The Microfinance Phenomenon, 2000

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In the 1990s, microfinance has captured the imagination of opinion leaders, governments and donor agencies. Supporters have argued that microfinance institutions (MFIs) can not only have a major impact in the fight against poverty, but can do so on a sustainable basis. At the same time, a number of critics have emerged. This paper considers the achievements of microfinance to date. It finds that most, but not all, of the evidence suggests that microfinance can play a role in reducing poverty. On the other hand, while it has become generally accepted that MFIs can and should become financially self-sufficient, few have actually done so. It may be appropriate for well-managed programs to receive some ongoing level of subsidization if they can be shown to be effective in reducing poverty. There is a continuing role for donors in the development of microfinance, but it is important that donors focus on quality rather than quantity.

Introduction

Microfinance is the provision of financial services, primarily savings and credit, to poor households that do not have access to formal financial institutions. In the 1990s, microfinance has captured the imagination of opinion leaders, governments and donor agencies as a key strategy for poverty reduction. At the same time, however, significant differences of opinion have emerged between the supporters of the microfinance movement and various critics, who have become increasingly numerous and vocal.

This paper considers the achievements of microfinance to date and offers some suggestions for the future. The section immediately following this introduction charts the rise of microfinance and outlines some of the key arguments advanced both by its supporters and by its critics. This is followed by a brief description of some of the main models of microfinance. Subsequent sections analyze progress in terms of the number of poor clients reached, the impact of microfinance in reducing poverty, and the success of microfinance institutions (MFIs) in achieving financial self-sufficiency. The paper then discusses the ongoing role for donor agencies in industrial countries to promote microfinance in the developing world, before offering some concluding comments.

Are the poor bankable?

In the decades following World War II it was widely believed that poor households were not bankable, that is, that it was not possible to provide financial services to poor households profitably. Loans for “microentrepreneurs” and poor farmers were generally provided through so-called “directed credit” programs, whereby banks were required to lend a certain proportion of their portfolios to particular client groups which would not otherwise have access to banking services. These programs had relaxed collateral requirements and generally charged subsidized interest rates, reflecting the view that the poor could not afford to pay market interest rates. Emphasis was placed on the employment generating potential of such credit, in a theoretical framework in which the transfer of labor from agriculture to industry was seen as a necessary concomitant of the development process, and employment creation in the industrial sector as the most effective means of reducing poverty.

Following the work of Shaw, McKinnon and other commentators in the early 1970s, directed credit programs increasingly fell into disrepute, especially in academic circles.1[1]2[2] Most importantly, they required large and ongoing subsidies, partly because of the subsidized interest rates but also because they had high cost structures and low repayment rates. They tended to suffer from politicization, with the benefits often going predominantly to non-poor households outside the target group. It also became accepted that the combination of interest rate controls and directed credit programs discouraged financial intermediation by reducing the incentive to save, and led to a misallocation of investment by directing funds into projects with relatively low rates of return.

The “informal” sector

Also in the early 1970s, attention was directed for the first time to the operation of an “informal sector” within the economies of developing countries in which the poor, who are unable to find wage employment in the industrial sector, engage in self-employment in a host of occupations such as trading, services like hair-cutting and shoe-repairing, the transport of goods and the processing and cooking of foods for direct sale.3[3] Over time, the concept was extended to include a “rural informal sector” in which landless laborers and households whose land was insufficient for their needs were seen to be eking out a similar existence from a variety of forms of self-employment.

This notion of a previously unnoticed universe of economic activity, additional to and outside of the normal measured national income, cast a spotlight on two neglected aspects of the economic life of the poor. First was the fact that in many countries women play a major, even dominant, role in informal-sector economic activity. The second flowed from the realization that formal wage-employment was growing, inevitably, much more slowly in most poor countries than the numbers of job-seekers. Also, for that reason, policies directed to “employment-creation” could not be enough to solve problems of poverty, other than over a very long time span. Hence job creation for the unemployed would have to be supplemented by a new emphasis on income-generation by the working poor themselves, through self-employment. The measure of success for such efforts would not be the creation of “jobs,” but rather a measurable growth in income generated by the working poor for themselves and their families.

The rise of microfinance

Beginning in the late 1970s, there was a recognition that among the obstacles preventing the working poor from improving their lives was the lack of access to financial services. From this developed a new emphasis on establishing financial systems able to reach poor clients on a more sustainable basis than had been possible under previous discredited schemes of directed credit. The Grameen Bank, established in Bangladesh in 1976 by Professor Muhammad Yunus, developed highly effective techniques for lending to the poor. These were based on techniques such as taking services to the village level, promoting and motivating groups of the poor, use of group guarantees, compulsory savings mobilization, transparency of credit transactions, intensive supervision of borrowers, and decentralized and cost-effective operations. Other institutions such as BancoSol in Bolivia and the *unit desa* system of Bank Rakyat Indonesia (BRI), also developed innovative techniques for lending to poor or near-poor clients.

