Defending Microfinance

Isobel Coleman

Promoters have hailed microfinance as the silver bullet of development. Advocates say that providing small amounts of credit to the world's poor can break their cycle of poverty. Moreover, they claim, this can be accomplished through self-sustaining programs. Just lend to the poor at market rates, and their high levels of repayment can fund the effort. Both of these claims, however, remain inconclusive after numerous studies. The mixed results of a wide array of impact assessments leave skeptics wondering whether microfinance really does alleviate poverty beyond anecdotal instances. While stories abound of people who have used microfinance to improve the lives of their families, it has yet to be demonstrated that microfinance makes a substantial difference at the macroeconomic level. Self-sustainability is also suspect, with data indicating that even those microfinance programs committed to financial sustainability cover only 70 percent of their costs.[1] Almost all programs are still substantially subsidized, especially those with explicit social objectives. Some experts have suggested that no more than five percent of microfinance institutions (MFIs) worldwide will ever be sustainable.[2] Layer on the unfortunate press surrounding cases of oversaturated markets with hopelessly poor and indebted borrowers, and one begins to question whether microfinance is all that its proponents claim.

The reality is that microfinance may be guilty of over-promising and under-delivering, but it is still an effective development tool.

The reality is that microfinance may be guilty of over-promising and under-delivering, but it is still an effective development tool. First and foremost, microfinance provides financial services to the poor; and the poor, like the rich —perhaps even more so because of their vulnerability—benefit substantially from the ability to smooth their income.[3] Second, microfinance has been shown

***Isobel Coleman** is a Senior Fellow at the Council on Foreign Relations, where she focuses on U.S. foreign policy issues. She is the author of "The Payoff from Women's Rights" (Foreign Affairs, May/June 2004).*

to support a number of other important development objectives—including improving school enrollments, child nutrition and health, maternal health, and female empowerment.[4] Third, even if most microfinance initiatives require some ongoing support, few other development programs come close to their cost-effectiveness.[5] For all of these reasons, donors should accept microfinance for what it is: not a silver bullet, but an important tool in the development toolkit. The rich world should redouble its efforts to extend additional resources to microfinance, continue to push for regulatory changes to make local financial systems more conducive to microfinance, and search for ways to bring successful programs to scale. Those organizations committed to poverty reduction must focus explicitly on serving the very poor by better tailoring products and services to meet their needs—even at the expense of other objectives.

THE EVOLUTION OF A MOVEMENT

Thirty years ago, in a small village in Bangladesh, Mohammed Yunus and a few volunteers began a radical experiment. Yunus believed that providing credit to the poor was not only financially sustainable, but could unleash a development wonder by giving the destitute the means to help themselves. He started providing small loans, with no collateral, to groups consisting of mostly female borrowers to start their own businesses. His efforts grew into the renowned Grameen Bank and became a major impetus behind the microfinance movement. From its humble roots, microfinance has grown tremendously over the last three decades. Although microfinance started out simply as small, non-collateralized loans, the term now covers a whole range of services provided to the poor, including savings, money transfers, payment services, and insurance. Today, more than 70 million of the world's poorest families have access to microcredi,, and that number has been growing by more than 35 percent a year.[6] The industry should come close to meeting the Microcredit Summit Campaign's ambitious goal of reaching 100 million of the world's poorest by 2005.[7]

Impressive as this may seem, it only scratches the surface of need. More than 900 million households in developing countries still have no access to formal financial services. The United States, a leader in supporting microfinance since the 1980s, has committed more than $2 billion to such projects in the past 15 years, averaging $155 million annually across almost 50 countries. Although this might seem like a large line item, it is a little more than half of what the United States plans to spend on one new attack fighter plane.[8] World Bank funding for microfinance is similar both in absolute size (which averages about $170 million per year) and in relative importance to overall funding priorities (averaging less than one percent of the Bank's lending).

