

# 5

## Microfinance: Where do we Stand?

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### 1 Introduction

Economies are built upon people buying and selling, lending and borrowing. The beauty of the market is that, when it works well, sellers are matched to buyers and lenders are matched to worthy borrowers. But when the market does not work well, goods go unsold and promising investment projects go unfunded. We understand why markets fail – the economics of information provides rigorous underpinnings for why credit markets, in particular, are so problematic.<sup>1</sup> The challenge has been to move from diagnosis to prescription. The challenge is particularly great in poorer regions, where individuals may have workable ideas and relevant experience but lack collateral. Even a £100 loan can make a difference to a small-scale shopkeeper or craftsperson in countries like Nepal or Uganda, but formal sector banks have steered clear, focusing instead on larger loans to better-established, wealthier clients.

The microfinance movement has aimed to change all that. The hope is that by using innovative new contracts, microlenders can both make profits and serve the under-served. While the full promise is as yet unmet (profits remain hard to squeeze out and the very poor are tough to reach), there are a growing number of success stories and, world wide, nearly 70 million low-income individuals are served by microfinance institutions (Daley-Harris 2003).

In this chapter we first focus on the innovations that have made microfinance possible. We then deliver an overview of recent trends. We argue that the future of microfinance institutions is ultimately in the hands of international donor agencies and local governments, which have been recently promoting competition and stressing financial self-sustainability as a way to maximize the breadth of outreach. The strategy is a major

departure from traditional approaches to foreign aid, and it challenges the role of applied welfare economics as the leading framework for policy analysis. In the traditional framework, cost–benefit analyses are used to determine the allocations of subsidies that can do the greatest good for the greatest number. In the new world of microfinance, many eschew subsidies for all but start-up expenses, and the aim is to become fully profitable, independent institutions.

In Section 1 we provide background to the current debate on the role and scope of microfinance institutions. In particular, we deliver a brief explanation of how the innovative “group lending” technique gained donors’ attention, and how it captured the imagination of academic economists. In Section 3 we argue that the dissemination of microfinance institutions was facilitated by additional innovations, and we focus on four: the use of “progressive lending”, the flexible treatment of collateral, the focus on women as customers, and the promotion of clients’ savings. In Section 4 we conclude by spelling out three main areas where the support of international donors and local governments can most effectively help microfinance institutions meet both their self-sustainability and social objectives.

## 2 Background

Microfinance grew out of experiments in Latin America and South Asia, but the best-known start was in Bangladesh in 1976, following a widespread famine in 1974 and a hard-fought war of liberation in 1971. In the 1970s Henry Kissinger famously called Bangladesh an “international basketcase”, but 30 years later Kissinger’s prognosis proves to be quite wide of the mark. Bangladesh continues to face economic, political, and social challenges, but it is hardly a basketcase. Fertility rates have dropped from an average of seven births per woman in 1970 to half that today; the economy has slowly moved forward, despite the continuing need for macroeconomic and fiscal reforms; and the microfinance movement has taken root across the nation, with over ten million customers spread across the country’s villages. Advocates argue that the microfinance movement has helped to reduce poverty, improved schooling levels, and generated or expanded millions of small businesses (e.g. Khandker 1998). The idea of microfinance has now spread globally, with replications in Africa, Latin America, Asia, and Eastern Europe, as well as in richer economies like Norway, the United States, and England. The latest count includes over 2500 institutions worldwide, each serving on average over 25 000 low-income customers.

No person is more closely associated with microfinance than Muhammad Yunus, an economist who was teaching at Chittagong University in the 1970s. In the midst of the famine, Yunus started looking for ways to improve the lives of the villagers living adjacent to his university. Together with his students, he seized on the credit market as the most direct and effective vehicle for development. Yunus started by lending to villagers from his own pocket and found that not only was he repaid on time but that the villagers were demonstrably benefiting from the new opportunities that the loans opened up. Yunus could not self-finance an initiative that hoped to spread beyond the village, however, and the challenge was to devise a mechanism that could be quickly replicated and that ensured high repayments while containing costs. With the government's blessing, the Grameen Bank was inaugurated in 1976, based on the premise of lending to the very poor at reasonable interest rates and without requiring collateral. In order to keep focused on the poorest clients, the bank instituted a rule (eventually relaxed) that they would only lend to households owning under a half acre of land, a rough indicator for being functionally landless.

The essence of microfinance is to draw ideas from existing "informal sector" credit mechanisms – like intra-family loans, Rotating Savings and Credit Associations (ROSCAs), and local moneylenders – while creating a viable conduit for capital infusions from formal sector banks, donors, and governments.<sup>2</sup> The lack of formal financial institutions in village economies has been long-acknowledged as a barrier to development, and millions of dollars in subsidy were channeled through state-run development banks beginning in the 1950s with the aim of reaching the poor. The initiatives were poorly designed, however, and credit was allocated according to political motives rather than need, management was lax, and repayment rates plummeted. India's Integrated Rural Development Programme (IRDP), for example, ended up with loan repayment rates around 30 per cent before being re-named and reformed. The Grameen Bank managed to persuade donors that it was possible for lending institutions in rural areas to be shielded from political interference and that lending to the poor could yield high repayment rates. For most of its life, Grameen has advertised loan repayment rates around 98 per cent.<sup>3</sup>

How did the Grameen Bank change the equation? The best-known story centers on the group lending methodology. While the Grameen Bank itself has modified many of its features in its new "Grameen Bank II" format (Yunus 2002), replicators worldwide still stay by the older model. The idea is that upon expanding to a new village, the bank holds