

...to gauge the value of People's Banks at its fullest, one should go among the people whom they have benefited—the small tradesman, the peasant, the cottager, who has by their help purchased, rod by rod, a little holding which he surveys with pride. One should go, as I have done, stick in hand, walking from cottage to cottage, and hear these people describe the contrast between erewhile and now, and listen to them telling of their little troubles and embarrassments, and how the bank stepped in to relieve them. Many such a tale there is which could not fail to warm a philanthropist's heart. —Henry W. Wolff, 1896¹

People do not march on Washington because of pie charts. —Andy Goodman, 2008

Chapter 1. Introduction²

Most popular accounts of microfinance—the provision of financial services to the poor—begin with a story, and with good reason. As the artificial intelligence pioneer Roger Schank discovered as he labored to make machines think like people, human memory is not a shelf of encyclopedias. Rather, people encode much of their knowledge about the world and themselves in stories. And story-tellers are most persuasive when the stories they tell resonate with narratives already embedded in the minds of their listeners, who then can see the experience of others through the lens of their own. Much of what we call comprehension, Schank submits, is the projection of our own stories onto others.³

This book begins with two stories. Both are about *microcredit*, the most well-known kind of microfinance, in which loans of roughly \$50–500 are made to poor people, often in groups. The first story is told by Muhammad Yunus, founder of the Grameen Bank in Bangladesh, and winner, along with the Bank, of the Nobel Peace Prize:

Murshida was born into a poor family of eight children. Neither her father nor grandfather owned any farmland. At fifteen she was married to a man from a nearby village who worked as an unskilled laborer in a factory. The first few years of the marriage went relatively well, but things turned sour when Murshida began having children. Just as their family expenses went up, her husband started bringing home less and less money. Finally it became clear that he was a compulsive gambler. During the 1974 famine, he was given a company bonus of 1,800 taka. He lost it all gambling. When Murshida complained, her husband beat her.

...

One day Murshida's husband came home after a week's absence and complained that there was not enough food for him. Murshida had cooked up something modest and had not eaten the entire day. Angry, her husband beat her and then left, saying he would return later in the morning. That day there was

¹ Wolff (1896), 12.

² Thanks to Anna Rain and participants in a June 2008 CGD seminar for comments on earlier drafts.

³ Schank (1990).

a thunderstorm, and as her husband had sold the roof of their house to pay gambling debts, Murshida and her three children were soaked. At that moment Murshida decided that something had to change. When her husband returned at midnight, Murshida confronted him.

“You have only brought a small quantity of flattened rice for your daughter,” she remembers saying, “but nothing for me. Yet everyone in the village says you earn a lot of money.” Her husband flew into a rage and beat her. Then he divorced her on the spot and told her to leave the house.

“What about the children?” Murshida asked.

“You can throw them into the river and let them drown, for all I care,” he responded.

Murshida sent word to her brother, who offered to take her into his home. Once she had moved in, Murshida found some more work spinning on contract. She heard about the Grameen Bank when it came to her village. Initially, the village leaders opposed Grameen and tried to prevent it from opening centers. One Grameen worker discouraged Murshida from joining, thinking she would move back to her husband’s village. But Murshida stopped another bank worker on the village path and begged him to give her money. “I told him I would swim across a river to attend Grameen Bank meetings if necessary. I told him that I wanted to follow him to wherever he was going to form a group, so I could join. I told him that he must give me money, otherwise I would not be able to survive with my children. He said I could not form a group right then, but that he would come to my home and form a group in a few days. And he really came!”