While these techniques differ between institutions, there are three key principles behind them. First, these MFIs know their market. The poor are willing to pay for access and convenience. Interest rates are market-oriented, but lending outlets are located near the client, application procedures are simple, and loans are disbursed quickly. Second, they use special techniques to slash administrative costs. Simple procedures are used and approvals are decentralized. Borrower groups often handle much of the loan-processing burden. And third, they use special techniques to motivate repayments. MFIs have developed a range of techniques to ensure high repayment rates, including the use of self-selected groups in which members guarantee each other's loans, intensive motivation and supervision of borrowers, incentives for borrowers, progressive lending, and compulsory savings requirements.4[4]

While a number of these institutions performed creditably in the late 1970s and 1980s, they attracted only limited international attention. In the 1990s, however, microfinance has captured the imagination of governments, donor agencies, and other opinion leaders in both industrial and developing countries. Microfinance has moved from the margins of the development debate to center stage. It is seen as much more than simply the provision of financial services to poor households, but as a key strategy for poverty reduction in its own right.

Changing paradigms of development

In addition to the success of high-profile MFIs such as the Grameen Bank and the charisma of its founder, the rise of microfinance has reflected a number of factors. First, changes in development paradigms have made policymakers more sympathetic to initiatives such as microfinance. The traditional economic development approach of the 1950s and 1960s emphasized economic growth, while the basic needs approach of the 1970s emphasized the direct provision of health, nutrition, and education rather than economic growth. Both of these approaches have been seen to be inadequate.

During the 1980s a self-consciously hard-nosed approach was followed by international financial institutions, in which emphasis returned to the importance of economic growth. Policy concentrated on "getting the macroeconomy right" through structural adjustment, which proved more predictable in imposing costs on the poor than in securing the economic growth which it was felt would eliminate poverty through "trickle-down" processes.

What has emerged more recently in response to the experience of the 1980s is an approach that, while market-friendly, nevertheless recognizes the importance of direct interventions to reduce poverty, as exemplified by the World Bank's *World Development Report 1990*,5[5] which renewed the focus on poverty. In this approach, sustainable reductions in poverty can be achieved by a dual strategy of promoting the productivity of the poor and providing basic social services to them. Microfinance is seen as an important means of increasing the productivity of the poor by addressing market failure in credit markets and harnessing market incentives.6[6]

A second factor is the appeal of microfinance to broad sections of the development community, encompassing a variety of ideological perspectives. As noted by Morduch:

> Advocates who lean left highlight the "bottom-up" aspects, attention to community, focus on women, and, most importantly, the aim to help the underserved. Those who lean right highlight the prospect of alleviating poverty while providing incentives to work, the nongovernmental leadership, the use of mechanisms disciplined by market forces, and the general suspicion of ongoing subsidization.7[7]

An international movement

The embrace of microfinance by the mainstream development community is exemplified by the establishment in 1995 of the Consultative Group to Assist the Poorest (CGAP), a multi-donor effort initiated by the World Bank to increase systematically the resources devoted to microfinance. CGAP now has almost 30 members, comprising international financial institutions and multilateral development agencies, as well as bilateral donor agencies. These agencies have pledged resources to support sustainable microfinance in accordance with "best practice" principles agreed by the group. Japan was not a founding member, but has since joined.

Subsequently, the popularity of the microfinance movement reached new heights, indeed an apotheosis, with the Microcredit Summit in Washington DC in February 1997. The Summit was attended by some 1500 organizations from 137 countries, including a number of heads of state. It launched an ambitious nine-year campaign to reach 100 million of the world's poorest families, and especially the women of those families, with credit for self-employment and other financial and business services by 2005.

The Microcredit Summit saw microfinance (or more particularly microcredit)8[8] as having enormous potential for reducing poverty. For instance, the Summit Declaration stated that:

> There now exist both a substantial track record of accomplishments and a significant body of scholarly studies that together paint a picture of microcredit as a compelling antipoverty and development strategy. Taken together, these accomplishments communicate the possibility of moving toward a world freed from the blight of poverty within a length of time measured in years, rather than decades or centuries.9[9]

The Microcredit Summit further argued that microcredit had the potential to help most of the world's billion poorest people, based on the following seven findings from practical experience and evaluative studies:

1. Very poor people are a good credit risk, especially in the context of mutual-responsibility systems.
2. Sustainability of programs in the developing world is achievable.
3. Microcredit models have exhibited a high level of replicability.
4. Programs grow to serve large numbers of very poor people.
5. Microcredit programs help borrowers work their way out of poverty.
6. Microcredit programs stimulate savings and asset accumulation among poor people.
7. Microcredit programs become vehicles for a variety of desirable social developments.

This scenario envisages a "win-win" situation, where MFIs can not only have a major impact in the fight against poverty, but can do so on a sustainable basis without the need for ongoing subsidization.

The critics of "microdebt"

As with any movement, however, there have been critics. Significant differences of opinion have emerged between the supporters of the microfinance movement and these critics, who have become increasingly numerous and vocal. The critics have not denied that MFIs can and should become sustainable. However, they have questioned the impact of microfinance on poverty reduction,10[10] and have highlighted the increasing distance between the expectations created by the supporters and the achievements of microfinance to date.

For instance, one prominent critic, Dale Adams of Ohio State University, refers not to microcredit, but to a “microdebt industry,” suggesting caustically that the microfinance movement, aided and abetted by governments and donor agencies, encourages poor households to take on loans that they may not be able to service.11[11] A more moderate critic, Gonzalez-Vega, has questioned the goals and expectations established by the Microcredit Summit, arguing that they are based on wrong assumptions about the role of finance and on a disregard of the difficulties of expanding the “frontier” of the financial system to include the poor.12[12] He argues that no serious identification of demand has preceded the numbers of expected beneficiaries, and that no serious acknowledgement of the obstacles faced and of the feasibility of permanently increasing supply has preceded the promises. From these and other critiques it is clear there is considerable disagreement at present about the potential of the microfinance movement. The following sections of this paper consider the achievements of microfinance to date.

