Micro Initiatives in Economic Development

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David M. Johnson
Associate Professor of Finance
Harding University

Introduction

The problem of poverty, particularly in the third world, is complex. Explanations for chronic economic stagnation include unstable and corrupt governments, misguided macroeconomic policies, colonization by more powerful nations, exploitation by other nations or by powerful multinational corporations, harsh climates, wars, natural disasters, and native cultural values that discourage development.[1] The headline solutions typically call for changes in macroeconomic policy, protectionist legislation, treaties, and debt forgiveness, or other aid from first-world countries. Progress in judicial, political and economic systems are certainly needed to provide more stable and equitable conditions for pervasive development to occur. In the meantime, numerous lives have been changed for the better through economic initiatives undertaken at the micro level. The proliferation and success of these programs in recent years heralds a movement that holds genuine promise for improving lives, family by family and community by community.

This paper will overview the background and motivation behind certain major microeconomic[2] initiatives and describe the basic forms these initiatives are taking. It will explain the evolution these programs are undergoing as they adapt to meet the needs of the underdeveloped communities they serve. It will also address certain myths concerning poverty, the poor, and economic theory that have been challenged as a result of these efforts.

The Problem of Poverty

Addressing the needs of "the poor" is a thorny matter. Although the term is often used as if "the poor" were a monolithic entity composed of homogeneous members, poverty is multi-faceted. Poor people may be so because of exploitation, physical or mental incapacity, poor decisions, ignorance, laziness, negative attitudes regarding work or the future, or just bad luck.[3] Because there are many reasons for poverty, the appropriate remedy for one case may serve to exacerbate the problem in another. Another matter concerns defining "the poor." Poverty is characterized by not just a lack of income or even material or financial wealth. Poor people often exhibit a worldview of hopelessness, fatalism, and short-term thinking that discourage effort, investment, and education. Poor people often lack "social capital" as well as financial resources. Poverty in economic terms is generally defined in terms of income, wealth, or both. The poverty level is relative, much higher in developed countries than in less-developed ones. It is strange indeed to regard one as "poor" in one setting even though that person has an automobile, indoor plumbing and color television. Still, poverty must be defined in order to proceed in its analysis and elimination, and given that economic values are relative, so will be our definitions of poverty.

It is too easy to become mired in semantics and theories about poverty, and at some point those who wish to do something about it must bull ahead despite an incomplete understanding. The human suffering from dire, persistent and pervasive poverty in third-world countries begs for remedy. Muhammad Yunus, founder of the Grameen (Village) Bank in Bangladesh in 1976, is the foremost pioneer and proponent of micro-lending programs directed at the poor. Devoted to a country which, for a decade, served as Poverty's poster child, he was forced to target his loan programs toward the very poor.

Yunus found that many poverty-alleviation programs failed at assisting the very poor because they defined the poor by ethnic or occupational groups, instead of by economic criteria. He observed a version of Gresham's Law at work, that if the poor and the non-poor are lumped together in a single program, the non-poor will "crowd out" the poor. That is, for whatever advantages the poor lack, whether street savvy, education, self-confidence, intelligence, or connections, the very poor would obtain fewer benefits than the lesser poor. Despite the limitations of this focus, poverty must be defined in terms of income and/or wealth to target the most poor. Yunus did so by identifying the poor as those constituting the lowest 25% of the income level in Bangladesh.

Economic Development Initiatives

The "give a man a fish versus teach a man to fish" proverb is well understood by those who have witnessed the realities of life in the third world. Economic development initiatives are a natural outgrowth of more urgent poverty relief efforts. Relief efforts represent the emergency repair required to mitigate acute human suffering. Development efforts are the preventive maintenance needed to address the long-term needs of people to rise above subsistence, to be able to look to the future with optimism, to provide for themselves and assist others in need, and to determine their own futures. With sufficient resources of their own, people may avoid the need for relief aid in the future. Economic development initiatives aimed at the third world typically fall into two categories, micro-enterprise development and micro-loan programs.[4]

Micro-enterprise Development

Micro-enterprise development is designed to foster the inception of new businesses and to provide advisory services for existing and new businesses, and specifically, very small (generally only one owner/employee) businesses. Just as there is a shortage of medical expertise in less developed countries, there is a lack of experienced business people who might serve as examples, mentors, and consultants. Economic development programs seek to fill this void. These organizations assist these people, as they come out of poverty, to adopt sound principles of business management and personal financial responsibility.