To boost microfinance initiatives around the globe, the UN General

Assembly in 1998 designated the year 2005 as the International Year of Microcredit. In 1999, a group of development agencies and industry leaders created the Consultative Group to Assist the Poor (CGAP). With a $10 million budget, the consortium acts as a resource center for the whole industry, incubating ideas, launching new products, and setting standards and legal frameworks. CGAP was created not a moment too soon, as the lack of standards had been taking a toll on the industry. Already, some regions, including parts of the Caribbean and Africa, are now oversaturated with MFIs pushing loans on the poor, leading to declining repayment rates and a spreading culture of default. Microfinance is unviable in several Caribbean markets due to the prevalent attitude that loans are an entitlement and do not need to be repaid. In some African countries, like Uganda, corrupt leaders have distributed microfinance loans to political supporters prior to elections.[9] A core challenge for CGAP is thus to find effective ways to stop bad practices—which usually feature the hand of government intervention—from ruining the market for other providers.

TO FIGHT POVERTY, FOCUS ON THE POOR

A number of studies have reached what is now perhaps an obvious conclusion: programs that focus on poverty alleviation rather than those that focus on financial results are more effective at reaching the very poor. What is still missing from most microfinance initiatives is an innovative mix of products targeted to reach the very poor—for example, loans with long grace periods before interest is due, loans with graduated interest rates to reach market rates, and more flexible savings products. Some studies have shown that delivering microfinance in conjunction with other services, such as health information, basic literacy, and business training, achieves better poverty reduction (although perhaps at a cost to financial sustainability).[10] Not only does a comprehensive approach to poverty reduction—for example, providing credit along with primary health and education—create positive synergies that are more likely to break the cycle of impoverishment, but the regular meetings of microfinance groups provide an effective delivery mechanism for other social services.

> *...Not everyone is cut out to be an entrepreneur and therefore suited for microfinance. While those at one end of the curve might excel...the vast majority of borrowers simply use their loans to improve their chances of survival...*

It is important to remember that not everyone is cut out to be an entrepreneur and therefore suited for microfinance. While those at one end of the curve might excel in their business ventures and succeed in lifting their families out of poverty, the vast majority of borrowers simply use their loans to improve their chances of survival in the short term. Those at the other end of the curve fail in their endeavors, risking indebtedness, the wrath of their borrowing group (if there is one), and shaming their families. Programs targeting the very poor should take steps to minimize the number of borrowers who fall into the latter group—for example, by screening business concepts and providing aid instead of loans to those who cannot comply with a repayment plan. Also, it should be recognized that some segments of the poorest populations—the old, the infirmed, and those displaced by war—might not be suitable microfinance clients.

Microfinance also promotes free markets and entrepreneurship, reduces the dependency of poor people on government and donor handouts, and contributes to the emergence of a middle class.

In 2000, the U.S. Congress passed legislation establishing microenterprise as an integral component of U.S. foreign assistance, with the specification that half of all grants must go to the very poor.[11] The U.S. Agency for International Development (USAID) now partners with more than 700 U.S., local, and international organizations to implement this initiative. As more established financial institutions expand into the less risky areas of microfinance, the United States and other development agencies should increase their commitment to reaching the very poor. USAID's goal should be revised to focus all of its grants on the very poor. The result may be lower levels of repayment—and therefore reduced financial sustainability—but also a significant expansion of banking services to those who currently have no access to them. USAID should assume the risk to promote poverty alleviation among the poorest.

MICROFINANCE AS A DRIVER OF OTHER DEVELOPMENT OBJECTIVES

Microfinance has been recognized as an important tool for achieving several key Millennium Development Goals (MDGs). In addition to poverty alleviation, microfinance has a positive impact on school attendance, increasing gender equality, reducing infant/child mortality, reducing maternal mortality, and increasing access to reproductive health services. Microfinance also promotes free markets and entrepreneurship, reduces the dependency of poor people on government and donor handouts, and contributes to the emergence of a middle class.

