The Credit Revolution: An Institutional and Historical Glance at Microcredit as a Culmination in Economic Theory

Caleb Shaw

TEXAS CHRISTIAN UNIVERSITY

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I understand the irony of living within means of blessing and financial stability while taking a bird's-eye view of examining the methods and theories to reduce poverty in developing nations with communities I haven't yet interacted with. So, I humbly submit this work with the hope of utilizing the gifts and provisions granted to me to invest in the continuing conversation and subsequent actions of the care of others.

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May these words of my mouth and this meditation of my heart be pleasing in your sight, LORD, my Rock and my Redeemer (Psalm 19:14)

INTRODUCTION

In his magnum opus, *An Inquiry into the Nature and Causes of the Wealth of Nations,* grandfather of economics Adam Smith asked a particular question within his very title, probing for the discrepancies between the level of wealth between nation-states. Or, put into a simple question, "Why are some countries wealthy while others poor?"

That question remains the enigmatic problem of the modern era. Despite living in arguably the most prosperous, materialistic, and comfortable time in human history, still roughly 8.5 percent of the global population live off less than the purchasing power of $2.15 per day, qualifying as extremely impoverished. This number spikes when increasing the net to a mere $6.85 per day, in which 46 percent of the global population lives below. These statistics should not live in a vacuum; however, the financial indicators are only one variable that represents the complex lives of people. There are several factors that contribute to and are associated with poverty including health measures, such as nutrition, child mortality, mortality rates; education measures, such as the amount of schooling, attendance, and what ends education meets; other living standards, such as reliance on traditional cooking sources, sanitation, access to potable water, electricity, and housing are some but not all the factors that contribute to poverty measures.[1]

While allocating resources, money, and poverty are about as old as time itself, Smith would effectively usher a new field of study into academia that would grow into the modern understanding of economics. Smith would argue in favor of the expansion of free trade through specialization, viewing interventionist policies of his time as harmful. However, this British society, which was hardly starting from square one, propelled massively through colonization and the beginnings of the Industrial Revolution. While roughly 60 percent of British society was still living in subsistence living conditions at the time of his writing, there were certain structures in place that lubricated the transition towards specialization easier.

This is a similar situation throughout economic history in which Smith and other economists, historians, bankers, geographers, historians, and philosophers have proposed their answer(s) to the question of poverty discrepancy. It seems that there is a starting point above subsistence living from which economic theory and policy stems from; however, the historical

[1] Zach Christensen, "Economic Poverty Trends: Global, Regional and National," Development Initiatives, 2023, https://devinit.org/resources/poverty-trends-global-regional-and-national/; Deborah Hardoon and Elena Suckling, "Multidimensional Poverty: Measures and Frameworks to Leave No One Behind," Development Initiatives, October 2022, https://devinit.org/resources/multidimensional-poverty-measures-frameworks-leave-no-one-behind/.

trend of a capitalist society has arguably produced the most prosperous time in human history. And yet, there is still absolute poverty.

In the world of economic development and poverty alleviation, perhaps one of the most current and alluring practices is that of microfinance. Microfinance refers to a financial practice that seeks to extend financial services, like credit extension, insurance, and other financial services to unemployed or low-income individuals who lack access to traditional and conventional banking sources with the hopes of alleviating absolute poverty. In their book *The Economics of Microfinance*, Dr. Beatriz Armendáriz and Dr. Jonathan Murdoch liken microfinance to a new movement within developmental economics, "dedicated to expanding access to small-scale loans, savings accounts, insurance, and broader financial service in poor and low-income communities."[2] In a similar vein, Rachael Meager writes, "Microfinance is a method of extending financial service to impoverished people who typically live on the fringes of the requirements needed to secure traditional bank loans, insurance services, or money transferring."[3]

Those seeking to use microfinance services might lack the collateral, credit requirements, or any financial resources that would allow them to secure traditional services. These services are provided through what is known as Microfinance Institutions (MFIs), which are primarily found in developing countries. As of 2020, The Microfinance market is valued at around $178.84 billion and is projected to reach $490.90 billion by 2030. The World Bank estimates that 1.7 billion adults are globally financially excluded from traditional financial services.[4]

Microcredit loans to the impoverished help alleviate fragile short-term consumption issues and income stresses while also representing a more efficient way of long-term investment in human capital and economic development through the promotion of entrepreneurship, fiscal responsibility, and community accountability. Where exclusion from traditional banking loans might lead to alternative loaning that could be potentially life-threatening or exacerbate cyclical poverty, microcredit allows borrowers and small business owners to make ends meet and allows lenders to establish independence and makes long-term sustainability possible.

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[2] Beatriz Armendáriz and Jonathan Morduch, *The Economics of Microfinance* (Cambridge: MIT Press, 2010), page 1, https://ebookcentral.proquest.com/lib/tcu/reader.action?docID=3339129&ppg=24.

[3] Meager, Rachael, Aggregating Distributional Treatment Effects: A Bayesian Hierarchical Analysis of the Microcredit Literature," *The American Economic Review* Vol. 112, No.6 (June 2022): 1818-47, https://doi.org/10.1257/aer.20181811

[4] "Microfinance Market Size, Share, Scope, Trends & Forecast," Verified Market Research, July 21, 2023, https://www.verifiedmarketresearch.com/product/microfinance-market/#:~:text=Microfinance%20Market%20Size%20And%20Forecast,on%20the%20global%20Microfinance%20industry.

The first goal of microfinance is to expand financial service access to these people in hope that it will provide ultimate self-sufficient practices and alleviate material need; however, the mere extension of access has proven to be not as effective as promised and must be done alongside additional services to be more effective.

I argue in this paper that the emergence of microcredit can be viewed as a culminating moment in historical-economic development theory, and in understanding the internal structure and the historical emergence, narrows the sphere of ignorance around poverty alleviation. Perhaps in viewing the ways in which things have been done poorly it allows policy makers and economists to revise their practice to greater success. I will first briefly introduce where the conversation of microcredit stands in academia, which is of mixed results, then move into the internal structure of microcredit, providing a strong base of information to build up from. This institutional analysis seeks to establish how microcredit theoretically answers the key issues of the principal-agent problem and could be used to justify its use. Then I will introduce several key schools of economic thought, placing them within a historical context to illustrate how microcredit emerged as a pluralistic approach to relieving poverty. Finally, I will look at some of the results of microcredit's progress and offer an explanation of where it could go with the importance of non-government organizations (NGOs).

HISTORIOGRAPHY

Microcredit burst onto the scene of developmental economics in 2006 when Muhummad Yunus, founder of the Grameen Bank in Bangladesh won the Nobel Peace Prize, despite having been founded in the 1970s. Since its semi-miraculous appearance, the relevance and popularity of microcredit operations have continually increased and so too have the conversations around it with 2 Nobel Prizes in Economics covering the issue. These conversations have osmosed from academic journals and articles to various books and even into greater accessibility to the public. Interestingly, microcredit has a long-standing history of formulated theories and ideas, and putting stake into them by practicing, so the trend of discussion is a bumpy process of theorization, application, revision, and forward progress.

