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**Microcredit -**  
**A Way to Overcome Problems of Financial Markets**  
**in Developing Countries?**

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# Abstract

Fighting poverty is the overall goal of the Millennium Development Goals (MDG). Africa has highest percent of poor people in the world and in order to achieve the MDGs poverty and development trends must take a new turn in almost all African countries. The overall objective with this study is to analyse and discuss why financial markets work inefficiently in developing countries and hence fail to reach poor and how provision of microcredits could be a way to overcome these problems. This is done through a case study on the Grameen Bank in Bangladesh and a case study on the microcredit sector in Ghana. Financial markets in developing countries function inefficient mainly due to the high levels of asymmetric information and risk. Financial markets in developing countries are characterised by dual economies, segmented and fragmented markets and a lack of supporting institutions. Asymmetric information gives raise to problems with adverse selection and moral hazard and consequently problems with screening, monitoring and enforcement. Microcredits are believed to be a way to overcome these problems. The overall conclusion of this study is that the provision of microcredits has the potential to be a means to solve problems of financial markets in developing countries. However, there might be better ways to adopt microcredits to the African context. Therefore there needs to be more focus and research on Africa and the effect provision of microcredits have on poverty alleviation in Africa.

**Key words:** Poverty, Microcredit, Grameen Bank, Ghana

“Let us be clear: microfinance is not charity. It is a way to extend the same rights and services to low-income households that are available to everyone else. It is a recognition that poor people are the solution, not the problem. It is a way to build their ideas, energy and vision. It is a way to grow productive enterprises, and to allow communities to prosper.”

Kofi Annan

”Some regard private enterprise as if it were a predatory tiger to be shot. Others look upon it as a cow that they can milk. Only a handful sees it for what it really is - the strong horse that pulls the whole cart.”

Winston Churchill

## List of Abbreviations

ADB	African Development Bank
CU	Credit Union
GDP	Gross Domestic Product
GHAMFIN	Ghana Microfinance Institutions Network
HDI	Human Development Index
IMF	International Monetary Fund
MDG	Millennium Development Goal
NGO	Non Governmental Organisation
SAT	Sinapi Aba Trust
UN	United Nations

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# 1. Introduction

Over 1.2 billion people in the world are today living on less than one US dollar a day<sup>1</sup>. In year 2000 at the United Nations Millennium Summit world leaders agreed to a set of measurable goals in order to combat *poverty*. There are eight specific goals with the overall goal of poverty alleviation; they are today known as the Millennium Development Goals (MDG).<sup>2</sup> (The Millennium Development Goal Report, 2005) The development of *financial markets* is not one of the eight goals. However, development of financial markets and most important – access to financial services - could be a means to contribute to the achievement of all eight MDG:s.

Poor people are *not passive victims*. Anyone that has visited a developing country knows that poor people can not afford to be unemployed, every opportunity is taken. Developing countries are full of potential, but the lack of access to financial services makes it hard for poor people to start up business. This is due to high levels of asymmetric information and risks which are enhanced by characteristics specific of developing countries, such as dual economies, fragmentation and segmentation. In order to reduce the high risks, the formal sector requires formal forms of collateral, which is something poor people often lack.

A new way of thinking started to spur in *Bangladesh* in the mid 70. It was the thought that provision of small sums of credit to a group of individuals could challenge and solve some of the problems with financial markets in developing countries. Today the idea has spread around the globe and all major international institutions, such as the World Bank, the International Monetary Fund (IMF) and the United Nations (UN) have embraced the idea and are today promoting microfinance activities.

The provision of *microcredits* to poor people has been shown to help people work their own way out of poverty. Microcredit seems to provide outreach, impact and sustainability, and is challenging the traditional “trickle-down-approach” by the new “bubble-up-approach”.

*Sub Saharan Africa* (referred to as Africa in the rest of the study) consists of 48 countries, 34 of them are ranked the world’s poorest countries by the UN’s Human Development Index

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<sup>1</sup> <http://hdr.undp.org/statistics/data/> (2006-03-15)

<sup>2</sup> The eight Millennium Development Goals are; 1) Eradicate extreme poverty and hunger, 2) Achieve universal primary education, 3) Promote gender equality and empower women, 4) Reduce child mortality, 5) Improve maternal health, 6) Combat HIV/AIDS, malaria and other diseases, 7) Ensure environmental sustainability, 8) Develop a global partnership for development. (Greenhill, 2002, p. 7)

(HDI) in 2005 (Human Development Report, 2005, p. 221). In order to fulfil the MDG countries in Africa must reverse this poverty trend. The World Bank (2005) concludes in its report on “Doing Business in Africa” that Africa is a high-cost and high-risk place to do business (p. 5). This makes it very hard for poor people to find institutions that will be able to provide sustainable credit. Africa has the lowest level on access to credit among poor people and there are less microcredit institutions in Africa than on any other continent.

*Ghana* is like many other African countries faced with high levels of poverty. Ghana is experiencing political stability unlike many of its neighbour countries in West Africa. Ghana has a relatively developed financial market and there is a long tradition of money collectors in the country. In the last decades there has been an increase of microcredit institutions based on the Grameen lending system in Ghana.

Microcredits have become a prime component of development strategy worldwide, and the UN nominated year 2005 to be the year of microcredit. There are many factors to be considered in order to develop a sustainable microcredit program reaching poor. In order to achieve the MDG:s focus needs to be placed on Africa and the effect microcredits could have on poverty alleviation in Africa.



## **1.1 Purpose**

The overall objective with this study is to analyse and discuss why financial markets work inefficiently in developing countries and hence fail to reach poor and how provision of microcredits could be a way to overcome these problems. The study's purpose is to contribute to the on-going research on economic behaviour in the absence of perfect information and complete markets. This study particularly focuses on Africa, where there has been little previous research. Specifically the essay seeks to understand and analyse the four following sub-questions:

- (i) Why do financial markets in poor countries work inefficiently and hence fail to reach poor people?
- (ii) How can microcredit institutions be a means to overcome problems of financial markets in developing countries?
- (iii) What are the factors behind the success of the Grameen Bank in Bangladesh?
- (iiii) To what extent has Ghana the potentials for success in developing an efficient and sustained microcredit sector?

## **1.2 Data and method**

In order to understand the complexity of financial markets and microfinance a theoretical framework consisting of previous work on financial markets and microcredit institutions in developing countries has been constructed. The framework lays the foundation for the case study of the Grameen Bank in Bangladesh and the microcredit sector in Ghana.

The factors behind the success of the Grameen Bank are identified with help of two models by Harper (2002). The first model is looking at complementary factors that have contributed to the success in Bangladesh and the second model is looking at the balance between sustainability and outreach in microcredit institutions.

Bangladesh has the longest history of microfinance institutions in the world. The Grameen Bank in Bangladesh has experienced immense success and is today reaching millions of poor people. This makes the Grameen bank interesting for a case study.

Ghana is chosen since there is an existence of significant microfinance industry and a variety of informal and formal channels for microfinance. There is also a legal system and a regulatory framework in place. Ghana is also experiencing political stability, contrary to many of its neighbouring countries in West Africa. It is worth bearing in mind that the Grameen Bank and microcredits in Bangladesh has been subject to much more rigorous analysis and research than Ghana where there is less published material.

### **1.3 Delimitations**

The terms *microfinance* and *microcredit* are used throughout this study. The term *microfinance* refers to all financial services that low-income households need; such as savings, insurance and transfer services. The term *microcredit* refers to a small amount of money lent to a client by a bank or other institution. The possibility to save presents an important aspect of financial markets in developing countries, due to limitations this will only be discussed briefly. This study focuses on the provision of microcredits and especially on the form of group lending that has been developed from the Grameen Bank in Bangladesh. For distinct features of microfinance see appendix A.

The gender aspect is important when discussing microcredits. This study will due to limitations not focus particularly on the gender perspective, even if it will be discussed in more general terms. There is a whole range of literature and research on the effect microcredits has on different areas of society (for example child labour) this will not be discussed in this study due to limitations.

## **2. Financial markets**

*“To say that savings, credit and insurance are central to the functioning of an economy is a platitude.”* (Besley, 1995, p 2125) This might be true. However, financial markets and financial intermediates are important for economic development and in order to allocate resources efficiently. Financial markets acts as a link between lenders and savers. This chapter will discuss the importance of efficient financial markets in developing countries.

### **2.1 Definitions**

#### *Development*

Ray (1998) defines the primary objective of the majority of the world's nations as economic development, with the aim to raise income, well-being and capabilities for the population of the country (p. 7). Development can be measured in different ways, in this study I refer to development as economic development through the accumulation of physical and human capital.

#### *Poverty*

Nobel Prize winner Amartya Sen (1999) has stated that: *“poverty must be seen as the deprivation of basic capabilities rather than merely low incomes.”* (p. 47) Despite the different degrees and kinds of poverty, the definition used in this study is the one of the World Bank. The World Bank defines extreme poverty as living on less than US\$0.75 a day and poverty as living on less than US\$1 a day. (World Bank, Development Report 2006, p. 18)

### **2.2 Financial markets and development**

Economic development involves the accumulation of physical and human capital; this implies that once the limitation of self-finance is reached, credit transactions will have a central place in this process (Bell, 1988, p. 764). Economic growth is generally agreed upon as important and even essential in order to eliminate poverty and raise the living standards of poor people. Most economic models are based on the assumptions of full efficiency and perfect markets. However, if markets are characterised by market failure and the assumptions not fulfilled there will be an inefficient allocation in the market. Market failure is common on financial

markets. (Besley, 1995, p. 2123) In order to overcome the problems of inefficient financial markets it is therefore essential to find ways to solve market failure of financial markets.

