Microfinance approaching middle age

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The article describes the performance of agricultural credit programmes during the 1950s–1970s and suggests that they later influenced the microfinance industry. Early features and problems of the microfinance industry are described, followed by a discussion of the challenges currently faced by the industry. The authors argue there is little evidence showing that micro-loans are lifting substantial numbers of people out of poverty, although loans may help take the edge off poverty. The article concludes that more attention should be given to deposits and to lending to small- and medium-sized industries

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SOMETHING ODD HAPPENED ON THE WAY to the birth of the microlending industry nearly four decades ago. For millennia prophets, poets, and politicians preached that debt led to immiseration. Shakespeare echoed this folk wisdom in *Hamlet* when he had Lord Polonius proffer financial advice to his son: 'Neither a borrower nor a lender be. For loan oft loses both itself and friend'. Centuries later the Japanese sage Ninomiya Sontoku complemented Shakespeare's advice by counselling that, 'One who does not endeavor to save … is not a man in the true sense of the word'.

It is unclear when popular opinion about debt switched from it being a slippery slope into poverty to it being a stair out of despair, but this metamorphosis can be traced to at least the 1930s when anxious politicians used deficit spending and credit programmes to spur economic recovery and to alleviate poverty. Credit projects were subsequently prominent in reconstruction efforts after the Second World War, as well as in concurrent agricultural development programmes. Because the seeds of the future are often found in the past, we briefly summarize our experiences with these agricultural credit programmes, and then suggest that they may provide insights into the origins of microfinance.

One of the authors (Adams) first encountered credit projects for the poor in Colombia in 1965 when he studied two programmes, one funded by the Agency for International Development (AID) that supported a supervised credit programme for small farmers, and the other supported by the Inter-American Development Bank (IADB) that was aimed at inducing small farmers to substitute other crops for coffee. Three lessons emerged from these studies, the first being that credit projects may yield unanticipated results. It turned out that virtually all the borrowers from the supervised credit programme – administered by the Land Reform Agency – had previously received loans from a government bank. Earlier, that bank had eliminated

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most borrowers of small amounts from its loan portfolio because they were viewed as costly clients. This meant that there was little additionally – measured by more total loans for poor farmers – as a result of the AID-supported venture.

Another unanticipated result occurred in the coffee-diversification scheme. Consistent with the intent of the project designers, most of the borrowers used some of their loans to plant non-coffee crops, thereby reducing the area planted to coffee. At the same time, however, many of them spent most of their loans on removing old coffee plantations and investing in new practices that produced more coffee on less land, resulting in substantial increases in coffee production – the opposite of what project designers intended.

These unanticipated results were accompanied by a second lesson. To determine the results of lending efforts it is imperative to recognize fungibility. The essential and most desirable feature of financial instruments is that they are easily exchanged for almost anything. Fungibility was exercised at three levels in the two projects. First, the government used AID's money to replace funds earlier lent by the government bank to small farmers, and these released funds were then used to augment lending to wealthier farmers. Second, at the level of the financial intermediary, the additional money provided by AID and IADB allowed lenders to substitute donor funds for more costly money they might have otherwise captured through deposits. Third, fungibility was exercised by borrowers who viewed project loans as just another source of liquidity, with the investments that were supposed to be funded by loans being only one of their many spending options. As a result, there were no direct lines of causality from loans to changes in borrowers' specific activities.

A final lesson that Adams drew from the research was the importance of continuity in financial services. For most individuals, using one or two loans has little impact on their well-being, but having sustained access to financial services allows them to capitalize on occasional economic opportunities and also enables them to manage more comfortably the ups and downs in their affairs. A credit card is an example of the benefits of sustained access to financial services. One may not regularly use a credit card, but having one makes life easier.