In gaining an understanding of where the dialogue of microcredit might currently stand, the genesis of its contemporary model the Grameen Bank is a good place to start. In his autobiographical work, *Banker to the Poor: Micro-Lending and the Battle Against World Poverty* (1999), microcredit pioneer Muhammad Yunus carefully describes the history and processes of how the Grameen Bank began. The book describes Yunus's early life, his formative years at university, as well as his professorship tenure at Chittagong University. Upon observing and collecting data concerning poor villages around him, Yunus discovered that most of the villagers could reach self-sufficient means by as little at 856 taka, or about $8 USD. He received a loan from a bank in Dhaka, began to make micro-loans to the villagers, and received apparent success with a repayment rate of over 95 percent.[5]

Yunus received the Nobel Prize in 2006 for his work with the Grameen Bank, and with its growing reputation and popularity, the stage was set for other theorists and practitioners to contribute. The 2011 work of Massachusetts of Technology professors Abhijit Banerjee and Esther Duflo, *Poor Economics: A Radical Way of Rethinking of the Way to Fight Poverty*, represents a significant departure from typical answers to the questions of economic development, arguing that traditional approaches to poverty alleviation have fallen short on promises towards meaningful and long-lasting change. They advocate for a more nuanced view of poverty, advocating for the context in which poverty occurs must be considered in tailoring specific policy recommendation. Their local-knowledge-first approach advocates for small, incremental improvements, rather than large-scale top-down programs that might be construed as a "man of systems" problem.[6] In a similar vein, Dr. Joanne Meyerowtiz published *A War on*

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[5] Muhammad Yunus, *Banker To The Poor: Micro-Lending and the Battle Against World Poverty* (PublicAffairs, 2007), ProQuest Ebook Central, https://ebookcentral.proquest.com/lib/tcu/detail.action?docID=665879.

[6] Abhijit Banerjee and Esther Duflo, *Poor Economics* (New York, NY: PublicAffairs, 2012), Kindle Edition, https://www.amazon.com/Poor-Economics-Radical-Rethinking-Poverty-ebook/dp/B007CI81IQ.

Global Poverty: The Lost Promise of Redistribution and the Rise of Microcredit, in which she takes a historical approach in explaining the trends in which previous methods of foreign direct intervention of development were unsuccessful and led to the subsequent rise in microcredit.[7]

Perhaps one of the most complete works covering the subject is *The Economics of Microfinance* (2005) by Dr. Beatriz Armendáriz and Dr. Jonathan Morduch. The authors provide a strong institutional analysis of microcredit, detailing an investigation into the basic structure of microcredit and overlaying that skeleton with economics language, concepts, incentives, and problems.[8] Likewise, *Portfolios of the Poor* (2009) by Daryl Collins et al. details methods in which impoverished people maintain the financial aspect of their lives and specifically detail how microcredit fits their wants, desires, and needs.[9]

While each of these works provides and attempts to answer the question of whether microfinance works, *Sustainability and Outreach of Microfinance Institutions,* edited by Doris Köhn, specifically addresses different ways in which success in microcredit operations are measured, looking at the relationship between financial and social success.[10] There is some work that challenges and critiques the work of microcredit. "Microfinance and the Illusion of Development: From Hubris To Nemesis in Thirty Years" by Dr. Milford Bateman and Dr. Ha-Joon Chang challenges the positive connotation surrounding microcredit, arguing that microfinance has failed in its original mission to reduce poverty and has trapped borrowers into poverty and cyclical borrowing loan traps. They argue that despite its evidence of failure, the appeal to a neoliberal success story of a successful entrepreneur keeps microcredit in place as a shiny tool with little payoff. [11]

Additionally, *Microfinance and Its Discontents* by Dr. Lamia Karim offers a strong critique against a key aspect of microcredit: lending for women. Traditionally, proponents of microcredit have argued that lending towards women provides financial independence and social freedom in areas that might be considered restrictive by western standards. Dr. Karim

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[7] Joanne Meyerowitz, *A War on Global Poverty: The Lost Promise of Redistribution and the Rise of Microcredit* (Princeton: Princeton University Press, 2021).

[8] Armendáriz and Murdoch, *Economics of Microfinance*.

[9] Daryl Collins, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven, *Portfolios of the Poor: How the World's Poor Live on $2 a Day* (Princeton: Princeton University Press, 2009), http://www.jstor.org/stable/j.ctt7rzr4.

[10] Doris Kohn, *Microfinance 3.0: Reconciling Sustainability with Social Outreach and Responsible Delivery* (Springer Berlin, Heidelberg, 2013), https://doi-org.ezproxy.tcu.edu/10.1007/978-3-642-41704-7.

[11] Milford Bateman and Ha-Joon Chang, "Microfinance and the Illusion of Development: From Hubris to Nemesis in Thirty Years," *World Economic Review*, no. 1 (January 26, 2012), https://ssrn.com/abstract=2385482.

offers a rebuttal in which the social codes of honor, which have been cited as one of the solutions to incentivize loan payment, have created a shame culture and expanded capitalist intents.[12]

What the historiography reveals about microcredit is still a novel trend in development theory that still has contending perspectives and arguments, with some analytical analysis, but not much being done in the process. There are scattered pieces of theoretical internal structure and the emergence of microcredit in a historical context in highlighting, and what I seek to do is bring these pieces together. By highlighting said internal structure and roping a history of economic development theory into microcredit's specific emergence, I hope to narrow the scope of ignorance in which we discuss. In viewing what hasn't worked and properly understanding where we are today, it can encourage policy makers, microfinance institutions, and other actors in the microcredit world to make more informed decisions to benefit their borrowers.

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[12] Lamia Karim, *Microfinance and Its Discontents: Women in Debt in Bangladesh* (NED-New edition, University of Minnesota Press, 2011), http://www.jstor.org/stable/10.5749/j.ctttsh21.

FOUNDATIONS

On a foundational level microcredit seeks to solve an issue of access. Consider a basic lending model, and the decisions the parties face. The first agent in the process is a lender, who can choose to loan to a borrower or not. In a traditional view, the lender will want to receive their money back with accrued interest to offset the opportunity cost of being without their money. Additionally, the borrower can choose to pay the loan back or not, which depends on their willingness and ability to pay it back. Willingness can be simplified with the analogy of a carrot or a stick, a carrot representing a reward for actions and a stick being coercive or corrective action.

At the end of the day, a proper lender won't want to lose their money, so there are information indicators like credit score that give them clues into the riskiness of their potential investment. Dr. Douglass North, a prominent economist associated with the new institutional school, touches on this subject matter in his journal article, "Institutions." Dr. North utilizes a broad understanding of human history, namely the development of trade, to highlight different issues associated in engaging in exchange. Dr. North posits that as long-distance trade became more apparent, a principle-agent problem emerged.[13] The principal is the person that owns an asset or engages in activities in which they would hope to acquire income. The agent is the person hired by the principal to carry out these decisions on behalf of the principal. In early tribal culture, this might involve utilizing family members, close of kin, or others associated with the tribe who had a vested interest to engage. An example of this can be found in Genesis chapter 27-31, when Isaac, the son of the patriarch Abraham and Sarah, sent his son Jacob to the region of Paddan-Aram to establish further prosperity for his family through trade through the marriage of his son Jacob to a daughter of Laban.

The thought behind utilizing a family member would be the hope that the principal could rely on the person's character and familial incentives to capitalize on the deal. It proves to be more costly to engage in trade with someone that might fall through on the deal, and so a problem occurs—the adverse selection problem.

