problems:

- FINANCIAL: receiving payment by customers and having access to credit;
- MARKET ACCESS: low demand for their products due to strong competitors in urban areas and isolation from the main markets in rural areas;
- INPUTS: access to and/or costs of inputs and production.[18]

Experts differ about the most sustainable approach for poverty reduction. Various approaches to identify tools and primary goals for fund provision might have diverse impacts on poor communities. Some experts state that in order to be sustainable, microfinance institutions should be able to compete and survive in a country's financial system. This implies that financial institutions have to provide funds for the largest number of people at the lowest risk and costs.

Some initiatives already developed by the IFC/World Bank, like the "*New Africa MSME lending program*", prefer concentrating on training banks and microfinance institutions on how to lend to micro, small, and medium enterprises. However, not only financial institutions should be integrated in the existing financial system, but borrowers should be, too. Some studies underline the importance of educating SMEs to comply with standards of banks.[19]

Some of these initiatives have led to the following conclusions:

- Assessing and managing risk is crucial for program sustainability;
- Improving access to finance requires action on both, supply and demand side;
- Access to resources (from the supply side) will not be a major constraint; this is also supported by initiatives on financing MFI growth through commercial capital.

When it comes to microcredit practices there is also a need to include **gender** and equity sensitivity. Research shows that women are usually involved in low productivity activities and represent about 60% of the world's poor. Jobs and know-how practices are most of the time in the hands of men who have exclusive access to resources. But despite the fact that women tend to face greater obstacles than men when dealing with poverty, it is very difficult for banks and other financial institutions to provide special treatment for them. For example, it would be difficult to fairly justify the provision of lower interest rates for enterprises run by only women than those run by men.

Women have become the center focus of many microcredit institutions and agencies worldwide. The reasoning behind is that loans to women tend to benefit more often the whole family than loans to men do. It has also been observed that giving women the control and the responsibility of small loans raises their socio-economic status, which is seen as a positive change to many of the current relationships of gender and class. However, there is an ongoing debate about whether microcredit loans have the power to truly change established political and economic relationships. 1.2 billion people are living on less than a dollar a day. Women are often responsible for the upbringing of the world's children and the poverty of the women results in physical and social underdevelopment of their children. Experience shows that "women are a good credit risk", and that they invest their income toward the well being of their families. At the same time, women themselves benefit from the higher social status they achieve within the home when they are able to provide income.[20]

---

[18] Integrating a gender perspective in microfinance in PAC countries
European commission, Directorate General VIII, Development, Development Policy, Social Human development, women and development, March 1998

[19] African Development Bank (ADB) pilot BDS & Financial services for Growth Oriented Women Entrepreneurs in Kenya, whereby ADB provides the finance and ILO the capacity building

[20] www.wikipedia.com

6. Solutions and Policy Recommendations

* An important lesson from past experience is that institutions should separate provision of **financial services** and **business support/training**. Institutions should concentrate on what they do best. Otherwise, problems regarding dependency from part of fund recipients as well as side costs may arise. For instance, a small entrepreneur who had followed advice from business support/training might not take responsibilities for business failures resulting from that advice. In addition, microentrepreneurs perceive the training often only as an additional cost to be able to receive a loan. Thus, financial institutions should provide funds and business support agencies should provide training and marketing advice.

* **Clusters** emphasize competitive and complementary relationships among small and medium enterprises that allow them to have a place in domestic and international markets. Cluster analysis can also help to identify specific opportunities and threats confronted by actors such as smallholder producers, NGOs, governments, medium and large firms. Industrial clusters can make a significant contribution to the accessibility of funds. Clusters cannot only enhance the ability of small firms to compete in the global market, but they can also allow SMEs to overcome constraints regarding size at the same time as they can offer possibilities of collective action to face common problems.

* The **supply chain approach** may develop collective infrastructures to reduce risks and transaction costs, and open up opportunities for private businesses to sustain national and international competition. All these goals are supposed to be achieved by connecting rural poor to SMEs operating together in the informal sector, and by focusing on opportunities that can generate growth, job creation, and investment increase in the private sector. Supply chain development provides the framework to build the bridge between informal and formal sectors, mitigate financing risk, and improve access to finance.

* **Support the capacity building of financial service providers**: This encompasses supporting actions to construct profitable SME lending programs, **develop new demand-driven** products supported by innovative solutions to collateral issues, such as the acceptance of more flexible forms of collateral, particularly for SMEs, with few fixed assets; the use of group guarantees and loan guarantee schemes for SMEs; more emphasis on cash flow (integrating suppliers' credit which remains the largest source of SME funding) than balance sheets in assessment of borrowing capacity; easy and effective loan application assessment methodologies, promoting financial leasing and factoring markets by improving the regulatory environment and strengthening leasing service providers.

* **Mitigate financing risk:** a key element to encourage investment in SMEs and access to finance in developing countries is to reduce SMEs' financing risk. This requires committed partnerships and a strong coordination among donor governments, multilateral development banks, local banks, and the private sector to develop and share a common approach to access to finance in a way that risk is reduced for both the borrowers and the provider of financial services.

* **Build a bridge and treat informal businesses and smallholder farmers as entrepreneurs:** A policy priority is to reform the division among informal and formal sectors to mainstream smallholder producers into economic growth and markets so as to enable them to engage in higher value added business activities. The main issue is to accompany this growing number of small businesses from the informal to the formal sector and to find practical solutions to fill the gap in knowledge and finance. This requires working efficiently and intelligently at the frontier between the two sectors and to build a bridge between micro- and SME finance to address one of the most crucial questions in emerging and less developed countries.

* **Create synergies in the financial sector:** There is a need to build on existing partnership efforts between MFIs and commercial banks, as already observed in some countries, like Colombia, Guinea, Tanzania and Haiti. Also, recent MFI access to financial markets increases their capacity to mobilize long-term finance and refinancing sources to be able to support investment needs along export supply chains with cost effective financial services.

* **Institution building:** This is not an end but a mean to support group-borrowers in order to offer more and better financial services. At the beginning there may be some conflicts between the group’s needs

and the institution building to be sustainable, like for example, covering costs vs. offering a larger number of services to the community. Financial institutions should be both financially sound and target group-oriented.[21]

* **Impact assessment:** Conduct research to assess the impact of provision of financial services for poor entrepreneurs and households as well as to apply lessons learned from past experiences to develop new instruments.

* **Gender and equity sensitivity**: Another challenge for donors and financial services providers is to integrate rights based, gender, and equity sensitivities for access to finance. Much has been said about the success of microfinance in providing opportunities to poor entrepreneurs who are excluded from the classical system. Having a gender perspective means to be aware that for the cultural, class, legal and/or other reasons men and women generally have different roles to fulfill, different access to and control over resources, different needs and priorities and as a result different constrains, opportunities and bargaining power in the way they relate. The best known group lending and savings institution is *Grameen Bank* in Bangladesh[22], which targets women on the basis they are more likely to pay back the bank than men.[23]

[21] "Critical issues in small and micro business finance", R. H. Schmidt and C.-P. Zeitinger, IPC Working Paper No.1, 1994
[22] www.grameen-info.org/bank/
[23] Integrating a gender perspective in microfinance in PAC countries; European commission, Directorate General VIII, Development, Development Policy, Social human development, women and development, March 1998