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Financial Inclusion and Microfinance: On the Cases of ODA and Analysis of the Poverty Reduction Effect

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1. Financial Access in Developing Countries and Microfinance Institutions' Function

The 2011 Global Financial Inclusion Database of the World Bank reports that about 89% of adults in high-income countries have an account at a formal financial institution while only 24% of adults in low-income countries have it. In particular, account penetration is universal within-economy income quintile in developed countries. There are large gaps, however, in the account penetration across within-economy income quintiles in developing countries. Within developing countries, 62% of adults in the highest income quintile own an account while only 25% of those in the poorest income have it. We conclude that the poor strata in developing countries experience larger difficulties in the access to financial service than those in high-income countries.

Lack of financial infrastructure may cause the difference in accessing financial resources. The 2012 Financial Access Survey data of IMF indicates that the number of commercial banks in high-income countries is 31 branches per 100,000 adults. However, it is only 8 in South Asia and 3 in sub-Saharan Africa (Ardic et al., 2013). Such lack of financial infrastructure is an obstacle to improving financial access. However, the bigger problem that the financially marginalized may face is that they do not possess enough assets to pledge as collateral to access financial services, such as loans. In developing countries where such discrimination exists in access to financial services, steps to improve financial accessibility distinguished from a simple infrastructure expansion are required to be taken. In other words, the steps to improve financial accessibility should aim for efficiency and equity. The financial system is also required to be designed to meet the targets to alleviate poverty.

The Asian Development Bank defines financial inclusion as creating a system that allows the financially marginalized and micro and small enterprises (SMEs) to access financial services at reasonable expenses. Therefore, the precondition of financial inclusion is financial access improvement. The ways to improve financial access largely consist of two parts: supply expansion that increases financial access opportunities and demand expansion that educates people to understand why financial services are necessary. In order to improve financial access, especially in developing countries, it is necessary to increase demand through a variety of ways, such as finance education and asset building assistance, and concurrently employ supply expansion policies to supply diverse loan products.

In this regard, the activities of microfinance institutions (MFIs) have a significant meaning in developing countries. Since the financially marginalized and SMEs, with lack of collaterals, have a difficulty in getting credit at a formal financial institution, MFIs carry out the function of supplying financial services by providing the financially marginalized and SMEs with financial services, such as saving, borrowing, remittance, and insurance. The MFIs also strive to increase the demand for financial services by offering nonfinancial services, such as teaching writing, fund operation capacity building, and income generation capacity building campaigns. Hence, the Economic and Social Commission for Asia and the Pacific (ESCAP, 2006) stresses that the MFIs are the essential tools of financial inclusion as well as key components for inclusive financial development.

Upon acknowledging that the development of microfinance institutions would be a measure of financial inclusion, major donor countries, such as Germany, Australia, and Norway, have extended aid to the microfinance area with ODA projects. However, Korea does not set out ODA policies for that area yet and has made almost no grant aid or credit assistance. Korea has made a promise of a steady increase of the ODA/GNI ratio up to 0.25% by 2015 to the international society. In doing so, it is necessary for Korea to benchmark the behaviors of major donors who has extended aid to various sectors. Considering this, this study analyzes the microfinance ODA projects of Germany and Australia, and presents the exemplary characteristics of each country that Korea will be able to use for Korean microfinance ODA projects. Moreover, this study makes an empirical analysis of whether the use of microfinance reduces poverty by using the methodology of Imai et al. (2012). This study casts light on the two aspects overlooked by Imai et al. (2012): (1) suitability tests for instrumental variables using a variety of methods and (2) estimation of poverty reduction effect by using two explanatory variables—average amount of microfinance loan per person and microfinance market size per country.

2. Analysis of ODA to Microfinance by Germany and Australia

a. Analysis of German ODA to Microfinance

Germany takes the lead in solving financial access problems for the financially marginalized and extending ODA to microfinance institutions (MFIs). Korea may learn a lot from Germany's actions. It supports inclusive growth by providing both financial and nonfinancial services to the important areas for development, such as agriculture, education, health, and environment. In particular, in order to improve the financial access of SMEs and low-income households, European Fund for Southeast Europe (EFSE) supplies loans related to agriculture, stock-farming, and agricultural product processing business, and the Development Facility offers technical training to them.

In addition, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) supports MFIs with ODA for the development of financial system. It first promotes the balanced economic growth of developing countries by improving the financial access of the financially marginalized and the SMEs and then getting them to use formal financial institutions. KfW Bankengruppe of Germany (KfW) supports the microfinance sector by using appropriate financing techniques according to target and situation. For instance, in provision of microfinance funds in the MENA area, it extended aid to small and medium-sized enterprises that have low financial access in many ways with various financial tools, such as medium and long-term loans, guarantees, standby facilities, equities, and bonds. The excellence of this case has also been proven by the 2011 SmartAid for Microfinance Index of the Consultative Group to Assist the Poor (CGAP). In addition, upon making a promise of an increase of the ODA/GNI ratio up to 0.7% to the international society, the German federal government has concentrated on distributing grant aids to the poorest nations and KfW on providing credit assistance. Similar to this, KOICA may consider providing grants to the poorest nations and EDCF may consider offering credit assistance like what KfW observes or expanding private participation in microfinance in other nations.

b. Analysis of Australian ODA to Microfinance

In order to extend ODA to the microfinance sector, Australia has established a systematic aid strategy in which it introduces a performance management system taking account of financial and social aspects. Consequently, policies are highly consistent. In particular, emphasis on the financial access improvement for women, the disabled, and the poorest is considered exemplary. In addition, because the microfinance performance index includes both the economic and social aspects, such as the poverty, economic and social inclusion, and empowerment of alienated groups, it is expected to have a direct effect on poverty reduction and resolving inequality. For example, in the "Campaign of Revolving Loan Fund", part of the Indonesian government's National Program for Community Empowerment (PNPM), it improves and expands the campaign considering the feedback on the results.

