“The Success of Micro-financing”

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The success of micro-financing

Abstract

Bangladesh is one of the poorest countries in the world. The paper discusses the barriers to economic growth as well as diverse strategies and programs that are responsible for Bangladesh's recent reduction in poverty. More importantly, this paper discusses how Bangladesh's innovative approach to micro-credit has contributed to the reduction of rural poverty and serves as a model of micro-entrepreneurship. The article presents a profile of the Bangladeshi micro-entrepreneurs and identifies the factors influencing their performance.

Keywords: micro-entrepreneurship, poverty, micro-credit, economic development.
JEL Classification: O16.

Introduction

Every market economy relies upon the financial intermediary function to transfer resources from savers to investors. In many developing countries such as Bangladesh, the absence of commercial banks has led to non-conventional forms of lending (Ceaser and Epstein, 2000). The micro-credit trend began in Bangladesh with the 1976 founding of Grameen Bank of Bangladesh (GB) which became the most prominent of the industry's successes. The rapid expansion of GB has drawn a considerable amount of interest that is focused upon the success, problems, and prospects of this emerging organization (Wells, 1998; Navajas and Schreiner, 2000). Khandker (1998) assesses the potential and limitations of micro-credit programs as an instrument for reducing poverty and delivering financial services to the poor, provides considerations for attempting its replication in other countries, and discusses the limitations of micro-finance.

This paper analyzes the entrepreneurial environment in Bangladesh, describes the factors that have a major impact on the development of micro-entrepreneurship, and discusses the relative frequencies of types of problems faced by respondents during the start-up and commercialization stages. The Kazanjian (1988) model is used to examine how business conditions influence the development and growth of entrepreneurial activities in micro-entrepreneurial businesses and how differences in the competencies of the owners of micro-entrepreneurial firms may moderate the relationship between entry timing and new venture performance. The findings of the study are used to make recommendations for policy makers regarding which elements of the environment may be improved to foster entrepreneurial growth in an economy of poverty.

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1. Literature review

The conceptual framework for analyzing determinants of small firm success has been presented in various studies (Almus and Nerlinger, 1999, Davidsson, 1989). The empirical research has demonstrated that for small firms there are many factors of significance: age, size, industry sector/markets, legal form, location, and ownership (Evans, 1987, Hall, 1987). For example, smaller firms grow at a greater rate than larger ares, and age of firm can be inversely related to growth (Storey, 1994). Bruderl et al. (1992) provided empirical research that showed startup firms with five or more employees have a much greater six-year survival rate than those that started with fewer than five workers. Storey (1994) argues that some locations are more conducive to firm growth. Almus and Nerlinger (1999) conclude that firms with high entrepreneurial propensity but limited liability are more willing to take risks since the founders' personal wealth is protected from excess losses of the firm. Legal form and financial assistance are crucial factors underlying firm growth rates (Wennekers and Thurik, 1999).

Several models have been advanced that attempt to label and explain the various stages of business firms development (Cowan, 1990; Galbraith; 1982; Smith et al., 1985). Models of organizational lifecycles and stages of development provide information on the types of problems (such as lack of financial support and assistance) encountered by firms over time and suggest that each stage of development (start-up, growth, maturity) is associated with a unique set of problems (Kazanjian, 1988). Several authors proposed different categorizations of organizational problems encountered by emerging small business firms (Kuratko and Hodgetts, 1989). The start-up stage is more associated with problems related to the lack of financial assistance, the creation and development of products and services, and external relations problems like securing financial resources. Sales, marketing, and organizational problems are more common at the growth stage of entrepreneurial firms in a developed capitalist economy.

Kazanjian's four-stage lifecycle model of entrepreneurial growth and development is shown in Table 1. This approach permits the examination of the growth and development of the micro-entrepreneurial firms that operate in Bangladesh, facilitates the examination of problems confronted by those micro-enterprises at their different levels of growth and development, and measures how those problems differ from the problems encountered by the firms that operate in a developed economy.