Less-developed economies do not provide the employment opportunities available in the industrialized world. As was the case in the West before industrialization, most production takes place on a very small scale, usually in homes. The ordinary worker must therefore serve as his/her own business manager, and must be sufficient in the various aspects of business operation to be successful. The task of the business resource center to educate and mentor can be critical in certain economies.

Enterprise development programs take various forms. An organization might establish a "business resource center" in a given town or city that would provide ongoing advisory services to new and existing businesses in marketing and distribution, general and production management, accounting, and finance. Some resource centers serve to help develop markets for goods and services, such as the establishment of a cooperative sales outlet or trading post. In this role, they assist producers in obtaining the best prices for their goods and advise producers on product improvement.

Another version, often used in connection with a local business resource center, assembles teams of experienced businesspeople from the home country to make site visits. These groups provide an infusion of fresh ideas and insights to the problems faced by local businesses and serve as mediators between the modern world outside and the local culture.

The center could also serve as an educational facility to train aspiring business owners in the basics of business ownership and management. There are many basic business concepts that are instilled in people who grow up in a modern capitalistic economy that are foreign to the thinking of those who have grown up in a controlled or poorly developed economy. Examples include:

1. the relationship between risk and reward;
2. the difference between the short-term and the long-term effects of a particular action;
3. economic notions such as those of opportunity cost, sunk cost, and incremental analysis;
4. the importance of planning for the future and of optimism about the future (the assumption of progress);
5. the value of competition; and
6. the relationship between quality, efficiency, and output.

The value of outside expertise or "free enterprise education" makes sense to economic educators such as ourselves, but it is not a given. Muhammad Yunus, founder of the Grameen Bank, is a strong critic of such programs. His opposition will be explained later, as we consider the second form of micro-initiatives, micro-loan programs.

Micro-loan programs

Although government-sponsored loan programs have existed for some time, the recent proliferation of non-government organization (NGO) micro-loan programs got its start in 1976 with the founding of the Grameen Bank in Bangladesh. Muhammad Yunus, founder of the bank, had earned his doctorate in economics at Vanderbilt University and returned to his native land to put his learning into practice. What he found was that he had learned much about the economics of wealth but little about the economics of poverty. He had the impressions that poverty was the result of inadequate education or effort by the individual to develop marketable skills, or due to wrongheaded economic policies that produced an inadequate demand for labor. If these two shortfalls could be remedied though prudent government action, including education, job skills training and individual motivation, poverty could be eliminated. In reality, said Yunus,

> The primary causes for poverty are not lack of human capital or lack of demand for labor. Lack of demand for labor is only a symptom, not a cause, of poverty. Poverty is caused by our inadequate understanding of human capabilities and by our failure to create enabling theoretical frameworks, concepts, institutions and policies to support those capabilities.[5]

There is a dearth of capital in the third world, and capital—not just money but the investment in productive equipment that money and credit enable--is critical to economic progress. When all people are living at a subsistence level, there is no excess to sell and no one with the surplus goods or money with which to buy. Surplus is the key to investment, which allows increased productivity, which in turn is the key to surplus and economic growth. Without surplus there is no excess to invest, and yet without investment there can be no progress. In a modern economy, an individual with the requisite idea and background can obtain the capital necessary to exploit the idea, but capital markets are practically non-existent in many areas of less-developed economies. An infusion of investment funds is therefore essential to economic progress in many areas of the third world.

As the saying goes, "It takes money to make money," and it often takes money to obtain money. From a traditional commercial banking perspective, collateral is essential. Yet very poor people have no collateral, which makes them unattractive credit risks. Due to the small size of each loan and the high cost of obtaining information on the borrower, micro-loans are of no commercial interest to conventional lenders. In many cases, poor people in these circumstances simply cannot get credit at any interest rate. In cases where they can obtain loans via the "informal credit market" (a euphemism for loan sharks and gouging suppliers), interest rates are oppressively high. In the Philippines, for example, a common lending arrangement available to the very poor is the "5-6 rule." Under this arrangement, a borrower receives five pesos in the morning and must pay back six pesos that evening. This amounts to an interest rate of 20% daily, or roughly 7,200% per year, an onerous arrangement in any culture.