### ***2.3. Financial markets in developing countries***

There are some common characteristics of financial markets in developing countries; dual economies, fragmentation and segmentation and lack of institutions and property rights. These characteristics will be discussed in this section.

#### *Dual economies*

The most important structural transformation that a developing economy goes through is the change from a predominantly rural economy to an industrial economy. The transformation is often accompanied by a move from traditional to modern forms of organisation. When these different forms of sectors coexist in an economy it is referred to as a dual economy. In the dual economy it often exist a formal and an informal sector. The Lewis Model explains growth in developing countries as the transition of labour between the two sectors in the dual economy. (Ray, 1998, p 395)

#### *Fragmentation and segmentation*

People in developing countries often stay their whole life in the same village. Local borrowers and lenders can thereby acquire relevant information of each other's resources and characters. Rural credit markets are therefore highly fragmented into different segments and there are barriers to entry. (Bell, 1988, p. 768) Within each segment of the market (each village) there is complete or nearly complete information and outside the segment there is almost non existent information. (Ibid, p. 769) It is not only the village structure that creates the fragmented market. The fragmentation occurs for different reasons, for example gender, occupation, ethnic devices or religion. (Robinson, 2001, p.157) This might result in an inefficient allocation of funds, and groups that would gain from a flow of funds between each other instead restrain from trading with each other. (Besley, 1995, p. 2135)

#### *Lack of institutions and property rights*

In order for financial intermediaries to be efficient they need support from a legal and regulatory framework. The establishment and enforcement of laws concerning property rights,

contracts, bankruptcies, default, mortgage and collateral is absolutely fundamental in order for the entire financial system to function efficient. Otherwise there will be high costs due to the high uncertainty and the increased risk. (Eggertsson, 1994, p. 35) In developing countries, particularly in rural areas, the important institutional foundation is often absent. This creates problems since lenders need a system that provides formal procedures for enforcement of financial contracts. If the process of enforcement is costly and there is high risk it will result in fewer lenders willing to lend out credit. The lack of laws, regulation and institutions are in many countries preventing the formal sector to deliver credit to poor borrowers. (Yaron, Benjamin and Charitonenko, 1998, p. 147)

It is also essential that other complementary institutions are in place a country. Problems occur in developing countries since the education sector is often underdeveloped which leads to high numbers of illiteracy and innumeracy. Development of infrastructure is another example of an often poorly developed sector. Difficulties with communication and transportation within the country raise the cost of formal banking for many individuals. (Besley, 1994, p. 33)

### **3. Actors on the financial market**

The financial market is like all markets determined by supply and demand. In a perfect market there should be equilibrium where supply meets demand. However, financial markets experience high levels of market failure and there is a gap between demand and supply. This chapter will look at the different actors that supply and demand financial service.

#### **3.1 Credit Lenders (Supply)**

Formal and informal institutional lenders work and function in different ways, this will be analysed and discussed in section 3.1.1 and 3.1.2. All financial institutions must nevertheless meet the break-even condition, that is net income must be at least equal to total expenditure (Hulme and Mosley, 1996, p. 19).

Bell (1988, p. 770) has categorised the different factors that make up the lender costs. These costs are usually covered by the interest rate;

- The opportunity cost
- The cost of administrating the loan
- A premium to cover the possibility that the borrower might face involuntary default or strategic default.

##### **3.1.1 Formal Lenders**

Formal lenders are government banks, commercial banks and rural banks. The formal sector is only covering a relatively small part of the population, mainly the wealthier and more political influential part of the population. This part is usually living in urban areas. (Besley, 1995, p. 2172)

The main problem faced by formal lenders is the lack of personal knowledge concerning the characteristics and behaviour of their customers (Ray, 1998, p. 532). Formal lenders therefore often require formal forms of collateral in order to reduce risk. In case of default it would be too costly for the bank to sell for example land or cattle that had been accepted as collateral.

(Ibid, p. 534) The large part of the population in developing countries is often situated in rural areas and experience shortage in physical capital and formal collateral.

### **3.1.2 Informal lenders**

The informal sector is widely diverse. *First there are financial flows between relatives, friends and community members.* These loans are usually charged without interest rate and handle the day-to-day cash problems of households to meet consumption and production needs. (Ray, 1998, p. 538) Loan between family members are also used to pay for education, repayments appear as urban-to-rural remittance. The main enforcement mechanism for these kinds of loans tends to be informal social sanctions. (Besley, 1995, p. 2176)

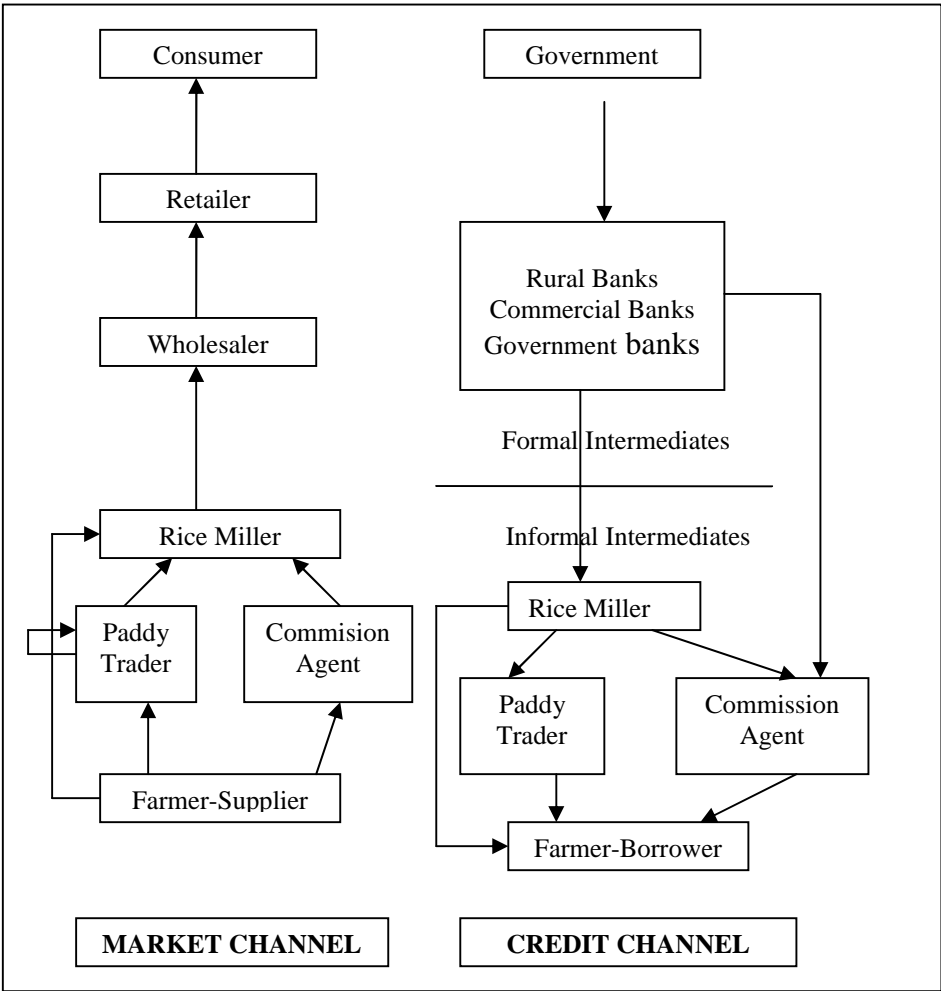
*Second, there are cooperatives, rotating savings and other self-help associations.* (Ray, 1998, p. 538) The informal credit associations have different names all over the world; in Ghana it is called Susu, in China it is called Hui and in India it is called Chit Funds. They operate by having a group of individuals putting a certain sum of money into a pot, which each period is given to one of the members of the association. The system repeats itself until everyone in the group has received the sum of money. These kind of financial services rely on social sanctions to ensure that an individual continues to contribute after he/she has won the sum of money. (Besley, 1995, p. 2176)

*Third, there are money lenders and informal banks.* They usually operate with a very high interest rate and most loans are given to individuals that the informal lender has a personal relationship to, in order to reduce risk. (Besley, 1995, p. 2180) Moneylenders are often the last resort for the borrower; this makes it possible for the lender to charge high interest rates. The high interest rates could be motivated by the fact that there are high cost associated with screening loan applicants and enforcing repayment in developing countries. There are also high default rates. (Stiglitz, 1990, p. 351) There seems as there is both a willingness and ability to pay a high interest rate in order to achieve credit.