As conceived by Mohammed Yunus, microfinance has an intentionally significant social component, in which Grameen borrowers are required to abide by the program's social contract. At the beginning of each weekly loan collection meeting, they must reaffirm Grameen's "Sixteen Decisions," which include having smaller families, educating all their children, practicing home improvement, and helping fellow group members during difficult times. Many other microfinance initiatives, some modeled explicitly on Grameen, have replicated the social contract concept (with some tailoring to the local population). Today, across Asia, Africa, and Latin America, there are millions who abide by a social contract as part of their loan eligibility. The social contract and the group dynamic (achieved through regular meetings of members) are recognized as important elements in the social change that accompanies microfinance initiatives, particularly with regard to the empowerment of female clients.

In many microfinance initiatives around the world, women comprise the majority of borrowers.[12] This is true for several reasons: women make up the majority of the poorest citizens of the world and are therefore targeted for poverty alleviation programs; they are more likely to have constrained credit than men; they have restricted access to the wage labor market; and they have an inequitable share of power in household decision making. The repayment rates of women clients are also superior to men's, especially in group-responsibility-based lending programs like Grameen's, where the shame factor within a close-knit society encourages minimal default.

Moreover, a variety of social benefits are more likely to accrue if the loans are given to women rather than to men. For example, women are more likely to invest profits in their families, while men are more likely to invest profits in their businesses.[13] Loans to women are more likely to benefit male consumption than male loans are to benefit female consumption.[14] Other studies have noted that household consumption increases more when women borrow than when men borrow.[15] In these cases, children are the primary beneficiaries. Additional income in the hands of mothers is associated with substantially larger improvements in child survival and nutrition than is additional income in the hands of fathers: for child survival, the marginal effect of female income is nearly 20 times larger than that of male income, and for child nutrition, the effect is four to eight times larger.[16] Studies have also noted that women who take microcredit loans have a significantly higher demand for formal health care than women who do not, and that expenditures on women's health needs increased.[17] This only happened when the recipients of loans were women.

FEMALE EMPOWERMENT—A LONG-TERM BENEFIT

A whole cottage industry has developed around determining to what extent microfinance results in female empowerment. Female empowerment is usually defined as an improvement in a woman's ability to influence or make decisions that affect her life. Significant areas include family planning, her children's lives, household expenditures, and her microfinance-supported business. In many markets, including Bangladesh's relatively mature microfinance environment, a majority of female loan recipients do not fully control their loans (husbands, fathers, or brothers make investment decisions). Nor do they get direct market access, which is an important route to empowerment.[18] Yet, in all instances, women are left with the responsibility of paying the loans, which are sometimes appropriated by husbands and frittered away on alcohol and drugs.

These are valid concerns, and should be addressed programmatically by MFIs that specifically target women. However, a broad set of studies concludes that microcredit indeed empowers women in terms of their ability to make large and small purchases, be involved in major family decision-making, and to participate in public action, mobility, and political and legal awareness.[19] Some have also observed reduced domestic violence against women borrowers and speculate that this is a consequence of women being regarded as more valuable economic members of the family once they start generating income through their microcredit loans.[20] Other studies have confirmed these findings: female borrowing increases female control of non-land assets,[21] increases their role in household decision making,[22] and elicits greater acceptance by their husbands of their participation in market-based economic activities.[23]

Not surprisingly, programs that exclusively target women are more likely to have a positive impact on women's empowerment. This is especially true when they are enhanced by other features, such as putting women in charge of their own banks, letting them make decisions on the feasibility of each others' proposed activities, electing their own leaders, or setting the terms and conditions of internal loans. Regular meetings also develop women's links and knowledge about one another, and any education received helps boost self-esteem.[24]

KASHF FOUNDATION—IMPROVING PAKISTAN'S PROSPECTS ONE WOMAN BORROWER AT A TIME

To understand the promise and the challenge of microfinance, it is helpful to look at a microfinance institution that has the potential to make a positive impact. In Pakistan, a country of 150 million people, 34 percent of the population lives on less than $1 a day, while 86 percent lives on less than $2 a day. Sixty-five percent of households have no access to financial services, so the demand for microcredit is high. The Kashf Foundation was started in 2000 by Roshaneh Zafar, a Yale-educated Pakistani woman on a mission to unleash the productive capabilities of Pakistan's poor female population (70 percent of which is illiterate). Kashf is focused on achieving financial sustainability: it targets not the poorest of the poor in Pakistan, but those living on $2 a day, since in its experience, repayment rates are better among the working poor as opposed to the truly destitute.[25] With a 20 percent interest rate, and a 98 percent repayment rate, it is the only financially sustainable MFI operating in Pakistan today.

