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Microfinance: no panacea, but useful instrument in fight against poverty

The recent meltdown of global financial markets linked to mortgage lending to poorer (sub-prime) households, particularly in the United States, has drawn a contrast with the relative stability of microfinance mechanisms that lend to the poor in developing countries. Microcredit schemes typically show high repayment rates and present a transparent business model, avoiding the excessive leveraging of mainstream financial institutions. This relative success is attributed to their innovative forms of group lending, whereby peer pressure serves as a substitute for collateral and group responsibility serves to minimize transaction costs. The prominent role of women as the counterparties in microfinance is often seen as another important reason for this success.

As policymakers ponder over how to rescue their macro-financial structures and prevent future collapses, it would seem pertinent to consider what lessons can be learned from the experience of microfinance in building economic security and achieving poverty reduction.

Explosive growth of microfinance

Over the past three decades, microfinance has grown dramatically. According to estimates presented in the *World Economic and Social Survey 2008* (WESS2008), there were more than 7,000 microcredit institutions in 2006, serving about 80 million people in about 65 countries, including some developed ones. At the same time, microfinance has expanded beyond being merely programmes of credit provisioning and now includes schemes of microsavings and microinsurance (see table). For example, the number of savers with Bank Rakyt Indonesia (BRI) had reached about 30 million by 2006, and a recent compendium of micro-insurance programmes prepared by the International Labour Organization in 2006 lists more than 74 such programmes worldwide, covering risks related to life, health, funeral expenses and crop failure (due to weather shocks).

Criticisms of microfinance

The expanding coverage and range of services associated with microfinance institutions (MFIs) can be taken as prima facie evidence of their success and help drive calls, including from the donor community, for them to play an even bigger role in development strategy. However, microfinance programmes have, particularly given their frequent reliance on subsidies, also faced serious criticisms over both their financial viability and comparative effectiveness in tackling poverty. In response, some have called for charging financially break-even levels of interest and the scaling up of operations, which, in turn, would make the macroeconomic impact of such programmes more tangible. Others have insisted that the main mission of microfinance is to serve the poor and worry that, since microfinance does not yet sufficiently extend its reach to the extreme poor, raising interest rates and increasing the scale of operation will only lead

Table: An overview of microfinance programmes

Type of microfinance programme	*Basic objectives*	*Present dimensions*	*Some prominent examples*
Microcredit	Provides collateral-free small loans to the poor	About 7,000 MFIs operating in about 65 countries, offering loans to about 80 million borrowers.	Grameen Bank. BRAC, BancoSol, ASA, Banco Compartamos and Bandhan
Microsavings	Facilitates saving by the poor by collecting small amounts on a frequent basis	About 35 per cent of MFIs provide savings services.	Bank Rakyt Indonesia (BRI), SEWA, Safesave
Microinsurance	Covers risks to health, life and income that the poor face in exchange for small insurance premiums.	About 100 programmes worldwide, mostly focused on health and life insurance, but some also insure farm incomes via crop insurance linked to weather indices	FINCA, BASIX, VimoSEWA, Gono Bima, Grameen Life, BRAC health, SSS, GRET, World Bank pilots in Ethiopia and Malawi

Sources: *World Economic and Social Survey 2008* and Microfinance Information eXchange (MIX).

Notes: BRAC: Bangladesh Rural Advancement Committee; ASA: Association for Social Advancement (Bangladesh); BancoSol: Bank of Solidarity (Bolivia); SEWA; Socio Economic Welfare Association (India); FINCA: Foundation for International Community Assistance (Uganda); BASICS: Bharatiya Samruddi Investment and Consulting Services (India); SSS: Society for Social Services (Bangladesh); GRET: Groupe de Recherche et d'Échanges Technologiques (Cambodia); SafeSave (Bangladesh).

to further exclusion of the poor from these programmes. Such critics do not think that microfinance programmes need to be financially viable in the short run and instead argue for providing temporary or permanent subsidies as part of effective welfare programmes.