The adverse selection issue occurs when someone cannot easily identify if the deal in which they are about to partake in will be fruitful or not and if it will be risky or not. In a traditional view the lender will want to receive that money with a little bit of an added amount called interest, which goes towards paying back the lender for being without their money. The mitigation of the adverse selection problem, and riskiness of partaking in loans is accomplished

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[13] Douglass C. North, "Institutions," *The Journal of Economic Perspectives* 5, no. 1 (1991): 97–112, http://www.jstor.org/stable/1942704.

through official information such as credit scores, borrowing and lending history, bank account information, and social security. For those in many developing nations, these sources of information are largely non-existent, so traditional banks have steered clear of this group of lenders. Because lenders do not know who or what they will be engaging in, there is a large cost associated with the transaction, because of the potential for loss.[14]

These insufficient requirements according to modern banking standards are something that borrowers in developing nations simply don't have. Economists have found that these people have a high degree of willingness to pay, but no ability to secure and pay back loans in a traditional system. So, microcredit primarily emerged to find a way for these underbanked individuals to access benefits of banking and implement practices that mitigate risk.

The first of these practices is the "micro" aspect. Microcredit involves extending small loans, ranging from as low as $15 to a couple thousand, to those people previously excluded from traditional banking resources. The thought is that greater amount of revenue relative to constant costs in business will increase the amount of profit and disposable income for a person, allowing them to consume more goods and services, thus increasing their utility. Some of this can be used towards unexpected and unforeseen expenses or mitigating unexpected or emergency expenses.

Utilizing data provided by the World Bank on the Bangladesh Rural Advancement Committee (BRAC), one can see this layout clearly. Between the years 1989 and 1994, the MFI loaned to roughly 2.5 million borrowers and about 13.8 billion Bangladesh taka in loans. Taking the total amount in loans, dividing it by the number of borrowers, and converting with historical Bangladesh Taka to USD conversion yields a rough estimate of the average amount each borrower received and presents as follows: $71.46 (1989), $103.23 (1990), $99.53 (1991), $134.05 (1992), $189.82 (1993), and $166.79 (1994).[15]

While some of the amounts might seem large, there are several factors that contribute to it. Namely, as there was no data that gave exact information on the number of borrowers in each group, just the total sum of borrowers and the amount of each group, it wasn't possible to achieve the exact average for individual and group borrowers. The amount of group loans amounted to between 10-20 percent of the total amount of loans each year and given that the loan amounts taken out by group borrowers will be higher than individual loans, it makes sense that the average amount per person will be biased towards the higher end of loans. Additionally,

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[14] Douglass C. North, "Institutions"

[15] Shahidur R. Khandker and Baqui Khalily, *The Bangladesh Rural Advancement Committee's Credit Programs Performance and Sustainability*, World Bank Discussion Papers No. 324 (Distributed by The World Bank, 1996), August 1996, https://documents1.worldbank.org/curated/fr/605821468743409347/pdf/multi-page.pdf.

BRAC is known for being an MFI that grants generally higher loans to its borrowers with a loan around $50 being its baseline.

Because of the constraints of the environment MFIs operate in, small loans are purported to be the most sustainable of loans. Given that the demographic of borrowers tends to be low-income individuals experiencing perhaps lower monetary costs, then extending smaller amounts of money makes sense. Additionally, lending small amounts of money helps microcredit institutions mitigate their risk, as borrowers lack the information indicators that lenders utilize to assess risk. Lending a small amount minimizes the potential for loss while still providing access to funds for potential borrowers, as well as decreasing the administrative costs, allowing forms to profitably lend to low-income areas. For the borrowers, small loan amounts are easier to repay, especially where incomes are low or irregular, and can allow greater flexibility and leniency.

Individual loans, however, are not the only way in which microcredit functions. In fact, the term "group lending" has become almost synonymous with microcredit. Dr. Armendáriz and Dr. Murdoch describe group lending as "arrangements by individuals without collateral who get together and from groups to obtain loans from a lender"[16] with groups being as low as three people to sometimes as high as ten to twelve. Pretty basic concept, right? Well, this function within microcredit has some of the most significant debate on its practice and use. Sometimes these groups are simple accountability reminders for repayments or strict monitoring and punishment. Sometimes they are more collaborative with group members relying on one another for their decision making.

The Grameen Bank, the pioneer and poster child of microcredit, traditionally utilized a joint liability model, where loans were made to individual members of a group, but the group faced consequences if a single member faced repayment issues. The Grameen Bank and BancoSol, a prominent Bolivian MFI, have omitted joint liability from their practices; however, many MFIs continue to utilize it, and groups remain one of the foundational elements of microcredit.

Group lending allows for the costs associated with adverse selection to be negligible. For example, if groups of individuals are encouraged to form on their own, then they will likely form into more risky groups and less risky groups based on localized knowledge and reputation. This is a term known as "assortative matching," and as risky borrowers face the possibility of denied future access through joint liability, it shifts the risk from the bank onto the borrowers themselves, mitigating the costs incurred by the lenders. If one thinks about a village or a group

[16] Beatriz Armendáriz and Jonathan Morduch, *The Economics of Microfinance*, 98

of villages, it wouldn't be hard to imagine the close-knit communal information people have on their fellow villagers. This social dynamic and reputation information is a key to reducing the transaction costs with loaning, and one that MFIs would not have to engage in because their borrowers are already facilitating the efficient sorting of borrowers. Because the banks are better insured against risk, this can decrease interest rates for both risky and safe borrowing types, allowing banks to break even.

This assumes that the borrowers have near-perfect information, even information on loaning patterns which might not even be around yet, on their peers and allows them to freely choose their groups. However, not every microcredit program utilizes this close-knit, village-oriented assumption, as many MFIs operate out of primarily urban areas like Mexico City or Bogota, where the population is more mobile and have little information on one another, leading to more heterogenous borrower groups. Interestingly, within these conditions of mixed borrower types, both groups can benefit, with risky borrowers gaining greater access to loans, as well as gaining the safe borrower friend to bail them out, while the safe borrower will experience higher returns under the risk-reward assumption that when the possibility of risky borrowers getting lucky happens, the safer borrow will experience higher returns.

Along with mitigating the adverse selection, group lending can also overcome a moral hazard problem, which refers to the action of undertaking an activity because the risk will be assumed by someone else. For instance, if a microcredit borrower decided to undertake an extremely risky investment or capital expenditure because they didn't seem personally responsible for it. One of the main costs associated with microcredit is that of monitoring and enforcement costs, making sure everyone is up with their loan payments and making sure to not partake in more risky behavior. A solution involves group members within proximity to one another monitoring their fellow members by imposing social or economic pressure on their fellow borrowers to avoid situations that would lead towards default. Groups could additionally take a more positive and collective identity around taking deliberate steps, like helping someone make their payments, attendance of budgeting and financial management classes, or even leniency if bumpy life circumstances prevent someone from making payments.

It is the form of external negative pressure through monitoring and enforcement that much of the criticism towards microcredit stems. Bloomberg writers Gavin Finch and David Kocieniewski argue that billions of dollars are poured into a system that offers poverty relief, but instead has entrapped borrowers into a cyclical loan pattern, rendering borrowers dependent on loans through a loosely regulated predatory system. They use examples from Mexico, India, and Sri Lanka in which borrowers had to take out loans and sell their homes and other possessions to repay loans, and in extreme cases, they resulted in suicidal ideation and some action towards it. Some of the reasons involved vague guidelines that lenders and collectors followed that didn't ensure client-protection, strict enforcement of payment that involved compulsory selling of assets, and a lack of leniency during the COVID-19 pandemic.[17]

In a similar position, Dr. H M Ashraf Ali argues that loan collectors, through non-government agencies (NGOs; non-profits) exert social, economic, and political control over the poor through violent action that creates power relation differences and, therefore, unequal opportunities.[18] Dr. Ali states that NGOs commit violence in direct and personal ways, as well as indirect and structural, that NGOs are "capitalist and accumulative rather than being agents for sustainable and equitable social and economic development."[19] The way in which NGOs committed personal violence was through confiscation of saleable assets, breaking property, selling corrugated tins, confining borrowers at the NGO center, and using shaming and coercive language. For structural violence, Dr. Ali argues that NGO officials, through rigid loan repayment schedule and ensuring a near 100 percent loan repayment rate, ignored the actual causes of poverty, and perpetuated a cycle of debt-to-pay-off-debt actions. He claims that NGO officials blamed individual self-destructive behaviors like spending the loans on non-productive purposes.