The Australian Agency for International Development (AusAID), which does not have a specialized microfinance division, strongly involves some international organizations and NGOs in implementing its microfinance projects. Korea International Cooperation Agency (KOICA), which also does not have a specialized microfinance division, may learn how to support microfinance sectors from AusAID. For example, it may use the expertise of the World Bank (WB), the Consultative Group to Assist the Poor (CGAP), or NGOs specialized in microfinance as implementing agencies. Korean development NGOs, such as Global Civic Sparing and Merry Year Foundation, have operated relatively specialized microcredit projects in the recipient countries. The National Credit Union Federation of Korea, on the basis of its development, has also experienced carrying forward several international cooperation projects with the neighboring countries. Therefore, if the Korean government cultivates its capacity to support the microfinance sectors in collaboration with the private sector or the international organizations while increasing the volume of ODA, high performance can be expected.

3. Poverty Reduction Effect of Microfinance

Utilizing Microcredit Information Exchange (MIX) data, the World Development Indicator (WDI), and PovcalNet, data on poverty released by the World Bank, this study estimates the effect of the average amount of loan per person from MFIs on poverty reduction in 78 countries. Because the definition of the poverty rate may vary depending on the calculation methods, this study used the Foster-Greer-Thorbecke poverty index (FGT), which is the typical poverty index. Following Imai et al. (2012), this study analyzes the effect of microfinance utilization on poverty in the macroeconomic perspective. They analyze the effect of the average amount of loan from the MFI per person on the poverty rate in the mid-2000s. However, it is necessary to verify again the results presented by Imai et al. (2012) because the number of users have skyrocketed and the commercialization of MFIs has rapidly progressed in the late 2000s. In addition, their analysis does not include the information of the microfinance market size per country. In order to remedy this lack, the analysis of this study includes the ratio of the total MFI loan amount to GDP per country.

While the increased loan amount from the MFIs contributes to the poverty reduction, improvement of the poverty rate may reduce the loan amount from the MFIs. It is because people who have escaped from poverty have no needs to get loans from the MFIs and the remaining borrowers are much likely to be those who can hardly repay the loans. In order to treat this endogenous problem brought by such reverse causality, this study utilizes instrumental variables. The cost of enforcing contract information from "Dong Business" data and the value of the two-year lag of the average loan amount per person per country weighted by the average number of MFIs per country are used. The increased cost of the enforcing contract is not directly related to the poverty rate. However, the less the cost of the enforcing contract, the easier the people can obtain capital from the MFIs and other institutional financing organizations. Second, the value of the two-year lag of the average loan amount per person per country weighted by the average number of MFIs per country is highly correlated to the amount of loans. However, considering that the repayment period of microfinance loan is usually short, it has little to do with the current poverty rate.

In addition, if the instrumental variables have a weak correlation with endogenous variables, the estimates would be biased as Angrist and Pischke (2009) claim. It is overlooked in Imai et al. (2012). To include this point in the analysis, the underidentification test, weak identification test, and overidentification test are performed. Finally we find that the instrumental variables are suitable.

The result is that the poverty rate significantly decreases by 0.463% as the average microfinance loan amount per person increases by 10%. This result conforms to Imai et al. (2012). The poverty rate significantly decreases by 3.4% as the total loan amount from MFI to GDP, the volume of microfinance market per country, increases by 1%. Therefore, this study concludes that the utilization of MFIs contributes to poverty reduction.

4. Implications

Major donor countries and international organizations regard microfinance as a tool for financial inclusion because the microfinance institutions provide the financially marginalized in developing countries with a variety of financial access opportunities. Moreover, evidence that the expanding use of microfinance decreases the poverty rate significantly has been found. However, Korea has rare experience of support for the microfinance sectors. Hence, it must establish aid policies while taking into account the following risk factors. First, in order for financial development to lead poverty reduction, it is necessary to set conditions for economic growth. For that, Korea has to pay attention to and support the development of capacity building programs for the borrowers. Second, in order for a developing country to develop further into a higher state, it has to have a well-organized financial system. For that, Korea may refer to the German aid methods. Given that microfinance is only part of the financial system and the size of Korea's ODA is smaller than that of Germany, however, it is more proper for Korea to build up experience in this area by carrying out some performance management-oriented projects similar to the projects of Australia. Third, since most ODA recipients are incapable of promoting financial development, it is necessary to create and provide them with a "Financial Development Master Plan" based on Korea's experience. Developing countries may find a lot to learn from the experiences gained from operating cooperatives, such as the National Agricultural Cooperative Federation or the National Credit Union Federation of Korea. Fourth, in order for microfinance institutions to provide more nonfinancial services than before, it has to consider connecting the provision of technology and participation of private enterprises as part of CSR projects. Lastly, this study relatively emphasizes the positive sides of microfinance. Improving financial access alone, however, cannot solve the poverty. Financial access improvement is only a necessary condition for poverty reduction, not a sufficient condition. In recent years, some microfinance institutions are commercialized and some negative effects are being reported. ODA to microfinance must be determined by appropriately considering these facts. To be specific, in order to avoid the negative effects, a close examination of the prospective recipients must be made beforehand.