The financial sector is significant for the creation and preservation of jobs in developing and industrialised countries. A financial system which functions well is one of the cornerstones of economic growth. Financial institutions mobilise resources for private and public investment and ensure that cashless payments can be processed quickly and safely.

The financial sector’s significance is particularly perceptible during crises. If the financial sector is unstable and does not provide adequate financing and if the framework conditions for investment and economic decisions are uncertain, this considerably restricts the real economy. The result is a lack of investment, low or no growth, unemployment and underemployment. The 1997 Asian crisis, the 1998 Russian crisis and the current financial and economic crisis show that weak and under-regulated financial systems trigger or intensify economic crises and can cause high unemployment and poverty.

The financial sector affects many sectors of the real economy from the promotion of small businesses to agricultural production, university education, cross-border economic infrastructure and direct foreign investment.

The German Development Cooperation is currently active in the financial sector in more than 400 projects and programmes in over 70 countries. Within this sector, the goals of the Development Cooperation are to improve access to financial services, close financing gaps and stabilise financial systems. As part of the Financial Cooperation, KfW Development Bank thus promotes the financial sector in many different ways. It supports local financial institutions in the financing of micro, small and medium-sized enterprises (MSMEs) and promotes environmental investments (e.g. in the fields of energy efficiency and renewable energies), housing, municipal investments, education and infrastructure – all with specific impacts on employment.

Below, we focus on improved access to finance for micro and small enterprises (micro-finance). Financial services for this target group are diverse, and they can be promoted in very different ways. KfW covers a wide range.

**Financing for micro and small enterprises**

Microfinancing aims to provide people with access to loans, savings, insurance and efficient payments system (financial inclusion). Such financial services provide customers with greater financial security and allow them to realise their economic potential. With a 2.1 billion euro portfolio, KfW is one of the most important providers of microfinance.

Poor sectors of the population, including many women and micro-enterprises, can be provided with long-term access to financial services through the development of local financial institutions which offer small loans, saving schemes, transfer facilities and small-scale insurance policies.

It would seem reasonable to assume that such access makes a positive contribution to employment in both the financial institutions which receive support as well as at final borrower level. In surveys, micro and small enterprises repeatedly name limited access to financial services as their greatest hindrance to growth. Nevertheless, research into the significance of micro and small enterprises for employment in developing countries is still in its infancy.

Employment in financial institutions (predominantly local microfinance institutions, commercial banks and funds) and at borrower level (in many business areas and sectors) triggered by promotion measures is regarded here as direct employment, whilst all of the suppliers of the borrowing small businesses and stakeholders in the downstream value chain benefit from an impact on indirect employment.

**Enterprise types and their potential**

Micro and small enterprises in developing countries can be divided into various types of enterprise:

- **Subsistence enterprises**, founded by an entrepreneur to safeguard his or her own livelihood (self-employment). Usually these entrepreneurs have few alternatives, so it is essentially a question of social security for the poor. In the majority of cases, these are enterprises in the informal sector, frequently with a seamless transition to private households. These households survive through various activities including micro-entrepreneurialism, day work and sometimes money sent home from family members working abroad (remittances).

- **Transformation enterprises**, where the entrepreneurs strive for more than subsistence and manage their enterprise with a view to growth and creating additional jobs within that enterprise (third-party employment). The entrepreneurs are more dynamic self-employed people whose enterprises tend to develop into businesses with a relatively steady course of growth.

Some researchers (e.g. Lena Giesbert) distinguish another group of informal enterprises: “constrained gazelles”. These enterprises have the potential for growth (although whether they are as agile as gazelles is open to conjecture), achieve high yields from a low
capital investment and have an entrepreneurial approach. But they encounter numerous barriers, frequently in the form of restricted access to capital and especially to loans. Research results from West Africa, Sri Lanka, India, Mexico and other countries document this type of informal entrepreneur.

The target group and customers (borrowers) of microfinance are frequently informal entrepreneurs including a large number of women. Predominantly, they are subsistence entrepreneurs, i.e. self-employed.

