DONOR BRIEF
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Helping to Improve Donor Effectiveness in Microfinance

MICROCREDIT: ONE OF MANY INTERVENTION STRATEGIES

Microcredit is one of many intervention strategies designed to alleviate poverty, generate income and promote employment. Due to its current popularity among donors, however, microcredit risks becoming a “one size fits all” intervention solution.

In choosing the most appropriate intervention tool for a specific situation, microcredit should be carefully evaluated against the alternatives. In many cases, savings and insurance services, micro-grants, infrastructure improvement, employment and training programs, and other non-financial services may be more effective tools for poverty alleviation and employment generation. Microcredit is generally most appropriate where ongoing economic activity and sufficient household cash flow already exist, as it may otherwise create an excessive debt burden.

When is microcredit successful?

- Success requires both client discipline (timely repayment) and institutional discipline (practices that lead to sustainability) on the part of the microcredit program.
- Microcredit is best implemented as a professional banking activity by a strong, local microcredit organization dedicated to operational self-sufficiency.
- Transforming a non-financial organization into a sustainable microfinance institution (MFI) requires substantial technical assistance and institutional development.
- Progress on performance should be monitored using clearly defined microlending performance indicators.

When may microcredit be inappropriate?

- Microcredit may be inappropriate in immediate post-emergency environments, severely disadvantaged rural areas, and as an intervention for the chronically destitute.
- Clients with debilitating illnesses (e.g., HIV/AIDs) and extremely dispersed, highly mobile and/or unstable populations are generally not suitable for microcredit programs.
- Microcredit is not recommended where there is dependence on a single economic activity and/or barter transactions; high risk of civil violence, natural disaster or hyperinflation; or in the absence of law and order.
- Microcredit is rarely sustainable where the regulatory environment creates significant barriers to sustainability by, for example, mandating interest rate caps or prohibiting non-collateralized loans.

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What other kinds of intervention strategies are suitable?

- Savings facilities and/or micro-insurance programs can provide the poor with a means to reduce their vulnerability by managing risk and cash flow...
- But regulated savings institutions may require technical assistance to develop appropriate products for the poor, while non-regulated institutions (such as informal savings associations) may need to become regulated entities.
- Financial entitlements such as termination payments, micro-grants, training and employment programs are often more suitable for immediate post-crisis situations, as well as for assisting the chronically poor and high-risk, low-experience groups.
- Grants, rather than microcredit, can be best used to overcome the social isolation, lack of productive skills and low self-confidence of the extreme poor, preparing them for eventual use of microcredit.
- Micro-grants and other financial entitlements can work well as first steps in comprehensive programs designed to "graduate" the poor from vulnerability to economic self-sufficiency.
- An example of a graduated strategy is BRAC's Income Generation for Vulnerable Groups Development program in Bangladesh. The program combines free food, skills training, health care and savings creation in an 18-month program designed to graduate clients to BRAC's mainstream microcredit program. Most graduated programs should, however, be implemented by multiple organizations in partnership.

What other interventions can strengthen the livelihoods of the poor?

- Investments in public infrastructure, including roads, communications and education, provide a foundation for self-employment activities.
- Community-level investments in commercial or productive infrastructure (such as market centers or small-scale irrigation infrastructure) facilitate business activity.
- Employment programs designed for "non-entrepreneurs" can make the poor more employable.
- Non-financial services – from literacy and business training to business development services such as consulting – build social capital and basic skills within the community.
- Legal and regulatory reforms create incentives for microfinance by streamlining microenterprise registration, abolishing artificial caps on interest rates, loosening regulations governing non-mortgage collateral, and reducing the cost of property registration.

This Donor Brief is a summary of CGAP Focus Note No. 20, "Microfinance, Grants, and Non-Financial Responses to Poverty Reduction: Where Does Microcredit Fit?" (May 2001), by Joan Parker of Development Alternatives, Inc., and Doug Pearce of CGAP.

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