Models of microfinance: Grameen Bank and others

In recent years there has been a proliferation of MFIs in developing and even industrial countries. A number of distinctive models have emerged. The Grameen Bank model, developed in Bangladesh, has been adopted in numerous countries with a variety of physical, cultural, and institutional settings, and is by far the best known microfinance model. The model involves careful targeting of the poor through a means test, generally with a strong emphasis on poor women, and intensive promotion of the program by field staff. Borrowers organize themselves into groups, generally consisting of five members, who guarantee each others’ loans. Program staff are also involved in intensive motivation and supervision of borrowers, including through weekly meetings. The model emphasizes compulsory savings mobilization, but there is generally little or no emphasis on voluntary savings. Sustainability is achieved through scale and by decentralized and cost-effective operations. Unlike some of the other models discussed below, individual borrower groups are not expected to become autonomous institutions.

The village bank model has also been widely replicated, mainly in Latin America and Africa, although the total outreach is only a fraction of that of the Grameen Bank model. In the basic model, the implementing agency organizes individual village banks with 30–50 members, and provides a loan for on-lending to individual members (the external account). These individual loans are repayable weekly over 16 weeks, at the end of which the village bank repays the entire loan plus interest to the implementing agency. If the bank repays in full it is eligible for a second loan, with the size of the second loan dependent on the amount that members have accumulated in savings. This process continues through subsequent cycles. Hence there is peer pressure to ensure full repayment so that the bank can receive subsequent loans. At the same time, the bank can lend members’ savings (the internal account). At the end of three years, the bank should have accumulated enough savings to enable “graduation,” with the internal account sufficient to meet members’ credit needs. This model is less structured than the Grameen Bank model and aims to develop autonomous institutions, but is more structured than the other models discussed below.

Credit unions are democratic, nonprofit financial cooperatives owned and governed by their members. They mobilize savings and provide loans for both productive and provident purposes. Membership is generally based on a common bond (for example, employment, geographic location, etc.). In many developing countries there are credit unions operating in the rural areas, and membership may include poor and low-income households. There is generally also an apex body that promotes primary credit unions, provides training and monitors financial performance. Rural credit unions have been successful in some developing countries such as Sri Lanka, but have been less successful in most other developing countries in the Asia-Pacific region.

The self-help group (SHG) model is most prominent in India. It has some similarities with the village bank model, but is less structured. SHGs have around 20 members. They are based primarily on the principle of lending their members' savings, but also seek external funding to augment these resources. The SHGs themselves determine the terms and conditions of loans to members. A number of nongovernment organizations (NGOs) specialize in promoting and motivating SHGs, but the goal is for SHGs to become autonomous institutions. Some NGOs operate as financial intermediaries, while others confine themselves to social intermediation, seeking to link SHGs to regulated banks or other funding agencies. The SHG model is well suited to combining microfinance with other interventions in areas such as health and education, but the relatively loose structure makes it harder to increase outreach quickly and to maintain high standards of performance.

A very different approach to those discussed above is the rural financial systems approach practised in Indonesia. In this model, there is a range of regulated financial institutions that provide financial services in the rural areas. By far the largest is BRI, which has established a network of *unit desa* (village units) to provide financial services in the rural areas. The *unit desa* provide basic deposit and loan facilities on a commercial basis through the use of highly decentralized and cost-effective operations. They are particularly successful in mobilizing savings. In addition to BRI, there is a large network of rural banks (BPRs) and other small financial institutions operating at the local level. While BRI and these small banks do not target the poor explicitly, their clients include many poor and near-poor households, the equivalents of which in most other countries would not have access to the formal financial system.

The outreach of microfinance

Despite the rapid growth in the number of MFIs in recent years, their outreach remains very small compared with the target of 100 million poor households established at the Microcredit Summit.13[13]

Outreach is not simply a question of numbers of clients. Gonzalez-Vega defines six types of outreach: 14[14]

1. Quality—The value of microfinance for particular clients.
2. Cost—The cost of microfinance to clients, including both interest and transaction costs.
3. Depth—The social value of extending microfinance to a particular client group. It is generally argued that it is socially more valuable to extend microfinance to the poorest clients.
4. Breadth—The number of clients reached.
5. Length—Whether clients will be reached with only one loan, or whether they will receive financial services on a permanent basis.

6. Variety—The range of financial services provided to clients. While many programs focus almost exclusively on loans, clients may also demand other services such as savings facilities, insurance and payment services.

While these aspects are all important, and are indeed inter-related, this brief discussion focuses on breadth and variety.

It is not possible to cite conclusive data on the number of clients reached by microfinance programs. In many countries there is a large number of programs, with most reaching only a small number of clients. It is also not clear which programs should be included, with many institutions serving both poor and non-poor clients.15[15]

Notwithstanding these caveats, CGAP suggests that worldwide, MFIs reach fewer than 2 percent of microentrepreneurs.16[16] This is as true in the Asia-Pacific region as it is in other regions, even though many of the largest MFIs in the world are in Asia. The BankPoor '96 Regional Workshop on Microfinance for the Poor in Asia-Pacific found that:

> Essentially, the task of outreach remains to be done. Of the target poor households in Asia-Pacific, less than 5 per cent have access to financial services. If we exclude Bangladesh—the only country where truly large numbers have been reached—the numbers to whom microfinance services have been extended falls to less than 1 per cent of the target group.17[17]

While outreach may have increased since that time, the various models of microfinance are unlikely to be serving more than 10 to 15 million clients worldwide at present.