At first Murshida borrowed 1,000 taka [about \$30] to purchase a goat and she paid off the loan in six months with the profits from selling the milk. She was left with a goat, a kid, and no debt. Encouraged, she borrowed 2,000 taka, bought raw cotton and a spinning wheel, and began manufacturing lady’s scarves. She now sells her scarves wholesale for 100 taka with tassels and 50 taka without. Murshida’s business has grown so much that during peak periods she employs as many as twenty-five women in her village to manufacture scarves. In addition, she has bought an acre of farmland with her profits, built a house with a Grameen Bank housing loan, and set up her brothers in businesses that include sari trading and raw cotton trading. Murshida has also emerged as a leader in her [Grameen Bank] center. She was elected center chief several times.⁴

The second story comes from the pages of *BusinessWeek*, and tells of Eva Yanet Hernández Caballero, a customer of the fast-growing Compartamos microfinance bank in Mexico:

Hernández, 29, the daughter of a small farmer, says her mother purchased several knitting machines in 1992, but lacked cash for yarn. The equipment remained idle for years. A loan, Hernández thought, would enable her to buy nylon and more machines. She aimed to lure home her brother and two sisters, who she says are undocumented workers with restaurant and hotel jobs in the U.S. Over four years, beginning in 2001, she, her mother, and a sister took out a series of loans ranging from \$200 to \$1,800, at an [annualized interest rate] of 105%. They rolled one into the next and used the money to increase their weekly output from 800 dozen pairs of socks to 1,500 dozen. At their peak, they say they brought in \$800 a week, more than enough to sustain an extended family of six.

Then things unraveled. Wholesale customers fell behind on payments. Compartamos’ steep interest rates took an unremitting toll, as Hernández and her relatives each missed several \$130 payments to the lender. That was a lot for the rest of the 23-member borrowing circle to make up. Resentment surfaced. Soon after Compartamos trumpeted her story in 2005, Hernández and her family were banished from the group.

⁴ Yunus (2003), 199–201.

Lacking capital, she has seen her production and earnings plunge to 500 dozen pairs of socks and \$270 a week. Her siblings remain north of the border. Stoic about her tarnished accomplishments, she is uncertain about the future. “It’s been a huge effort,” she says, “and we’re barely afloat now.”⁵

I offer these stories to demonstrate both the power and the limitations of narrative as knowledge. The stories of Murshida and Eva are moving. It is easy to imagine how a reader encountering either alone would accept the implied lesson of microcredit as a savior or a snare. She would assemble in her head a general story of how microcredit changes people’s lives, made convincing by the concrete instance and by ties to his own experience. A stack of statistical studies would not leave as strong an imprint. For example, Pierre Omidyar, the founder of eBay, was drawn to microcredit by the way it channels capital from rich people on one side of the planet to the poor people on the other. He saw microfinance as a metaphor for his own success in building a global marketplace powered by fruitful but anonymous linkages and became one of microfinance’s biggest investors.⁶

But while either story is powerful alone, their juxtaposition creates cognitive dissonance. Murshida and Eva follow opposite arcs after encountering microcredit. Murshida’s ascent offers us precious hope while Eva’s descent plays into our cynicism. The contradiction forces many questions. When does giving small loans to the poor trap them and when does it give them freedom? Is Murshida’s story the rule that proves the exception or is Eva’s?⁷ In other words, how do we judge which story is representative? Presumably, Yunus and his staff selected Murshida’s story from thousands of Grameen members’ biographies with a sharp eye for compelling successes. On the other hand, Keith Epstein and Geri Smith, the *BusinessWeek* reporters, may have sought the worst cases. Glory in journalism follows the scoop. There is also a deeper question about whether any story (or statistic) can be representative, since each client’s experience with microfinance is unique. Because the human mind comprehends the world by

⁵ Keith Epstein and Geri Smith, “Compartamos: From Nonprofit to Profit,” *BusinessWeek*, December 13, 2007.

⁶ Bruck (2006).

⁷ It should be noted that Yunus does not see these two stories as comparable; he has drawn a sharp distinction between Bangladeshi microcredit, which is dominated by groups that charge about 20 percent interest per year and are not driven by the profit, and Mexican microcredit, which is largely provided by for-profit companies charging rates approaching 100 percent.

simplifying it, we constantly seek generalizations—“truths.” But generalizations in the social realm are never wholly true, and it is often hard to know just how far off the mark they are. The truth turns out to be an elusive thing.