Before moving on to a rebuttal to these points, I must interject and state that I am not minimizing the horrific experiences that Finch, Kocieniewski, and Dr. Ali highlight in their work. It is deeply disheartening to hear that the suffering of people isn't alleviated, and, in some cases, exacerbated to the point of selling property and assets as well as suicide. This is a sobering reality of living within a broken world, but it could be useful to MFIs to alter their screening processes of loan officers and implement monitoring of loan officers as well as alter their loan policies to try and prevent these from escalating. The issues they bring up seem to be abnormal, however, and seem to throw the baby out with the bathwater, in that they equate a small percentage of defaulters, who already only compromise about 5 percent of the total loaners, that experience more negative treatment as intrinsically negative, and by association, the practice is

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[17] Gavin Finch et al., "How Microfinance Pushes Poor Borrowers Deeper in Debt in Developing Economies," Bloomberg.com, May 3, 2022, https://www.bloomberg.com/graphics/2022-microfinance-banks-profit-off-developing-world/?embedded-checkout=true.

[18] H. M. Ashraf Ali, "Blaming the Poor and Legitimizing Coercive Loan Recovery Strategies: Unveiling the Dark Side of NGO Practices in Bangladesh," *Anthropologica* 56, no. 1 (2014): 177–91, http://www.jstor.org/stable/24469649.

[19] Ali, "Blaming the Poor and Legitimizing Coercive Loan Recovery Strategies" 181

a net negative, even to the extreme that Dr. Ali argues, "the poor are deprived of social justice, and excluded from an opportunity for economic development."[20]

If small loans encapsulate the amount and group lending represents the primary mechanism of microcredit, what remains of the *type* of loan? The dominant and most positive narrative in microcredit is when loans are geared towards local entrepreneurs and entrepreneurship groups, who will generate sufficient income to facilitate a move out of poverty for themselves, and with an expansion of business, those around them. Esperanza Internacional, a microfinance firm based out of the Dominican Republic, has distributed nearly 300,000 loans amounting to almost $100,000,000 in funds with a 94 percent repayment rate. They feature many success stories on their entrepreneurs on their website, including Joassaint Odalaine, who utilized a loan from Esperanza to start a food stand that serves travelers in eastern Dominican Republic which allowed her to solidify her citizenship status, expand her business, improve her home, as well as be able to support her daughter's pursuit of university in Italy.[21]

While microenterprise loans are the most well-known stories, "livelihood" supporting loans, those that might cover medical bills, rent payments, or traditional means of living like farming, animal husbandry, and fishing, also make up a significant percentage. The Love Mercy Foundation based out of northern Uganda operates a seed-loan program called Cents for[22] Seeds, in which 30 kg bags of beans or sesame are lent to women, who will cultivate and harvest the crop. Each harvest will typically generate 150kg of seeds, and the women will return 30 kg worth of their harvest to cover the borrow, plus a little interest. Then the remaining 120kg can be used for food for their families or be sold at market to increase their general prosperity. Since its founding in 2010, Cents for Seeds has reached nearly 28,000 women, and in 2023, 2,551 women graduated from the program's educational programs.

Drs. Jasjit Singh, Pushan Dutt, and Azri Adbi expand on the differences between these two types of loans in their work, "Microfinance and Entrepreneurship at the Base of the Pyramid,"[23] and challenge some of the assumptions made in examining micro-entrepreneurship. The first of those assumptions, and often the primary backing for microcredit, is that the people that it seeks to serve have "the necessary ideas, skills, and social conditions to improve their

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[20] Ali, " Blaming the Poor and Legitimizing Coercive Loan Recovery Strategies," 189

[21] Andrea Smith, "Joassaint: The Future Is Sweet," Esperanza, March 17, 2022, https://esperanza.org/joassaint-the-future-is-sweet/.

[22] "Cents for Seeds / Love Mercy Foundation," Love Mercy Foundation, accessed April 28, 2024, https://www.lovemercyfoundation.org/causes/cents-for-seeds/.

[23] Jasjit Singh, Pushan Dutt, and Arzi Adbi, "Microfinance and Entrepreneurship at the Base of the Pyramid," *Strategic Entrepreneurship Journal* 16, no. 1 (2022): 3-31.

livelihoods," and that the main thing missing is simply a lack of capital. The second is that microenterprises promise a larger social impact than lending to those traditional activities. And the final is that the standardized model of lending can be applied, regardless of customer needs. They found "little support to the popular view that microenterprise loans have a larger average benefit than traditional livelihood loans," and even found that those engaged in traditional activities are themselves entrepreneurs as they have knowledge of markets, customer bases, and operating within the communities they serve. They caution viewers against a "one size fits all" approach to these loans and advocate for greater context-dependent practices that don't simply involve loaning but understanding the communities it affects.

Finally, microcredit operations have been aimed towards affecting women by promoting financial affirmative action. The Microcredit Summit Campaign estimated that by the end of 2007, 70 percent of microfinance clients worldwide were women, and those that classified as the "poorest" candidates, women took 83 percent. The Grameen Bank has a client base that is 95 percent women. Data from the Microfinance Information Exchange suggests that for more than half of the Non-Governmental Organizations (NGOs or Non-Profits) associated with microfinance, 85 percent of the clients were female with at least a quarter of them serving women exclusively. But why specifically target women? Wouldn't this exclude a valuable pool of borrowers?[24]

What was discovered is that formal-sector banking tended to favor men because they tended to run larger business and control the assets commercial banks desired. Women, on the other hand, made up a large swath of the informal sector of businesses. Because Microcredit is aimed towards targeting those located within the informal sector, it would make sense that they would be the largest recipient of loans. Additionally, women faced credit constraints with fewer alternative avenues for securing credit, so they were more likely to negotiate their way into microcredit contracts.

One of the other arguments in favor of loaning towards women is the lack of labor mobility. On average, women in developing nations are more likely to work in or near their homes, so bank managers can monitor and enforce contract at lower costs, as well as facilitate group monitoring, as peers that are likely staying home more often face an easier task of monitoring each other. However, the strongest argument lies in the decreased mobility as well as fear of social sanctions. Women tend to be less risk-adverse than men, allowing them to solidify a reputation of reliability and allowing banks to decrease the risk they incur and

[24] Armendariz and Murdoch, *Economics of Microfinance*, 211

hopefully make their profit work. For example, in 1991, only 1.3 percent of women who were granted loans in Asia faced trouble repaying their loans. [25]

Microcredit has utilized many practices of various combinations such as group lending, loans towards local entrepreneurs, and targeting women specifically to both minimize adverse selection and moral hazard problems, as well as addressing specific systemic biases traditional banking creating. So, in the ways that microcredit could theoretically be practiced, it solidifies itself as a strong solution for extended credit towards the underbanked. However, much can be said for the historical context that it emerged from, specifically as a pluralistic approach of many economic theories.

[25] Armendariz and Murdoch, *Economics of Microfinance*. 219.