Unlike a reliable credit card, neither of the Colombian programmes persisted. In the AID-funded programme, for example, most loans were made at a nominal interest rate of only 6 per cent per year, while the average costs for the lending agency to provide and supervise loans were about 25 per cent per year. In addition, inflation rates at the time varied between 10 and 20 per cent per annum, so that the purchasing power of the lender's loan portfolio eroded at a rate of more than a third each year. This erosion caused lending to contract and also led to loan recovery problems; as the prospects of receiving future loans declined, borrowers lessened the value that they placed on maintaining a relationship with the lender by repaying their loans. All this resulted in the eventual death of the programme. Concurrently, based on unanticipated results, the IADB decided not to fund further the coffee-diversification project.

The second author's (Vogel) interest in microfinance initially focused on deposits. During his studies at Stanford he worked with Edward Shaw, a pioneer in stressing the importance of savings. A few years later, in 1979–81, Vogel directed an AID-funded

project in Peru aimed at reforming a cooperative bank and a few affiliated credit unions, primarily by enhancing deposit mobilization (Vogel, 1984). The setting for the project was challenging: Peru was suffering economic stress and inflation, credit unions were faltering, and the cooperative bank was frail. The project had four elements: increasing the incentives for savings by paying higher interest rates on deposits, improving the quality of deposit services, providing special incentives for bank and credit union employees to stimulate interest in deposit mobilization, and campaigns involving advertising and prizes. The results of the project were impressive with the bank increasing its overall deposits almost sevenfold in just two years. This lessened the dependence of the bank and participating credit unions on outside funding. Vogel's experience in Peru led him to name deposit mobilization the 'forgotten half of rural finance'.

Adams's immersion in the problems of lending to the poor came with a position at The Ohio State University, doing further research there on rural finance for three decades and working for a time with AID. The latter included participating in a worldwide review by AID during 1972–73 of Small Farmer Credit Programmes. These experiences, plus subsequent research, led him to be sceptical about the effectiveness of directed and subsidized credit programmes, as many of the problems he saw were systemic rather than unique. Numerous programmes suffered loan recovery problems, as low interest rates, combined with inflation, eroded the real value of loan portfolios. Lending could only be sustained by continual infusions of outside funds. The fact that many of the subsidies associated with these programmes were captured by the non-poor, plus the frequent meddling for political advantage in lending decisions further troubled him. It became increasingly apparent that so-called cheap credit was no bargain for poor people when they received few of the subsidized loans and, furthermore, when those fortunate enough to receive inexpensive loans often had only transitory access to them. Low interest rates on deposits were also no bargain for savers, be they rich or poor. Work in Latin America by Vogel and colleagues showed that many credit unions were weakened or destroyed by low interest rate policies. They could only be reformed if more rational interest rates were employed and more emphasis placed on mobilizing deposits. Vogel noted that the availability of outside funds led credit unions to ignore member deposits in favour of less-expensive donor money, which further resulted in rent-seeking behaviour among credit union leaders. He, along with others, also recognized that prudential regulation and supervision were challenges that intensified as more emphasis was placed on capturing deposits.

The authors eventually recognized that interest rates play multifaceted roles in financial markets, including as indicators of market efficiencies. Interest rates simultaneously affect the behaviour of borrowers, depositors, and, of course, the financial intermediaries themselves. Concessionary rates on loans impact the profitability and durability of the lenders, while also depressing the interest rates that intermediaries pay on deposits. It was further noted that non-remunerative lending and deposit-taking often ended up being unstable and transitory.

Seminal research by Cuevas on transaction costs further clarified problems associated with providing financial services to the poor (Cuevas and Graham, 1984).

Two aspects of these costs were particularly important: the individual costs incurred by various participants in financial markets; and the ways in which interest rate policies affected how these costs were allocated among lenders, borrowers, deposit takers, and savers.