A watershed event in Yunus' experience related to a widow in a village near his university. The woman made very nice bamboo stools, but was unable to get ahead despite hard work and frugal management of her resources. Yunus discovered that she was unable to afford the $.20 cost of raw materials, and so was forced to continually borrow the money from a local moneylender. As a condition of the loan, she was required to sell her product to him at a price so low that she earned only $.02 per day from her labor. Yunus extended his investigation in that village, and found that this type of arrangement was common. He figured that for lack of working capital totaling $27, 42 workers remained entrapped in grinding poverty.

Seeking a long-term solution, Yunus approached the banks. Because the poor had no collateral, the banks were not interested until Yunus agreed himself to serve as guarantor of their loans. Even after a number of years of very good experience in making and collecting on loans to the very poor, Yunus was still unable to convince the banks to extend loan services to the poor. They wanted collateral. In 1983, Yunus obtained permission to establish an independent bank known as the Grameen (literally, "village") Bank. Today it lends to over 2.3 million people, of whom 94% are women. The average loan amount is about $175 and the historical repayment rate is 95%.[6]

The success of Grameen has inspired the formation of others in various areas of the world, most notably in Sub-Saharan Africa, Southeast Asia, and in Central and South America.

Meeting the Credit Needs of the Poor

To succeed in markets shunned by commercial banks, micro-loan institutions must revise the traditional ways of designing loans to remain financially viable. What are the key techniques to providing efficient, sustainable, and financially responsible credit services to the poor?

In the first place, micro-loan programs must identify other methods of credit appraisal and security to substitute for the lack of collateral and costly individual customer loan appraisals. Among the most common methodologies is the use of group lending. The groups range from small homogeneous groups of three to ten individuals (Grameen Bank, K-REP, BancoSol) to larger groups of 10 to 50 members (FINCA). The group members collectively guarantee loan repayment. For example, the Grameen Bank extends loans to groups of five people. Because the groups are generally composed of neighbors, a measure of informal credit analysis occurs as members are recruited. The poorest two group members receive their loans first, and the others receive loans only after the first two begin regular loan payments. The failure of a person to repay his loan has serious implications for the individual and for the community since repayment of today's loans will determine the availability of future loans. This scheme involving group member selection and peer pressure combine to produce a high repayment percentage and thus to keep institutional loan evaluation costs down. Also, the administrative costs per borrower are reduced and the group guarantee serves as a substitute for collateral requirements.[7]

In addition, many micro-loan programs incorporate a compulsory savings program as part of the arrangement. The savings are available to the member only after the loan is repaid. For people who have been subsisting day-to-day, the concept of setting aside a surplus for the future is novel. Also, many of these programs target women for several reasons. Women are typically among the most poor because their work hours are restricted due to family responsibilities and because, in some cultures, they may not have the access to other credit avenues that men may have. In addition, the commitment of women to the welfare of their families makes them better prospective borrowers, evidenced by their better repayment records and their willingness to form groups.

In the second place, micro-loan programs must recognize their customers' needs. In this regard, it is important to note that most microenterprises require very little capital for equipment, machinery or tools. The greater need is for working capital—inventory, materials and supplies. Thus, short-term financing in small amounts is the greatest need. Most loans average a few hundred dollars, with loan terms that average a few weeks to six months. Most microenterprises are operated out of the home as family businesses, and most by women. Because of the multiple roles these customers fill, features such as expeditious loan processing and convenient locations are important. In order to provide these services, micro-loan programs have found it necessary to simplify the loan application procedures and decentralize the approval process. One program in Uganda uses a group of experienced (and successful) borrowers from each village who serve as the loan committee. Their knowledge of the community is critical, and their responsibility for their decisions provides the incentive to be diligent. Many programs provide an assurance of greater loans in the future once current loans are repaid. Some more highly evolved financial institutions may also require regular savings as a condition of the loan.

Poor customers want services such as rapid loan approval and disbursement, and convenient hours and locations, and they are willing to pay for those services. Although these services entail greater costs that would be reflected in higher interest rates, these rates are still very attractive compared to the rates they would pay in the informal credit market.