Moreover, many programs offer only a limited range of products, and do not meet all of the financial service needs of their clients.18[18] For instance, most MFIs have concentrated almost exclusively on credit, prompting some commentators to describe savings as the "forgotten half" of financial intermediation.19[19]20[20] Most practitioners were convinced that the poor had little capacity to save. However, in recent years a number of institutions have discovered that poor clients are often able to save considerable amounts, and that they value safe and convenient savings facilities. Consequently, many more institutions have begun to offer voluntary savings facilities. On the other hand, mobilizing savings places a heavy responsibility on MFIs to develop more sophisticated risk and liquidity management capabilities to ensure that the savings of poor clients are protected. It is generally considered that only institutions that are subject to prudential regulation and supervision should be permitted to raise deposits from the general public, but the position regarding more limited forms of savings mobilization is less clear.

Hence while microfinance programs have already reached a large number of poor households, they have a long way to go if they are to provide comprehensive financial services to a significant proportion of the world's poor. Moreover as discussed in subsequent sections, a number of constraints may make it very difficult to achieve a major expansion in outreach, especially in the short term.

Impact in reducing poverty

As noted above, microfinance has been seen as an important tool for reducing poverty. In theoretical terms, it is easy to see how this may be the case. In most developing countries, opportunities for wage employment in the formal sector of the economy are extremely limited, and the vast majority of poor people rely on self-employment for their livelihood. It is well documented that for many such "microentrepreneurs," lack of access to financial services is a critical constraint to the establishment or expansion of viable microenterprises.21[21]

What is the empirical evidence for the link between microfinance and poverty reduction? Until recently, there has only been limited attention to this critical issue. In 1996 Sebstad and Chen conducted a review of 32 early impact studies.22[22] The main findings were as follows:

- Twenty-six studies included data on enterprise impacts. Most found that credit had a positive impact on enterprise income, with average increases attributed to the loans ranging from 25 to 40 percent. Most studies also found positive changes in output, with some finding that access to loans increased asset accumulation and employment.
- Eighteen studies included data on household impacts. The six studies which examined household income found credit had a positive impact, although the increases varied. Some studies also found increases in household expenditures. However, impacts on health and nutrition and on children's education were mixed.
- Several studies looked at the impacts of credit on women's empowerment. The findings from Asia were generally positive, but the findings from Africa showed little change in decision-making patterns.

While the impacts were generally positive, many of the studies reviewed were not very rigorous. Some did not use control groups, while others had small sample sizes or suffered from other methodological difficulties.

Also in 1996 Hulme and Mosley published a study which examined the impact of 13 MFIs in seven countries.23[23] Hulme and Mosley derived two very influential conclusions. First, they found that for the very poor, loan impacts were on average small or negative relative to the control group. On the other hand, households on or above the poverty line generally experienced a positive impact compared to the control group. The authors argued that clients above the poverty line are more willing to take risks and invest in technology for "promotional" activities, whereas very poor borrowers tend to take out small, subsistence-protecting loans. This suggests that microfinance may not be effective in reducing poverty among the very poor.

Second, they found that the "impact curves" for MFIs with high financial sustainability were consistently higher than for those with lower sustainability. For any given level of income, clients of sustainable institutions achieved higher increases in income than clients of unsustainable ones. The authors suggested that the higher interest rates charged by sustainable MFIs screen out borrowers whose projects have relatively low rates of return, and that sustainable institutions tend to operate savings schemes which are valuable to clients.

This finding has been used to argue that reforms to increase the financial viability of MFIs can increase their poverty impact at the same time. Nevertheless, it is not clear if this finding is robust. It was based on a comparison of only five MFIs for which the necessary data were available, three with high sustainability (one each in Bolivia, Indonesia and Kenya) and two with low sustainability (both in Malawi). Impact is likely to depend on a wide range of country and region-specific factors relating to the local economy, and it is not clear if these results would necessarily be replicated in other programs.24[24]

More recently, a number of studies have considered the impacts of programs in Bangladesh using a sample of 1800 households and sophisticated econometric techniques. These are probably the most rigorous studies conducted to date. However, even using this common data set, different researchers have come to different conclusions. Pitt and Khandker found that:

- Household consumption increases by 18 Bangladesh *taka* for every 100 *taka* lent to a woman, and by 11 *taka* for every *taka* lent to a man.
- Non-land assets also increase substantially when borrowing is by women, but not by men.
- Schooling of boys increases whether men or women borrow, but schooling of girls increases only when women borrow from Grameen Bank, and not from other programs.25[25]
- By contrast, Morduch found no increase in consumption or education, but he did find evidence of consumption smoothing across seasons.26[26]

There is insufficient evidence based on these studies to draw strong conclusions. Most, but not all, of the evidence suggests that microfinance can play a role in reducing poverty by increasing the income and consumption of poor households, and possibly through positive social impacts as well. On the other hand, there are also suggestions that the very poor may not benefit from microfinance.