Most microcredits are requested by customers in order to maintain an existing business (working capital loans, substitute investments) or to expand an existing enterprise. Such enterprises are normally founded with personal funds – often from the family – but might also be funded by microcredits.

Subsistence enterprises in the informal sector rarely generate new jobs. Even successful, self-employed micro-entrepreneurs only sometimes develop into small or medium-sized enterprises which create jobs (graduation). It is estimated that 10-20% of microfinance customers develop into small businesses through such graduation processes and eventually offer employment to third parties, i.e. employ people who are not family members. Assessments here differ. Figures fluctuate between "just 10%" and "considerable 10-20%!

However, the decisive forces when it comes to the creation of jobs for dependent employees do seem to come more from the sector of innovative small and medium-sized enterprises and the large-scale enterprise sector, i.e. the formal sector. There are many indicators of this.

Why promote financing in the informal sector?
Informal enterprises are far more numerous in developing countries than formal enterprises. Especially in sub-Saharan Africa, the majority of employment is in informal enterprises. Enterprises in the informal sector are those which most require access to adequate financing options. Events as children starting school, marriage, death and old age, crop failures and accidents/illness lead to particular financial needs. Loans and financial services responding to these needs probably have a low impact on employment, yet they have extremely positive development impacts because they can offset income fluctuations of the poor and consequently tangibly improve their standard of living. The line between the consumptive and investive use of loans is often fluid from the perspective of poor households. For example, paying a bill for medicine by means of a microcredit so that a worker can quickly get back to work might be a vital and legitimate course of action, since it will prevent an extended period of illness and a slide into poverty. The maintenance of existing jobs and thus the prevention of a descent into greater poverty is also an important goal which contributes to social security.

As microfinance is about more than safeguarding employment, choosing potentially successful micro-enterprises with the potential to create jobs is often not the primary concern when local financial institutions grant loans.

Microfinance does, however, stimulate the entrepreneurial activity of borrowers. This has been proven in individual studies for developing countries. Induced activity consisted of business expansion (e.g. stocking up warehouses, Banerjee et al. 2009) and the formation of small businesses as an additional source of income for families.

Regardless of the debate on self-employment versus third-party employment, the individual life cycle approach can also be used with regard to the increase in employment. Education financing and the building up of reserves through savings accounts play a decisive role before people reach working age. The development of reserves can be used to finance education and training later on. Security and a reduction in risks thanks to insurance policies are important for people of working age. These measures protect / preserve the workforce. Micro pension schemes allow individuals to make the years which follow their working life financially secure.

In the light of information on access to financing for micro-enterprises and lack of financing as a hindrance to growth, microfinance in developing countries is a promising approach to the promotion of employment.

Agriculture – a special sector for microfinance
Various types of agricultural investment can significantly increase the income of farmers in developing countries since their agricultural technology level is extremely low, especially in the case of small-scale farmers. Even simple investments can yield really high returns, which allow farmers to pay commercial interest rates for loans from the financial markets of developing countries.

Microfinance institutions are particularly suitable for this economic sector, since with efficient organisation and credit analysis methods for informal enterprises (no proper accounting system, balance sheets or traditional collateral are requested), they can also reach small agricultural businesses and evaluate them as borrowers. Working capital financing is important in addition to investment financing. The development of rural areas is encouraged through modern communications technology (branchless banking). To a certain extent, this can considerably reduce the costs of access to financial services for both financial institutions and users.

KfW promotion in the field of microfinance
KfW’s main approach to promotion in the field of microfinance is to strengthen local financial institutions so that they are able to offer sustainable financial services to micro and small enterprises. This is achieved through an improvement in liquidity and improvement of the financial institution’s financing instruments. KfW thus helps to establish and refine microfinance institutions, develop the approach of local financial institutions to enterprise promotion, develop the networks and holdings of these institutions and form regional or global funds which promote all of these measures. A solid and successful example here is KfW’s equity investment in international microfinance networks and banks.