The Evolution of Micro-loan Programs

Over the years, a number of micro-loan organizations have evolved into more complete financial institutions. The Grameen Bank started as a private loan guaranty program but was transformed into a full-fledged lending institution. Similar changes have occurred in other programs in order to meet the needs of the poor for saving as well as lending services. Some have likewise transformed from primarily charitable institutions into for-profit entities. The ability of these institutions to thrive in markets previously thought unprofitable yields a number of lessons about the workings of competitive markets, as well as insights about human ingenuity, adaptability, and faith.

Rhyne and Otero[8] have identified four stages of transformation in the function of non-governmental organizations (NGOs) devoted to meeting the credit needs of the poor. Their analysis is helpful to understand how various organizations function and how they are positioning themselves to meet the future.

Level 1: Traditional, highly subsidized programs obtain funding by grants or soft (below-market rate, subsidized) loan deposits to cover operating expenses and establish a revolving (perpetuating) loan fund. Customers are charged zero or below-market rates of interest. As a result, even with loan repayment rates typically well above 90%, the program must continually solicit grants or charitable contributions to replace funds lost to bad loans and operating costs. Growth must be financed from still more contributions, and is therefore restricted by fund-raising capabilities.

Level 2: Programs at this level raise funds on terms near, but still below, market rates. They may do so by mixing grant funds with funds borrowed at market rates, so-called "blending." The rates charged to customers cover the cost of funds and some operating expenses, but grants/contributions are still required to sustain the operation.

Level 3: Most, but not all, subsidy is eliminated. According to Rhyne and Otero, it is necessary to attain this level in order to achieve large-scale operations, which is why most of the better-known credit programs function at least at this level. The Grameen Bank functions at this level, as do certain of the ACCION programs.

Level 4: The program is fully financed from the savings of customers and funds obtained at commercial rates. Credit unions function in this way, as do BancoSol in Latin America and the Bank Rayat Indonesia (BRI) Unit Desa system in Indonesia.

The differences between programs functioning at Level 3 versus Level 1 or 2 are primarily a matter of the degree to which the program is willing to purchase funds at market rates rather than to solicit grants, contributions, and soft money loans. This, in turn, is related to the disposition of the institution toward charging market interest rates. Although some programs intentionally may be kept small and localized, it seems that many would prefer to grow and expand their services to the poor, but are unable to do so due to lack of funds.

The greater the dependence of a micro-loan program on grants and contributions, the more limited its ability to grow. In highly inflationary environments it will see the actual value of its loan portfolios dwindle, regardless how remarkable the collection rate, and with it its ability to serve the poor. While the amount of grant funds available from a particular foundation or government, or the contributions available from this donor or that one may be limited, a practically unlimited pool of funds is available to those willing to pay market rates for it. However, in order to obtain funds at market rates on an ongoing basis, programs must be willing and able to charge market rates to loan customers. Because of the nature of the customer, market rates will be well above those charged by commercial banks. In general, those programs that have balked at charging these high rates have done so for one of several reasons:

1) Legal interest rate ceilings prevent them from charging higher rates.
2) Some programs believe that demand for funds would be insufficient at higher rates.
3) Charging higher rates is considered to be exploitative and unfair to the poor, or at least has the appearance of unfairness.

Rhyne and Otero respond to these reasons by explaining, first, that many interest rate restrictions are being removed year by year. Second, programs that have begun to charge market rates have experienced growth, not shrinkage. Third, because poor people do represent greater credit risks in conventional terms, they merit higher interest rates. Further, they accept this fact and are willing to pay the higher rates to obtain access to the credit they need, especially when the informal credit market alternatives are far more injurious. Realizing that a number of micro-loan programs were initiated by charitable organizations, many of them religious, it is understandable, the reluctance of some to shift to more economically-motivated policies. Still, experience testifies that these programs will be limited in their ability to grow and meet the vast credit needs of the earth's poor if they do not accept market solutions.

Full-Service Financial Institutions for the Poor

Only the Level 4 programs represent truly sustainable programs that can cover costs of bad loans, operating expenses, costs of borrowing—indeed to cover all costs, including an adequate return to the owners. To achieve Level 4, programs must accept deposits as well as make loans, and not only accept them, but compete for them. A valid concern is whether there is widespread interest among the poor for savings services. Do poor people have anything to save, and would they choose to put their money into financial assets if they were available?