Many of the costs involved in financial transactions, for both loans and deposits, are relatively fixed for intermediaries and their clients, regardless of the size of the transaction. For example, it takes about the same amount of time and effort for a saver to make a small deposit as it does to make a large one. The same is true for deposit takers who use about the same amount of resources to process small deposits as they do to handle large ones. Similarly, there are fixed costs associated with obtaining and extending loans, regardless of the size of the transaction. The fixity of these costs, other things equal, causes intermediaries to prefer large loans and large deposits. Transaction costs incurred by clients also have a differential impact on borrowers. Unlike interest payments that are proportional to the amounts involved in loans or deposits, transaction costs incurred by clients weigh relatively more heavily on borrowers of small amounts, as well as on those who make small deposits, while the reverse is true for clients doing larger transactions who are less affected by their relatively small transaction costs.

Interest rate controls can also influence how lenders allocate transaction costs among participants. If lenders are unable to use interest rates to ration loans, they may adopt procedures that result in additional transaction costs for non-preferred borrowers – an alternative method of rationing. Typically, non-preferred clients include borrowers of small amounts and possibly new borrowers. This rationing may occur by requiring non-preferred clients to visit the lender numerous times to negotiate, obtain, and repay loans, while allowing preferred borrowers to transact loans in fewer steps.

In addition to a flawed finance paradigm, many agricultural credit programmes performed badly because agriculture and rural areas in general were punished by perverse macroeconomic policies for several decades after the Second World War. Price controls on agricultural products, distorted exchange rates that penalized agricultural exports, and lack of public investments in rural areas resulted in meagre investment returns for rural entrepreneurs. Fortunately, for the youthful micro-lending industry, macroeconomic conditions dramatically improved – particularly lower inflation – beginning in the late 1970s and 1980s, thereby providing more hospitable economic environments for micro-entrepreneurs.

The early years of microfinance

We were exposed to the birth of the microfinance industry at a seminar in Dacca, Bangladesh in 1978 where a young economist from Chittagong University described a programme that provided tiny loans to exceedingly poor women. Based on our earlier experiences with using loans to treat rural poverty, we were apprehensive about Professor Yunus's activities, but we later revised our opinions when his efforts blossomed into a worldwide industry.

Although not widely recognized, some important lessons from the earlier experiences with agricultural credit prepared the ground for the microlending industry. Early on it was recognized that making small loans to poor people was costly. Fortunately, the previous discrediting of the subsidized-credit approach, coupled with liberalized financial policies in general and lower inflation, allowed microlenders flexibility in setting interest rates. This permitted the industry to come to emphasize sustainability and subsidy independence. Closely associated with this, microfinance leaders developed techniques to reduce transaction costs for both clients and financial intermediaries – both major problems in earlier agricultural credit efforts. There was also a belated recognition that poor people could benefit from deposit services and that this was a desirable way of capturing funds for lending, something that critics of earlier agricultural credit programmes argued should have been done. In addition, the dismal performance of most government-owned development banks that had handled earlier agricultural loans led to the formation of non-governmental organizations (NGOs) to do much of the new lending.

The earliest years of the microfinance industry were dominated by Bangladeshi experiences where NGOs did most of the lending and developed most of the new technologies. For example, group lending was substituted for traditional collateral and was also a way of reducing some transaction costs for both lenders and clients. The emphasis in Bangladesh on lending to women likewise became a dominant feature in the industry. Many of these early programmes captured some savings though 'forced deposits', mostly as a substitute for traditional collateral, but the overwhelming majority of the funds for lending were provided by outside sources. Initially, microfinance institutions (MFIs) mostly ignored voluntary deposits, often because they lacked legal permission to accept them, but also partly because of the folk wisdom that the poor cannot save. In addition, if MFIs had stressed capturing deposits, it might have lessened their ability to attract funds from donors, thus taking the spotlight off loans as a treatment for poverty, and diluting the assertion that borrowers were creating micro-enterprises.