Table 1. Stages of growth and development of an entrepreneurial firm

Conception and development stage	Stage I
Commercialization stage	Stage II
Growth stage	Stage III
Stability stage	Stage IV

Competence plays an important role in strategic management and is particularly important in the growth and development of new businesses. A firm's competence is understood in terms of how it meets the basic requirements for success in the industry environment. Competence represents entrepreneurial skills that can be applied to strategic performance such as financial, managerial, functional, and organizational skills, all of which are influenced by an entrepreneurial firm's reputation and history, and arises from the strengths and weaknesses of individuals in the firm, the degree to which an individual's capability is effectively applied to a common task, and coordination of a group task (Andrews, 1987). In order to provide a wider definition of competence, Kay (1995) refers to four types of general competence that a firm may possess: architecture, reputation, innovation, and control of strategic assets (Table 2).

Table 2. Types of general competence a firm may possess

Architecture: A firm's ability to create knowledge and to respond to changing circumstances, foster easy and open exchanges of information within the firm and other groups of firms, know where critical interactions occur for a venture, and collect information about such interactions in the most timely and cost-effective manner.
Reputation: The positioning of the venture and its managers in external status hierarchies that communicate information to customers and shareholders on quality, efficiency, dependability, and related performance attributes. A positive reputation serves to lower the search costs of customers, buyers, and suppliers and thus influences their decisions regarding doing business with the venture.
Innovation: The resources which when skillfully developed and marketed can lead to strong market advantages. The capabilities involved in bringing new innovations to market include the limiting of bureaucratic pressures during product development, providing a place within a firm where new products can mature without being stifled by standardized control systems, and creating channels through which innovations can be matched to customer needs.
Control of strategic assets: These are skills at exploiting market situations that limit the extent of price competition, restrict entry or imitation, or raise the price of switching to substitute products. The effective use of joint liability among borrowers and competence in controlling strategic assets enhances firm profitability.

Limited competence indicates that an entrepreneurial firm lacks important contacts, credibility with buyers, and other industry-specific information that may lead to a greater risk of failure (Bruderl and Schussler, 1990). Industry-specific capital can be a significant determinant of venture survival (Bruderl et al., 1992). New venture performance, whether seen in terms of survival or probability of survival, appears to be enhanced by management skills with high levels of business competence. Success is more likely to be achieved by entrepreneurs with prior experience (Chandler and Hanks, 1991; Vesper, 1990). These individuals need to have entrepreneurial and marketing skills, which involve not just knowledge of who to market toward but also how to market.

2. Background on the economy of Bangladesh

2.1. The Bangladeshi economy. Bangladesh is one of the poorest countries in the world with a per capita income of about \$350. The poor generally lack food and medical services and have no access to education. As a result, poverty is passed from one generation to the next (Pearl and Phillips, 2001). The country is predominantly agrarian; rural poverty dominates the economic landscape.

A lack of consistency in government policy toward industrial development aggravates the problems brought about by the flight of most entrepreneurs to Pakistan after 1971. Initially, policy was based on a socialist philosophy proclaimed in rather vague terms by the constitution and the country's first leader, Sheikh Mujibur Rahman. Large-scale enterprises were nationalized, and private investors were only allowed to participate in small-scale enterprises (Khandker and Chowdhury, 1996).

The government formed in 1975 reversed this industrial policy. The objective was to move away from socialist goals by encouraging private investment in industrial development and stimulating foreign investment. Although the new policy met with little measurable success, the government stayed the course of increased privatization. The 1990s brought a new wave of market liberalization with growing interest in privatization (Khandker and Pitt, 1996). The GDP of Bangladesh has been growing at an average annual rate of more than 5 percent since 1990. In 1985, about 40 percent of industrial assets remained under public control; today, most of the country's industries are privately owned.