### 3.1.3 Linkages between Formal and Informal Lenders

The last decades there has been a new attempt to try and combine the formal and the informal credit sectors. The formal sector has proved more efficient in intermediating funds over a long term and reaping scale economies whereas the informal sector have solved the information and enforcement problems in a better way. (Besley, 1995, p. 2182) Often there are natural linkages between the two sectors, informal lenders often borrow from formal lenders and then they borrow to the part of the population that would not qualify for credit for the formal institutions (Ray, 1998, p. 538). See figure 3.1

**Figure 3.1 Linkages between the formal and informal sector**



Source: Ray, 1998, p. 538



### **3.2 Credit borrowers (Demand)**

In a way to overcome the time lag of economic activities, people borrow money which they later repay with future payoff from their investment. (Ray, 1998, p. 529) There are different kinds of capital; *fixed-*, *working-* and *consumption capital*. *Fixed capital* is capital required in order to purchase and organise fixed input factories, production processes, machines and warehouses. This is the capital that is important when determining the overall growth of an economy. *Working capital* is used in order for production to run efficiently and to smooth the lag between production expenses and sales income. Low-income borrowers are typically demanding short-term working capital loans. *Consumption capital* is demanded by poor individuals reaching financial problems in case of a sudden down turn in production, when a crop fails or faced if with illness. (Ibid p. 531)

#### *Involuntary default*

If the borrower values his/her collateral, good reputation and future access to credit he/she will only default if he/she is unable to repay the loan out of current income (Bell, 1988, p. 771). There is despite this a relatively high level of default in the formal sector in developing countries. The borrower might be unable to repay the loan either if the loan is being invested in a too risky activity or if the loan is invested in activities that are hard to turn into monetary repayment, such as education. (Ray, 1998, p. 529) Developing countries are often exposed for external shocks such as poor weather or a change in commodity prices on the world market. This could also explain the high default rate in the formal banking sector. (Besley, 1995, p. 2173)

#### *Voluntary or strategic default*

If the borrower is able to repay the loan but decides not to, it is referred to as voluntary or strategic default. (Ray, 1998, p. 529) This reflects the difficulties of the formal bank sector to enforce borrowers to repay the loan. Voluntary default occurs not only in formal markets but also in informal markets. For a young worker with no social or family connections in the village the best strategy might be to lend money and then literally run. (Bell, 1988, p. 771) The gender perspective is an interesting aspect in this situation. It is not socially accepted in many developing countries for young women to leave their village and start up a life by their own.

## 4. Problems with financial markets

Poor people are most likely to be excluded from the formal financial markets, since they lack reliable collateral, are less likely to be literate and numerate, are faced with higher transactions costs and often lack the influence that is needed in order to obtain a loan. (Besley, 1995, p. 2196) This section presents an overview of the problems associated with financial markets.

### 4.1 Asymmetric Information

Similarly to other markets, the financial market is faced with market failure. It takes the form of *asymmetric information*. Long (1994) illustrates the problem of asymmetric information as: “When two parties enter a contract, one may have information that would - if it were known to the other party – change the nature of the contract.” (Calomiris and Himmelberg, 1990, p. 147) Asymmetric information can be divided into *adverse selection* and *moral hazard*, which give rise to problems of *screening* and *enforcement*. These problems become more severe in developing countries since there is a lack of information and data concerning potential bank clients, and due to the specific characteristics of financial markets in developing countries. (Hulme and Mosley, 1995, p. 1)

#### 4.1.1 Adverse Selection

Adverse selection occurs when one part has more information than the other part (almost always the case) and when one side of the market cannot observe the other side of the market. (Varian, 1999, p. 648) The lender has all incentives to present him/her as a reliable character even if he/she is not; this can be referred to as “*hidden information*” (Bell, 1988, p. 765). This creates a problem for the lender since he/she might not be able to observe certain characteristics of the borrower that would be valuable (Besley, 1995, p. 2131).

Both formal and informal credit lenders are faced with the problem of *screening*. Formal credit lenders often lack personal knowledge of the borrowers. In developing countries there is also a problem with lack of written accounts and business plans, resulting from low levels or lack of education. (Hulme and Mosley, 1995, p. 2) The problems of adverse selection and

screening might lead to a reduction of loans, which could result in too little investments being made in a country.

#### **4.1.2 Moral hazard**

Moral hazard illustrates the problem of not being able to control the behaviour of the borrower after he/she has received the money. There is a situation in where one side of the market cannot observe the actions of the other. (Varian, 1999, p. 648) This can be referred to as “*hidden actions*”. The lender has all incentives to act in another way than would be optimal for the borrower. (Bell, 1988, p. 765) The borrower may for example be tempted to switch the original project for a more risky one and it is likely that the borrower is less concerned with the success of his project if it is not his own money that is at stake (Besley, 1995, p. 2131).

Moral hazard creates a problem with *enforcement* (Besley, 1995, p. 2131). The lender must ensure that borrowers follow their plans and some kind of *monitoring* must be conducted. This imposes a cost to the lender. The lack or underdevelopment of institutions enforcing credit in developing countries (such as the police and courts) increases costs of enforcing repayments of loans. In developing countries there is also often a problem with poorly defined property rights. (Besley, 1994, p. 33)

### **4.2 Mechanisms to reduce asymmetric information and risk**

There are different ways to conquer the problems of screening, monitoring and enforcement in financial markets. Formal markets have traditionally handled these problems with the use of the interest rate and requirements of formal collateral. These mechanisms are not as well adapted to the informal market.

#### **4.2.1 The interest rate**

One of the most important indirect mechanisms to reduce risk is the interest rate. Banks try to make sure that the interest rate on a loan will cover the level of risk on the loan. (Stiglitz and Weiss, 1981, p. 393) If the interest rate is raised in order to balance losses from default, it has

the function of a screen which regulates the risk of the composition of the loan portfolio. (Varian, 1993, p. 607) If a project is successful the lender will normally receive repayments and a fixed rate while the borrower will collect the residual profit. If the project fails both parties will be hurt and have to face loss. Lenders want to be compensated for this risk and therefore they tend to apply high interest rates. (Besley, 1994, p. 35)

The problem with adverse selection and screening creates a dilemma. This happens for two reasons; first, a higher interest rate will to a larger proportion attract high-risk borrower, since they are aware that their possibilities to repay the loan are low they are the ones most likely to be willing to pay the high interest rate. Second, the high interest rate is also decreasing the return on succeeded projects; this has the implication that a high interest rate encourages firms to undertake projects with lower probabilities of success but higher payoffs when successful. (Stiglitz and Weiss, 1981, p. 393) This makes it hard for borrowers to reduce the risk in an optimal way by using the interest rate. Instead credit will be granted borrowers that have secure collateral.

#### **4.2.2 Collateral**

Collateral is frequently used as a screening device to overcome adverse selection and an enforcement device to overcome moral hazard. The most common forms of collateral are fixed assets, such as land or buildings. (Besley, 1995, p. 2132) However, collateral can take many different forms; it could be anything from property rights, land, and labour or even something as a rationing card (Ray, 1998, p 546). Formal credit lenders might not accept less formal forms of collateral since it would be too costly for the bank to sell for example land or cattle in case of default (Ibid, p. 534).

These less fixed forms of collateral are more common on the informal financial market. In developing countries land rights and property right are for example often not well formed which makes it hard for poor people to put up collateral. (Besley, 1995, p. 2132) The collateral needs to be regarded highly of either both the lender and the borrower, or of the borrower but not the lender (Ray, 1998, p. 546).

### **4.3 Concluding remarks**

Financial markets in developing countries works inefficient mainly due to the high levels of *asymmetric information* and *risk*. Asymmetric information gives raise to problems with *adverse selection* and *moral hazard* and consequently problems with *screening*, *monitoring* and *enforcement*. These problems become even more sever in developing countries, since the financial markets there are characterised by *dual economies*, *segmented* and *fragmented* markets and a *lack of supporting institutions*.

Poor people often lack formal forms of collateral, such as land or property, which normally is required by formal financial institutions. This raises transaction costs and lead to poor people getting excluded from the formal financial market. The informal financial institutions have been better at solving problems of asymmetric information and of reducing risks. The informal institutions are however not as good as the formal financial institutions at reaping economies of scale and large outreach in lending. This creates a gap between demand and supply on the financial markets and leaves large parts of the population in developing countries without access to credit. Without access to credit it is hard for poor people to change their situation.

## **5. Microcredit**

Microcredit refers to the provision of financial small loans to poor and very poor self-employed people. These people are often (due to problems discussed in previous sections) excluded from the formal market and instead they seek credit on the informal market. This section will focus on microcredit as a way to overcome problems of asymmetric information and characteristics of financial markets in developing countries.

### ***5.1 Different forms of microcredits***

The term microcredit refers to wide range of different financial intermediates; from the traditional moneylenders, pawnshops, friends and relatives to the Grameen type of microcredit (discussed in chapter 6). Different lenders have different aims with the provision of credit; a money lender is more likely to be motivated by profit than the Grameen Bank which focuses on poverty alleviation. This makes it important to distinguish between different forms of microcredit in order to minimise confusion. Muhammad Yunus, founder of the Grameen Bank, recently came up with a classification system of ten different forms of microcredit (see appendix B).