One reason for the early success of MFIs in Bangladesh was the dense population in its villages and cities. This reduced the transaction costs of forming and servicing groups of borrowers. This urban bias continued in other countries where most MFIs concentrated their activities in cities and towns, while finding it more difficult to work in rural areas. These difficulties included the costs of offering financial services outside urban centres. The Bangladeshi influence on the industry extended to evaluations, as most of the early, comprehensive credit-impact assessments were done using Bangladeshi information. The results of these studies, in turn, heavily influenced early opinions about the effectiveness of microlending in reducing poverty. Furthermore, policy makers interpreted the high repayment rates as proof that borrowers were benefiting from loans.

Along the way, some non-NGOs joined the industry, examples being a few reformed state-owned banks, credit unions, and the SHG Movement in India. The activities of banks such as the Bank Rakyat in Indonesia, BAAC in Thailand, and later Khan Bank in Mongolia, and BANRURAL in Guatemala were particularly noteworthy.

These were large organizations, compared with most NGOs, and, as banks, they were authorized to accept voluntary deposits. Their origins also prepared them to provide financial services in rural areas, both lending and deposit-taking, while their size and coverage of diversified areas permitted them to deal with the risks inherent in agricultural lending.

Rapid growth and diversity of institutional forms became prominent features of the youthful industry. Numerous new organizations emerged to promote microfinance. Some organizations, such as ACCION, BRAC, CARE, FINCA, the Grameen Foundation, ProCredit, Village Savings and Loan Associations, Freedom from Hunger, and Women's World Banking offered funding and technical assistance for MFIs that practised their brand of microfinance. Other organizations such as the Boulder Institute of Microfinance, CGAP, MicroSave, MicroCapital, Microfin, the Microcredit Summit Campaign, the European Microfinance Platform, the SEEP Network, and the Microfinance Gateway promoted the industry in general. Dozens of new organizations, some of them social investors, also emerged to act as second-storey banks and venture capitalists for MFIs.

Another notable feature of the maturing industry was the change in sources of funding for lending. Initially, various donors, some investors, and governments provided most of the money. Based on the success of Bank Rakyat Indonesia and Grameen Bank II somewhat later in capturing deposits, voluntary savings began to contribute to the supply of funds for lending. This tendency was amplified by some NGOs such as Calpia, Mibanco, and Banco Sol in Latin America that satisfied regulatory standards to become banks and were thus permitted to accept deposits. Organizations that drew capital from the general public for on-lending to MFIs added to the diversity of funding sources. Several Initial Public Offerings (IPOs) also provided funding, with all these changes eventually resulting in a diverse pattern of funding sources. Some entities, such as Grameen Bank II, the Village Savings and Loan Associations, many of the private rural banks in the Philippines, most credit unions, and some of the MFIs/banks, came to rely on voluntary deposits for most of their lendable funds. At the other end of the spectrum, most MFIs continued to rely on a variety of outside sources for money to lend.

Until less than a decade ago microfinance was known mostly for MFIs dispensing loans and only secondarily for capturing deposits, but two new systems are rapidly connecting millions of additional poor people, especially in rural areas, to formal financial services: branchless banking and government-to-person payments (G2P). These programmes have been promoted by commercial banks, telephone companies, or other for-profit entities, rather than emerging from NGOs/MFIs. In some countries, such as Brazil and Colombia, non-bank banking agents have extended these new services to virtually every corner of the country. Elsewhere, such as in the Philippines, South Africa, and Kenya, electronic networks using mobile phones have connected banks with millions of poor people, particularly in rural areas, who previously had little or no access to formal financial services.

Numerous governments also use G2P programmes to distribute funds electronically (Pickens, Porteous, and Parker, 2009). Some of these are social programmes, such as the conditional cash transfer programme in Mexico called *Oportunidades*

and a comparable programme in Brazil called *Bolsa*. Other programmes, such as the National Employment Guarantee Act in India, distribute wages electronically as part of a rural works effort that provides jobs for the rural poor. Numerous other countries increasingly pay government workers and retirees their salaries and pensions through electronic payment systems. These technologies have dramatically reduced the costs involved in small transactions, while also lessening the corruption that can accompany the distribution of government funds.