A THEORETICAL AND HISTORICAL APPROACH

Perhaps the earliest recorded instance of what one might consider microcredit happened through a network of firms with religious backing through the Catholic Church, the Monti di Pietà, started in perhaps one of the most important places for western banking, Italy. Interestingly, in the almost 560-year history since, the Monte de Pieta laid the historical foundation for the broad themes of microcredit operations, such as extension of credit to those outside of the system, a reliance on outside loaning, and inkling to many of the NGO/non-profit microfinance institutions.

The driving factor for economic practice in the Middle Ages was how closely it aligned with the teaching of the bible or the Catholic Church's interpretation of biblical practice. Most prevalent was the teaching against usury. A contemporary understanding might understand this as charging unreasonably high interest rates on loans that unfairly favor the lender. There was a historical trend at the time both within the Catholic Church and Islam that extended this practice to include more moderate amounts of interest or no interest at all. There were prominent banking families and groups, such as the Medici family in Florence, who did charge interest and were viewed in a negative light as predating on the less fortunate. By extension, this is many of the rationales in which microcredit has been justified, that in providing a safe, low-principal, and low-interest loan to those outside the access of traditional banking, it will keep the vulnerable from accessing predatory loan practices in the informal sector.

The first recorded Monte di Pietà sprung into being in 1462 in Perugia with an estimated forty more being developed between 1462 and 1470. It functioned from philanthropic base from wealthier parishioners or members of the community. This collection of capital from gratuitous donations, known as monte, would then be dispensed to the loan recipients. Loan recipients would give a valuable item, a non-money collateral, in exchange for the loan. Loan amounts would only be roughly two-thirds the amount the item was appraised for, and charged at low to moderate interest rates, with the hope that the lenders would have their bases covered. This interestingly avoided the issue of usury in placing the base of loans into a charitable intent, as the wealthier folks would donate money for the Monte employees to lend out versus an intent with solely making profit.[26]

The Monte di Pietà was highly successful in extending its practice across western Europe and perhaps more importantly, in establishing a precedent of a practiced attitude against predatory money lending in addition to establishing a method of loaning extended to a group of

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[26] Brian Pullan, Catholics, Protestants, and the Poor in Early Modern Europe. *The Journal of Interdisciplinary History* 2005; 35 (3): 441–456. doi: https://doi.org/10.1162/0022195052564315

people traditionally outside traditional systems. Dr. Andrea Gatto writes, "This was the first example of loan aimed at investing directly in groups of people from the same village, that is, group lending."[27] This emphasis on group lending will become integral into the contemporary understanding of microcredit.

By 1492, with Columbus' landing in Hispaniola, the Western world was beginning to turn a new page in the era of exploration, conquest, and colonization. Economics likewise began to become dominated by an extractive form of capitalism characterized by monopolies, protectionist policies, and government charters. The economic concept of mercantilism would come to dominate this period in economic history. Mercantilism is not an economic school in the traditional sense in that it lacks a unified framework, but was a term was coined by Adam Smith to describe a group of similar trade policies. In general, mercantilism favored large amounts of exports than imports because it was rooted in an idea of bullionism. Bullionism, stemming from the word "bullion," meaning *coin*, is an understanding that wealth is derived from the sheer amount of gold or precious metals a nation contains. Just the amount. That's it. Not what you could do with that gold, just the gold itself.

So, in passing trade policies that favored exports, a nation would aim to receive a net surplus of gold or other precious materials from the trade. The idea was to create a self-sufficient powerful nation state that could go toe-to-toe with other empires of the time. For the colonial powers of Spain, Great Britain, France, and the Dutch, protectionism and the extraction of gold and other precious resources would define a "scramble for power" in the creation of strong self-sufficient states. The underriding belief was that the amount of wealth in the world was fixed, meaning there was a no-sum gain attitude and sharp competition between nations at the time. They were all competing for more and more of what they understood to be a fixed pie.[28]

This is generally what mercantilist policies dictated. Now in the contemporary setting, there is a widespread rejection among economists and policy makers of the "fixed-pie" idea and rejection of wealth being solely defined by amounts of gold in coffers. So how could these ideas connect to the current times? It comes down to specific policies. Namely that common mercantilist practice was to promote domestic industries through tariffs on imported goods.[29] The idea was to incentivize domestic producers to produce more exports or to contribute to the

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[27] Andrea, Gatto, " Historical Roots of Microcredit and Usury: The Role of Monto Di Pieta inItaly and the Kingdom of Naples in XV-XX Centuries," *Journal of International Development*, July 2018, Vol. 30 Issue 5 (July 2018): 911-914

[28] C.W, "What Was Mercantilism?", *The Economist*, April 23, 2013, page 3

[29] Learn Liberty, "Prof. Brian Domitrovic: How Mercantilism Started the American Revolution," YouTube, April 6, 2017, https://youtu.be/aWxvfkFbKy0; 0:53.

building up of the nation, a part of that self-sufficient idea. The legacy of colonialism and, by extension, mercantilist thought is very much present-day and one of the many factors in which emerging economies today have had an enduring legacy of colonialism, with many African countries not even securing independence until the 1960s. With an emphasis on shipping raw material goods towards production capabilities in the homeland, much of the infrastructure in the colonized nations mirrored extraction, such as rail lines that aren't connected that go from the interior to the coast. Production capabilities in specifically African and Central American countries were largely non-existent, leading towards much lower relative poverty among a mother nation's citizens and its colonies, with an enduring legacy of these nations constituting the majority of absolute poverty statistics.

Adam Smith, who coined the term mercantilism, is the grandfather of Classical Economics, and with him, some new practices and theories took root. He and his contemporaries, like David Ricardo and John-Stuart Mills, provided theories that advocated for a step away from strict government and, by extension, colonial interference in the economy. While they recognized that colonialism seemed to be profitable for the greater power of the nation, there was a more efficient way to allocate scarce resources. Dr. Edward Kittrell writes, "Both leaders [Smith and Ricardo] were especially aware of the role of colonization in offsetting the decline in profits…and to their followers they bequeathed a framework that could simultaneously be critical of colonization yet recognize its great value under extenuating political conditions… the exclusive trade of the mother country with colonies resulted in a malallocation of resources."[30]

The growth theories of Adam Smith, David Ricardo, and Mills are all contingent on the idea that a person's amount of wealth can be created through trade, which becomes mutually beneficial and is a positive-sum game. Both Smith and Ricardo utilized a labor theory of value, which places the value of a good dependent on the sheer amount of labor put into it. For Smith, this would involve only the labor put into production, but Ricardo viewed it as the labor that went into production of the capital, manning the capital, etc. Holding to these assumptions, then leads one to understand their individual theories of growth.

Smith advocated for free-trade, and that wealth and prosperity could be expanded on through the division of labor. Simply put, division of labor is specialization. It is breaking apart a task into smaller sections and having a person in charge of those sections. An example of this

[30] Edward R. Kittrell, "The Development of the Theory of Colonization in English Classical Political Economy," *Southern Economic Journal* 31, no. 3 (1965): 191, https://doi.org/10.2307/1055555.

would be the classic Henry Ford assembly line, in which labor is divided and organized to produce a good at a much more affordable price. Smith argues that there are three primary sources of gaining productivity in the division of labor—specialization, time between task, and increased use of dedicated capital. As a person becomes more specialized in doing a single task, they become very skilled at it, make fewer mistakes, and waste less and less material. If you have ever tried to do multiple jobs in a day, you know that it takes a little bit of energy to switch between tasks. Not only does this apply to the work force, but Smith argues that in focusing one's energy on a single task, it decreases the physical act of moving to a new workplace and the mental energy. As people are using capital goods in their production, they will become keenly aware of how the object works, how it would be improved upon etc. This applies to both physical capital as well as human capital. As someone is working more and more, they become aware of the inefficiencies involved with a system of production and can innovate the processes, machines, or organize people towards more efficient things.[31]

Regarding microcredit, this idea can be extended simply to the village setting. In providing capital through loans towards the under-banked, they can begin the process of moving towards division of labor; perhaps moving away from more traditional work towards sustenance living and allocate the work of resources towards other tasks.