Microfinance is also likely to be more effective in some circumstances than in others. It is likely to be most effective in reducing poverty where there are opportunities for income-generating activities in the informal sector of the economy, that is, where there is a viable market for the goods and services that microentrepreneurs produce. Countries and regions with high population densities and large numbers of landless or near landless households would appear particularly well-suited to microfinance. By contrast, microfinance is likely to be less effective in reducing poverty in regions with low population densities and predominantly subsistence production, where there is less scope for market activity. It is acknowledged, however, that these comments are speculative and that there is very little empirical evidence on the effectiveness of microfinance in different settings.

Hence the evidence as it is suggests that microfinance can make a contribution to poverty reduction in some circumstances, but that it is hardly a panacea. There is no evidence, for instance, that microfinance has the potential to help most of the world's billion poorest people, as suggested at the Microcredit Summit, or that potential demand, in terms of the number of poor households that could benefit from microfinance, is as high as 100 million. On the other hand, there are enough positive findings to suggest that microfinance does have a role as one element in a more comprehensive strategy for reducing poverty. And the argument concerning relatively short-term impacts on poverty may miss another important point. The strengthening and extension of rural financial systems, to which the microfinance enterprise contributes, may prove essential for long-run economic progress.

The financial self-sufficiency of microfinance institutions

Financial self-sufficiency requires microfinance programs to cover all administrative costs, loan losses and financing costs from operating income, after adjusting for inflation and subsidies and treating all funding as if it had a commercial cost. 27[27] In recent years, it has become generally accepted that MFIs can and should become financially self-sufficient.28[28] Many reasons have been advanced as to why MFIs should become sustainable:

- First, funding from donor agencies is limited, and it is argued that it will not be possible for MFIs to expand to cover more than a small proportion of poor households on the basis of donor funds. Hence if MFIs are to expand significantly they need access to commercial sources of finance, and this in turn requires MFIs to become self-sufficient.
- Second and related to the argument above, while microfinance is currently attracting a great deal of attention from donor agencies, this will not always be the case. Hence MFIs that are not sustainable will not survive when donor agencies move on to the next development "fad."
- Third, subsidized programs do not have as strong incentives to be efficient as unsubsidized ones.
- Fourth, it is argued that subsidized programs are often captured by non-poor households who are attracted to take out loans because of the cheap interest rates, rather than benefiting poor households.
- Fifth, as noted above it has been suggested that sustainable programs may have greater impact in reducing poverty than subsidized programs.
- Sixth, it is argued that subsidized programs that do not operate in a business-like manner send the wrong signals to clients, who are expected to be business-like in their own activities.

The Guiding Principles for Selecting and Supporting Intermediaries agreed by donor agencies suggest that successful MFIs should be able to achieve financial self-sufficiency within five to 10 years.29[29] However, while there is a broad consensus that MFIs should become financially self-sufficient, few have done so in practice. Of the 49 MFIs in the Asia-Pacific region that were studied for BankPoor '96, including virtually all the largest and most successful MFIs in the region, only six were financially self-sufficient. Only two of these, the Association for Social Advancement in Bangladesh and SEWA Bank in India, were reaching substantial numbers of poor clients.30[30] These findings are broadly consistent with the findings from the MicroBanking Bulletin.31[31] The MicroBanking Bulletin found that out of 86 leading MFIs worldwide which submitted their data, 40 were financially self-sufficient. Most of these were in Latin America, rather than Asia.32[32]

It should also be noted that these two studies included only the most successful MFIs. An informal poll at a recent microfinance conference found that some experts estimate that no more than 1 percent of NGO programs worldwide are currently financially sustainable, and that perhaps another 5 percent will ever reach sustainability. The other 95 percent will either close down or continue to require subsidies, either because their costs are too high or because they do not charge their clients interest rates sufficient to cover their costs.33[33]

Moreover, Morduch has recently suggested that those institutions that are financially self-sufficient tend to be those that do not serve the poorest borrowers.34[34] For instance, a study of BancoSol in Bolivia, which is financially self-sufficient, found that its typical clients are among the "richest of the poor," and are clustered just above the poverty line. Similarly, the BRI *unit desa* system, which is also financially self-sufficient, also lends predominantly to non-poor households. Estimates suggest that only 29 percent and 7 percent of borrowers from these two institutions respectively were below the poverty line.35[35] By contrast the Grameen Bank, which specifically targets poor borrowers, is not financially self-sufficient. While the bank reports profits that amount to $1.5 million between 1985 and 1996, these profits rest on $16 million of direct grants, $81 million of implicit subsidies via soft loans, $47 million of implicit subsidies through equity holdings, and at least $27 million in delayed loan loss provisions.36[36]

These findings have prompted Morduch to reconsider the accepted wisdom that all MFIs should necessarily achieve financial self-sufficiency. In this analysis, there may be a case for ongoing subsidization of MFIs if the benefits of such subsidies exceed the costs. He comments that:

> Grameen's self-reported successes have been exaggerated, but even if the bank is not the economic miracle that many have claimed, it is not obvious that its failure to reach financial self-sufficiency is in itself a problem. As long as benefits sufficiently exceed costs and donors remain committed to the cause, Grameen could hold up as a wise social investment.37[37]

He also points out that failure to achieve financial self-sufficiency does not in practice necessarily mean that programs will operate on a limited scale. For instance, Grameen Bank and Bangladesh Rural Advancement Committee together reach around 4 million borrowers, even though neither is financially self-sufficient.38[38] If, as seems reasonable, we regard each of these clients as representing a household, then the lives of perhaps 20 million poor people in Bangladesh are touched to some extent by the work of these two MFIs.