Robinson[9] answers 'yes' to both questions, with specific reference to the Indonesian experience. Given the lack of credit facilities, poor people do save in various forms, for example, in jewelry, grain or small livestock. Because of the need for liquidity among the poor, demand for savings alternatives probably exceeds the demand for credit. Robinson addresses two 'widespread myths' related to savings in third world countries: the myth of rural undersavings, and the claim that there is insufficient demand for savings instruments in rural areas of the third world.

Financial institutions typically have been unsuccessful at mobilizing rural savings in less-developed countries such as Indonesia, but Robinson blames the problem on wrongheaded policies rather than lack of demand.[10] The success of the BRI programs began in 1983 with major financial reforms. Deregulation of the Indonesian banking system allowed BRI to establish market rates on loans and savings deposits, to design new savings instruments and financial services, and to pursue policies that were more favorable to depositors. As a result, village bank deposits rose from $17.6 million in 1983 (the time of deregulation) to $1.3 billion in 1991.

According to Rhyne and Otero, the successful evolution of these institutions to full-service providers is based on the following elements:

1) a market perspective that understands the customer and designs products and services to met his needs;
2) the recognition that savings can be as important as credit for microenterprises; and
3) the insistence that financially viable institutions provide only financial services.

This paper has already noted the importance of understanding the needs of the poor—the need for innovative ways to evaluate and manage credit risk; the need for predominantly short-term loans to finance working capital; and the importance of speed and convenience in processing loans. Likewise the demand for savings services has been briefly addressed above.

Finally, Rhyne and Otero claim that financial services institutions, in order to best serve the needs of the poor, should restrict themselves to providing savings and credit products. Yunus makes the same claim. Their reasons and explanations provide insight both into the successful management of a micro-loan program, and in how to show respect for people who have characteristically been regarded as sub-human.

The Grameen Bank does not provide consulting or educational services, nor does it suggest uses for the money. Grameen clients borrow as part of a group of five borrowers. Borrowers are encouraged to make their own decisions, yet at the same time to consult the other group members. According to Yunus, when asked for advice, Grameen representatives are trained to respond "Grameen has lots of money, but no business ideas." This policy keeps the Bank out of the borrower's business decisions, and therefore not directly responsible in the event of failure. Socially, this policy empowers the individual with his or her decisions. Poor people are often denied credit for the ability to make decisions for themselves. After all, the reasoning goes, if they were good decision-makers, they wouldn't be poor. This result obtains regardless of whether one disregards the poor as undeserving of concern, or whether one out of the highest motives regards the poor as children, unable to think and choose wisely for themselves. Paternalism, though well-intentioned, undermines empowerment and leads to dependency and failure.

Challenging Myths about Poverty and the Poor[11]

The micro-loan experience has yielded some interesting findings about human nature and about economics. The results are simultaneously challenging and encouraging to those who study economics and who are concerned about finding realistic answers to the problem of chronic poverty.

The following widely held beliefs about poverty have been challenged by the work of various micro-loan programs:

1) Poor people are poor due to lack of marketable skills. If they can be trained in a skill, they will be employable and rise from poverty. As evidence of this attitude, many microenterprise development programs aimed at reducing poverty have focused on job training. Yet programs aimed at producing skilled workers will not be generally effective in an economy that does not produce sufficient jobs. In economies where capital is concentrated in the hands of the few, the worker may still be subject to a system where an inordinate share of value-added goes to the business owner and the employee has a dismal chance of rising above poverty. The way of the self-employed allows them to capture more of the benefits of their efforts.

2) Entrepreneurs are a select group of people, different from the rest of us in some key "gifts." Poor people don't have those gifts, or they wouldn't be poor. Entrepreneurs are considered to be more visionary, risk-tolerant, independent, free-thinking, and creative than the rest of us. Those not blessed with sufficient entrepreneurial traits are designated as "Labor" by economists. However, the vast majority of third-world poor make their living by small-scale self-employment. They identify their markets, purchase raw materials, allocate resources to production, arrange financing, and plan for their future. Because they are so small individually, they are often dismissed as part of the "informal sector," or even regarded as part of the underground economy or black market. Regarding them as entrepreneurs should result in greater respect for their efforts and their contribution to the economy.