Example project: ProCredit Group
The ProCredit Group runs ProCredit banks in 21 countries. It is a public-private partnership which aims to promote access by micro and small enterprises and other disadvantaged customer target groups to financial services. ProCredit Group has become the leading financial services provider in numerous developing and transformation countries:
- ProCredit Bank’s network of branches service 2.9 million customers, many of them in poorly developed, rural regions.
- Its core business relates to microcredits and, increasingly, agricultural loans. Its loan portfolio has grown from 390 million euros (2003) to 4.2 billion euros (end of June 2012). 76% of loans are less than 10,000
euros; around 93% are less than 30,000 euros. In the last three years, more medium-sized loans with longer terms have been approved and paid out to increasingly finance investment in addition to trade financing.

- ProCredit banks make a significant contribution to mobilising savings in partner countries. With more than 3.6 million savings accounts worldwide, it offers its customers a safe way to save money. More than 3.5 billion euros are currently invested in ProCredit savings accounts.

Since the mid-1990s, the ProCredit Group has been supported by KfW Development Bank on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ). At present, KfW holds an equity investment of 46.7 million euros in the parent company ProCredit Holding. KfW also helps individual ProCredit banks to expand their range of loans to micro and small enterprises through long-term refinancing and training measures. KfW and the ProCredit Group also collaborate successfully on financing energy efficiency.

There is a direct impact on employment at financial institution level in the form of the 16,000 ProCredit Bank employees worldwide. More than 90% of these are local employees, many of them in management and senior management positions. The holding company’s annual report details the entrepreneurial development of individual micro-enterprises which have grown through ProCredit financing, including Cosméticos Tocatlaán in Bolivia, which manufactures and markets cosmetics, and entrepreneur Cecilia Balsecai in Ecuador, who successfully produces and sells ecologically friendly bags. Both enterprises have succeeded in creating jobs.

### Topics for further research

As yet, there has been little investigation into the growth opportunities of micro-enterprises, and there is an absence of meaningful data for most countries in which KfW promotes microfinancing. Amongst other winners, the KfW Research Prize 2012 was awarded to researchers who investigated the subject of informal micro-entrepreneurs and discovered that many of them have an amazingly high productive potential which, however, requires targeted development in order to be realised. In our opinion, research issues with a particular practical significance include the following:

- The growth of enterprises in the informal sector, including small-scale agriculture, and their contribution to the creation and preservation of jobs.
- General and sector-specific criteria for the selection of young and innovative enterprises with the potential to create new jobs.
- The impact on the costs and processes of microfinance institutions if borrower selection is less geared to borrowing capacity than to growth potential-
- Criteria for “good jobs” in the informal sector
- The economical measurement of indirect impact on employment

### Conclusion: microfinance creates specific employment

Microfinance customers are generally independent micro-entrepreneurs creating their own employment. The special potential of microfinance therefore lies in supporting subsistence entrepreneurship to job seekers who are largely without other opportunity. This takes place in countries where social security networks are frequently non-existent or inaccessible.

However, it is not realistic to expect that the microfinance approach might trigger a wide entrepreneurial movement where flourishing small and medium-sized enterprises which create jobs emerge from a pile of sole traders.

If there is to be a greater focus on impact on employment in addition to the numerous other positive effects of microfinancing, support would have to be geared more specifically to those young and innovative enterprises which actually create jobs. Amongst other things, financial institutions such as the ProCredit Group promoted by the Financial Cooperation of KfW show how this is effectively and cost-efficiently possible with the existing microfinance institutions and their lending technologies in the context of microfinance. These financing institutions have expanded their field of promotion through the addition of financial services for small and medium-sized enterprises in the formal sector (financial broadening), thus continuing to offer their microcustomers support when they grow, especially during the decisive stage when they change from an informal to a formal enterprise.

### Further information

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1 There are currently ProCredit banks in the following countries: Democratic Republic of Congo, Ghana, Mozambique, Bolivia, Columbia, Ecuador, El Salvador, Honduras, Mexico, Nicaragua, Albania, Bosnia and Herzegovina, Bulgaria, Georgia, Kosovo, Macedonia, Moldova, Romania, Serbia and Ukraine.

2 KfW’s investment with its own funds and at KfW’s Banking Group’s own risk.