Morduch's analysis deserves further attention. Experience to date suggests that even in ideal circumstances, it is extremely difficult for MFIs to achieve financial self-sufficiency. The task appears even more difficult for those MFIs that specifically target poor clients. This suggests that the "win-win" scenario suggested by some advocates, whereby MFIs can both operate profitably and effectively reduce poverty, may be overly simplistic. There may be a case for well-managed programs to receive some ongoing level of subsidization if they can be shown to be as effective or more effective than alternative strategies for reducing poverty. At the same time, this argument would not seem to call into question the imperative for MFIs to attain as high a degree of self-sufficiency as possible by minimizing costs and charging market-oriented interest rates. The higher its degree of self-sufficiency, the greater the extent to which an MFI can leverage donor funds to maximize outreach.

The role of donors

Donors and governments have played a critical role in the development of microfinance to date. In a study of nine countries in Asia, McGuire, Conroy and Thapa found that few if any financial institutions reaching significant numbers of poor clients have been established without the support of funding agencies. They argue that without this support, it is unlikely that there would be a microfinance sector at all.39[39]

Even those institutions that are now self-sufficient have relied heavily on subsidies to reach this stage. For instance, the Indonesian government invested considerable resources in the *unit desa* system of BRI to cover operating deficits of the units until they became profitable, as well as meeting the costs of staff training and technical assistance. BRI also received significant support from external agencies.40[40]

This suggests a continuing role for donors in supporting microfinance. Indeed, if microfinance were to expand significantly donors would need to play a much greater role. The Microcredit Summit estimated that reaching 100 million households would require funding of $21.6 billion in grants, low-interest loans and commercial loans, with more than half of this being provided through grants and concessional loans.41[41]

Nevertheless, this does not mean that donors should throw a lot more money at microfinance. As noted by Gonzalez-Vega:

> Insufficient funds … appear not to be the binding constraint to the expansion of microfinance in most developing countries. Instead, most experts … agree that the major bottleneck is a shortage of retailing capacity, ie a shortage of well-designed and sustainable organisations, with competent staff who can implement a cost-effective microfinance technology.42[42]43[43]

Gonzalez-Vega goes on to say that what is critical for the future of microfinance is institution-building. He adds that most experts agree that unless donors and governments support these institution-building efforts, they will be insufficient to achieve the desired expansion in microfinance.

Building strong, sustainable institutions is a painstaking process. Even if it is accepted that potential demand for microfinance is as high as the 100 million households targeted by the Microcredit Summit, for donors simply to increase funding to try to achieve such a target would do more harm than good. Experience in some countries has already shown that increasing funding beyond the capacity of MFIs to absorb it leads only to disbursement pressures and reductions in program performance. Moreover, undisciplined programs offering cheap credit with limited imperative to repay can easily drive good programs out of the market. As in most areas, the quality of donor activity is more important than the quantity.

Guiding principles for donors

The Guiding Principles for Selecting and Supporting Intermediaries agreed by major donor agencies in October 1995 provide a number of suggestions as to how support by donors and government can best be directed to maximizing outreach and sustainability.44[44] Most importantly, governments and donor agencies should only support institutions which demonstrate a capacity to reach poor clients on a sustainable basis.45[45] The Guiding Principles suggest that such MFIs should have three clusters of characteristics.

First, they should be strong institutions. They should have institutional cultures and structures that can support sustained service delivery. This includes sound governance, freedom from political interference, and strong business plans for expansion and sustainability. They should also have accurate management information systems and meaningful, transparent financial reporting that conforms to international standards. It is important that donor agencies assess these aspects when deciding which MFIs to support.

The second cluster relates to quality of services and outreach. MFIs seeking support should focus on the poor and have lending terms and conditions that meet the needs of their clients, such as quick, simple and convenient access to small loans. Where possible they should offer savings services. They should also demonstrate significant progress in expanding outreach. It would also be appropriate for donors to target MFIs with high impact in terms of poverty reduction. However, more work on the impact of microfinance in different circumstances is needed before such targeting could be undertaken with confidence.

Third, institutions should have sound financial performance. They should charge market-oriented interest rates and maintain low arrears. They should have clear plans for steadily reducing dependence on subsidies and for increasing operational and financial self-sufficiency over time.

In brief, if donors wish to ensure that their support for microfinance has maximum impact, they need to look very carefully at the institutions they support and ensure that such institutions meet a number of key criteria. While the major donor agencies have endorsed these principles, they are not always followed in practice.

Among multilateral institutions the World Bank has taken a leading role in microfinance. It provides the secretariat for CGAP, the donor consultative group, and has developed a portfolio of microfinance projects in all geographic areas and with a diversity of approaches. The Asian Development Bank (ADB) has announced a strategy for microfinance in the Asia-Pacific region46[46] and has recently flagged a major increase in the direct "poverty-alleviation" elements of its lending program. Among bilateral donors, the United States Agency for International Development (USAID) has the largest microfinance portfolio.

Japanese ODA and microfinance

Japanese Official Development Assistance (ODA) has, historically, been heavily weighted toward infrastructure projects with heavy engineering and capital goods inputs. For a variety of reasons, "software" projects involving institutional development, of which microfinance systems are a prime example, have not been important components of Japanese ODA. This may account for some hesitation in Japan's acceding to membership of the CGAP (which, as mentioned above, it has now done).