3) Capitalism is driven exclusively by profit-maximization. The profit-maximization rule assumes that owners are motivated solely by self-interest, and that they establish commercial enterprises in order to maximize their wealth. Institutions engaged in charitable activities are termed "non-profit" activities. They exist for other motives than self-interest. Although many for-profit businesses engage in charitable activities, those are assumed to be motivated by the public relations benefits tot he firm. Many, however, cannot easily be explained in terms of profit-maximization motives. The tradeoff between financial return and "social return" is one in which firms engage often, yet is not appreciated by mainstream free enterprise economic theory. Can economists describe a commercial enterprise that is motivated by both financial and social concerns?

4) Capitalism focuses on the individual at the expense of community. The Grameen experience demonstrates that micro-loan programs can be designed to enhance mutual dependence and cooperation while showing respect for individual initiative and individual accountability. Successful micro-loan programs will seek to understand and to take advantage of social structures in the culture rather than to undermine or work against them. For example, the policy of using loan committees composed of community members, besides providing an economical way to evaluate prospective loans, serves to emphasize the responsibility of the indigenous people for the program and upholds those people as successful role models for others.

5) Free markets are an integral part of the solution to pervasive and chronic poverty. First world prosperity was not the result of massive government programs to redistribute wealth, provide job training, or make loans. Similarly, third-world poverty will not be eliminated by such programs. There is simply not enough wealth to redistribute such that all will be well-off. Any true solution to poverty must address issues of wealth production as distribution. Capitalism declares that prosperity is available to all, and that the only limitations are those we place upon ourselves.

6) Poor people are not poor because of capitalism, but rather because of political, legal, and social structures that prevent their access to free markets. Capitalists should be

proponents of freedom of thought and action as well as freedom of economic choice. Free market advocates should speak more boldly to the evidence that the freedom of religion, the press, speech, and association rarely exist where there are not also free markets.

Conclusion

The purpose of this paper was to provide an introduction to the burgeoning field of micro-development initiatives, and particularly micro-loan programs. The success of thousands of institutions devoted to providing financial services directed at less-developed areas and poor people in particular spells hope for billions. The experience and varied success of these organizations have shattered a number of myths about the poor, poverty, and the form these institutions are taking in order to meet the needs of the poor.

Evidence shows that financial services institutions focused on the poor are feasible and are necessary to meet the credit needs of the very poor. Innovative ways of credit analysis and delivery are being used to make credit available to a very vulnerable group, and showing the power of free enterprise to help people help themselves.

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[1] Coverage of the various explanations is found in *The Third World: Opposing Viewpoints*, edited by Janelle Rohr, Greenhaven Press, 1989, and *Underdevelopment is a State of Mind: The Latin American Case* by Lawrence Harrison, Madison Books, 1985.

[2] The definition of microenterprise is not precise. Rhyne and Otero apply the term to enterprises with ten or fewer employees. In general, the microenterprises contemplated in this paper are tiny businesses with only one or two employees.

[3] It's not my intent here to provide a complete list, but simply to note that there are many reasons that one may be poor.

[4] In more developed economies, vocational training would be another aspect of microeconomic development programs. However, training for a specific vocation requires the availability of employment opportunities. In many areas of the third world, employment opportunities are not available or attractive. Therefore, the emphasis in most development programs is on training owners of tiny businesses.

[5] Yunus, Muhammad, Journal of International Affairs, Fall 1998, 52, no. 1, p. 48.

[6] Ibid., p. 51.

[7] Rahman, S., Micro-finance: Helping the Poor Help Themselves, UNESCO Courier, January, 1999.

[8] Rhyne, Elizabeth and Otero, Maria, Financial Services for Microenterprises: Principles and Institutions, in The New World of Microenterprise Finance, Rhyne and Otero, editors, , Kumarian Press, 1994.

[9] Robinson, Marguerite, , Savings Mobilization and Microenterprise Finance: The Indonesian Experience, in The New World of Microenterprise Finance, Kumarian Press, 1994.

[10] Where savings services are accessible to the poor, these savings rarely return to the community in the form of loans. Thus, the cycle of saving, borrowing/lending, investing, surplus and saving so critical to economic progress is broken.

[11] A number of assumptions about micro-loan programs and poverty are addressed in Microfinance and Poverty: Questioning the Conventional Wisdom, by Hege Gulli, The Inter-American Development Bank, 1998.

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