

Microfinance: a tool for poverty reduction in developing countries

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Key Words

Microfinance, Microcredit, Poverty reduction, Poverty, Economic hardship, Developing countries.

Abstract

Microfinance has proved to be one of the effective tools for poverty reduction in developing countries. Following the success stories of the Grameen Bank in Bangladesh, the microfinance revolution has stormed the developing countries today. This paper looked at whether or not microfinance is an effective strategy for poverty reduction in developing countries.

It was found out from the related literature that microfinance has a positive impact on poverty reduction and so, it is an effective tool for poverty reduction in many countries including Bangladesh, Bolivia etc. However there are doubts about its large scale impact. It also became clear from the literature that the impact of microfinance on poverty alleviation is a keenly debated issue and it is generally accepted that it is not a silver bullet, it has not lived up in general to its expectation. However, when implemented and managed carefully, and when services are designed to meet the needs of clients, microfinance has had positive impacts, not just on clients, but on their families and on the wider community.

It was recommended among others that more efforts needs to be geared towards institution building including the strengthening of groups especially Self Help Groups(SHG). There is also the need for the development of more effective management information system to promote the consolidation of sustainable financial service delivery through well performing Self Help Groups (SHGs).

Introduction

Most developing countries especially those in Africa are faced with severe economic hardships and deteriorating levels of economic performance.

Poverty therefore is one of the major problems confronting developing countries today and is at the centre of development policy (Chirwa, 2002). It is no surprise that the World Bank (2001) chose the theme of *Attacking Poverty* in its development report. According to the report about 2.8 billion out of the 6 billion people in the world live on less than US\$2 a day and 1.2 billion on less than US\$1 a day in the 21st Century. Of the 1.2 billion who live on less than a dollar a day, 43.5 percent are in South Asia, 24.3 percent are in Sub-Saharan Africa and 23.2 percent are in East Asia and the Pacific. The World Bank (2001) also observes that poverty in developing countries is shifting toward South Asia and Sub-Saharan Africa. It is widely accepted that one major cause of poverty in developing countries is lack of access to productive

capital, with formal financial institutions mostly excluding the poor in their lending activities (Chirwa, 2002). One strategy in many developing countries has been to implement Microfinance programmes to offer credit to the poor. Through a number of impact analyses it has been proved at the international level that Microfinance programmes contribute to the achievement of several aspects of the Millennium Development Goals (MDGs) including poverty reduction; and from the success stories of countries like Bangladesh and Bolivia many developing countries including Ghana have formally introduced microfinance as one of the interventions to reduce poverty.

In Ghana, even though Microfinance has existed in some form for many years various governments formally and consciously started implementing the strategy of microfinance to deal with the problem of poverty in the 1990s.

Concepts

Microfinance

Researchers and practitioners have not precisely agreed on the definition of microfinance. However, one thing is clear; to most researchers, practitioners and experts microfinance has evolved as an economic development approach intended to benefit low-income women and men (UNDP Microstart Guide 1997). According to Ledgerwood (1999), the term Microfinance refers to the provision of financial services to low-income clients, including the self-employed. Financial services according to Ledgerwood (1999), generally include savings and credit, insurance and payment services. Microfinance, according to Otero (1999, p.8) is "the provision of financial services to low-income poor and very poor self-employed people". Schreiner and Colombet (2001, p.339) define microfinance as "the attempt to improve access to small deposits and small loans for poor households neglected by banks." Therefore, microfinance involves the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector.

However, the Consultative group to assist the poorest (CGAP) stresses that to most people microfinance means providing very poor families with very small loans (microcredit) to help them engage in productive activities or grow their tiny businesses. Over time, microfinance has come to include a broader range of services (credit, savings, insurance etc.) as we have come to realize that the poor and the very poor who lack access to traditional formal financial institutions require a variety of financial products (www.cgap.org). Notwithstanding the above, the Ceylinco Grameen Credit Company Ltd in Sri Lanka defines microfinance as "extending small loans to large number of poor entrepreneurs who cannot qualify themselves to obtain traditional bank loan" (<http://www.ceylincogrameen.lk/micro.htm>).

Furthermore the World Bank considers microfinance as "small scale financial services primarily credit and savings provided to people who farm or fish or herd; who operate small enterprises or micro-enterprises where goods are produced, recycled,

repaired, or sold; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and other individuals and groups at the local levels of developing countries, both rural and urban (THE WORLD BANK- Perspectives on Development-WINTER 2001/2002 pg 90). The UNDP Microstart Guide also sees microfinance as the provision of credit, and other financial services like savings, and insurance to micro, small and medium scale enterprises (Microstart Guide, UNDP, CITICORP FOUNDATION, 1997).