This study will focus on the Grameen type of group lending; the basic principle is to lend to groups of individuals rather than to specific individuals. All group members become jointly responsible for each member's loan; this creates a form of social collateral and the system works as both a screening and enforcement mechanism. (Harper, 2002, p. 171) The Grameen lending system will be discussed in more detail in next chapter, this chapter will look at how provision of microcredits could be a means to overcome problems of financial markets in developing countries.

### ***5.2 Can microcredit overcome problems with financial markets?***

This chapter will first look at how provision of microcredits can overcome problems with asymmetric information and thereby increase efficiency of financial markets, second, look at a model by Harper (2002) that describes the need for microcredit institutions to balance sustainability and outreach in developing countries.

### **5.2.1 Microcredit and market failure**

The problem with asymmetric information in developing countries becomes more severe due to the specific characteristics of financial markets in developing countries, such as dual economies, fragmentations and segmentation of the markets. Microcredit can serve as a mechanism to overcome the problems of screening, monitoring and enforcement that arise from asymmetric information.

#### *Social collateral*

Peer monitoring is an important mechanism for overcoming problems with screening, monitoring and enforcement. The asymmetry of information is reduced through self-formed groups. Individuals in the group possess information about each other that banks cannot obtain without substantial costs. (Stiglitz, 1990, p. 353) Besley (1995) refers to this as social-collateral; one individual serves as another individual's guarantor and pledge her own collateral for another person. The social collateral may also take the form of peer group punishment. The peer punishment makes default costly to the borrowers. (p. 2132) Group lending is taking advantage of the fact that members of the group provide information and enforcement mechanisms (Ibid, p. 2186).

#### *Screening problem*

Group lending presents a way to overcome problems with screening. When individual are gathered in self-formed groups within the same segment, they will have information advantage over formal financial institutions. The members of a group will be able to screen out bad borrowers. (Stiglitz, 1990, p. 362) The fact that if one borrower defaults, no group member is allowed to borrow again, creates another incentive to screen out bad borrowers (Ray, 1998, p. 578). Group lending takes advantage of the fact that borrowers within the same segment have close to full information of the behaviour of the other members of the group.

Self-formed groups tend to drive risky borrowers out of the market, since the risks of the project is borne by the other borrowers instead of the bank alone. (Ray, 1998, p. 580) There is a danger that members of the group will be over conservative in their choice of projects, which could result in that socially beneficial projects will be turned down due to the risk of private losses for all members if one member default. (Ibid, p. 581)

### *Monitoring and the enforcement problem*

Members of groups must be given incentives to monitor other members of the group. In the Grameen Bank this is done through jointly responsibility for repayment of loans and no member have access to further credit until all members have repaid their loans. (Stiglitz, 1990, p. 180) In a small group the risks are higher if one member *involuntarily defaults* since there are fewer members that will bear the costs. However, the incentive for members to monitor other members is higher in a small group and it is easier to avoid free-riding in a small homogenous group. (Ibid, p. 361) Administrative costs might be higher in a small group than in a large group, due to loss of economies of scale. (Hulme and Mosley, 1996, p. 27)

The problem with group lending is if one member of a group experience *voluntary default* or if the borrower might run in to genuine problems of repaying the loan, *involuntary default*. The first problem is believed to overcome with social pressure and screening; the second problem is more problematic. In case of genuine problems of repaying the loan, there could be incitements for other members of the group to also default on their outstanding loans. This might happen due to the fact that one member's involuntarily default destroys future loans for all members of the group. This problem could be overcome by lending sequentially to group members. This is done by the Grameen Bank. Sequential lending also minimizes the possibility of a coordination failure, a situation in where all members are solvent but each member declares default in the expectation that others would as well. (Ray, 1998, p. 580)

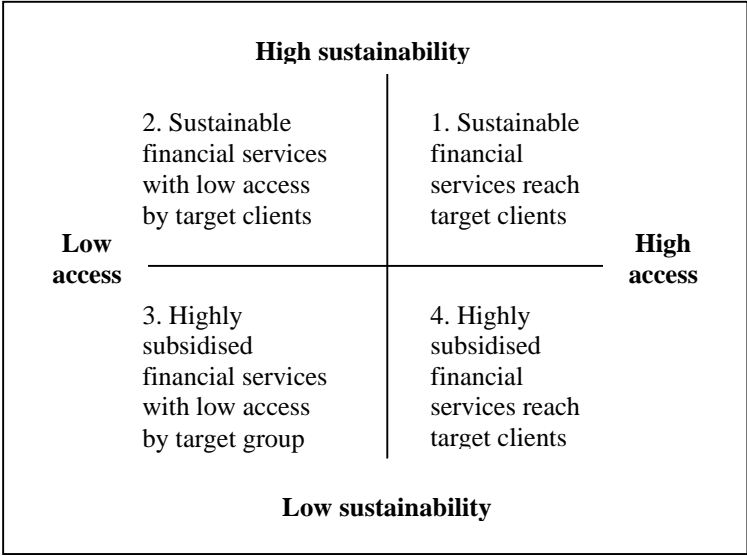
### **5.2.2 Balance sustainability and outreach**

The potential of microcredits to reach a large number of people is today well understood (Robinson, 2001, p. 9). Microcredit managed in the right way has also the potential of sustainability and self-generating funding in the long run.

Harper (2002) illustrates the problems of balance and combining outreach and sustainability in figure 5.1. The formal sector often shows high sustainability but little outreach to poor clients (quadrant 2). Traditional efforts by NGOs may reach poor but are often unsustainable (quadrant 4). Good microfinance combines both sustainability and outreach (quadrant 1). The worst case scenario is when financial services are heavily subsidised and has low outreach (quadrant 3). (p. 20) Microfinance therefore seems to have the possibility of providing a way to target poor people without creating a donor dependency in the long run.



**Figure 5.1 Combining outreach and sustainability**



Source: Harper, 2002, p. 20

*Sustainability*

In order for microcredit institutions to become a permanent and dynamic part of society it needs to reach sustainability. The term sustainability refers to everything from ability to find and maintain donors to the ability to cover all costs. (Harper, 2002, p. 188) The basic condition is that break-even is met and that the funding is secured in the long-run (Hulme and Mosley, 1996, p. 27). There is a risk that microcredit institutions become too donor dependent, since the presence of donors can not (or should not) be a permanent solution in a developing country. In the initial phase, there might be start-up costs that require additional funding, but it is essential that the donor reliance is reduced over time.

In order to achieve sustainability, institutions need to minimise the administrative costs. When lending to a group of individuals, there are economies of scale which lower the administrative costs of the borrower. (Hulme and Mosley, 1996, p. 27) In developing countries people often demand small and uneconomic sums which have high administrative costs since there are little economies of scale (Ibid, p. 2). The interest rate needs to be set at a level that ensures sustainability. Studies show that poor people have a willingness and ability to pay a high interest rate in order to obtain access to finance. (World Bank, 1998, p. 4) This shows that the problem is not ability or willingness to pay a high interest rate, the problem is rather that poor people lack access to credit.

Daley-Harris (2002) agree that microcredit institution has the potential of sustainability, but stress that there are a whole range of factors that needs to be taken into consideration in order to achieve sustainability (p. 67). One particularly important factor is the presence of diseases in developing countries. Dunford (2002) points out that in some countries HIV/AIDS epidemic is so severe that it threatens the sustainability of microcredit institutions. The epidemic is reducing the loan portfolio, decreasing client retention and microcredit institutions are faced with death of experienced staff members. (p. 98)

### *Outreach*

One of the most important aspects of microcredit institutions is the ability to reach those poor people that are excluded from the formal market. The term outreach is not only referring to the geographic coverage, but also to the number of members and the volume of lending. (Khandker, 1998, p. 84) This section will first look at the potential of microcredits to reach the poorest part of the population and second how microcredit institutions target women.

Studies have indicated that microcredit institutions are not reaching the poorest part of the population. This is for example reflected when self-formed groups are chosen, the poorest people are often excluded, since they are considered to be “too poor” for group membership (Hulme and Mosley, 1996, p. 130). It could also be a consequence from the fact that poor people might be afraid they will not be able to live up the requirements of weekly savings and weekly meetings (Harper, 2002, p. 188). The problem of group formation can to some extent be overcome by the use of an upper level of income and wealth in order to obtain loans and member partnership. As discussed earlier, as long as all group members have the same low level of income it should not create a problem.

Microcredits have the potential to have powerful impact on women’s empowerment. Daley-Harris (2002) finds that most women experience some degree of empowering when their financial situation is improved and they can contribute to the family’s economy (p. 213). Studies have found that women perform better than men in managing meagre resources and promoting micro enterprises. There is also evidence indicating that the “*ego problem*” of men makes it difficult for them to beg for small sums of money, additionally is cultural practice often preventing men from engaging certain businesses such as hair-dressing and petty-trading. (Anyanwu, 2004, p. 5) Women tend to place a higher value on improvements of well being, such as enhancing the household’s nutrition level and increased opportunities for

children's education. (Mosley and Rock, 2004, p. 483) This factors stress the importance for microcredit institutions to target women.