This book aims to probe and limn the truth of microfinance, such as it can be understood, and draw out the implications for all those who back microfinance or contemplate doing so. It does so by viewing microfinance through the perspectives of history, economics, ethics, and politics; and through the eyes of poor clients struggling to protect and improve their lot and microfinance managers struggling to break even. Each perspective offers a piece of the truth of microfinance. Many books have been written about microfinance, but I don't think any other has quilted together so many perspectives. If this quilt can be described in a few statements, perhaps they are that the poor need financial services at least as much as the rich; that this is why microfinance is far less novel than usually believed; that much of what characterizes modern microfinance, such as the focuses on women and credit, arose out of business practicalities rather than the belief that these emphases maximize impact; that the statistical evidence for impact is remarkably weak; that the ancient conundrum of usury, of deciding when credit empowers and when it enslaves, lurks unresolved in microfinance too; that the politics of aid rewards those who accentuate the positive, leading to distorted and distorting expectations of what microfinance can do; and yet that any business that gives financial maneuvering room to a hundred million voluntary customers must be doing something right.

Oddly, what is being looked at through all these lenses is surprisingly difficult to pin down. One can define “microfinance” as any financial service—credit, savings, insurance, money transfer—designed for the poor. But that might include, for example, the Indian postal bank system, whose reported 124 million savings accounts make Grameen's 7.7 million seem trifling, and are not usually what

people have in mind when they say “microfinance.”⁸ Nor does “microfinance” usually seem to mean the savings and credit clubs that poor people around the world have organized among themselves for centuries. In practice, “microfinance” usually refers to *systems for delivering financial services to the poor that draw on outside technical and financial support*. It is an investor-centric notion, where by “investor” (to define another term) I mean anyone who would finance microfinance with grants, loans, or equity investment. In effect, since postal savings banks are not investible, they are invisible. Since this book is ultimately interested in providing guidance for investors, I will generally use the narrower investor-centric definition. The methods that account for most such microfinance were developed in the late 1970s and early 1980s.

The need for a better understanding of the social return to microfinance grows as more is invested in it. Today, microfinance institutions (MFIs) receive grants, loans, and equity investment from a panoply of actors—rich-country governments, major private charities such as the Bill & Melinda Gates Foundation, pension funds, “high net worth individuals,” and regular folks who can place small amounts through Kiva.org. In 2007, Compartamos went public in a spectacular initial public offering that brought in \$450 million, turned the founders into multimillionaires, and generated nine-figure gains for early investors including the American non-profit Acción International and the World Bank’s private sector lending arm, the International Finance Corporation (IFC).⁹ The Gates Foundation, backed by the two largest American fortunes ever, has issued multimillion dollar grants aimed at linking [xxx] million poor people to the formal financial system by [20xx].

Between 2004 and 2006, the amount of foreign investment in microfinance, counting both loans and “equity” investment (ownership stakes) tripled, to \$4 billion, according to Xavier Reille and Sarah Forster at the Consultative Group to Assist the Poor (CGAP) in Washington, DC. Just over half that total

⁸ Data set for CGAP (2004); Grameen Bank Monthly Update, December 2008, grameen-info.org/index.php?option=com_content&task=view&id=453&Itemid=527.

⁹ Rosenberg (2007).

came from government development lenders such as the IFC and Germany's Kreditanstalt für Wiederaufbau (KfW). Historically, such public agencies took the lead in investing in microfinance, but a diverse assembly of private players appears to be surpassing them as a source of capital. TIAA-CREF, the giant U.S. pension fund institution, has committed \$100 million. eBay founder Pierre Omidyar gave his alma mater Tufts University an equal sum, requiring that it be invested in microfinance. Sequoia Capital, an early Google investor, and private equity firms Blackstone and Carlyle have closed deals in the tens of millions. Through his investment vehicle Legatum, New Zealand billionaire Christopher Chandler took a majority interest in Share Microfin, investing some \$25 million in 2007.¹⁰ In late 2008, as world credit markets dried up, Share's larger competitor, SKS Microfinance, raised \$75 million in equity capital, the largest such deal ever.¹¹ And groups with names like Grey Ghost and Blue Orchard have floated vehicles to pool and channel funds from larger groups of investors, public and private, to lend to and invest in microfinance groups.¹² Nearly all this money is financing *microcredit*, a service that needs capital for fuel.