2.2. Poverty alleviation in Bangladesh. Several diverse strategies and programs are responsible for Bangladesh's recent reduction in poverty. As the Green Revolution spread technology, food production increased in the late 1970s and early 1980s (Hassan, 2002). In the late 1980s, the Bangladeshi government created employment opportunities in rural areas through the Food-for-Work program. This program made a significant impact in poverty alleviation (Graham and Manning, 2000). Another important program, feeding disadvantaged groups, has been in operation since the mid-1980s. It was introduced with the purpose of addressing the problem of malnutrition among rural mothers and children. In 1999 alone, more than 500,000 tons of grain was distributed under this program. More than one thousand nongovernmental organizations (NGOs) presently operate in Bangladesh, and most of them have poverty alleviation programs such as providing employment opportunities for marginalized groups. There also has been an increase in the flow of remittances sent home by Bangladeshi workers employed overseas. This has increased the disposable incomes in those households with family members working abroad (Pearl and Phillips, 2001).

All these policies are further augmented by the provision of micro-credit to the poor. The best-known program of this type is the Grameen (Village) Bank (GB) (Hassan, 2002). This program provides micro-credit to the landless and near landless without collateral. GB has been financially self-sufficient since 1993 and is now one of Bangladesh's largest banks with more than 1,200 branches. In 1997, the bank underwrote more than two million loans totaling $1 billion in more than 35,000 villages throughout Bangladesh. More than 93 percent of the borrowers were women, and the repayment rate was 97 percent. Evidence is mounting that the micro-credit program has played a key role in the battle against poverty (Khandker, 1998).

2.3. Grameen credit. Development of micro-credit in Bangladesh started with the establishment of Kaligram Krishi Bank by Tagore in 1905. Bangladeshi economist Muhammad Yunus founded the Grameen Bank (GB) in 1976 and then introduced a typical micro-credit product in 1983 when the market started to grow. GB took a fundamentally new approach to the problem of lack of access to credit for the poor. It targeted landless poor, a group it defines as those rural dwellers who own no more than one-half acre of land or assets valued not more than one acre of land.

GB's lending philosophy is not based on any collateral or legally enforceable contracts but on "trust". Loans are offered for creating self-employment for income-generating activities and housing for the poor, as opposed to consumption. In order to obtain loans, an applicant must join a group of borrowers. Loans can be received in a continuous sequence. A new loan becomes available to a borrower if the previous loan is repaid. All loans are to be paid back in weekly or biweekly installments (Graham and Manning, 2000).

The bank uses the group lending approach to reduce the risk of nonpayment. Although loans are disbursed on an individual basis, the group is very important in that it provides both collective support and peer pressure. The group itself acts as a mechanism for the determination of creditworthiness. All members of the group must maintain a good credit rating to remain eligible for new loans, and group members watch over and support each other in their microeconomic endeavors. The loans are relatively small, a few hundred dollars at most, and the repayment period is relatively short, about a year or so. Typical clients for micro-credit are the poorest people, and women are major beneficiaries of the lending activities. Donors select the categories they would like to support (Graham and Manning, 2000).

Today GB is the only self-sufficient microfinance creditor in the country responsible for setting its own interest rate. GB lends funds at 20% per annum. This rate is high, but it is still lower than the rates charged by the moneylenders. The weekly installments by each member include the payment on the principal plus three other components which constitute the group's savings and insurance fund. The group members may decide on consensual basis when they want to extract money from this fund. Money from the group fund is usually lent out to group members' interest free. This fund allows individuals access to money in times of sickness or social ceremony without the need for a source of informal credit (Hassan, 2002).

3. Results of the survey: basic characteristics of micro-entrepreneurs in Bangladesh

The data for this study were collected in Dhaka, Bangladesh, in the summer of 2005. A sample of 100 small micro-entrepreneurial firms was randomly selected from a list provided by the Micro-credit Association of Small Businesses with the assistance of the GB in Dhaka. The questionnaire elicited information on the size and nature of operation, business objectives, level of employment, financial assistance received, business training, and micro-credit financing.