Adulthood

The microfinance industry has matured to include thousands of MFIs, credit unions, and banks with hundreds of thousands of employees. Many countries have dozens or even hundreds of MFIs making small loans. The industry makes the equivalent of many tens of billions of dollars in loans to hundreds of millions of clients and captures the equivalent of many billions of dollars in deposits. In addition, new branchless banking services and G2P programmes have connected with hundreds of millions of additional poor people, including in rural areas. Few weeks go by when there isn't a training course, seminar, or conference somewhere that focuses on microfinance. These accomplishments are impressive, but, like most human endeavours, praise has increasingly drawn scepticism and even criticism as the industry matured.

Where certainty once prevailed about loans being an effective treatment for poverty, that conclusion is increasingly being questioned (Dichter and Harper, 2007; Roodman and Morduch, 2009; Duvendack, Palmer-Jones, Copestake, Hooper, and Rao, 2011; Roodman, 2011,). Dealing with these doubts is perhaps the most serious challenge the industry faces, since it was built on the assumption that microloans could alleviate poverty. Obviously, most micro-borrowers benefit from using loans; otherwise they would not vote with their feet and repeatedly repay and return for further loans. But, using loans to deal with life's risks and using loans to climb out of poverty are substantially different – the first being comforting, the second being a cure.

Substantial money and time have been spent on credit impact assessments. Even those studies that have collected large amounts of data and have employed advanced methods report results that are sometimes questioned. Far more assessments have involved case studies, success stories, anecdotes, and even horror stories to support advocates' or critics' views. Some assessments employed flawed research techniques involving selection and attribution problems that produced excessively favourable results (Adams and Vogel, 2013). Another disconcerting feature of these assessments is that the conclusions reached are often correlated with those who did the assessment. If done by advocates of microlending the outcomes are almost inevitably positive, while the results of evaluations done by donors are often mixed, and those done by independent researchers frequently report negative results. It is also discouraging that none of these assessments documents the number of individuals who have been lifted out of poverty in any meaningful sense.

This uncertainty about microlending results might be traced back to the initial notion of a typical microborrower. They were often thought to be embryonic entrepreneurs who only lacked credit to develop a business. The success stories that are cited by promoters of microlending suggest that some borrowers may fit this stereotype. However, the diverse results from many credit impact assessments hint that most micro-borrowers don't fit the entrepreneurial mould. Instead of striving to maximize profits, most micro-borrowers are trying to minimize risks by diversifying their sources of income, rather than seeking efficiencies through specialization (Vogel and Schulz, 2011). If micro-borrowers are mainly trying to manage risk, this may explain why there is so little evidence showing that microlending is lifting people out of poverty, and, perhaps, why only a few successful small- and medium-sized enterprises (SMEs) are emerging from microlending efforts.

The high interest rates charged by some MFIs are another concern. While a few microlenders charge as little as 2 per cent or even less per month on their loans, other prominent MFIs charge in excess of 8 per cent per month. The weighted average for the industry appears to fall in the 3 to 5 per cent per month range when security deposits are factored into borrowing costs (Rosenberg, Gonzalez, and Narain, 2009). Some differences in interest rates are understandable given the variety of loan products that are offered, the types of clients served, and the maturity of the MFI. Nonetheless, an adult industry should largely be efficient, with the interest rates on loans being one measure of that efficiency. Interest rates on microloans have drifted down in some countries, notably Bolivia, but in a number of other countries they have remained stubbornly high, thus suggesting a lack of competition and perhaps a lack of efficiency. This, in turn, often attracts the attention of politicians who call for interest rate controls, as has occurred recently in India, Ecuador, and Nicaragua.