Japan's first foray into microfinance occurred in 1995 with a ¥3 billion loan to the Grameen Bank of Bangladesh. While this performed the useful function of augmenting Grameen's loanable resources with soft funding, the Japanese initiative was more cautious than creative. It provided no precedent for a systematic program of Japanese support to microfinance, since very few other MFIs exist which are capable of absorbing such volumes of capital. Japanese ODA is not geared to dealing with small entities, nor to providing the capacity-building which is the most pressing need of MFIs. This difficulty, and Japan's caution in this unfamiliar field, made it slow to sign up for another microfinance loan.

However, in 1999 Japan agreed a ¥1.4 billion project in Sri Lanka, its second initiative in the field. To some extent the cautious approach is seen again, in that Japan is pledging support for an existing project with a good track record, from which the original donors have withdrawn after fulfilling their obligations. The new phase of this project does, however, appear to mark a distinct advance in Japanese commitment to the sector, with the project design including substantial "software" elements such as institution-building and human resource development.

Conclusions

In the 1990s, microfinance has captured the imagination of governments, donor agencies, and other opinion leaders as a key strategy for poverty reduction. Supporters have argued that microfinance can create a "win-win" situation, whereby MFIs can not only have a major impact in the fight against poverty but can do so on a sustainable basis without the need for ongoing subsidization.

At the same time, significant differences of opinion have emerged between the supporters of the microfinance movement and various critics. The critics have questioned the impact of microfinance on poverty reduction, and have highlighted the increasing distance between the expectations created by the supporters and the achievements of microfinance to date.

There has been a proliferation of MFIs in developing and even industrial countries. However, despite the rapid growth in the number of MFIs, their outreach is unlikely to be more than 10 to 15 million worldwide. While this is a significant number, it is small compared to the target of 100 million established at the Microcredit Summit.

Most, but not all, of the evidence suggests that microfinance can play a role in reducing poverty by increasing the income and consumption of poor households, and possibly through positive social impacts as well. On the other hand, there are also suggestions that the very poor may not benefit from microfinance. Microfinance can make a contribution to poverty reduction in some circumstances, but it is not a panacea.

While it has become generally accepted that MFIs can and should become financially self-sufficient, few have actually done so in practice. Experience to date suggests that even in ideal circumstances, it is extremely difficult for MFIs to achieve financial self-sufficiency. The task appears even more difficult for those MFIs that specifically target poor clients. This suggests that the “win-win” scenario may be overly simplistic. There may be a case for questioning the current absolute commitment to financial self-sufficiency. It may be appropriate for well-managed programs to receive some ongoing level of subsidization if they can be shown to be effective in reducing poverty. The argument for subsidization is stronger if MFIs are acknowledged as contributing to the development of rural financial infrastructure which can be seen as a public good necessary for longer-run economic progress.

Donors have played a critical role in the development of microfinance to date, and there is a continuing role for them. However, the major constraint to the expansion of microfinance is lack of capacity in MFIs, not lack of funds. Even if it is accepted that potential demand for microfinance is as high as the 100 million households targeted by the Microcredit Summit, for donors simply to increase funding to try to achieve such a target would do more harm than good. It is important that donors focus on quality rather than quantity.

Notes

1 Edward S. Shaw, *Financial Deepening in Economic Development* (New York: Oxford University Press, 1973); Ronald I. McKinnon, *Money and Capital in Economic Development* (Washington DC: The Brookings Institution, 1973).

2 Notwithstanding these criticisms, many developing countries still maintain directed credit programs. The largest and best-known of these is the Integrated Rural Development Program in India.

3 The concept of the informal sector was introduced in a paper by Keith Hart, “Informal Income Opportunities and the Structure of Urban Unemployment in Ghana,” paper presented at a conference on Urban Unemployment in Africa, University of Sussex, 1971.

4 Elisabeth Rhyne and Maria Otero, “Financial Services for Microenterprises: Principles and Institutions,” in Maria Otero and Elisabeth Rhyne, eds., *The New World of Microenterprise Finance* (West Hartford: Kumarian Press, 1994).

5 World Bank, *World Development Report* (Washington DC: Oxford University Press, 1990).

6 For a discussion of market failure in credit markets, see Joseph Stiglitz, “The Role of the State in Financial Markets” in World Bank, *Proceedings of the World Bank Annual Conference on Development Economics* (Washington DC: World Bank, 1993).

7 Jonathan Morduch, “The Microfinance Promise,” *Journal of Economic Literature*, Vol. 37 (December 1999), pp. 1569–1614, p. 1570.

8 “Microfinance” encompasses both credit and savings, while “microcredit” focuses primarily on credit. The significance of this distinction is discussed below. Some critics of the “Microcredit” Summit maintain that its very name has acted to prevent a proper understanding of the importance of the “savings” side of the microfinance coin, at least among non-specialist observers.

9 Microcredit Summit, *Declaration and Plan of Action*, 1997.

10 The “financial systems” approach emphasizes the establishment of sustainable financial systems able to reach clients not traditionally served by the formal financial system. In this approach, financial services are simply another product (albeit an important one) consumed by poor and low-income households, and are not presumed to have any special powers in terms of poverty reduction. The “effectiveness” of such financial services is measured by the demand for them, rather than by their impact in reducing poverty.