While Adam Smith advocated for the division of labor as a method of expanding prosperity, David Ricardo offered another method of specialization—comparative advantage. To understand comparative advantage, one must understand that this advantageous gain isn't towards one party. It benefits everyone. Comparative advantage is a relative gauge between parties. Generally, it stipulates that the comparative advantage of production is granted to the party that can produce at a lower opportunity cost than their competitor. Opportunity cost is the cost incurred by someone when they pursue something which means forgoing something else. In a classic understanding of tradeoffs, it means that if someone could be doing two things at the same time, the cost of pursuing one of those things is the gain someone would make if they pursued the other. If the opportunity cost of pursuing one activity is lower, then Ricardo says to pursue. Even if a producer is better at another, meaning they are more efficient, but if their opportunity cost of doing something is lower, than it is a more efficient endeavor. This means

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[31] Eamonn Butler, *The Condensed Wealth of Nations and the Incredibly Condensed Theory of Moral Sentiments*, The Adam Smith Institute, August 3, 2011; page 22, https://www.adamsmith.org/research/the-condensed-wealth-of-nations

that no matter, a person can be productive in some capacity because they will be able to pursue an activity at a lower opportunity cost than someone else.[32]

The theories of growth of Smith and Ricardo are centered on long-term growth and particularly applicable on large macroeconomic scales, like between countries. As previously stated, both Smith and Ricardo advocated more fair-trade oriented policies, so the thing that would hinder the kind of economic growth associated with division of labor and comparative advantage would be anything that hinders free trade. However, John Stuart Mills focuses on the governmental and societal role as they pertain to civil rights and liberties. His argument follows that individuals act in self-interest to make themselves better off and improve their lives, so when people can participate freely and voluntarily in market exchanges, they will not only make themselves better off while simultaneously improving the lives of others.

What is most pertinent to Mills, is his work *Subjection of Women*, an essay in which he advocates for women's rights over their bodies and persons, for women to own and control property, have a say in domestic decision-making, for the custody and care of children, and to freely be able to separate and divorce. This is purely on a case of making the greatest use of people's talents and promoting a culture of equal opportunity, which would in turn greater benefit society. Regarding microcredit, as previously stated, the vast majority of those that undergo microcredit contracts are women, and in incorporating them into the development of a society, there is a greater degree of wealth and prosperity.[33]

Beginning in the late 19th century, a revolution began in economics. While the Classical School was the forerunner, there was also the new "uni," which began a totally different way of viewing costs and benefits and value. Previous economists of the classical school thought primarily in total costs and total benefits in their cost-benefit analysis. This revolution began at two prominent schools of thought: The Neoclassical and the Austrian. The marginal revolution represented a significant shift in economics in which cost and benefits were determined but also value. The Classical School utilized labor theory of value, but with the allocation of resources towards their most highly valued subjective use became the dominant way of thinking. Within the Neoclassical framework, which is the mainstream school of economics, concepts—such as scarcity, the laws of supply and demand, and the incentives of producers to think along the "margins" i.e., what is the cost and benefit incurred to produce the very next item—begin to emerge.

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[32] Marginal Revolution University, "Introduction to Ricardo," published via YouTube, 2015. https://youtu.be/E_KaL6KpCy4?si=mqdwQ9U_NzvxhWIL

[33] David Brink, "Mill's Moral and Political Philosophy," Stanford Encyclopedia of Philosophy, August 22, 2022, https://plato.stanford.edu/archives/fall2022/entries/mill-moral-political/#SexEqu.

There are several assumptions that must be covered to ensure a complete understanding of the Neoclassical school. The first is that in the quest to legitimize economics as a science, the theories that Neoclassical purport as laws are considered universal and unchanging, and these laws govern the behavior of individuals. There is a pull towards resource allocation to align with the preference of consumers who value the resource at its "true" value. The way to ensure this is through free markets, which are held to operate under the full employment assumption, where the market will always gravitate towards an outcome in which all resources are fully employed, leading toward long-term stability.

There are four primary contributions of the Neoclassical School to the discussion of microcredit: the exogenous growth theory, the endogenous growth theory, the principle of diminishing marginal returns to capital, and the role of women in the household. Exogenous is a term that means "outside" or external of a system. The system in this case is the amount of input that determines output. Within the Solow Growth Model, output is a function of the inputs of labor, capital, and technology. These factors have a positive relationship with capital, meaning as one of them increases, output increases, but they do so at a diminishing rate, meaning that initially, as the amount of inputs increase, there will be a higher rate of return, but this rate of return will decrease.[34]

A consumer has a basic choice to either consume or save. The rate of savings determines how much investment is contributed to capital, which other people can utilize for productive uses. As people save more and deposit money in banks, banks will then loan of capital ventures, which can also provide increases in labor. So, within the short run, if a consumer chooses to save more, they are increasing the amount of investment, which will then increase the amount of capital in the system, leading to greater amounts of output. More output means an increase in living standards and overall prosperity.

An issue arises in the long run, however, in that capital can wear out and must be replaced. This is called depreciation. When depreciation becomes equal to investment, this is known as the steady-state level of capital in which every amount of capital is being replaced by a new unit which is bought by investment. There isn't any new additional capital being produced, so output levels are steady. The next option, then, is to turn to technology or technological shocks that make capital more efficient to jump towards a greater degree of output. There are several predictions that the Neoclassical school makes under the Solow Model. In the short run, countries with higher savings/investment will have higher living standards. Higher population

[34] Marginal Revolution University, "Intro to the Solow Model of Economic Growth," YouTube video, 3:15, March 28, 2016, https://youtu.be/eVAS-t83Tx0?si=gHN5z4LUkvFZAH-F.

growth rates will exhaust capital. Capital investment should flow from wealthy countries to poorer countries because the poorer countries will receive a larger marginal benefit with the addition of capital, and overall, as a result, countries will converge to similar levels of living standards. This is known as the principle of diminishing marginal returns to capital.

The Neoclassical School gained prominence both during and after the Second World War. Its use of scarcity and allocation of resources towards their most useful use proved vital in the allocation of supplies both during and in the rebuilding period after the war. One of the dominant views at the time involved the diminishing marginal returns to capital, in which contribution towards the macroeconomic and GDP factors would naturally flow from strong economic countries toward the less strong, and many of those "strong" countries experienced great decimation of their productive capital. For a quick example, imagine the economic development as a pyramid, with government structures being at the top of the pyramid and its citizens being at the bottom.[35]

The Neoclassical also advocates for intervention in specific cases, namely, to insure consumer sovereignty. However, it was utilized and justified for intervention in the post war period to rebuild. Keeping in mind the pyramid, countries would grant money to other countries, with the hope of government sponsored investment to rebuild some of the production capacities that were destroyed during the war or update existing ones to then trickle down towards the people. Perhaps the strongest example of this was the Macarthur Plan, in which the United States granted steel production technology to Japan and Germany to rebuild their production infrastructure, and it worked. The two countries recovered immensely and enjoy top spots on the world's current economies. This concept became known as foreign-direct investment and would come to dominate much of humanitarian and foreign aid during the 20th century.