Almost all this support for microfinance is motivated in part by the pursuit of "social return" in the form of better lives for deserving people. Investors want to see microfinance empowering a young mother in an Indian village with more leverage with her husband over how the family spends its money. They want to see it free a woman in the Bolivian Alto Plano to open a kiosk offering lamp battery recharging to the men who scratch a bare living out of an ancient silver mine.¹³ They want her children never to go to bed hungry. They want to help build thriving financial institutions that empower millions of poor customers and give them a route out of poverty.

¹⁰ "Legatum Invests over 100 Crore (Us\$25 Million) for Majority Interest in Share Microfin Ltd., India's Leading Microfinance Institution," Legatum, Dubai, legatum.org/docs/20070515.pdf

¹¹ "SKS Microfinance Raises \$75 mn," *Financial Express* (India), November 10, 2008.

¹² Reille and Forster (2008).

¹³ As did Maria [X] in the documentary, "The New Silver." [cite]

Through bitter experience, financial markets have slowly developed conventions and disclosure rules to improve the information flow around *financial* return. But in the world of microfinance, high-quality information on *social* return is scarce. Of course, the mere existence of thriving, competing, innovating institutions such as Grameen and Compartamos is a sign of success. And a hundred million clients cannot all be wrong. This book will take these viewpoints seriously. But it will also argue that claims that microfinance reliably reduces poverty rest on a reed far thinner than most understand. The underlying problem is that social return is much harder to define and measure than financial return. Improvements in people's lives along dimensions such as health, education, and income cannot be naturally denominated in a single currency. And such gains often play out over years, mingling with the effects of everything from cyclones to road paving, making it nearly impossible to trace the social return on microfinance alone. Then there is the problem of distinguishing correlation from causation: which comes first, borrowing or prosperity? Only now, three decades after the birth of modern microfinance, are researchers putting microcredit to drug-trial-like tests that can reliably measure some of the impacts.

Microfinance practitioners and promoters have naturally moved to fill this breach in knowledge with success stories. At every link in the human chain from ultimate recipient to ultimate investor, incentives reinforce natural human tendencies to accentuate the positive. Thus like Lyndon Johnson getting briefed by his generals in the White House Situation Room during the Vietnam War, microfinance investors receive information that has been filtered several times.¹⁴ Occasionally the filtering represents a breach of public trust, as when a government agency suppresses an unfavorable evaluation of a program. But human nature, often bolstered by powerful organizational incentives to show success, leads us all to marshal the best evidence, arguments, and stories for causes we believe in. Not even academia, which aspires to objectivity, is free of biases toward positive results. And its results are filtered by others. "We do have some use for these studies," wrote Susy Cheston of Women's Opportunity Fund and

¹⁴ On Johnson, see Kearns (1998 [1976]), 167.

Larry Reed of Opportunity International in a thoughtful 1999 piece about the scope and value of academic-style research. “We quote liberally from them (as long as they are in our favor) when we apply for funding. However, we rarely use them when we are doing our planning.”¹⁵

The heart of this book is an analysis of the question of what is known about the impact of microfinance. The analysis is organized around three major notions of economic and social development that permeate the global conversation on microfinance: development as freedom, development as institution-building, and development as measurable impact.

Amartya Sen, who wrote *Development as Freedom* and won a Nobel in economics, argues that development is inherently about increasing freedom: freedom not merely in the libertarians’ sense of freedom from interference, but freedom as greater agency in one’s life. High income, education, health, and democracy all give people more control over their lives. These freedoms reinforce one another so that any one is both a means and an end. Sen famously noted that no democracy has suffered a major famine: relative freedom from tyranny begets freedom from a particular want. Sen has also cited studies showing that across India, better-educated women have fewer children.¹⁶ He suggests that microfinance can increase freedom too: “The availability and access to finance can be a crucial influence on the economic entitlements that agents are practically able to secure. This applies all the way from large enterprises...to tiny establishments that are run on micro credit.”¹⁷ Viewing development as freedom leads to specific questions about microfinance. How much leverage does it give women within their families and communities? How often does *microcredit* in particular *reduce* freedom, as it appears to have for Eva in Mexico? How can we tell which microfinance organizations operate in ways that limit the risk? Buried in these modern questions is the old one of when, if ever, interest on credit is just. Is it a matter of interest rates or also the relative power of lender and borrower? The ancients never resolved the issue: Chris-

¹⁵ Cheston and Reed (1999), 8.