Lack of hard data and impartial analysis make it difficult to judge the merit of many of these criticisms and counter-criticisms. In the end, it is likely to be broader issues of development policy that determine future approaches to microfinance.

Recent trends in the evolution of microfinance

Meanwhile, microfinance itself continues to evolve in response to both criticisms and its own internal dynamics. One clear trend is the increasingly variegated nature of the programmes. Many MFIs have diversified into microsavings and microinsurance programmes, seeking synergies and gaining from economies of scope through lower administrative and overhead costs. As the above example of BRI illustrates, microsavings programmes can provide access to a cheap source of funds, thus reducing dependence on outside support. Similarly, by servicing existing clientele and using available organizational infrastructure, many MFIs have achieved a faster uptake of microinsurance programmes and, by containing adverse selection through operating among a familiar pool of clients, have become financially viable. Furthermore, microinsurance programmes have also helped reduce the economic vulnerability of borrowers, enabling them to avoid problems associated with servicing loan obligations during times of distress or calamity.

Several MFIs have also succeeded in scaling up their operations. Apart from gradually increasing the size of loans given to existing successful borrowers (a common practice with microcredit programmes) they have also extended loans for new investments in larger undertakings, such as construction, major house repair and medium-sized businesses.

Some MFIs are venturing into purely commercial enterprises in order to diversify their services or to generate a higher profit that can be ploughed back into microfinance operations. Thus Grameen Bank of Bangladesh, the pioneer of microcredit, has now expanded into trade, manufacturing, the cell phone business, etc. The Bangladesh Rural Advancement Committee (BRAC), another giant MFI in Bangladesh, has started its own conventional commercial bank.

Some MFIs have become profitable enough to attract private investors. Mexico's Banco Compartamos, for example, went public in April 2007 to capitalize on its profits and raise capital. Its public offering of 30 per cent of the company's holding was 13 times oversubscribed and led to a valuation of the company at $1.6 billion. Banco Compartamos argues that its high profitability based on high interest rate spreads has enabled its fast expansion, based on retained income, from 60,000 to over 800,000 customers between 2000 and 2007. Other microfinance lenders are, however, very critical of an unduly commercial approach whose very high interest rates are seen as surrendering the very principles of microfinance.

Yet other MFIs have moved in opposite directions, attempting to reach the extreme poor. They have done so by devising special types of loans suitable for the purpose, such as the Custom Made Credit programme of the Grameen Bank, or a combination of support instruments, such as combining microcredits with welfare provisioning (in cash and in kind) and training. The BRAC Income Generation for Vulnerable Group Development programme, implemented with assistance from the Government of Bangladesh and the World Food Programme, is an example of such an effort to reach the ultra poor.

Microfinance as part of wider development strategy

One thing is clear, however: microfinance schemes cannot solve the problems of poverty and insecurity by themselves. This is evident from the fact that countries such as Bangladesh and Bolivia, which have seen a significant expansion of microfinance, have not been the frontrunners in reducing poverty. In contrast, East Asian economies, which had little or no development of microfinance, achieved substantial poverty reduction through fast macroeconomic growth, strong links between the formal banking sector and large-scale enterprises and high rates of investment, initially in labour-intensive, export-oriented activities.

At the same time, however, fast economic growth is not a sufficient condition for poverty reduction. Research has shown that an important factor in East Asia's successful growth strategies was the relatively egalitarian initial distribution of wealth, achieved through radical land distribution and shared improvements in education and health care.

Recognizing this factor may provide a more constructive approach to expanding microfinance programmes. By putting some assets directly in the hands of the poor and enhancing their social position, thereby increasing their access to various private and public sector resources, microfinance may also help create a more egalitarian initial distribution needed to launch an equitable growth process. However, in this role, microfinance may be complemented by other social policy tools, such as workfare, cash transfer schemes or other welfare measures. ■

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