It is clear from the above that there are several definitions for the “microfinance concept”. The most simple one is; microfinance is providing small loans (microcredit) to poor families so that they will get an opportunity to start their own business even if it is small.

Microcredit

Micro-credit is just the provision of small loans to microenterprises, whilst Microfinance goes beyond that as has been explained above. Microcredit emphasizes the provision of credit services to low income clients, usually in the form of small loans for micro enterprise and income generating activities. The use of the term 'microcredit' is often associated with an inadequate amount of the value of savings for the poor. In most cases, the provision of savings services in 'microcredit' schemes simply involves the collection of compulsory deposit amounts that are designed only to collateralize those loans. Additional voluntary savings may be collected but the clients have restricted access to their enforced savings. These savings become the main source of capital in the financial institutions (Bakhtiari , 2006). In the literature, the terms microcredit and microfinance are often used interchangeably, but it is important to highlight the difference between them because both terms are often confused. Sinha (1998, p.2) states “microcredit refers to small loans, whereas microfinance is appropriate where NGOs and MFIs¹ supplement the loans with other financial services (savings, insurance, etc)”. Therefore microcredit is a component of microfinance in that it involves providing credit to the poor, but microfinance also involves additional non-credit financial services such as savings, insurance, pensions and payment services (Okiocredit, 2005).

Poverty

Social definition of poverty

Some people describe poverty as a lack of essential items – such as food, clothing, water, and shelter – needed for proper living. At the UN’s World Summit on Social Development, the ‘Copenhagen Declaration’ described poverty as “...a condition characterised by severe deprivation of basic human needs, including **food, safe drinking water**, sanitation facilities, **health, shelter, education** and information.” When people are unable to eat, go to school, or have any access to health care, then they can be considered to be in poverty, regardless of their income. To measure poverty in any statistical way, however, more rigid definitions must be used.

Statistical definition of poverty

While there are various numerically defined methods to measure and quantify poverty, two are simple enough that they are often used to define poverty (other methods are examined in the Measuring Poverty I and Measuring Poverty II), relative poverty measurement and absolute poverty measurement. Both are based on income or consumption values making gathering information to compile statistics on poverty much easier.

Relative Poverty

Relative poverty measures are the simplest ways to determine the extent of poverty in individual countries. Using this method, the entire population is ranked in order of income per capita. The bottom 10% (or whatever percentage the government chooses to use) is then considered 'poor' or 'impoverished.' This can be fine for country-wide measurements, but it has some major drawbacks in global use. If, say, a 10% relative poverty measurement was applied in a global setting, it would appear that both an industrialized country, such as the U.S., and a sub-Saharan African country had the same 10% poverty rate, even though the conditions of the poor in sub-Saharan Africa are much worse than conditions in the U.S. For this reason, absolute poverty measures are more often used to define poverty on a global scale.

Absolute Poverty

Absolute poverty measures set a 'poverty line' at a certain income amount or consumption amount per year, based on the estimated value of a 'basket of goods' (food, shelter, water, etc.) necessary for proper living. For example, if \$5 a day is determined to be the income poverty line in a country, then anyone with an income of less than \$1860 would be considered impoverished. If instead a poverty line based on consumption was used, anyone consuming goods with a monetary value of less than \$1860 would be in poverty.

The most commonly used definition of global poverty is the absolute poverty line set by the World Bank. Poverty is set at an income of \$2 a day or less, and extreme poverty is set at \$1 a day or less. This line was first created in 1990 when the World Bank published its World Development Report and found that most developing countries set their poverty lines at \$1 a day. The \$2 mark was created for developing nations with slightly better income levels than their \$1 a day counterparts. More developed countries are permitted to set their poverty lines elsewhere (it would be silly to assume a statistically significant group of people in the U.S. made less than \$1 a day, though there are obviously many impoverished people living there). For highly industrialized countries, such as Britain, Japan, and the U.S., the absolute poverty line is usually set higher (for example, the line has been set at \$14.40 in the past). The 2005 poverty line for single individuals in the United States is set at \$26.19 a day.

As of 2001, 1.1 billion people, or 21% of the 2001 world population, had incomes less than the World Bank's '\$1 a day' line for extreme poverty. 2.7 billion people had incomes less than the World Bank's '\$2 a day' line for poverty. While this is a decline from past years (in 1981, there were 1.5 billion people in extreme poverty), it still means

that almost one-half of the world's population lives in poverty, mainly in sub-Saharan African and South Asia.