Female empowerment is an explicit Kashf goal. One hundred percent of its borrowers and about half of its loan officers are women. However, recognizing the reality of its patriarchal society, Kashf allows male relatives to direct the loans. Recent impact assessments confirm that even with men directing the loans, women borrowers feel their stature in the family has improved. Clients report a 30 percent rise in income after one year. Over the course of the year, nearly a third of Kashf clients crossed over the poverty line, as opposed to almost no change in poverty levels in the control group. Kashf clients also report spending significantly more on health care than those in a control group, though levels of illness do not differ between the two groups.

Although Kashf has grown rapidly since its inception to more than 65,000 clients in a few short years, its growth prospects are constrained by insufficient resources. It costs about $8,000 in start-up funds to open a new branch, making it difficult to fund expansion through its existing operating budget. Franchising is under consideration as a means of more rapidly expanding to meet the vast needs of Pakistan's poor. Kashf's challenge is to find ways to achieve scale, which then allows it to reap the benefits of size and lower costs. Pakistan, a country burdened by intense poverty, a rapidly growing population, and political and religious extremism, depends on the success of organizations like the Kashf Foundation. Kashf undoubtedly makes a significant difference in the lives of its female clients. Whether it can make a difference to Pakistan as a whole remains to be seen.

CONCLUSION AND RECOMMENDATIONS

Microfinance is an important development tool. While overall economic impact is still hard to demonstrate, this could be because MFIs have not invested sufficiently in data collection and impact assessments, and also because few MFIs have achieved the scale they need to start showing up in national accounts. Yet, to focus on measurable macroeconomic results risks losing the forest for the trees. An evaluation of microfinance programs should not be based simply on how profitable, or even sustainable they are, but how cost-effective they are in realizing their development objectives. At a minimum, microfinance brings crucial financial services to the poor at market rates.

Successful poverty alleviation requires a multi-pronged strategy, and microfinance should be part of that strategy. It is an important contributor to achieving the MDGs. Women's empowerment is perhaps the most complex, and potentially the most powerful of these goals, and microfinance clearly helps drive female empowerment.

The greatest challenge facing the industry today is how to achieve scale cost-effectively. Sometime in the next 12 to 18 months, a milestone will be attained of serving 100 million of the poorest families with microcredit. But that still leaves nearly one billion more to reach. Current growth rates would have to increase exponentially for microfinance to make a measurable dent in global poverty. Most of those without access to banking services today do not live in relatively accessible locations like the Caribbean and Central America (which have already experienced oversaturation), but in distant locales like rural Africa and Afghanistan. Providing microfinance inexpensively in areas largely devoid of roads and any modern communications technology presents new challenges. New models, such as franchising, must be considered. New sources of capital, such as foreign equity, and tapping increased savings through new products in local markets should be explored. With 2005 as the International Year of Microcredit, it is time for the world to embrace microfinance. ■

NOTES

1 *Microbanking Bulletin, Issue No. 2* (Boulder: Economics Institute, 1998); and Jonathan Morduch, "The Microfinance Promise," *Journal of Economic Literature* 37 (4) (1999).

2 For an explanation of this widely-quoted estimate, see Jonathan Morduch, "The Microfinance Schism," *World Development* 28 (4) (2000): 627.

3 While the data on poverty alleviation is mixed, microcredit clearly helps poor clients smooth their income, and thereby smooth their consumption. Jonathan Morduch, "Does Microfinance Really Help the Poor? New Evidence from Flagship Programs in Bangladesh," Working Paper (1998).

4 The 2002 AIMS (Assessing the Impact of Microenterprise Services) synthesis report, commissioned by USAID, sums it up: "Microfinance does make a difference. However, its impact is neither consistent across countries, nor across domains...To the extent that there are positive impacts at the household, enterprise and individual levels...the primary beneficiaries are women."