An allegation made against microlending is that many of its clients are trapped in debt, frantically borrowing from various sources to keep from drowning. The recent brouhaha in India over suicides among borrowers highlighted this concern. Inevitably, some borrowers will find themselves in this unenviable position. A few ensnared borrowers is one thing, but thousands of people caught in debt traps, if really true, is far more serious. Some individuals may continue to borrow in desperation as they fall deeper into debt, but, of course, MFIs could not persist if most of their borrowers were caught in these downward spirals, and it certainly isn't in their best interest to facilitate such self-destructive borrowing. Indeed, the fact that millions of individuals are repeat borrowers can, as an alternative, be interpreted as a sign of mostly good relationships between clients and MFIs. Instead of fleeing a bad association through defaulting on their loans (or simply not borrowing again from that MFI), most micro-borrowers choose to stay 'married' to their MFIs by regularly repaying their loans. Repeat borrowers are a key to MFI profitability because of the high costs of making initial loans. This leads MFIs to pay as much attention to retention rates as they do to loan recovery rates.

A related issue is determining the aggregate size of the potential market for microfinance. There are about 2.5 billion people who live on the equivalent of US$2.50 or less per day, and some industry leaders imply that most of them are candidates for loans. The industry is currently reaching roughly 10 per cent of this number,

measured by number of loans made – ignoring the fact that clients may have multiple loans. But, is it realistic for the industry to expand lending more than 10-fold? One major qualifier in using 2.5 billion as a goal is that more than half of the poor are children, too young to be candidates for loans. Perhaps another 5 to 10 per cent of the poor are elderly people who may be too aged to use loans advantageously, while other poor people are physically or mentally disabled and similarly unqualified to borrow. A further qualifier is that it is unrealistic to expect that every poor couple will take two loans. Considering all of these qualifications, a more realistic estimate of the aggregate market for microloans is likely significantly less than 20 per cent – possibly closer to 10 per cent – of the 2.5 billion poor people.

In contrast, the potential market for deposit service is likely to be much larger, based on the typical ratio of the number of depositors compared with borrowers found in credit unions where the number of deposit accounts may exceed the number of loans by several multiples. Given this, it might be a huge task to double the number of micro-borrowers, but at the same time the number of depositors might be doubled or tripled relatively easily. It goes without saying that the potential market for money transfers and bill paying via electronic media is an even larger number, perhaps as many as 80 to 90 per cent of the adult poor.

A related, but somewhat different, consideration arises when estimating the effective demand for microloans in a local area. Some microfinance advocates assume the unmet demand is quite large. But, a dominant feature of micro-borrowers is that they often work in markets where many others produce or offer identical goods or services. A single micro-borrower may enter an existing market or expand the size of an existing business without causing perceptible adverse effects on others – for example, if she is only one of 50 women selling potatoes in a central market. The other 49 vendors may not even notice that their incomes are slightly less than they were before the new lady entered the market. But, the impact of a dozen additional vendors using microloans to promote the sale of potatoes would almost certainly adversely affect the incomes of the original 49 vendors. Overall, the community benefits from such an expansion in microlending would be close to zero, as the gains realized by the new vendors would be mostly offset by the losses among the original vendors, a result connected to the *fallacy of composition*.

Two other concerns have surfaced about the microfinance industry: that it mobilizes too few deposits and makes too few agricultural loans, both related to easing poverty. It is important to remember that in most countries the majority of the poor persist in rural areas, and that most poor people are virtually sure to benefit from expanded savings opportunities. The size of financial institutions is likely related both to making agricultural loans and to capturing deposits. As mentioned earlier, an MFI often must be of substantial size before it qualifies to become a deposit taker, with credit unions being major exceptions. Similarly, geographic diversity, which requires size, is also important for a financial institution to manage the risks involved in agricultural lending. Even if more appropriate financial infrastructure can be developed in rural areas, agricultural lending may still be a challenge because of the associated costs and risks. In addition, as Harper (2012) has noted, the average rates of return on agricultural investments are often well below returns in other

segments of the economy, perhaps helping to explain why MFIs have not penetrated more deeply into rural areas.