Models of Microfinance

Among the proliferation of microfinance institutions (MFIs) in developing countries and even some industrialized countries, a number of distinguishable models of microfinance have emerged. These include the Grameen model, Solidarity Group Lending model, Village Bank model and many others.

Grameen Model

The Grameen model targets clients from rural or urban (densely populated) areas and are usually (although not exclusively) women from low-income groups. The selection of the clients is done through **means tests** which are applied to ensure outreach to the very poor who are pursuing income-generating activities-microenterprises Ledgewood (1997).

This model, according to Berenbach and Guzman, (1994) is based on group peer pressure whereby loans are made to individuals in groups of four to seven members who collectively guarantee loan repayment, and access to subsequent loans is dependent on successful repayment by all group members. Payments are usually made weekly Ledgerwood (1999).

Village Banking

Village Banks are community-managed credit and savings associations established to provide access to financial services in rural areas, build a community self-help group, and help members accumulate savings (Otero and Rhyne, 1994). This model was developed in the mid-1980s by the Foundation for International Community Assistance (FINCA). Membership in a village bank usually ranges from 30 to 50 people, most of whom are women. Membership is based on self-selection. The bank is financed by internal mobilisation of members' funds as well as loans provided by the Microfinance Institution (MFI).

Latin America Solidarity Group

The Solidarity Group Lending model makes loans to individual members in groups of four to seven. The members cross-guarantee each other's loans to replace traditional collateral. Clients are commonly female market vendors who receive very small, short-term working capital loans. This model was developed by ACCION International in Latin America and has been adapted by many MFIs.

Credit Union (<http://www.grameen-info.org/mcredit/cmodel.html>)

A credit union is a unique member-driven, self-help financial institution. It is organized by and comprised of a particular group or organizations, who agree to save their money together and to make loans to each other at reasonable rates of interest.

The members are people of some common bond: working for the same employer; belonging to the same church; labour union; social fraternity; living/working in the same community. A credit union's membership is open to all who belong to the group, regardless of race, religion, colour or creed. A credit union is not-for-profit, democratic financial union which is owned and governed by its members, with members having a vote in the election of directors and committee representatives.

Susu Groups

Susu Groups (SGs), which are by far the most important informal financial institution for savings mobilisation in Ghana, are under an umbrella organization called the Ghana Co-operative Susu Collectors' Association (GCSCA). The Ghana Co-operative Susu Collectors' Association was established in 1994 as an umbrella organization for all Regional Susu Collectors Societies in Ghana.

Community Banking

The Community Banking model essentially treats the whole community as one unit, and establishes semi-formal or formal institutions through which microfinance is dispensed. Such institutions are usually formed by extensive help from NGOs and other organizations, who also train the community members in various financial activities of the community bank. These institutions may have savings components and other income -generating projects included in their structure.

In many cases, community banks are also part of larger community development programmes which use finance as an inducement for action.

Rotating Savings and Credit Associations (ROSCAs)

These are formed when a group of people come together to make regular cyclical contributions to a common fund, which is then given as a lump sum to one member of the group in each cycle (Grameen Bank, 2000a) cited in Wrenn(2005). According to Harper (2002), this model is a very common form of savings and credit. He states that the members of the group are usually neighbours and friends, and the group provides an opportunity for social interaction and are very popular with women. They are also called merry-gorounds or Self-Help Groups (Fisher and Sriram, 2002) cited in Wrenn(2005).

Related Literature

The issue of whether or not Microfinance is an effective tool for poverty reduction compared to other alternative strategies has engaged the attention of

development economists and the world at large. Is microfinance a tool for poverty reduction?

In an attempt to address this question, Adams and Pischke (1992) compared modern (1990 era) MFIs to the failed rural credit agencies and Agricultural development banks established by governments of developing countries in the 1960s and 1970s that not only did nothing to advance poverty alleviation but also wasted millions of dollars of public funding and concluded that the modern MFI industry is destined for failure because of the similarities between the two. Buckley (1997) after analyzing field summary data from Kenya, Malawi, and Ghana concluded that fundamental structural changes in socioeconomic conditions and a deeper understanding of the informal sector behaviour are needed for microfinance to prove effective.

