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Breaking Cyclical Poverty: An Examination of Microlending's Effects and Return on Investment

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Abstract

Since the beginning of civilization, poverty has been an issue. It has sparked revolutions and brought down great empires. Most recent, credible estimates state that roughly over 3 billion people in the world live at or below the poverty line of $2.50 a day. This reality can be traced to various factors- war, social inequality, national debt, etc- and makes poverty one of the most pressing issues society faces. To address the former, many efforts have been made including microlending. In this paper, microlending and its effects will be analyzed in depth to determine whether it is viable and how its consequences impact cyclical poverty.

Keywords: Foreign Investment, International Capital Movement, Rate of Return, International Lending, Foreign Aid, Poverty
JEL Codes: F21, F34, F35

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I. Introduction

It is important to completely understand what poverty is; $1.90 a day is considered the poverty line. With this in mind, the World Bank published a 2013 report with the following:

TABLE 0.1 World and Regional Poverty Estimates, 2013

Region	Headcount ratio (%)	Poverty gap (%)	Squared poverty gap (%)	Poor (millions)
East Asia and Pacific	3.5	0.7	0.2	71.0
Eastern Europe and Central Asia	2.3	0.6	0.3	10.8
Latin America and the Caribbean	5.4	2.6	1.8	33.6
Middle East and North Africa[a]	—	—	—	—
South Asia	15.1	2.8	0.8	256.2
Sub-Saharan Africa	41.0	15.9	8.4	388.7
Total, six regions	12.6	3.8	1.8	766.6
World	10.7	3.2	1.5	766.6

Source: Latest estimates based on 2013 data using PovcalNet (online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/.
Note: Poverty is measured using the US$1.90-a-day 2011 purchasing power parity (PPP) poverty line. The six-region total includes all developing regions. World includes all developing regions, plus industrialized countries. Definitions of geographical regions are those of PovcalNet. — = not available.
a. Estimates on the Middle East and North Africa are omitted because of data coverage and quality problems. The population coverage of available household surveys is too low; the share of the total regional population represented by the available surveys is below 40 percent. There are also issues in the application of the 2011 PPP U.S. dollar to the region. These issues revolve around the quality of the data in several countries experiencing severe political instability, breaks in the consumer price index (CPI) series, and measurement or comparability problems in specific household surveys. These caveats suggest that further methodological analyses and the availability of new household survey data are both needed before reliable and sufficiently precise estimates can be produced.

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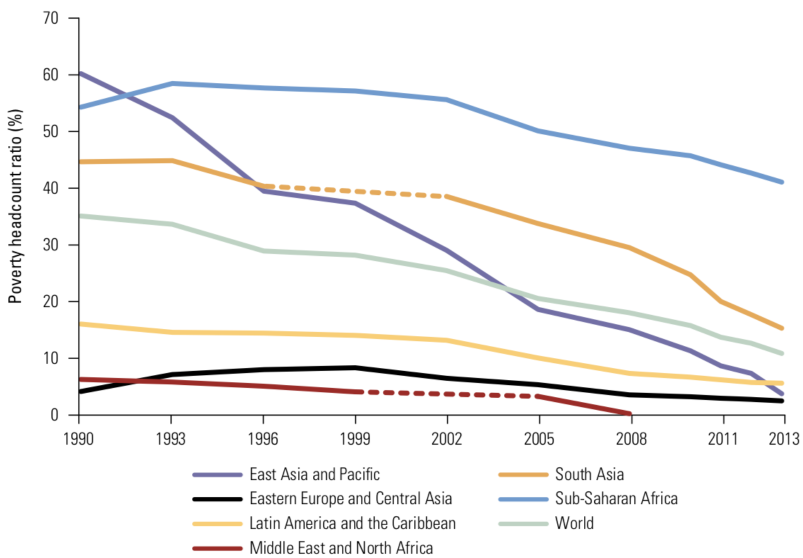
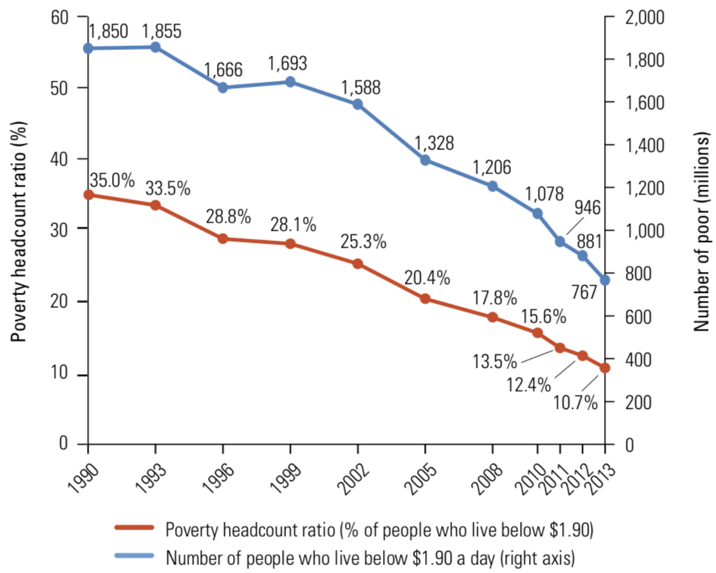
According to this data, it can be seen that poverty impacts the Sub-Saharan Africa region at a much higher rate than the others.