### **5.3 Concluding Remarks**

Asymmetric information gives rise to problems with screening and enforcement. There is a possibility of taking advantage of the different characteristics that occur on the financial markets in developing countries and thereby overcome the problems with asymmetric information. In fragmented markets there is often complete or nearly complete information in the different segment. The construction of self-formed small groups within each segment will provide members information that formal banks do not have access to. When members of the group are jointly responsible for each member's loan; the group will act as social collateral. This reduces both the problem of screening and enforcement, since members of the group will choose members with low default risk and there will be social pressure not to default.

Microcredit has the potential of being self generating. In the beginning there might be a need for external support in order to cover the initial start-up costs, but in the long run funding of microcredit institutions have to be sustained and donor-dependency reduced. In order to obtain sustainability it is important to reduce administrative cost and gain economies of scale. It is important to remember that poor people show both willingness and ability to pay high costs for credit.

In order for microcredit institutions to be successful they need to have a good outreach, not only geographically, but it needs to reach the poorest parts of the population. There have been indications that microcredits seldom reach the poorest segments in the society. This could partly be solved by putting an upper limit to wealth and income in order to achieve a loan. However, there is a risk that the most vulnerable groups such as disabled and ill people are not targeted. Microcredit might not be the appropriate way to improve the situation and eliminate poverty in these segments. Women have been particularly targeted since studies shows better results with female borrowers, since women tend to invest in less risky and more socially beneficial activities than men.

## 6. Experiences from Bangladesh – The Grameen Bank

There are today over 1000 microcredit institutions operating in over 40 000 villages in Bangladesh.<sup>3</sup> The most successful institution is the Grameen Bank, which has inspired and spurred microcredit institutions worldwide. The Grameen Bank is rather unique in that sense that it has succeeded in both outreach and sustainability. (Ray, 1998, p. 584) Most microcredit institutions in Africa have relied on the Grameen model when starting up microcredit institutions (Mosley and Rock, 2004, p. 468). This makes it particularly interesting to look at the factors behind the success of the Grameen Bank in Bangladesh. For basis facts about Bangladesh see appendix C.

### 6.1 Brief history of the Grameen Bank<sup>4</sup>

The Grameen Bank started out as an experimental project in 1976 by the Bangladeshi professor Dr. Muhammad Yunus. He wanted to test the hypothesis that poor people can generate self-employment without external help if they are merely given financial resources and credit at reasonable interest rates and under appropriate conditions. (Bernasek, 2003, p. 371) Dr. Yunus explains the idea behind the Grameen Bank as following: *“You look at the smallest village and the tiniest person in that village: a very capable person, a person desperate to work. You have only to create the proper environment to support these people so that they can change their lives through their won efforts”*. (Bornstein, 1996, p. 3)

In 1983 the project was turned into the Grameen Bank, with government holding of 90 percent of the shares in paid-up capital and under a special law. In 2005 the governments shares had decreased to six percent and 94 percent of total equity were owed by the members of the Grameen Bank. The Grameen Bank had in 2005 over 5,58 million borrowers and 96 percent of them were women. The loan repayment rate is an exceptional 99,01 percent. The Grameen Bank has not received any donor funds since 1998, the existing growing deposits are enough to both expand its credit programs and repay current loans. The Grameen Bank has four different interest rates, 20 percent for income generating loans, 8 percent for housing

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<sup>3</sup> <http://www.yearofmicrocredit.org/docs/countryprofiles/Ghana.doc> (2006-03-16)

<sup>4</sup> Grameen comes from the Bangla word gram which means village, and like the name implies it is in the villages that the Grameen Bank operates and function. (Bornstein, 1996, p. 3)

loans, 5 percent for student loans and 0 percent for struggling members.<sup>5</sup> This study focuses on the income generating loans.

## **6.2 Factors of success of the Grameen Bank**

The reasons behind the success of the Grameen Bank in Bangladesh have given rise to much research and literature. This study focuses on three issues. First, the construction of the Grameen Bank's lending system and how it deals with market failure and asymmetric information, second, three complementary factors identified by Harper (2002) as contributing to the success, third an analysis of the balance of sustainability and outreach in the Grameen model.

### **6.2.1 The Grameen Bank lending system**

Yunus (2005), Khandker (1998), Montgomery, Bhattacharya and Hulme (1996) and Elahi (2003) have identified seven special features of the Grameen Bank;

- 1. The provision of loans to generate income*
- 2. The use of social rather than economical collateral.*
- 3. Decentralised structure*
- 4. The high number of motivated and dedicated field staff.*
- 5. The routine collection of weekly instalments of small amounts of money.*
- 6. The promotion of savings mobilisation.*
- 7. The use of a positive interest rate*

The Grameen Bank gives loans to a group of individuals, rather than to specific individuals. Each borrower is individually responsible for repayments of the loan and each client has an individual savings and loan account. If one of the members defaults, all members of the group will be sanctioned. Potential clients to the Grameen Bank are asked to form groups of five members, which are then organised into centres with five to seven of such groups. The formation of this system facilitates the intermediation process. (Harper, 2002, p. 171) It is in the end the group and not the Bank that evaluates loan proposals (Bornstein, 1997, p. 2).

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<sup>5</sup> <http://www.grameen-info.org/bank/GBGlance.htm> (06-02-24)

The lending system requires a strict and dedicated organisation with weekly meetings supervised by bank staff. The weekly meetings serve as an important platform for inspiration and it is also here that savings and repayment are collected. (Harper, 2002, p. 172) The idea is to lower transactions costs for the borrower by collecting loan repayments each week at the same place and the same time near the borrowers' premises. This increases pressure on the borrower to repay the loan. (Hulme and Mosley, 1996, p. 24) All members make regular savings which provides an insurance mechanism for the program and institutions in case of default (Harper, 2002, p. 171).

### **6.2.2 Complementary factors of success of the Grameen Bank**

Harper (2002) stress three complementary aspects on the success of the Grameen Bank in Bangladesh; the densely populated areas, social and economically homogenous borrowers and the Bangladeshi Institutional set-up.

#### *Densely populated areas*

Groups in the Grameen Bank meet once a week, less frequent meetings have been proven less successful. Bangladesh has a high population density of 1061 persons per km<sup>2</sup>. (Harper, 2002, p. 178) The Grameen system, based on the assumption on strict regulation and frequent meetings, is better suited in densely populated areas where the transaction costs of attending meetings are lower.

#### *Socially and economically homogenous*

The Bangladeshi village communities are socially and economically homogenous, most people are poor and the large part of the population is Muslims. There is for example less divergence than in the neighbour country India. This might make it easier to persuade people to join together in groups and centres and it might reduce the level of fragmentation within villages. (Harper, 2002, p. 178) The fact that there is an overall demand for access of credit in the whole society might also facilitate mobilisation of the demand for microcredits.

#### *Institutional set-up*

The institutional set-up in Bangladesh is likely to have influenced that way that the Grameen Bank has developed its lending system. (Harper, 2002, p. 179) The Grameen Bank is protected by an act of Parliament from regulatory interferences; the other around 1000

microcredit institutions in Bangladesh is however not regulated. This has raised concern in Bangladesh, since there are still a growing number of institutions that lack regulation.<sup>6</sup> The fact that the Grameen Bank was able to receive protection and support in the initial state has probably contributed to the success.

### 6.2.3 Sustainability and outreach

#### *Sustainability*

The Grameen Bank is today able to sustain funds and cover its costs. The Grameen Bank has not received any donor funds since 1998, the existing growing deposits are enough to both expand its credit programs and to repay current loans<sup>7</sup>. The Grameen Bank has been able to use the initial donor funds in a way that has secured long-run sustained funding. The Grameen Bank is charging a higher interest rate than commercial banks. (Khandker, 1998, table 5.3) The interest rate is still lower than interest rates charged by microcredit institution in for example Latin America. The Grameen Banks' large number of borrowers reduces the administrative costs in a way that has made it possible to maintain the interest rate at a relative low level compared to other regions.

Bangladesh has a low spread of HIV/AIDS. The HIV prevalence is less than one percent, there is nevertheless always an uncertainty of the actual number of people infected with HIV.<sup>8</sup> Poor people are often faced with lower immune system due to malnutrition. This of course affects the ability to managing businesses, but there is no specific epidemic in Bangladesh that is threatening sustainability of microfinance institutions. Another important aspect is that the provision of credit is likely to enhance the levels of nutrition and hence health in society.

#### *Outreach*

The Grameen Bank has an extensive outreach (Gallardo, 2001, p. 3). In order to reach the poorest parts of the population, staff from the Grameen Bank is visiting each members home to assess the poverty level before members are formally admitted to the group. The strict forms for the Grameen Bank lending and the weekly meeting makes it hard for members to try and hid information about wealth and income level. (Harper, 2002, p. 189) The system is

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<sup>6</sup> <http://www.yearofmicrocredit.org/docs/countryprofiles/Bangladesh.doc> (2006-03-16)

<sup>7</sup> <http://www.grameen-info.org/bank/GBGlance.htm> (06-02-24)

<sup>8</sup> [http://data.unaids.org/Publications/Fact-Sheets01/Bangladesh\\_EN.pdf](http://data.unaids.org/Publications/Fact-Sheets01/Bangladesh_EN.pdf) (06-03-25)

very dependent on the high number of staff, and the groups are to a large extent driven by the staff. The high number of staff makes it possible to have a stricter control of the borrowers and to also have a higher outreach. (Harper, 2002, p. 185) The Grameen Bank prefers female members to male members, approximately 96 percent of the borrowers are women.<sup>9</sup>

## **6.4 Concluding remarks**

The Grameen Bank has been able to construct a successful way of handling its loans and the system has served as a model in the microcredit sector. The Grameen system has a high reliance on the social collateral and a strict system with weekly meeting supervised by a large number of motivated staff. There is therefore a high level of decentralisation.