Some industry leaders are concerned about mission drift, supposedly a tendency to make larger loans to successful borrowers at the expense of new, possibly poorer and newer clients. The fear is that parts of the industry are lessening their poverty-alleviation efforts in favour of not 'graduating' their best clients to commercial lenders. These concerns are based on the natural preference of lenders for repeat customers and to make larger loans to them, which is an essential aspect of microfinance technology. A better measure of drift is an increase in the average size of loans made to new clients. We see no problem in MFIs making larger loans to successful clients, as long as they continue to seek new clients and extend small loans to them. After all, an MFI is likely to be in the best position to make informed judgements on such 'up-market lending'. Graduating clients to a lender who specializes in making larger loans is wishful thinking, given that there is a 'missing middle' or 'gap' in most financial systems: a lack of formal finance for SMEs.

Challenges of middle age

Humans and even firms and industries experience life cycles. In this sense, the microfinance industry is approaching middle age. During this phase some firms employ new leaders who design new goods or services, or place more emphasis on some existing services, such as deposits in the case of MFIs. Sometimes this also involves mergers and consolidations that increase firm size. Occasionally these changes may also involve forming new justifications for the organization. The recent criticisms of the industry might be interpreted as signs of middle age that could lead to significant changes in microfinance.

The enthusiasm for microlending is based on the expectation that it is an effective poverty-alleviation tool. This hope was enthusiastically embraced by many politicians and donors who heaved a sigh of relief as they turned poverty alleviation efforts over to MFIs/NGOs. However, it is disconcerting that, after nearly four decades, there is little reliable evidence effectively documenting that microlending, in fact, is reducing poverty. Over the same period, tens of millions of people in some countries such as China have been drawn out of poverty by rapidly growing economies, absent much microlending. This leads us to wonder if microlending requires an adjustment in its justification. Is it still worth heavy promotion, even if it proves not to be lifting many people out of poverty?

Some critics of microlending argue that many poor people do not want more debt and, instead, would prefer a dependable job. Ostensibly, some micro-borrowers use their loans to upgrade to more dependable self-employment, to employ family members more productively, or even to employ non-family members and thus effectively become SMEs. Unfortunately, most credit impact assessments provide no information on the increase in non-family employment that is associated with micro-borrowing. Might the microfinance industry have more impact on employment, and hence poverty, if it supported more of its borrowers who have

firms that are becoming SMEs, and who are thus more prone to hiring non-family members?

In the *Divine Comedy* Dante places usurers in the inner ring of his seventh circle of Hell. Even though his medieval views about moneylenders were grossly overdrawn, it is still a stretch to argue that numerous MFIs charging around 100 per cent per year on their loans is a poverty solution. Indeed, if most poor people had sustained access to investments that had rates of return in excess of 100 per cent per year, many of them would not remain poor for long as they scrambled to use their own assets, remittances, and informal loans to capitalize on such excellent opportunities. Many of them would soon be operating profitable SMEs. Paying a high rate of interest on an occasional small loan to deal with emergencies for a short period of time is part of the plight of the poor, but such borrowing is an exceedingly steep and hazardous ladder out of poverty. Furthermore, poor people who borrow are often more concerned about the transaction costs they incur in taking a loan than they are about the interest rate charged on the loan. Nonetheless, to avoid being consigned to the lower reaches of Dante's Hell, the microfinance industry should strive to become more efficient and competitive, and endeavour to reduce the interest rates charged on loans.

As also mentioned earlier, size is important when it comes to capturing deposits and to providing financial services in rural areas. Does it make economic sense to have dozens or even hundreds of small MFIs in a country? Are they, at least in part, an artefact of their sources of subsidized funds? Would the overall costs in the industry be reduced through mergers and consolidation? Similarly, might the costs of providing second-story banking and venture capital to MFIs be reduced if there were fewer and larger organizations that provided funds to MFIs? Would fewer subsidies for the mature parts of the industry stimulate this consolidation?