The majority of micro-entrepreneurial businesses surveyed were very small and largely a heterogeneous group, belonging to the "informal" sector. There were about 70 percent of businesses operated by females and 30 percent operated by males. According to the respondents, there is an increasing number of very poor women in Bangladesh who successfully operate their own micro-entrepreneurial businesses. They belong to very poor families or live alone with their small children and often do not have enough money to be able to have one decent meal a day. These women have positive attitudes towards self-employment or micro-enterprise and have never felt oppressed or powerless. Some launch a business project to raise their economic status while others venture into the business arena to do “something different”. Many women launch a business in order to do something that is worthwhile for their society. Bangladeshi female micro-entrepreneurs have positive and ambitious attitudes towards self-employment but are constrained by lack of resources, primarily capital.

Female micro-entrepreneurs are making their presence felt not only in urban areas but also in rural zones of Bangladesh. The majority of female micro-entrepreneurs comes from poor backgrounds and has chosen to go into business because they are confident in their own capabilities. Village women mainly start businesses as part of their struggle for survival, but with a little support from micro-finance institutions supported by non-governmental organizations and social welfare organizations they can go beyond the subsistence level and make positive economic profits from their business activities. They are able to innovate and change the production function and discover new suppliers of inputs and new markets. In this sense, they are true entrepreneurs as they introduce new products and new methods of production, discover new sources of raw materials, and carry out a new organization of an industry.

The most important micro-entrepreneurial industries in Bangladesh are jute and cotton textiles, tea, paper and newsprint, rayon, sugar, cement, chemical fertilizers, and light engineering. More than two-thirds of those employed in manufacturing are engaged in rural small-scale industries. These micro-entrepreneurial firms manufacture a very wide range of products for the local markets. Handloom weaving of sari and lungi cloth lengths is particularly important. Rope-making, boiling sugar cane to make gur, rice-milling, bamboo and cane industries, woodworking, garment manufacture, vegetable oil extraction, pottery, black-smithery, and silk rearing and spinning are other common rural industries. There are also micro-entrepreneurs in more modernized fields like electrical and mechanical repairs, welding, photography, and watch repairing.

The micro-entrepreneurial garment firms have been growing rapidly since the early 1980s. They contributed almost 70 percent of Bangladesh’s hard currency with an export value of $3.5 billion in 1997. The number of garment factories increased from 2,353 in 1996 to 2,963 in 1999, employing 1.51 million workers. An important characteristic of this industry is that 90 percent of its workers are women. Low labor cost and a well-disciplined labor force give Bangladesh a comparative advantage in this industry (Hassan 2002).

The respondents’ micro-entrepreneurial businesses operated by females were concentrated in sugar production (12 percent), jute and cotton textiles production (12 percent), tea production (10 percent), garment and clothing manufacture (7 percent), pottery making (6 percent), woodworking (7 percent), silk and rayon production (5 percent), handloom weaving of sari (4 percent), cement and chemical production (4 percent), and paper newsprint production (3 percent). Male micro-entrepreneurs operated in other manufacturing and others (21 percent), cement and chemical production (6 percent), and woodworking (3 percent).

According to respondents, the micro-entrepreneurial females invest great efforts into starting very specific, self-employed activities or into expanding or diversifying their existing enterprises. Belonging to a group of women of a similar background gives a woman more confidence. The average age of female respondents was about 39.5 years of age compared to 40 years for male micro-entrepreneurs. According to female respondents, their families are not against their micro-enterprise, and if they are married their husbands either do not interfere with or have joined in the micro-business.