5 USAID reports that nearly half (49 percent) of the MFIs it assists (comprising 83 percent of its total loan portfolio) are fully financially sustainable. "Microenterprise: Laying the Foundation for Economic Development," *Microenterprise Results Reporting for 2002* (Washington: U.S. Agency for International Development, 2004), 4.

6 The Microcredit Summit Campaign defines "poorest" as those living on less than a $1 per day, or anyone in the bottom half of those living below their nation's poverty line.

7 The goal was set in 1997 when less than 8 million of the poorest had access to microcredit.

8 One new F/A-22 fighter plane, nicknamed the raptor, is estimated to cost $258 million.

9 "Uganda: When Microfinance is Not a Good Idea," *Africa News,* December 31, 2002.

10 Jonathan Morduch and Barbara Paley, "Analysis of the Effects of Microfinance on Poverty Reduction," *NYU Wagner Working Paper Series, No. 1014* (June 2002): 84-91.

11 The Microenterprise for Self-Reliance and International Anti-Corruption Act of 2000.

12 Ninety-four percent of Grameen Bank's 2.4 million clients are women; 85 percent of Bangladesh Rural Advancement Committee's 3 million microcredit borrowers are women; and more than 66 percent of USAID's clientele are women.

13 Jennifer Sebestad and Gregory Chen, "Overview of Studies on the Impact of Microenterprise Credit" (June 1996).

14 R. I. Rahman, "Impact of Grameen Bank on the situation of poor rural women," *BIDS Working Paper No.1* (Dhaka: Grameen Evaluation Project, 1986).

15 Mark M. Pitt and Shahidur R. Khandker, "The impact of group-based credit programs on poor households in Bangladesh: Does the gender of participants matter?" The *Journal of Political Economy* (October 1998): Volume 106, Issue 5: pp. 958-997.

16 Duncan Thomas, "Intrahousehold Resource Allocation: An Inferential Approach," *Journal of Human Resources*25(4), (Fall 1990): 635-665; and "Incomes, Expenditures and Health Outcomes: Evidence on Intrahousehold Resource Allocation," *Intrahousehold Resource Allocation in Developing Countries: Models, Methods and Policy* eds. Alderman, Haddad, Hoddinott, (June 1997): 142-164.

17 Priya Nanda, "Women's Participation in Rural Credit Programs in Bangladesh and their Demand for Formal Health Care: Is there a Positive Impact?" *Health Economics* 8, 1998.

18 Ann Marie Goetz and Rina Sen Gupta, "Who takes the credit? Gender, power and control over loan use in rural credit programs in Bangladesh," *World Development* 24 (1) (1994): 45-63; and Brooke A. Ackerly, "Testing the tools of development: credit programs, loan involvement and women's empowerment," *IDS Bulletin* 26 (3): 56-68.

19 The most comprehensive of these is Naila Kabeer, "Money Can't Buy Me Love: Re-Evaluating Gender, Credit and Empowerment in Rural Bangladesh," *IDS Discussion Paper 363* (Brighton: University of Sussex, Institute of Development Studies, 1998).

20 Hashemi, Shuler and Riley, "Rural credit programs and women's empowerment in Bangladesh," *World Development* 24 (4) (1996): 635-653.

21 Pitt and Khandker, 958-997.

22 Kabeer, 34-42.

23 Bina Agarwal, *Bargaining and Gender Relations: Within and Beyond the Household* (Washington, International Food Policy Research Institute, 1997).

24 Anton Simanowitz and Alice Walter, "Ensuring Impact: Reaching the Poorest While Building Financially Self-Sufficient Institutions, and Showing Improvement in the Lives of the Poorest Women and Their Families," *Pathways Out of Poverty*, ed. Harris, Kumarian Press Inc., 2002. (August 2002).

25 Many of the Kashf Foundation's clients are considered to be among the "poorest" as defined by the Microcredit Summit Campaign-those in the bottom half of a country's population living below the poverty line.