However, what came to work in Germany and France, didn't exactly work in other contexts, as the top of the pyramids would become overinflated, and agents within the top would not be incentivized to relinquish their benefits. During the 1950s and 60s, "modernization" campaigns were the norm, following the presidencies of Dwight Eisenhower and the more liberal and activist administrations of John F. Kennedy and Lyndon B. Johnson. These modernization campaigns promoted both domestic and foreign schemes of technological improvement, industrial complexes, infrastructure, and experimentation with new agricultural production. In his first year in office, President John F. Kennedy established the Peace Corps,

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[35] John T. Harvey, "Neoclassical Economics" in *Contending Perspective in Economics: A Guide to Contemporary Schools of Thought*, 2nd Edition. (Northhampton: Edward Elgar Publishing, 2020, 42-45

the Alliance for Progress which was focused on economic development in Latin American, and the United States Agency for International Development (USAID). These exemplified foreign modernization and direct investment approaches by constructing dams, power plants, highways, and engaging in the "green revolution." By the 1970s, however, these efforts were plagued by failure, corruption, coercive practices, environmental damage, and poverty remained rampant.[36]

The solution was to shift from bilateral aid to redistribution campaigns, headed by international banks that would determine what the most productive uses of funds were. The International Bank for Reconstruction and Development or the World Bank and the International Monetary Fund would come to be the largest players in this development. These organizations took a foreign direct investment approach in the rebuilding phase after World War II but began to alter toward redistribution and specifically toward post-colonial nations. In the wake of the defeat of fascism, many former imperialist and colonial nations sought their chance and declared independence and looked to develop their economies. In the mid-80s, up to thirty African countries signed structural adjustment loans with the World Bank, which gave loans in the hope of economic development, and the International Monetary Fund (IMF), which would function as a lender of last resort in times of crises.

However, part of these structural adjustment funds mandated changes within the sovereign internal economics policies of countries, advocating for free-market policies that favored the nations of the developed world to insert their own production capacities while booting out domestic producers.[37] In theory, this would avoid the overinflation issue from the top and seek to develop from the bottom up. What ended up happening, however, was that countries began to amass an astounding amount of debt through the World Bank, which never saw any real development. In the 1970s, the OPEC nations, who enjoyed massive amounts in "petrodollars," deposited billions of dollars in western banks who would then lend that money out through commercial loans to the governments of developing nations. By 1979, developing nations had grown from $70 billion in debt to $300 billion. As the "Volcker Shock" of 1979 transpired, the United States Federal Reserve restricted the money supply, which raised interest rates on loans but pushed the nation into a massive recessionary period, which rippled across the globe. Private and government banks began to pull back their investments, which affected the nations reliant on global loans.

Amid this drama of global lending, in 1981 prominent economist Gary Becker published his *Treatise on the Family*, in which he utilized male and female preferences towards household

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[36] Meyerowitz, *A War on Global Poverty,* 183-220.
[37] Meyerowitz, *A War on Global Poverty,* 183-220.

function to examine the decisions of expenditures and other "non-economic" activities in the household like the number, education, and health of children. His main goal was to examine how households allocate their resources and how it could be maximized through comparative advantage. Becker found that if the wage in market sector was higher for males than females, it would be more efficient for men to work more in the market sector and for women to stay and pursue household work. So, it would be optimal for men to benefit from their comparative advantage by specializing in activities outside, and women should devote more time in unpaid household work. However, what many sought to change the decision making proves by advocating and allocating loans to women would thus have a higher bargaining power and move the family towards making more economically sound decisions.[38]

Many international aid governments, NGOs, and firms began to shift their focus to lending primarily to women. As early as the 1970s, the Self-Employed Women's Association (SEWA) in Ahmedabab, India, entered the credit world as an intermediary to help women in India apply for loans in the traditional sector process, aid in the application stage, and oversee payments to banks families were already indebted to. They lent small amounts of money—some loans only being 50 rupees—and additionally started to promote savings programs. SEWA gained international traction during the women's movement but gained legitimacy when USAID made a study on the organization, which bolstered its credibility. SEWA grew, and so too did other firms spring up specifically geared towards women, such as the Women's World Banking in 1978.[39]

Returning to a theoretical approach, let us now examine the endogenous model, which was pioneered in 1990 by Paul Romer. "Endogenous" means having an internal cause or origin and centers around the decisions of people which will either speed up or slow down the rate of technological progress. On the consumer side, they wish to maximize their utility, meaning they attempt to derive the highest amount of satisfaction at the lowest cost possible. They can choose to either consume now or in the future and how to spend their time working at leisure or through education. If there is a choice to forgo spending now, higher savings can increase capital investment, and spending time in education increases the knowledge available to society. For the firms, they are likewise trying to maximize their profits, which could be given back to shareholders through dividends or invested in new capital goods or even research and development. The main takeaway is that investment in human capital through education and research and development will speed the rate of technological progress and increase the growth

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[38] Armendariz and Murdoch, *Economics of Microfinance*, 221.

[39] Meyerowitz, *A War on Global Poverty,* 196

rate of the country. While this model was finalized in 1990, it had practiced implications before, and other areas of investment, like education and development of human capital, alongside external factors, representing what successful microcredit organizations practice today.[40]

When Muhammad Yunus established the Grameen bank, the poster child for contemporary microcredit operations, trends in economic theory were already lined up for him to combine and present a new form of aid. In the 1970s Bangladesh was holding on by thread, threatened by a devastating cyclone and a genocidal war that fractured its people. The newly formed government and NGOs sought foreign aid and received almost $1.4 billion in funds to put towards use with little avail. In 1974, another flood struck the nation, ruining the crops and agricultural products designed to grow the nation's economy and leading to widespread famine. Within this frame, Yunus sought a rural development program at Chittagong University. In 1977, he set up the Grameen Bank project with the goal of loaning small successive loans at commercial rates of interest to allow locals to grow business and lift themselves out of poverty. By 1982 the Grameen Project had eighty-six branches that served over fifty-thousand borrowers, and Yunus would decide to split it off, forming the Grameen Bank. It experienced tremendous success and growth by 1989, serving more than half a million borrowers and more than five thousand branches. Per month it loaned around five million dollars at a default rate of 0.4 percent.

The Grameen Bank was the pioneer in modern microfinance and a forerunner in economic development theory for the poor. Its success spawned a host of similar organizations both within its borders and across the Atlantic. The Bangladesh Rural Advancement Committee (BRAC) was founded in 1972 during the turbulent time and would later incorporate microfinance into its practices. Additionally, the Association for Social Advancement (ASA) began to exclusively partake in microcredit operations in 1991, and alongside the Grameen Bank are some of the largest humanitarian groups targeting the poor of Bangladesh. In Latin America, both the Foundation for International Community Assistance (FINCA) and BancoSol began lending along microcredit practices in the mid-1980s. So, the success of the Grameen Bank propelled a revolution in banking and development aid into the projected $500 billion industry by 2030.[41]

The recent nature of microfinance has led to a large increase of literature around the subject, as well as criticism of the system. From a theoretical institutional standpoint,

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[40] Marginal Revolution University, "Paul Romer," YouTube video, March 31, 2015, 5:30-9:44, https://youtu.be/NxqNRnxUd7E?si=WoOF8IZduSLBXWwt

[41] Mohammad Zainuddin and Ida Md. Yasin, "Resurgence of an Ancient Idea? A Study on the History of Microfinance," *FIIB Business Review* 9, no. 2 (2020): 78-84, doi:10.1177/2319714520925933.

