How microcredit has hurt the poor and destroyed informal business

By Milford Bateman

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Post-apartheid South Africa provides ample evidence of the debilitating trajectory of the microcredit movement. The expansion of microcredit and the informal microenterprise sector was one of the policy responses of the first democratically elected government.

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This was how it was going to deal with the legacy of poverty and high unemployment in the black community. But evidence shows that microcredit didn't create large numbers of sustainable jobs. Nor did it raise incomes in the poorest communities. Instead, the deployment of microcredit precipitated a major disaster.

South Africa saw a dramatic fall in average incomes in the informal economy - around 11% per year in real terms - from 1997-2003. This was brought about by two things:

- a modest rise in the number of micro enterprises in townships and rural areas driven by greater availability of micro credit, along with
- little additional demand due to the austerity policies of the government.

What then happened was that the self-employment jobs created by the expansion of the informal sector were offset by the fall in average informal sector incomes. Increased competition softened prices and reduced turnover in each microenterprise as existing demand was simply shared out more widely. Poverty inevitably spiked.

The microcredit movement thus helped plunge large numbers of black South African's into deeper over-indebtedness, poverty and insecurity. At the same time, not coincidentally, a tiny white elite became extremely rich by supplying large amounts of microcredit to black South Africans.

Not surprisingly, many in South Africa say that microcredit brought about the country's own sub-prime-style financial crisis. It had its own local flavour, generating even more disturbing race-based exploitation overtones than even in the US.

Latin America

In Latin America for over two decades an increasing number of microcredit institutions and some commercial banks have massively expanded the supply of microcredit. Surely, as arch-neoliberal Hernando de Soto long promised, there should be evidence of a "bottom-up" microenterprise-driven miracle?

Well, there isn't.

Instead there is growing evidence that micro credit has helped destroy Latin America's economic base. This happened because scarce financial resources - savings and remittances - were channelled into unproductive informal micro-enterprises and self-employment ventures, as well as consumer loans. Communities were thus "dumbed down" not "scaled-up" to become more productive and growth-oriented.

This negative assessment was also reached by the mainstream Inter-American Development Bank.

It bravely reported that the proliferation of microenterprises and self-employment ventures was the principle cause of deeper poverty, inequality and economic weakness between 1980 and 2000. Its conclusion was quite damning:

> *the overwhelming presence of small companies and self-employed workers in Latin America is a sign of failure, not of success.*

More fundamental problems

A more fundamental problem with microcredit is related to its presumed role in securing a long-term "bottom-up" development trajectory. Africa is most often given as the obvious example of a region held back by a shortage of entrepreneurs.

The international development community, aided by high-profile African economists like Dambisa Moyo, continually stress this point. They argue that microcredit is desperately needed to create an African entrepreneurial class. This, it is argued, will serve as the vanguard of job creation and sustainable development.

But development economist Ha-Joon Chang points out that this argument is entirely bogus. He argues that Africa already has more individual entrepreneurs than perhaps any other continent. Many more are being created thanks to rafts of new microcredit programs initiated by commercial banks.

Yet it is because of this trajectory that Africa largely remains trapped in poverty and under development.

There are three main reasons why the expansion of microcredit has helped preclude the emergence of a growth-oriented local economic structure in Africa.

First, the arrival of microcredit induced the over supply of tiny "buy cheap, sell dear" trading operations. This, predictably, led to:

- very high levels of displacement - jobs killed in other competing microenterprises, and
- exit - many more failed microenterprises.

Second, the financial sector in Africa has switched into supporting the much more profitable microcredit sector. Informal microenterprises and consumption spending get support. Formal small and medium businesses don't. They are much riskier and can only pay low interest rates. But they are much more important in reducing poverty and underpinning longer term development.

So we find a perverse situation. The more productive formal small and medium business sector is starved of financial support. Meanwhile the hugely unproductive informal microenterprise sector is being stuffed full of microcredit.

Third, the market share grabbed by rafts of largely "here today and gone tomorrow" informal microenterprises has militated against patient capital accumulation and organic growth by better placed formal enterprises.

A fundamental block on growth

The core problem everywhere in developing countries is quite simple: the microcredit model actually works as a fundamental block on sustainable development and growth at the local level.

The economic history of developed countries and the East Asian "tiger" economies shows one thing very clearly. The key to sustainable growth and development is the financial system's ability to intermediate scarce financial resources into growth-oriented enterprises. These are enterprises that:

- operate formally,
- are big enough to reap some economies of scale,
- can deploy some key technologies,
- innovate,
- make use of trained labour,
- export,
- cooperate horizontally through networks and clusters as well as vertically through supply chains and subcontracting, and
- can facilitate the creation of new organisational routines and capabilities.

The microcredit model actually sends developing countries off in completely the wrong direction. It does this by absorbing the financial resources, time, effort and policy attention which should have gone into supporting the most productive enterprises.

The microcredit sector today is like a rapidly growing weed that absorbs the sunlight and nutrients required by the more valuable but slower growing crops around it. The microcredit model is not one of the solutions to endemic poverty, inequality, low productivity and under development. Rather, it is one of the principle causes.

This is part of a series of articles The Conversation Africa is running on financial inclusion and micro credit and their role in economic development.

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