Although there has been increased interest in deposits/savings in microfinance thanks, in part, to the efforts of the Gates Foundation, the Seep Network, Oxfam, the Village Savings and Loan Associations, and CARE, many people continue to view the industry as mostly making loans. Nonetheless, savings, rather than debt, has been the traditional way for poor people to deal with poverty as demonstrated by the continuing popularity of informal savings groups, and by centuries-long, savings-based efforts to provide financial services to the poor. Loans do allow borrowers to make expenditures earlier than is the case for those who save, but borrowing is accompanied by the risks of not being able to repay loans – a risk not involved in savings/deposits. Such risks are accentuated in microlending where relatively high interest rates and the joint liability included in some group borrowing often substitute for traditional collateral. What is becoming increasingly clear is that many of the poor, perhaps a majority, would prefer to have access to safe and attractive deposit services, over more debt. As evidence of this, most retail banks and all credit unions have more clients who are depositors than are borrowers.

The results of microlending lie along a continuum. On one end, some borrowers experience downward debt spirals and provide fodder for critics. Perhaps a similar number of individuals are on the other end of the continuum. They used loans to develop successful small enterprises, and in the doing, significantly elevated their

economic status. Supporters of microfinance, of course, feature these success stories. Unfortunately, the credit impact assessments done to date fail to document the number of borrowers who are in the extremes of the continuum, but it is likely in the single digits for both groups. Most borrowers fall in the middle where loans primarily allow households to smooth household consumption and deal with emergencies. This takes the edge off poverty, but it does not eliminate it. If microlending is, in fact, a weak instrument for reducing poverty, policy makers must seek other ways of addressing this universal problem. Will new approaches emerge out of the current microfinance industry? Overall economic growth, for example, is beyond what MFIs can influence. Also, the new cash transfer programmes in numerous countries, which may hold promise for poverty reduction, are all government projects (Fiszbein and Schady,, 2009). In retrospect, perhaps it wasn't within the province of microfinance to eliminate poverty.

What to make of it all?

Middle age is a time for contemplations about the past, the present, and the future. Regarding the past, the microfinance industry has been a clear winner when compared with earlier agricultural credit efforts: it has persisted while most post-Second World War agricultural credit programmes collapsed; it creatively dealt with transaction costs; and it has also mostly employed rational approaches to interest rates, critical issues that were badly managed earlier. Most impressive of all, a large number of social entrepreneurs have built a variegated array of organizations that now comprise the industry. In doing this, they employed innovations that enabled the industry to provide sustained, formal financial services to hundreds of millions of poor people, a remarkable achievement that deserves praise.

Nevertheless, regarding the present, it is regrettable that by its own initial objectives, building a large and sustainable industry has not been enough. In a final accounting the results of the industry must be measured against its original goal of poverty reduction. The fact that large numbers of poor people continue to use the services of the industry is certainly proof that they benefit from doing so, but it is in no way proof that they are escaping poverty. Sadly, the ambiguous and mixed results of disparate and often flawed credit impact assessments fail to clarify this vital issue. This may suggest that the industry should adjust its objective to something more modest – making poverty less painful, for example, by providing sustained financial services to poor people, even though this revised objective might be less appealing to donors.

Regarding the future, the microfinance experience provides further evidence on the limited contribution that credit programmes make to poverty alleviation. Like the Sirens' Call in Greek mythology, the melody of 'loans-for-the-poor' has proved irresistible for policy makers and donors. But, poverty is a complex malady that usually cannot be solved by loans alone. Loans do not make up for the lack of fertile soil or water, eradicate weeds, compensate for bad policies, cure endemic diseases, reduce road ruts, make unprofitable investments profitable, substitute for the lack of law and order, or compensate for bad schools. Although the microlending

melody was, and still is, seductive, it may have inadvertently diverted resources and attention from other programmes that might have been more effective in lessening poverty.

If more debt isn't the answer to poverty, as poetically suggested by Shakespeare, what is? Regarding the modest role that financial markets might play in this effort, we propose that Sontoku may have offered an answer that was closer to the mark when he praised saving (Ishiguru, 1987).

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