microcredit has practices in place that help mitigate both the adverse selection and moral hazard problems, but has that been effective? In general, the consensus is that it is not as successful as proponents wished, while not nearly as negative as opponents predicted, and its critics often knock harmful enforcement of loans. A 2016 article written by Tahir Mahmood, Muhammad Farooq Arby, Tauquir Hussain, and Abdul Sattar found a positive and significant relationship between microcredit loaning and both income generation and living standards in the Punjab region of Pakistan, meaning as microcredit loaning increases, so too do living standards and income.[42]

However, Dr. Aneel Karnani argues in a 2007 article that microcredit is greatly limited, and the eradication of poverty could be better suited towards large labor-intensive industries. Karnani targets the entrepreneurial aspects, stating that although there is funding towards entrepreneurship, the vast majority of borrowers still live in subsistence living and do not have the means to have a vast impact because their businesses are limited with few paid staff, few assets, and operate at a small scale. Karnani also points out that China, Vietnam, and South Korea have significantly reduced poverty with very little microfinance activity, while Bangladesh, Bolivia, and Indonesia haven't been as successful at reducing poverty despite a massive influx of microcredit. Karnani argues that microcredits aren't microentrepreneurs by choice and would "gladly take a factory job at reasonable wages if it were available."[43]

By contrast, anecdotal evidence from organizations such as Ezperanza and Love Mercy paint a picture of gradual, sustainable lending practices while incorporating local business owners. It's very clearly a successful story, especially when the option of shifting capital from western nations to developing nations doesn't seem to be serving these communities. However, some of the opponents have cited the examples of violence and prejudice against borrowers and forcing borrowers into microcredit loan-based cyclical poverty. So what gives?

Perhaps an answer lies in the types of institutions that are doing the lending. In 2010, the World Bank collected data that encompassed the larger microfinance institutions including microfinance banks and credit unions that operated on a for-profit basis, non-governmental organizations (NGOs or nonprofits), as well as non-bank institutions. Within the data set, they found that NGOs make up roughly 45 percent of the institutions but manage 21 percent of the total assets, meaning the for-profit organizations manage roughly 80 percent of the assets. The

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[42] Tahir Mahmood, Muhammad Farooq Arby, Tauqir Hussain, and Abdul Sattar, "Impact of Microfinance on Income Generation and Living Standards: A Case Study of Dera Ghazi Khan Division," *Pakistan Economic and Social Review* 54, no. 1 (2016): 73–80, https://www.jstor.org/stable/26616699.

[43] Aneel Karnani, "Microfinance Misses Its Mark (SSIR)," Stanford Social Innovation Review: Informing and Inspiring Leaders of Social Change, 2007, https://ssir.org/articles/entry/microfinance_misses_its_mark#bio-footer.

study also found that most commercial microfinance banks made loans that are about four times larger than NGOs.[44]

In a 2022 article, *The Impact of Microfinance Institutions on Poverty,*[45] authors Chikwira, et. al examine the south African country of Zimbabwe in which roughly 7.9 million Zimbabweans are living in extreme poverty conditions. They found that microfinance institutions were quickly growing at about a 11.7 percent rate, while interestingly, poverty rates are also accelerating. In their study they highlighted several variables that played into the conversation.

Within their regression analysis, they used independent variables of MFI loan growth, SME growth, and agricultural output. The logic follows that with a higher loan volume to SMEs, the lower the risk of households slipping into poverty. The growth of SMEs will lead to expanding enterprises or expansion and will likewise provide the impoverished with better wages and improve their quality of life, etc. Their model showed an initial negative relationship between the independent variables of MFI load volume, SME expansion and between that of poverty within the short run. Meaning that as MFIs expand, poverty decreases. However, they found it returned to equilibrium levels. Intuitively, this makes for some head scratching as loans would typically be used for long-term economic growth. Despite SMEs accounting for roughly 80 percent of employment within a developing economy, they found a difference in the type of loans being distributed and argued for a more sustainable practice of loaning.

In a similar argument, Barclay O'Brien categorizes two schools of thought regarding MFIs: those focused on sustainability like financial self-sufficiency, and those with a greater depth of outreach, which has a greater emphasis on the pure banking aspects. In extending the depth of outreach, it is plausible to think that this would generally alleviate the levels of absolute poverty, a more short-term oriented goal, and financial self-sufficiency seeks to decrease the discrepancies of relative poverty within communities, a focus of long-term growth. O'Brien states that NGOs and NGO networks adhere primarily to this first option, "[NGOs] offer a range of services including those outside what is traditionally considered microfinance, namely loans, savings, insurance and remittance…they offer a range of social and economic programs, and NGO networks will often integrate these activities with their MFIs." He continues to state that there is considerable evidence that offering microcredit operations in conjunction with other

[44] Asli Demirgüç-Kunt, "Microfinance: Dream vs. Reality:," World Bank Blogs, March 17, 2010, https://blogs.worldbank.org/en/allaboutfinance/microfinance-dream-vs-reality#:~:text=NGOs%20are%20smaller%2C%20and%20although,21%20percent%20of%20the%20assets.

[45] Chikwira, Collin, Edson Vengesai, and Petronella Mandude. 2022. "The Impact of Microfinance Institutions on Poverty Alleviation" *Journal of Risk and Financial Management* 15, no. 9: 393. https://doi.org/10.3390/jrfm15090393

non-financial services, like health and education, provides a broader impact and less focus on material gain.

The assumption made in the argument of utility increasing standard of living and livelihood is that there is already infrastructure in place that allows those gaining new profit to consume freely—like the presence of grocery stores, easily accessible health care, contractors, etc.—or is on its way to being implemented through a new division of labor. As for-profit companies enter the microcredit market, this assumption is continued with the same expectations, leading to a bubble of loans. However, many of those services aren't even available for people to consume if they are living in an absolute poverty environment. So, NGOs recognize this and attempt to implement those services alongside microcredit operations instead of merely expansion of lending.

CONCLUSION

Andrea Gatto writes, “microcredit is a response to credit market incompleteness: the failure of the banking system to guarantee access to credit to the poorest…”[46]. In seeking to alleviate poverty, for-profit organizations have largely dominated the microfinance market, simply incorporating new, riskier, and at-risk borrowers into their financial net. While microcredit existed primarily to address an issue of access, its main type of lenders have overemphasized the extension of capital as a solution for absolute poverty alleviation and have neglected additional services needed for poverty alleviation, such as health and education services.

Microcredit operations through non-profits represent a shift from economic thought dominated by foreign-direct investment and a top-down approach to economic development. While factors that went into an official state structure increased, those near the bottom of the barrel did not receive the benefits and additionally suffered under structural loan programs. However, microcredit loans invert the pyramid, focusing on building the foundation of developing countries. These businesses, collectively known as small and medium enterprises, are the backbone of microcredit operations and made up of those willing and now able to provide for themselves and their loved ones. Interestingly, as the microcredit industry grows, it is incentivizing for-profit companies to enter the game hoping to get in on the action, leading to a growing amount of loans that are potentially not getting the job done. While their short-run profit margins might be satisfied, it ultimately hurts those they are attempting to help in the long-run by not establishing lending practices, structures, and additional services that provide a more holistic approach to poverty alleviation. For now, microcredit takes the place of development before.

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[46] Gatto, Andrea, “ Historical Roots of Microcredit and Usury: The Role of Monto Di Pieta inItaly and the Kingdom of Naples in XV-XX Centuries,” *Journal of International Development*, July 2018, Vol. 30 Issue 5 (July 2018): 911-914

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