Female entrepreneurs may have a few years of formal education, but it is not central to their inclination or the actual activity. About 33 percent of male micro-entrepreneurs and 27 percent of female micro-entrepreneurs had some business training. However, 37 percent of females and 24 percent of male respondents had less than elementary education. Their micro-enterprises are based on skills acquired in previous employment or wage work, related to traditional female occupations, or in an area in which they feel innovative and confident.

Table 3. Occurrence of competencies necessary for success by a stage of development

	Stage I	Stage II	Stage III	Stage IV
	Conception & development	Commercialization	Growth	Stability
	Type of competency (percentages)			
Innovation	100%	100%	N/A	N/A
Reputation	100%	100%	N/A	N/A
Architecture	95%	78%	N/A	N/A
Control of strategic assets	88%	90%	N/A	N/A

The micro-entrepreneurial businesses in Bangladesh included in this study had achieved Stages I and II of their operations (Table 3). According to respondents, *innovation* was one of the key elements of competency at both stages.

Reputation played an important role at the first two stages of firm's development. A positive reputation served to lower the search costs of customers, buyers, and suppliers and helped them in their decisions regarding doing business. Respondents stated that *reputation* became a source of sustainable competitive advantage in a very difficult environment that operated under poverty. Most small-business owners feel that reputation is something they have to build on their own. As the Bangladeshi micro-entrepreneurs operate in poverty, the effectiveness of their business reputation came from doing their own marketing without external help. They also agreed that building reputation took a considerable amount of time. It was a very slow process that took several months and often involved winning customers over one by one. They all mentioned that building trust and a good reputation required that the business delivered good-quality products and services along with good value. The other key elements of reputation building that respondents most frequently cited included the human qualities of integrity, honesty, communicate effectively, reliability and exceeding expectations.

Architecture involved gaining skills about knowing where critical interactions occur for a business and collecting information about such interactions in the most timely and cost-effective manner. According to the respondents, there were seven areas of the architectural competencies that they considered as required for their micro-business success. They included: 1) leadership (instills trust, provides direction, and delegates); 2) adaptability (adjusts to circumstances and thinks creatively); 3) business relationships (builds personal relationship and facilitates team success); 4) task management (works efficiently and competently); 5) production (takes action and achieves results); 6) development of talents (cultivates individual talents and motivates others); 7) personal growth and development (displays commitment and seeks improvement). All these competencies played a very important role at the first two stages of firm's growth and development.

Competence in *controlling strategic assets* enhanced firm profitability. It generated competitive pressures from new entrants or industry competitors that eventually led to the dissipation of excess profits and a return to competitive conditions. As Bangladesh micro-entrepreneurial firms have been operating in increasingly difficult conditions, *control of strategic assets* was an important competence at the first two stages of growth and development.

The specific set of competencies that were necessary for success does not vary widely across micro-entrepreneurial businesses, and they are difficult to have prior to entry due to the nature of industries operating within a poverty level economy. A new micro-entrepreneurial business can be successful with largely industry-specific competencies at the time of initial entry, but it requires organizational and marketing capabilities to grow and prosper in an economy of poverty.

Table 4. Basic characteristics of family businesses by gender and type of business

Annual growth rate* of profit	Male	Female
Average	908%	543%
Pottery making	-	1165%
Rope-making	-	715%
Woodworking	1652%	526%
Jute and cotton textiles production	-	523%
Tea production	-	464%
Paper and newsprint production	-	270%
Sugar production	-	167%
Garment and clothing manufacture	-	80%
Handloom weaving of sari	-	79%
Silk and rayon production	-	69%
Other manufacturing	877%	-
Cement/chemical production	646%	-
Characteristics of micro-enterprise businesses	Male	Female
Average annual profit at the start	US$21 5	US$303
Average annual profit after receiving micro-credit	US$596	US$732
Average annual growth rate of profit after receiving micro-credit*	908%	543%
Average number of workers at the start	1,9	1,7
Average number of workers after receiving micro-credit	3,2	2,8
Average growth rate of workers after receiving micro-credit**	100	90,7
Average age of business owner (in years) at the start	41	39
Average age of business (in years) at the start	5.8	5.8
Number of business owners who had training at the start	33%	27%

Notes: * Annual growth rate of profit = [(Current profit - profit at the start)/(profit at the start)] x 100. ** Annual growth rate of workers = {[(Current number of workers) - (number of workers at the start)]/(number of workers at the start)} x 100.