In contrast, Woller et al. (1999), after assessing the current microfinance companies believe that the movement is very different from the failed rural credit agencies of the 1960s and 1970s, thereby making direct comparisons between the two not perfectly valid. In partial support of the above, Woller and Woodworth (2001) argue that to date, top-down macroeconomic poverty alleviation and development policies also have likewise experienced significant failures. According to Schreiner (1999), Sanders (2002), and Bhatt (1999) microfinance may not be an effective poverty alleviation policy in the US. Schreiner analyzes US microenterprise programmes and finds that although some programmes can move some people from welfare to self-employment, it only works one percent of the time. Furthermore Schreiner shows that those who are successful in the transition have above average assets, education, experiences, and skills. Sanders tests the impact of microenterprise development programmes and calls into question their effectiveness as an anti-poverty strategy.

Meanwhile Bhatt (1999) finds that the evidence for the impact of U.S. microenterprise programmes is mixed -- some programmes have worked while others have failed. Schreiner and Woller (2003) compare evidence about the effectiveness of microenterprise programmes in developing countries and the US. They conclude that microenterprise development is much more difficult in the US than in developing countries, and they suggest some ways to address the challenges of US microenterprise development. Other studies reach more ambiguous conclusions about the effectiveness of microfinance as a policy tool. Analyzing MFIs in Nepal, Bhatta (2001) asserts that due to the topology and extreme poverty levels in Nepal, it will be difficult for MFIs to have any meaningful impact on poverty. Nonetheless, he goes on to suggest that MFIs should expand into the hill and mountainous areas and target women so as to increase the probability of success. As to whether Microfinance is an effective poverty alleviation tool or not the study by Snow and Buss (2001) in sub-Saharan Africa conclude that a comprehensive and a better goal-oriented assessment is needed to determine if microfinance is an effective policy for poverty alleviation.

According to Morduch and Haley (2001), there is extensive evidence that microfinance has a positive impact on the first Millennium Goal: that the number of people living in extreme poverty (defined as those living on less than \$1 per day) will be reduced by half between 1990 and 2015. For instance: Hossain (1988) asserts that "Grameen Bank members had incomes about 43% higher than the target group in the control villages, and about 28% higher than the target group nonparticipants in the project villages".

A study conducted by World Bank in collaboration with the Bangladesh Institute of Development Studies, and cited by Hashemi and Morshed (1997) showed that the Grameen Bank not only "reduced poverty and improved welfare of participating households but also enhanced the household's capacity to sustain their gains over time."

Furthermore Kamal (1996) "noted higher rates of per capita income among Micro Credit programme borrowers compared to those who did not borrow.

Again a research conducted by Chowdhury et al. (1991) showed that women (and men) participating in BRAC sponsored activities have more income (both in terms of amount and source), own more assets and are more often gainfully-employed than non-participants". Mustafa et al. (1996) confirmed this (above for BRAC) and noted that "members have better coping capacities in lean seasons and that these increased with length of membership and amount of credit received. According to the study those who had been members of Microfinance programmes for 48 months or more experienced an increase in assets of 112%.

Recommendations from impact studies

- A review of key existing microfinance programmes, using recognized poverty assessment/wealth ranking tools, should be organized to determine the current poverty levels of Microfinance clients.
- A percentage of development partners' new and renewing microfinance programmes funding should be allocated directly to programmes that target the poorest. This percentage should be continuously increase until the poorest receive a percentage that is proportional to their representation in the population. Targeting should be done through the use of recognized poverty assessment/wealth ranking tools.
- Funding for new and renewing microfinance programmes and projects should include resources for summary evaluations to be carried out regularly throughout implementation to provide information about the intake poverty level of clients as well as for the basic financial and social impact assessments.
- More efforts need to be geared towards institution building including the strengthening of group functioning in existing Self Help Groups (SHGs) as well as the promotion of the structures of SHGs.
- There is a need for the development of more effective management information systems to promote the consolidation of sustainable financial service delivery through well performing SHGs. The future strategy should also focus more on

training and capacity building of SHG members as it would improve the productivity of financial service delivery.

- For reducing apparent regional imbalances in Linkage Banking more emphasis should be put in future strategies on widening the outreach of Microfinance programmes. To increase the effectiveness such outreach strategies may have to include different delivery models. SHGs' role in development could be further enhanced through an increased involvement in development programmes in the area.
- Microfinance clients or beneficiaries should be constantly trained in Record/Book-keeping, Financial management, Marketing and Customer service, Basic planning and Decision making, etc. This will help expand their businesses, and hence reduce poverty.
- Interest rates charged by MFIs should be reasonably affordable so as to help grow the businesses of their clients instead of collapsing them.