FIGURE 0.2 World and Regional Trends, Poverty Headcount Ratio, 1990–2013



Source: Latest estimates based on 2013 data using PovcalNet (online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/.
Note: Poverty is measured using the US$1.90-a-day 2011 PPP poverty line. Breaks in trends arise because of a lack of good-quality data.

FIGURE 0.3 Trends in the Global Poverty Headcount Ratio and the Number of the Global Poor, 1990–2013



Source: Latest estimates based on 2013 data using PovcalNet (online analysis tool), World Bank, Washington, DC, http://iresearch.worldbank.org/PovcalNet/.
Note: Poverty is measured using the US$1.90-a-day 2011 PPP poverty line.

Figure 0.3 illustrates the decrease in global poverty; however, at 767 million in 2013, it is still a significant problem.

II. Microlending

Microloans are small loans that are issued by individuals rather than banks or credit unions. These loans can be issued by a single individual or aggregated across a number of individuals who each contribute a portion of the total amount (Hayes 2018). They are popular in developing countries where traditional loans from banks are unavailable. Often, microloans aren't backed by collateral, which increases the risk of the lender in the case of default.

Improved social welfare and ability to successfully end cyclical poverty from microlending depends not just on depth of outreach but also on worth to users, cost to users, breadth, length, and scope (Navajas Et Al 1998). In a study of Bolivian Micro Finance Organizations (MFO), Navajas Et Al 1998 established the Fulfillment of Basic Needs (IFBN) index as a way to measure the impact of a MFO with the following formula:

$$\text{IFBN} = \left(\frac{1}{4}\right) \cdot \sum_{j=1}^{4} \frac{x_j}{x_{jnorm}}.$$

The range of the ratio of *K_J* to *K.lnorm* depended on the range of answers in the nationwide assessment.

Figure 1 displays the IFBN distribution of 5 MFOs across the country of Bolivia. in a box-and-whisker plot.

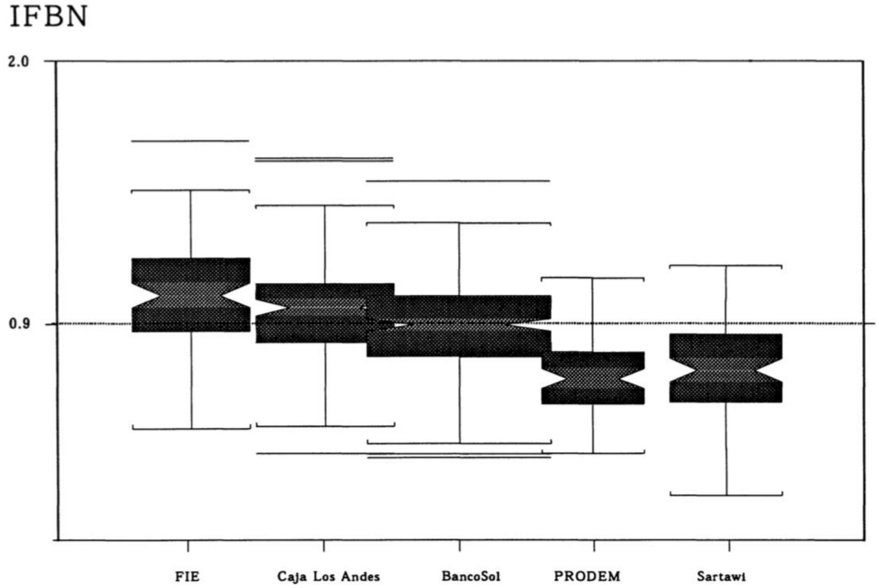
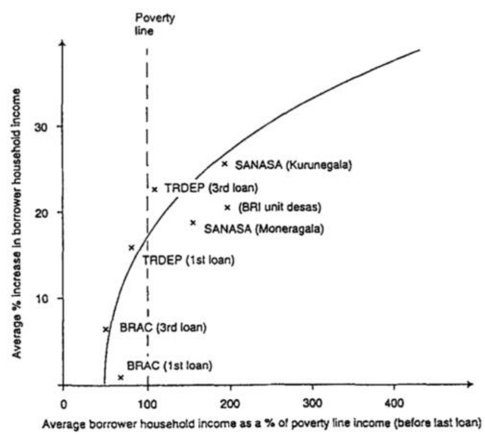