The average profit per year both before and after receiving micro-credit was higher for female micro-entrepreneurs than for their male counterparts. Among the female businesses pottery making, rope making, woodworking, jute and cotton textiles, and tea production had more than a 400% increase in profit. The average number of workers before receiving the micro-credit was about 1.7 for female and 1.9 per male micro-entrepreneurs. After receiving micro-credit, the growth rates of workers' employment ranged from 100 percent increase in the employment for the male micro-entrepreneurs and 90.7 percent for their female counterparts. The high rate of growth for both profits and employment are due to providing a micro-credit to those who were close to poverty level. A small amount of US$100 can provide a great change in the level of employment and production of those firms.

Despite the many problems and obstacles encountered at different levels of their development, the micro-entrepreneurial businesses were able to grow. During their first two stages of growth and development, they had to operate under uncertain and poor economic conditions, unfair and poor banking conditions and preferences, a low level of capitalization, and poor infrastructure. Given all these difficulties, the respondents have displayed intensive activity and a high level of entrepreneurial propensity. After receiving micro-credit assistance, the ability to be able to make efficient and rational decisions enabled most of the respondents to succeed, grow, and move up to the second stage of development. The assistance of the micro-credit was the most critical factor for the micro-entrepreneurial firms to survive and reach Stage II. According to all respondents, Bangladesh's innovative approach to micro-credit has significantly reduced poverty within their families allowing them and their families to fulfil their dream of poverty reduction.

Conclusions and policy implications

Bangladesh's approach to micro-credit has significantly reduced rural poverty and serves as a model of micro-entrepreneurship. The borrowers of micro-credit in Bangladesh are primarily women. Much of their success as micro-entrepreneurs can be attributed to Grameen Bank, which has given an elevated priority to building highly entrepreneurial human capital. The GB program has allowed the poor to become more self-reliant and create employment and has focused heavily on the realization of the human potential by pooling the meager resources of the rural poor.

The success of GB has internationalized the micro-credit concept and has made micro-lending initiatives for poor people, specifically for women, a new paradigm to achieve the goal of equitable and sustainable micro-entrepreneurial development. Women were the primary target of the micro-credit program because of their positional vulnerability and strong sense of discipline. The group lending structure and the effective use of joint liability among borrowers enabled GB to maintain its high repayment rates on invested loans, generate interest revenue, and create institutional financial sustainability. The joint liability of group members gives lending institutions an alternative to conventional loan collateral.

In rural Bangladesh as well as in other underdeveloped economies, the pressing need is not for policies which aim at liberalizing the financial markets. The real need is financial innovations that can effectively lower credit costs for non-preferred borrowers. Given the Grameen Bank's success in this area, the governments in developing and emerging economies should encourage or direct donor agencies to provide more resources for similar projects. A Grameen-type bank in turn will retail the funds to promote sustainable and self-managed micro-entrepreneurial activities and can improve access to credit for small rural or urban producers, landless farmers, and other people with low or no income. Special attention can be given to the needs of women and other disadvantaged and vulnerable groups.

Further research into developing micro-credit in developing and transitional economies such as those in Central and Eastern Europe is needed and should help provide a better understanding of the importance of these programs in alleviating poverty. The research should focus on developing incentives that improve access to credit and strengthen the capacity of organized credit systems to deliver financial services to the impoverished and other vulnerable groups. It should also focus on expanding financial networks, building on existing networks, promoting attractive opportunities for savings, and ensuring equitable access to credit in underdeveloped economies.

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