Discussions and Conclusions

It can be inferred from the study that Microfinance can positively impact on poverty if the above recommendations are effectively implemented. This supports a research conducted by Morduch and Barley (2001) for CIDA that there is ample evidence to support the positive impact of microfinance on poverty reduction as it relates to fully six out of seven of the Millennium Goals. In particular, there is overwhelming evidence substantiating a beneficial effect on income smoothing and increases to income.

However, there is less evidence to support a positive impact on health, nutritional status and increases to primary schooling attendance. Nevertheless, the evidence that does exist is largely positive. The impact of microfinance on poverty alleviation is a keenly debated issue as we have seen and it is generally accepted that it is not a silver bullet, it has not lived up in general to its expectation (Hulme and Mosley, 1996). However, when implemented and managed carefully, and when services are designed to meet the needs of clients, microfinance has had positive impacts, not just on clients, but on their families and on the wider community. There is however a need for greater assessment of these wider impacts if the true value of microfinance to development is to be understood (Zohir and Matin,2004) cited in Wrenn(2005). One such tool for measuring wider impact is a livelihood security analysis based on a livelihoods framework which analyses how a project impacts on the livelihoods of beneficiaries.

Empirical evidence dictates that the poorest can benefit from microfinance from both an economic and social well-being point-of-view, and that this can be done without jeopardizing the financial sustainability of the MFI. While there are many biases presented in the literature against extending microfinance to the poorest, there is little empirical evidence to support this position. However, if microfinance is to be used,

specific targeting of the poorest will be necessary. Without this, MFIs are unlikely to create programmes suitable for and focused on that group.

Most international discourse on the subject also perceives micro-finance “as an approach with significant further potential for poverty alleviation and economic empowerment”. International literature further asserts that “micro-finance began alleviating poverty several decades ago when organizations in Latin America, Bangladesh, and other developing nations began testing the notion of lending small amounts to impoverished people (mostly women). By the 1980s, the success of institutions such as ACCION and Grameen prompted many NGOs and International Organizations to provide micro-finance services.

As more micro-finance institutions (MFIs) proved that the poor were reliable borrowers, entrepreneurial, and willing to work hard to escape poverty, the micro-finance industry grew to a remarkable 8,000 MFIs by 1999. Thus, according to (Hussein and Hussein, 2003) the growth in the MFI sector was sufficient proof that microfinance was a panacea for poverty.

However, there are doubts as to whether microfinance can have large scale impact. The long term, widespread impact does seem limited. Due to the petty nature of its investments Hulme and Mosley (1996) cited in Santen(2010) believe that in order to achieve structural economic growth and pull people out of poverty, more is needed than credit. The types of enterprises that are inspired by microfinance are mostly executed within a household and borrowers usually do not hire employees. Therefore the wider impact on a larger economic scale and on the lives of non-borrowers is questionable (Hulme and Mosley 1996).

When analysing the impact of microfinance, the outreach towards the extreme poor and the chronic poor indicate questionable results as well. As discussed by Kimenyi (2007) and Yunus (1999) and cited by Santen (2010), skills to produce and market goods are important, but also human capital plays a major role in the achievements of MFIs in reaching the poor. Since many programmes handle group or village lending structures, social capital is necessary for one to be able to join a programme. Especially the chronically poor are often located in desolated areas (CPRC 2009). Isolated poor or individuals amongst the bottom poor that lack human and social capital tend not to become members of MFIs (Khandker, 1998). Microfinance can therefore never achieve a large enough outreach.

Khandker (1998) agrees with Hulme and Mosley and Kimenyi that the petty nature of the businesses and the low skilled levels of performance and knowledge of the borrowers are harming the sustainability of the growth that is achieved. In order for the poverty alleviation to be sustainable, an increase should be seen in productivity and income rather than in consumption. Khandker (1998) argues for more activities with

high growth potential to initiate long- term poverty reduction. In order to do this, an increase in loan size will be necessary.

Finally, it is argued (though highly debatable) that the commercialization of MFIs hamper the growth of Micro and Small scale enterprises; in fact some of them even collapse due to the high interest rates charge by the MFIs. Examples of these Micro and Small scale enterprises can be found in Ghana, and other developing countries. In the same countries there are some micro and small scale enterprises that have expanded due to the assistance of the MFIs. That is why I say it is highly debatable.

Suggestions for further research/study

- Factors accounting for the growth and collapse of micro and small scale enterprises (Clients of MFIs) in developing countries.
- Sustainability of Microfinance Institutions (MFIs) in developing countries.

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