¹⁶ Ibid, 196–99, citing Murthi, Guio, and Drèze (1995).

¹⁷ Sen (1999), 39.

tianity used to ban interest, Islam still does, and whatever the doctrine, there have long been Christians and Muslims who charged interest even if by another name.

Joseph Schumpeter, the 20th century economist who popularized the idea of “creative destruction,” offers us a second notion of development. In Schumpeter’s view, the hero of economic development is the entrepreneur who pursues innovations that disrupt established ways of making and selling things. In this view, development is a continuing cacophony of economic revolutions that save society from stagnation and political revolution. The greater the threat of disruption, the more it checks the excesses of corporations, forcing them to innovate and compete to the benefit of the customer. Disruptive innovations need not be high-tech. Just as Sears drove many small American retailers out of business with its catalog, Wal-Mart marginalized Sears decades later with its aggressive cost cutting. Nor must the entrepreneurs work for a profit. If he were alive today, Schumpeter would recognize Yunus and the other non-profit tinkerers and visionaries of microfinance as heroes of development-as-transformation. He would probably see the mere existence of major microfinance institutions (MFIs) in Bangladesh, India, Indonesia, and Mexico, employing thousands and delivering to millions a service once thought impossible, as the essence of development. In this view, the spread of microfinance is as obviously economic development as the spread of the mobile phone among the world’s poor. Important questions from the development-as-transformation perspective have to do with the extent to which finance for MFIs is helping them grow, innovate, and compete. Is the avalanche of new investment cultivating a thousand flowers or is it causing a few to grow large, overshadowing the others and squelching competition? Do business imperatives limit the quantity and type of services MFIs can provide to the poorest?

The third notion of development, most associated with academics, is that of measurable impact. If microfinance radically expands people’s freedom, if burgeoning microfinance institutions so enrich the fabric of society, shouldn’t the benefits be measurable in the strength of the roof over a borrower’s

head, in how many of her children are in school, in the level and stability of her income? As Cheston and Leed put it, “just knowing that we increased the debt of 100 million people will not tell us that we accomplished what we set out to do, even if we delivered that debt in a financially viable manner.”¹⁸ And if the impacts can be measured, doesn’t that render moot the philosophizing about freedom and transformation? The problem is that impact is surprisingly hard to measure. If someone shows you a successful microcredit borrower and an unsuccessful non-borrower, you could probably think of several stories to explain that pattern. The MFI may have chosen to lend only to successful entrepreneurs. Or unsuccessful entrepreneurs may have tried credit and dropped out. More generally, it may only operate in more affluent provinces, ones linked by good roads to the cities. Or perhaps the choice was the borrower’s: only households with good, going businesses dare take on the obligation of credit. And can we be sure that the successful borrower’s gain is not coming at the *expense* of the non-borrower, so that the net gain is zero? Ruling out such stories in order to establish causality from financial services to a net improvement in quality of life—finding statistical evidence that is *only* consistent with that story—is extremely difficult. MFIs and their backers have commissioned hundreds of evaluations over the years, almost none of which succeeds in ruling out these other stories. Some practitioners who work daily with apparently appreciative customers roll their eyes at the researchers who insistently ask, “How do we really know this helps?” Perhaps the practitioners want to reply with a question of their own: “If you are so smart, why don’t you tell Murshida how to live her life?” But pursuit of empirical truth is what researchers are trained for, and just as they should hesitate before telling practitioners how to do their jobs, so should practitioners acknowledge researchers’ competence in measuring microfinance’s social return.