Bangladesh is a very densely populated country with a poor homogenous population; these are other important factors behind the success of the Grameen Bank. The institutional set-up has helped the Grameen Bank. The Grameen Bank was in the beginning receiving donor support both from the Government of Bangladesh but also from the public (mainly foreign aid). Over the years the bank has been able to sustain the funding and at the same time maintained a high outreach. The fact that the bank has managed to decrease the reliance on external funds is an essential factor behind the success.

The fact that the Grameen Bank was established and developed driven by the strong belief and enthusiasm of its founder is a factor that has to be taken into account. It is an endogenously initiated process by a Bangladeshi professor and not another project externally imposed on a developing country. The success of the first project created a positive circle. The success increased the demand for microcredits, which spurred new microcredit institutions and foreign donors channelled large amounts of aid into the growing microcredit industry. This increased the awareness of microcredits among poor people in Bangladesh, which led to a raise in the demand.

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<sup>9</sup> <http://www.grameen-info.org/bank/GBGlance.htm> (06-02-24)



## **7. Microcredit in Africa**

In this study there is often a reference to Africa as one. It is however important to remember that the continent Africa constitutes of 48 different countries with different colonial history, different religions, different levels of human capital and faced with different problems. However, the countries of Africa are at the same time faced with many similar problems and it is the only continent in where almost all countries are facing problems with reaching the MDG. There has been little research on provision of microcredits in Africa. This section aims at highlight this factor and serves as an introduction to the case study of Ghana in next section.

### **7.1 Access to credit in Africa**

Compared with other continents Africa is experience lower levels of savings and less access to credit. There is also less microcredit institutions in Africa than in other continents in the world. Less then 8.5 percent (5.2 million people) of the poorest families in Africa have access to credit<sup>10</sup>. This can be compared with Asia where 38 percent (59.9 million people) of all the poorest families have access to credit. (Gibbons and Meehan, 2002, p.6) See figure 7.1 on next page.

There are over 900 microcredit institutions in the world; approximately 260 of them are located in Africa (Fiddler and Paxton, 1997, p. 1). The challenge in Africa is to build capacity in the financial markets sector by drawing on the lessons learned from international “best-practice” institutions but at the same time adapt these lessons and systems to the African context.

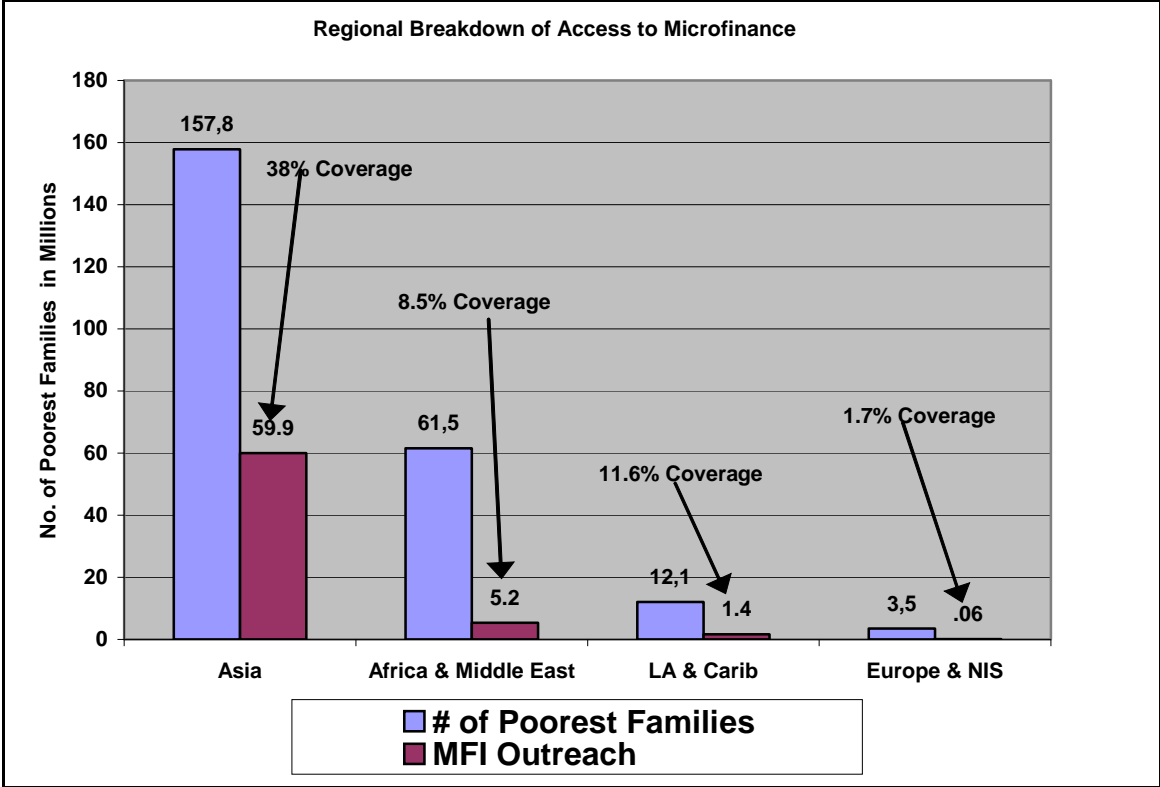
The high levels of poverty combined with slow growth in the formal sector have forced a large part of Africa’s population to enter self-employment, employment in small indigenous enterprises or to rely on small-scale agriculture for survival. (World Bank, 1998, p. 2) There are calculations that over 50 percent of financial activities in Africa are conducted in the

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<sup>10</sup> The statistics is including North Africa and the Middle East which indicates an even lower percentage for Sub Saharan Africa.

informal sector and therefore not part of the official statistics. (Skr. 1997/98:122) These people need access to credit in order to conduct business in a successful way.

**Figure 7.1 Regional Breakdown of access to Microfinance<sup>11</sup>**



Source: Gibbons and Meehan, 2002

The high HIV/AIDS prevalence in Africa is another problem. High rates of people with HIV result in default, either because people are too ill to work or because they have to pay medical costs for family members. There are also problems with other diseases such as malaria, tuberculosis and diarrhoea. One way to target this problem is to link microcredit services with education in health, many microcredit institutions are also providing clients with condoms. (Economist, 2001, p. 44) This shows the need for further research in this area. Different forms or lending systems might be more appropriate in fighting the problems and in order to achieve sustainability of microcredit institutions in Africa.

<sup>11</sup> <http://www.microcreditsummit.org/pressinfo.htm> (06-02-19)

## **8. Case study on Ghana**

Ghana is chosen for a case study since it in the last years has evolved a growing microcredit industry in the country and there is a legal and regulatory framework in place. Ghana has a relatively developed financial market and the country is experience political stability. The study will focus on the microcredit sector that has been developed in recent years and which has similar features to the Grameen Bank's group-lending system. Other forms of credit institutions in the semi-formal and informal sector, such as Credit Union and Susu collectors will only be briefly discussed. See appendix D for basic facts about Ghana.

### ***8.1 Macroeconomic context***

Ghana has a population of about 20 million people and the population growth is about 3 percent a year. Recent statistics (2005) indicate that 63 percent of the population lives in rural areas and 37 percent in urban areas. Ghana has an annual growth rate of 4,5 percent, and a relatively high inflation rate of 11,8 percent (ADB, 2005, p. 3). The economy is heavily dependent on world market commodity prices, especially on cocoa, which make it vulnerable to external shocks (Gallardo, 2001, p. 9).

Estimates from the Ghana Living Standards Survey indicate that poverty in Ghana has declined between 1992 and 1999 from 51,7 percent to 39,5 percent, while extreme poverty has declined from 36,5 percent to 26,8 percent over the same period (ADB, 2005, p. 11). The poverty reduction has been concentrated to the capital Accra and the rural forest areas. In the rural areas the poverty levels are still high (52 percent) compared to the urban areas (23 percent). (Steel and Andah, 2003, p. 3)

### ***8.2 Structure of the financial market in Ghana***

Ghana has a tiered system of different laws and regulation for different types of institutions. The financial system in the country falls under three main categories: formal, semi-formal and informal. (Gallardo, 2001, p. 15)

- *The formal sector* is regulated under the Companies Code 1963. Financial institutions are licensed by the Bank of Ghana under either the banking Law 1989 or the Financial Institutions (Non-Banking) Law 1993. Most of these financial institutions target urban middle or higher income households. (Steel and Andah, 2003, p. 3) The commercial banking system dominates by a few major banks which reach only about five percent of the households (Ibid, 2003, p. 4). This leaves the large part of the population without access to formal credit (Gallardo, 2001, p. 15).