Figure 1: Box-and-whisker plot of the distribution of the IFBN for sampled borrowers from the five MFOs

Mosley et al., (1998) also analyzed the effect of microlending. It estimated the impact of 13 microfinance institutions in seven developing countries on poverty and other target variables and attempted to relate such impact to the institutions' design features. The study found that:

WORLD DEVELOPMENT



The relationship of the average borrower income to average increase in household income since last loan: comparison between schemes. Source: Hulme and Mosley (1996, Vol. 1, p. 113).

"For each of the institutions studied, the impact of lending on the recipient household's income tended to increase, at a decreasing rate, as the recipient's income and asset position improved, a relationship which can easily be explained in terms of the greater preference of the poor for consumption loans, their greater vulnerability to asset sales forced by adverse income shocks and their limited range of investment opportunities…" Mosley Et Al (1998).

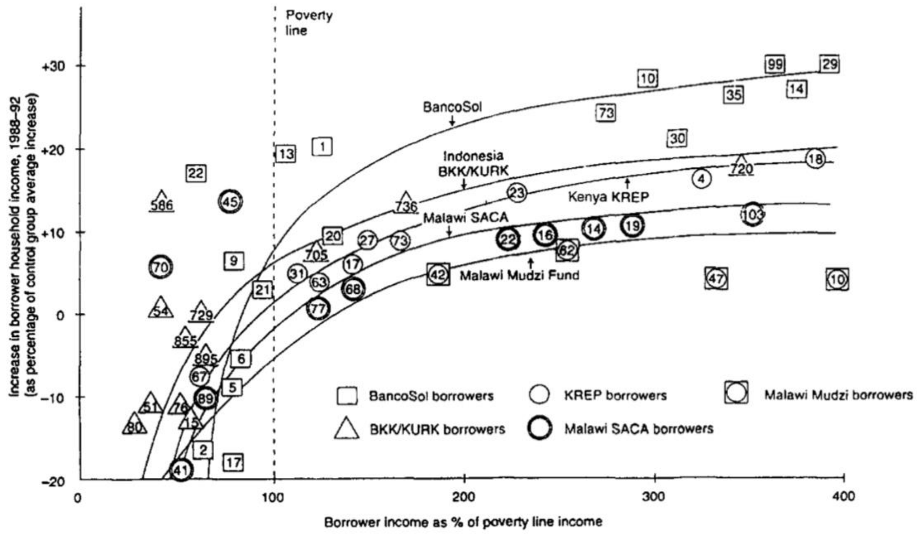


Figure 2. *Loan impact in relation to borrower income: within-scheme data. Only a few specimen data points, together with the regression line for each organisation, are indicated. Full data arrays are available from the authors on request.*

With this conclusion and the data from the Navajas study, it is seen clearly that microlending can benefit borrowers in poverty.

III. Return on Investment

Microloans are high risk investments for creditors; as mentioned earlier, they typically aren't backed by collateral and so defaults rates are are high. To lower the risk, MSOs often diversify investments. With this in mind, the interest rates are relatively high: 6- 31.9 % (Hayes 2018).

IV. Conclusions

The advantages of peer-to-peer economics through microlending are evident: lenders can be uplifted out of poverty by using their loan to start a business, and creditors receive a high ROI. While default rates are slightly higher, the benefit is clear, and risk can be decreased through diversification.

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