The scholarly literature on the impacts of microfinance is remarkably thin, owing to both the difficulty of establishing causality and the career risk for practitioners of being associated with demonstrat-

¹⁸ Cheston and Leed (1999), 6.

ed failures.¹⁹ An important exception is the paper by Dean Karlan of Yale University and Jonathan Zinman of Dartmouth College, which is the first test of credit for the poor that is *randomized* much in the way that the U.S. Food and Drug Administration requires of drug trials; it finds encouraging results for a payday lender in South Africa.²⁰ Randomized trials of programs that fit better into the usual conception of microcredit are underway in [India, Peru, and the Philippines], and should shed more light within a year or so. However, the late sociologist and experienced evaluator Paul Rossi once offered an Iron Law of Evaluation to the effect that “the expected value of any net impact assessment of any large scale social program is zero,” and followed up with a Stainless Steel Law that “the better designed the impact assessment of social program, the more likely is the resulting estimate of net impact to be zero.”²¹ Rossi’s metallic laws are actually soft enough to admit exceptions, but they do counsel caution as we await the results of the randomized microfinance tests.

Thus, concerned investors should mind the gap between rigorous evidence and soaring rhetoric about microfinance’s *transformative* impact on the poor. If investing in microfinance “merely” builds dynamic institutions that are enlarging the freedom of most of its poor clients, it is doing well by the standards of foreign aid, whose history is checkered with failure. But conversely, if the research does not permit us to be sanguine about the transformative value of microfinance, then nothing about how it is currently implemented is sacred. For instance, the U.S. Congress’s directive that half of U.S. government aid for microfinance go to the very poor—those in the bottom half of the poor, measured by income—seems ungrounded in any evidence that, to put it provocatively, the poorest people are the best ones to put in debt.²² To the contrary, in Bangladesh, as probably in most places, the poorest and richest alike avoid—or are excluded from—mainstream microcredit programs. “Experience has shown that the

¹⁹ Armendáriz de Aghion and Morduch (2005), ch. 8; Savedoff, Levine, and Birdsall (2006).

²⁰ Karlan and Zinman (forthcoming).

²¹ Rossi (1987).

²² U.S. Public Law 108–484.

very poor (those whose cash flow is so weak that they cannot find a modest fixed sum each and every week) and the well-to-do (those who find the weekly routine too cumbersome for such modest loans) do not participate in the schemes.”²³

In fact, much of what characterizes modern microfinance—the dominance of credit, the focus on women, the use of groups—appears to have been ingeniously designed, or to have evolved, as a way to solve the tough business problem of mass-producing financial services for the poor without losing one’s shirt.²⁴ These choices may indirectly help the poor by allowing MFIs to grow and serve more people, but whether they are directly giving the poor what they most need is less clear. Probably the most important financial services in *your* life are the ones that help you hold things together in bad times and good, in sickness and in health: a savings account that helps you prepare for a wedding, a retirement fund to assure a comfortable life after you stop working, health insurance to prevent a run-in with cancer from bankrupting your family, life insurance to provide for them if you die. The poor look to financial services to meet the same need for managing spending, and for them it is not a matter of retiring to Palm Beach but procuring enough to eat year-round. Microcredit can help them in a pinch, but savings and insurance, services that are often overlooked in the current wave of investor enthusiasm, work better if equally business-sound techniques can be found to deliver them in quantity.

The modern microfinance movement began with tiny experiments in Bangladesh, the Dominican Republic, and Indonesia in the 1970s and early 1980s. To a surprising degree, those experiments drew on far older models, especially the credit cooperatives that flourished in Germany starting in the 1850s. But the modern movement has also broken new ground. It has linked rich-world capital markets with poor-world street markets to a degree without historical precedent. It has touched some [100] million clients and its explosive growth shows no signs of abating. It has favored women. These are spectacular

²³ Rutherford (2008), 4.

²⁴ Roodman and Qureshi (2006).

achievements, borne of a blend of vision, innovation, salesmanship, hard work, and respect for the poor. But as Pankaj Jain and Mick Moore write, “To properly appreciate the great achievements of the micro-credit movement, one has to be more skeptical of its self-image than is normally considered polite or respectful.”²⁵ Without minimizing those achievements, this book aims to ask tough and appropriate questions of the movement and to learn lessons for the support of microfinance and other projects to aid the poor.

²⁵ Jain and Moore (2003), 29.