11 This term is frequently used by Dale Adams in “devfinance,” an influential email discussion group on microfinance maintained by the Ohio State University.

12 Claudio Gonzalez-Vega, “Microfinance: Broader Achievements and New Challenges,” Economics and Sociology Occasional Paper No. 2518, Rural Finance Program, Ohio State University, 1998.

13 Most commentators accept that outreach also remains low compared with potential demand, even if they do not accept that potential demand is as high as was suggested at the Microcredit Summit.

14 Claudio Gonzalez-Vega, op.cit.

15 For instance, while Bank Rakyat Indonesia’s *unit desa* system is often referred to as an MFI, it is estimated that only around 7 percent of its borrowers are below the poverty line. See David Hulme and Paul Mosley, *Finance Against Poverty* (London: Routledge, 1996).

16 Consultative Group to Assist the Poorest, *Status Report* (Washington DC: CGAP, 1998).

17 I. Getubig, J. Remenyi and B. Quinones, eds., *Creating the Vision: Microfinancing the Poor in Asia-Pacific* (Kuala Lumpur: Asian and Pacific Development Centre, 1997), p. 10.

18 Even in terms of credit, many MFIs offer only a very limited range of loan products, with little flexibility in repayment schedules and even loan amounts.

19 This expression appears to have been coined by Robert Vogel, “Savings Mobilization: The Forgotten Half of Rural Finance” in D. W. Adams, D. Graham and J. D. Von Pischke, eds., *Undermining Rural Development with Cheap Credit* (Boulder: Westview Press, 1984).

20 As noted above, this focus on credit rather than savings is reflected in the name of the Microcredit Summit.

21 See, for instance, Foundation for Development Cooperation, *Banking with the Poor* (Brisbane: FDC, 1992).

22 Jennifer Sebstad and Gregory Chen, *Overview of Studies on the Impact of Microenterprise Credit* (Washington DC: USAID, 1996).

23 David Hulme and Paul Mosley, *Finance Against Poverty* (London: Routledge, 1996).

24 It has also been suggested that there are inconsistencies in the results, and that sample sizes are small for some of the most important studies. See Jonathan Morduch, “The Microfinance Promise,” *Journal of Economic Literature*, Vol. 37 (December 1999), pp. 1569–1614.

25 Mark Pitt and Shahidur Khandker, “The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of Participants Matter?”, *Journal of Political Economy*, Vol. 106, No. 5 (1998), pp. 958–996.

26 Jonathan Morduch, “Does Microfinance Really Help the Poor? New Evidence from Flagship Programs in Bangladesh” (California: Hoover Institution, Stanford University, 1998).

27 Consultative Group to Assist the Poorest, *Format for Appraisal of Microfinance Institutions* (Washington DC: CGAP, 1997).

28 The terms “sustainable” and “self-sufficient” are sometimes used interchangeably. However, self-sufficiency is taken here to refer to the financial dimension of sustainability, while sustainability is a broader concept with both financial and institutional dimensions.

29 Committee of Donor Agencies, *Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries* (Committee of Donor Agencies for Small Enterprise Development and Donors’ Working Group on Financial Sector Development, 1995).

30 I. Getubig, J. Remenyi and B. Quinones, eds., *Creating the Vision: Microfinancing the Poor in Asia-Pacific* (Kuala Lumpur: Asian and Pacific Development Centre, 1997).

31 Calmeadow, *The MicroBanking Bulletin*, Issue No. 3, 1999.

32 While the data for individual MFIs are not published, only 16 of the 86 MFIs were in Asia, and the grouped data suggest that on average, the MFIs from Asia had lower levels of self-sufficiency than those from Latin America.

33 Cited in Jonathan Morduch, “The Microfinance Promise,” *Journal of Economic Literature*, Vol. 37 (December 1999), pp. 1569–1614.

34 Ibid.

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36 Jonathan Morduch, “The Grameen Bank: A Financial Reckoning,” unpublished paper, 1999.

37 Jonathan Morduch, “The Microfinance Promise,” *Journal of Economic Literature*, Vol. 37 (December 1999), pp. 1569–1614, p. 1592.

38 Jonathan Morduch, “The Microfinance Schism,” *World Development*, Vol. 28 (April 2000, forthcoming).

39 Paul B. McGuire, John D. Conroy and Ganesh B. Thapa, *Getting the Framework Right: Policy and Regulation for Microfinance in Asia* (Brisbane: Foundation for Development Cooperation, 1998).

40 Consultative Group to Assist the Poorest, State-owned Development Banks in Microfinance, Focus note No. 10, 1997.

41 Microcredit Summit, *Declaration and Plan of Action*, 1997.

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43 Even the Microcredit Summit itself acknowledged that the greatest challenge, even greater than mobilizing funding, is the need to build local institutional capacity.

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45 As noted above there is a case for supporting MFIs that do not attain full financial self-sufficiency but have a significant impact in terms of poverty reduction. Nevertheless, it is important that such MFIs have realistic business plans for *increasing* their self-sufficiency, to enable increased outreach for any given level of subsidy.

46 Asian Development Bank, *Microfinance Development Strategy* (Manila: ADB, 1999).

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[38] Jonathan Morduch, "The Microfinance Schism", *World Development*, Vol. 28, April 2000 (forthcoming).

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