- *The semi-formal sector* is the NGOs and the Credit Unions (CU) which are formally registered but not licensed by the Bank of Ghana. The NGOs and CUs are often focusing on poverty alleviation and mainly poor clients. They are not licensed take deposits from the public and therefore they have to rely on external (usually donor) funds. (Steel and Andah, 2003, p. 4)

- *The informal sector* is to a large extent covered by a range of activities known as Susu. The long tradition of Susu collectors offers poor people an opportunity to save money. People give the collectors a fixed amount each day and at the end of the month the collector receives one day's saving as commission. (Robinson, 2001, p. 242) Susu collectors have on average 150-200 women market vendors and microenterprise owners as their clients (Gallardo, 2001, p. 12) The informal sector also includes moneylenders, self-help groups and personal loans from friends and relatives. (Steel and Andah, 2003, p. 4)

### **8.3 Microcredit sector in Ghana**

There are different types of institutions providing microcredits in Ghana. The formal and semiformal microcredit institutions reached approximately 1.5 million borrowers. The Ghana Microfinance Institutions Network (GHAMFIN) was established in 1998 and it is an umbrella organisation with over 70 regulated and non-regulated Microcredit institutions.<sup>12</sup> The objective of GHAMFIN is to serve as a knowledge-centre for the microfinance industry and to provide information and statistics. This is a much needed incentive, since the information today is very dispersed - when provided. (Steel and Andah, 2003, p. 5)

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<sup>12</sup> <http://www.yearofmicrocredit.org/docs/countryprofiles/Ghana.doc> (06-03-16)

GHAMFIN is also providing staff training and assistance with capacity-building. (Gallardo, 2001, p. 10) The most successful microcredit institutions in Ghana, with the largest number of clients (16 000), is Sinapi Aba Trust (STA). The Institutions were funded in the mid-90s, and they have not yet published any monitoring reports and there are little financial data available. This makes it hard to evaluate the performance of STA. (Ibid, p. 23)

## **8.4 Performance and success of microcredit institutions in Ghana**

Microcredit institutions in Ghana, like in most African countries, have adopted the features of the Grameen Bank, discussed in section 6.2.1. Therefore the special features of the construction of the lending system will not be discussed in this chapter. The two models by Harper (2002) will be used as a framework when analysing and determining the potential for success of the provision of microcredit in Ghana The section will first look at complementary factors for the success of the Grameen Bank in Bangladesh (in section 6.2.2) and second, on the balance between sustainability and outreach (in section 6.2.3).

### **8.4.1 Complementary factors of success**

#### *Densely populated areas*

Ghana has a relatively low population density of 90 persons per km<sup>2</sup>, even if it is almost double the average West African population density of 46 persons per km<sup>2</sup>. (ADB, 2005, p. 6) The fact that the country is sparsely populated presents an obstacle for cost effective provision of microfinance. Transactions costs become high both for institutions and for clients. (Fidler and Paxton, 1997, p. 3)

The poor quality of roads and the underdeveloped network of roads raise transaction costs even higher. (ADB, 2005, p. 6) It is more difficult for microcredit institutions to monitor the groups and it requires more employed staff since it is hard for one officer to cover large areas. Clients experience high transportations costs and the weekly meetings become a time consuming activity. Most rural sparsely populated areas are also inaccessible to audio and television signals, this makes it hard to reach out with information. (Pralhad, 2005, p. 13) Mosley and Rock (2004) stress the importance of infrastructure; such as roads and communications networks in order to conquer the problems of densely populated areas. They

find this to be one of the main reasons behind the low sustainability of microcredit institution in Africa. (p. 497)

#### *Socially and economically homogenous*

Ghana is a fairly heterogeneous country, with different ethnic, religious and languages groups. There is a relatively high GINI coefficient of 0.41 which indicates an unequal spread of wealth in the country.<sup>13</sup> The large part of the almost 21 million large populations is considered to be poor; the largest divergence is between the rural and urban areas. (ADB, 2005, p. 3) Ghana is considered to be a political stable country, despite its politically unstable neighbours. There is a risk of increased fragmentation due to the heterogeneity, which might decrease inefficiency. The relatively high level of inequality might affect the ability to mobilise demand for microcredits, since the richer and more influential part of the population already might have access to credit.

#### *Institutional set-up*

The Government of Ghana has seen the potentials for the microcredit industry and has provided a tiered structure of institutions and regulation for microcredits. (Steel and Andah, 2003, p. 2) The regulation is still in its implementation stake and it is yet too early to evaluate the effects it will have on microcredit institutions. However, the foundation has been put in place and Ghana is in the frontier when it comes to regulation of microcredit institutions not only in Africa, but among developing countries worldwide. The government is supporting microcredit institutions, but the sector is mostly supported by NGOs and international aid agencies.

### **8.4.2 Sustainability and outreach in Ghana**

#### *Sustainability*

The occurrence of microcredit institutions is relatively new in Ghana. There are no large institutions such as the Grameen Bank. Instead there is an array of smaller microcredit institutions. (Fidler and Paxton, 1997, p. 5) In Ghana, and West Africa in general, there is a relatively high cost of providing microcredit services. This is due to several different reasons; lack of economies of scale, high average salaries for loan officers and less clients per loan

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<sup>13</sup> <http://www.yearofmicrocredit.org/docs/countryprofiles/Ghana.doc> (06-03-16)

office. (Ibid, p. 7) The high costs require high interest rates in order to sustain the lending. The largest microcredit institution in Ghana has 16 000 clients, this can be compare with the Grameen Bank that has almost 5.6 million client. It is hard for microcredit institutions in Ghana to achieve economies of scale in the same way that is done in Bangladesh. It took the Grameen Bank over 20 years to reach sustainability, most microcredit institutions in Ghana have only been operating for less than 10 years.

High rate of HIV/AIDS and malaria affects the sustainability of microcredit institutions. The national prevalence rate of HIV/AIDS in Ghana is estimated to be between three and five percent, in some areas it is even higher. There is a rapid spread despite increased efforts to fight the epidemic. (Gallardo, 2005, p. 17) Malaria is the highest single source of mortality in Ghana. (ADB, 2005, p. 9) The health situation is a sever problem since it threatens to undermine the microcredit sector. One way to solve this is to combine microcredit with education.

#### *Outreach*

The expansion of microcredits in last years has to a larger extent than in Bangladesh been driven by NGOs and development aid agencies. There is today no microcredit institution that is large enough to gain economies of scale. Instead most of the microcredit institutions are smaller scaled and the microcredit sector is still in the beginning. One factor that could have impact is that the demand is not high enough; aid might be funded traditionally in another way in Ghana. (Gallardo, 2005, p. 15) Most microcredit institutions in Ghana are primarily lending to women. There has been a long tradition of Susu collectors lending particularly to women market vendors. (ADB, 2005, p. 9)

### **8.5 Concluding Remarks**

It is yet too early to evaluate the success of provision of microcredits in Ghana. There are some indications that Ghana is moving in the right direction. The high level of risk and the high costs are challenges that need to be overcome in order for the microcredit sector to achieve sustainability.

Ghana has the regulatory framework in place and microcredit activities have gained support from the government of Ghana. The umbrella organisations GAHMFIN have an important role in promoting microcredit activities since the microcredit sector is lacking large institutions. GHAMFIN plays an important role in order to start a positive circle in the same way as has happened in Bangladesh. There is a risk that provision of microcredits will be perceived as an exogenously imposed process, and that there won't be the same feeling of ownership as in Bangladesh.

The main challenge in Ghana, as in the rest of West Africa, is to be able to reach sustainability of funding. There are high costs associated with provision of microcredits in Ghana. This is due to relatively high labour costs, difficulties achieving economy of scales, sparsely populated areas that raise the transactions cost for both the lender and the borrower. The high level of HIV/AIDS in Ghana presents another risk factor that makes it hard for microcredit institutions to achieve sustainability.

This highlights the fact that more research is needed in order to understand the specific challenges that not only Ghana, but many countries in Africa are facing. People in Ghana need to access credit as desperately as poor people elsewhere. It is therefore essential to find a way to solve the problem of sparsely populated areas, bad communication and the restrained health sector. It might be that provision of microcredits is not the best solution in some areas, but with new technology there might be ways to solve some of the problems with remote areas and poor communication.



## 9. Conclusions

Fighting poverty is the overall goal of the MDG. Africa has highest percent of poor people in the world. In order to achieve the MDG poverty and development trends must take a new turn in almost all African countries. Microcredit is believed to be a way to overcome problems on financial markets in developing countries. Poor people would have better chances to improve their situation if they had access to credit. Development of financial markets is not one of the eight MDG, but if problems on the financial markets are overcome this could contribute to the accomplishment of all eight goals.

This study first looks at problems on financial markets. Financial markets in developing countries function inefficient mainly due to the high levels of asymmetric information and risk. Financial markets in developing countries are characterised by dual economies, segmented and fragmented markets and a lack of supporting institutions. Asymmetric information gives rise to problems with adverse selection and moral hazard and consequently problems with screening, monitoring and enforcement. Since poor people often lack formal forms of collateral, such as land or property, which normally is required by formal financial institutions, they become excluded from the formal financial credit markets.

Microcredit provides a possibility to take advantage of the different characteristics occurring on financial markets in developing countries. When the market is fragmented into different segments, there is often complete or nearly complete information in the different segments. The construction of self-formed small groups within one segment gives members the possibility to obtain information that formal banks lack access to. Members of the group will be jointly responsible for each member's loan; the group will act as social collateral. This reduces both the problem of screening and enforcement. Microcredit has the potential of being self generating. There have been indications that microcredits seldom reach the poorest segments in the society, partly this could be solved by putting an upper limit to wealth and income. It has showed that women are better at handling microcredits and invest the credit in a socially beneficial way.

The Grameen Bank has been able to construct a successful way of handling its loans and the system has served as a model in the microcredit sector. The Grameen system has a high

reliance on the social collateral and a strict system with weekly meeting. It has a large number of motivated staff responsible and in charge of the weekly meetings. Complementary factors contributing to the success is the high population density, the poor and relatively homogenous population and the institutional set-up that provides support to the Bank at an early stage. Another important factor that has to be taken into account is that the initiator of the Grameen Bank is the Bangladeshi professor Mr Yunus and he has been a strong motivating power for the Grameen Bank.

It is yet too early to evaluate the success of microfinance in Ghana. However, when looking at the potential for success there are indications that Ghana is moving in the right direction. There is a regulatory framework in place which regulates microcredit activities in Ghana and there is a growing demand and awareness of microcredits in the country, even if the microcredit industry still is in the initial phase and to a large extent driven more by donors than by demand from people in Ghana.

However, there are severe challenges that need to be overcome in order to achieve success. The main challenge in Ghana is to be able to sustain funding. There are high costs associated with the provision of loans in Ghana, due to high costs of labour and administration. This is partly a result of small institutions lacking economies of scale. The country is sparsely populated which raises the transactions cost for both the lender and the borrower. The population is more heterogeneous than in Bangladesh which might affect the ability to mobilise a large demand for microcredits Ghana has high levels of people infected with malaria and HIV/AIDS; this is severely threatening sustainability of microcredit institutions.

The lack of access to credit services is a significant obstacle to the development and sustainability of microenterprise in Africa, as well as in developing countries on other continents. Provision of credit can help poor people to change their situation. It is however essential to remember that in order for microcredits to work efficiently complementary institutions are crucial, such as the sectors of education, infrastructure and health. Microcredit is not a magic medicine that will promote development in a magic way. However, it could be a means, together with support of other sectors in the country, to enhance the welfare of the population. The microcredit sector in Bangladesh reached sustainability after 20 years and most microcredit institutions in Ghana were established within the last 10 years.

The overall conclusion of this study is that provision of microcredits is a means, together with support of other sectors in the country, to solve problems of financial markets in developing countries. However, there might be better ways to adapt the provisions of microcredits to the African context. The case study of Ghana shows difficulties with sparsely populated areas, heterogeneous populations and the high degree of diseases, especially HIV/AIDS. These difficulties are threatening the ability to sustain funding of the microcredit institutions in Ghana. In order to conquer these problems there needs to be more focus and research on Africa and the effect microcredit has on poverty alleviation in Africa.

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## Appendix A: Distinct features of microcredit

Category	Traditional Banking	Microcredit
Ownership and Governance	<ul style="list-style-type: none"> <li>• Profit-maximizing and individual shareholders</li> <li>• Centralized decision-making</li> </ul>	<ul style="list-style-type: none"> <li>• Mainly non-profit institutional shareholders</li> <li>• Decentralized decision-making</li> </ul>
Client Characteristics	<ul style="list-style-type: none"> <li>• Diverse formal business and salaried individuals</li> <li>• Geographically dispersed clients</li> </ul>	<ul style="list-style-type: none"> <li>• Low-income entrepreneurs with rudimentary family businesses and limited formal documentation</li> <li>• Located in a specific geographic area</li> </ul>
Lending Methodology	<ul style="list-style-type: none"> <li>• Collateral and formal documentation</li> <li>• Salary incentives are a minor part of loan officer compensation</li> </ul>	<ul style="list-style-type: none"> <li>• Character and cash flow analysis through on-site inspections</li> <li>• Salary incentives are a major part of loan officer compensation</li> </ul>
Product Characteristics	<ul style="list-style-type: none"> <li>• Larger amount</li> <li>• Longer terms</li> <li>• Lower interest rate</li> <li>• Monthly repayments</li> </ul>	<ul style="list-style-type: none"> <li>• Smaller amounts</li> <li>• Shorter terms</li> <li>• Higher interest rate</li> <li>• Weekly and bi-weekly repayments</li> </ul>

Source: Janson, T., Rosales, R., Westley, G, 2004, p. 23

## **Appendix B: Classification of different form of microcredit**

Yunus (2004) divides microfinance into ten different classifications.<sup>14</sup>

- a) Traditional informal microcredit, such as money lenders' credit, pawnshops and from friends and families.
- b) Microcredit based on traditional informal groups, such as tontin and susu.
- c) Activity-based microcredit through conventional or specialised banks (for example agriculture credit, livestock credit, or fisheries credit).
- d) Rural credit through specialise banks.
- e) Cooperative microcredit, such as cooperative credit, credit union, savings banks.
- f) Consumer microcredit
- g) Bank-NGO partnership based microcredit.
- h) Grameen type microcredit
- i) Other forms of NGO microcredit.
- j) Other types of non-NGO non-collateralised microcredit

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<sup>14</sup> <http://www.grameen-info.org/bank/WhatisMicrocredit.htm> (06-03-25)



## Appendix C – Short facts of Bangladesh



### Short facts<sup>15</sup>

**Area:** 143 998 km<sup>2</sup>

**Population:** 152,6 millions (UN 2005)

**Capital:** Dhaka

**Head of State:** President Iajuddin Ahamed

**Language:** Bengali

**Major religions:** Islam, Hinduism

**Life expectancy:** 63/62 years (women/men)

**GNI/Capita:** 440 (UN 2004)

**Percent of population under 1 US\$/day:** 36%

**Literacy rate:** 41 percent (UN 2004)

**Main exports:** Garments, fish, jute goods, leather products

### **Short political and economical context**

When India gained independence in 1947, Bengal was divided in a western part, going to India and an eastern part that joined Pakistan as a province called Eastern Bengal. In 1971 Bangladesh gained independence after a bitter civil war that divided Pakistan in two parts. Bangladesh spent 15 years under military rule, in 1990 democracy was restored, and the first democratic parliamentary elections were held in 1991. Next elections will be held in the end of 2006 and the beginning of 2007.<sup>16</sup>

Bangladesh was in the beginning of the 1990s faced with great development pessimism. The country is still very poor but it has over the last 15 years managed to turn the negative trend and is today facing reduced income poverty and improvement of human development indicators. This is due to different factors; such as empowering of women, target transfer, extended health programs and an increase of active partnerships with the civil society. (HDI, 2005, p. 46)

<sup>15</sup> [http://news.bbc.co.uk/2/hi/south\\_asia/country\\_profiles/1160598.stm](http://news.bbc.co.uk/2/hi/south_asia/country_profiles/1160598.stm) (06-02-19)

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[http://www.manskligarattigheter.gov.se/dynamaster/file\\_archive/060123/e6d09c2cfd59091bc4369e1509b54ebb/Bangladesh.pdf](http://www.manskligarattigheter.gov.se/dynamaster/file_archive/060123/e6d09c2cfd59091bc4369e1509b54ebb/Bangladesh.pdf) (06-03-25)

## Appendix D – Short facts of Ghana



### Short facts<sup>17</sup>

**Area:** 238,533 km<sup>2</sup>

**Population:** 20, 9 millions (UN 2005)

**Capital:** Accra

**Head of State:** President John Kufuor

**Language:** English, African languages

**Major religions:** Christianity, indigenous beliefs, Islam

**Life expectancy:** 57 years (women), 56 years (men)

**GNI/Capita:** US\$380 (UN 2004)

**Literacy rate:** 54 percent (UN 2004)

**Percent of population under 1 US\$/day:** 45%

**Main exports:** Gold, cocoa, timber, tuna, bauxite, Aluminium, manganese ore, diamonds

### Short political and economical context

Ghana was the first African country to gain colonial independence from Britain in 1957. Ghana was ruled in 35 years of a succession of military regimes until 1992 when a new constitution was approved, and multiparty presidential and parliamentary elections were held. The last elections in 2004 passed peacefully and were won by the incumbent President and his New Patriotic Party. (ADB, 2005, p. 2) Ghana is often chosen as a model for political and economic reforms in Africa. It has a high-level peacekeeping role with peacekeeping troops in Liberia, the Ivory Coast, Sierra Leone and Democratic Republic of Congo.

Since the elections in 1992 there has been a positive economic development. The government has implemented structural reforms. The Ghanaian economy is heavily dependent on agriculture (39 percent of the economy, and directly employs 70 percent of the labour force). The industrial sector is weak, even if both the manufacturing and gold mining sector have experienced growth in the last five years. (ADB, 2005, p. 7)

<sup>17</sup> [http://news.bbc.co.uk/2/hi/africa/country\\_profiles/1023355.stm](http://news.bbc.co.uk/2/hi/africa/country_profiles/1023355.stm) (06-02-19)