…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, 1896[[1]](#footnote-1)

People do not march on Washington because of pie charts.—Andy Goodman, 2009

**Chapter 1. What’s the Story?**

Most accounts of microfinance—the businesslike provision of financial services to the poor—begin with a story. So I think it is fitting to start my inquiry into microfinance with stories. Here are two, about the most well-known kind of microfinance, micro*credit*, in which loans of $50–1,000 or so are given to poor people, often in groups. Both stories, I assume, are true. The first story is told by Muhammad Yunus, who won the Nobel Peace Prize along with the Grameen Bank he founded:

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 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 [borrowing group]. She was elected center chief several times.[[2]](#footnote-2)

The second story comes from a documentary by the Dane Tom Heinemann called “The Micro Debt”:

Narrator: We…return to a little village in the northern part of Bangladesh. Here we met Razia, and her daughter. Razia also has loans with Grameen Bank. She wanted to give her daughter an education.

Razia [in English subtitles]: I had cows, I had jewelry and I had the house. I sold everything to pay the debt off.

Heinemann: So you just told me that you had to sell your house. Can you show me your house?

Razia: Yes, I can.

Heinemann: Okay, let’s go…. [*walking*] So Razia for how long [a] time did you have that house you had to sell?

Razia: For 15 years.

Heinemann: You built it yourself, your family?

Razia: Yes, we did. We bought the land and built the house ourselves. [Now] I have nothing left to sell, except the kitchen pots.

Heinemann [*now all are seated in a courtyard*]: If you think back, do you sometimes feel that you should never have taken the first loan?

Razia: Then I would never have had to sell my house. I built the house without taking any loans.

Heinemann: And now it has become a never-ending story to you, and your family.

Razia: That’s right. I can’t get out of it. I’ve tried everything but it failed up to now. I had no money to pay the installments. So I decided to sell the house. These [microfinance] organizations never stop. They really pressed me. They come and stay until they get their money. They press us to sell our belongings. So I sold the house to pay the debt. [*The camera zooms in on the long, sad face of Razia’s teenage daughter. A single tear descends her cheek. One senses years of burden.*]

I offer these stories to demonstrate the power and the limitations of narrative as knowledge. The stories of Murshida and Razia are individually moving. It is easy to imagine how you, encountering either alone, would accept the implied lesson of microcredit as savior or snare. You would mentally assemble a general story of how microcredit changes people’s lives, made convincing by the concrete instance and by parallels with your own experiences and aspirations. A stack of statistical studies would not leave as strong an imprint. More than almost any other approach to helping the world’s poor, microfinance has this power to generate stories that resonate with potential supporters. Pierre Omidyar, the creator of eBay, saw a metaphor for his own success in microfinance, with its market-friendly leveraging of social networks to substitute for collateral. He became one of microfinance’s biggest supporters, giving his alma mater Tufts University $100 million to invest in the field.[[3]](#footnote-3)

But while the two stories are each powerful alone, their juxtaposition creates cognitive dissonance. Murshida’s ascent offers us hope while Razia’s descent plays to our cynicism. I set up the contradiction in order to force some critical questions. When *do* small loans entrap and when do they free? Is Razia’s story the exception that proves the rule or is Murshida’s? Presumably Yunus and his staff sifted Murshida’s from the biographies of thousands of Grameen members. Likewise, Heinemann may have sought the worst cases: glory in journalism follows the scoop. Can either story be trusted as representative? Indeed, can any story (or statistic) be representative? Each client’s experience with microfinance is unique. We constantly seek generalizations because we can understand the world only by simplifying it. But almost all generalizations in the social realm, as distinct from the realm of physics, with its pristine laws, are partly false—and how much so is often hard to tell. The truth turns out to be an elusive thing.

Until a couple of years ago, the microfinance industry got on pretty well with stories and opportunistic use of academic studies. The general impression was that microfinance was a proven weapon against poverty. But the last two years have dealt the industry a series of blows that have left industry insiders and outsiders increasingly muddled about microfinance. In mid-2009, respected academics released the first two high-quality, randomized studies of the impact of microcredit on poverty. Neither found an effect over the approximately 18-month study periods on bottom-line indicators such as household spending and the number of children going to school.[[4]](#footnote-4) Simultaneously, New York University’s Jonathan Morduch and I reported that what *had* been the leading (non-randomized) studies finding that microcredit reduced poverty were fatally flawed.[[5]](#footnote-5) Outside the ivory towers, microcredit industries crashed in Bosnia, Morocco, Nicaragua, and Pakistan in 2008 and 2009. The causes variously included fast growth, global recession, debtor revolts, and political backlash.[[6]](#footnote-6) 2010 brought worse. In January, Nigeria’s young microfinance banking industry tipped into crisis as institutions began defaulting. In October, amid reports of suicides and subprime-like overlending, the government of the state of Andhra Pradesh, India’s microfinance hotbed, ambushed private microcreditors with an extremely restrictive new law. Weeks later, Tom Heinemann’s controversial documentary gave Bangladesh’s prime minister Sheikh Hasina an opening to rekindle her vendetta against Muhammad Yunus. She all but called him a bloodsucking moneylender.[[7]](#footnote-7)

Early in 2011, Vijay Mahajan—one of the most thoughtful and effective human beings in microfinance, the man who led the way to commercialization in India, and one of India’s 50 most powerful people *Businessweek*—embarked on a singularly humble act.[[8]](#footnote-8) He went on a *Shodh Yatra*, a 60-day soul- and truth-searching journey across India, looking to reconnect with poor people and learn from them anew. “Unable to match Gandhi, one can at least mimic him….I will walk while in a village or a town, stopping by every once in a while to have a dialogue; and drive between habitations.” On his first day, he blogged the depths of his uncertainty:

“Here I am in the middle way, Having had twenty years, Twenty years largely wasted… The years of l’entre deux guerres [between two wars]”. TS Eliot’s lines come to mind and it metamorphoses into “Here I am at the end of the way, Having had thirty years, Thirty years largely wasted… The years of les guerres de l’interne [internal wars]”

…

Thirty years…largely wasted? Who can tell? Just emerging raw from the microfinance crisis. A field which was received a Nobel Prize for one of its pioneers, Dr Mohammed Yunus and was widely praised till a year ago is now widely condemned – by people like Bangladesh PM Sheikh Hasina, and the former Reserve Bank of India Governor Dr YV Reddy. What is real? The earlier assessment or the current one? What is real is what the people say.[[9]](#footnote-9)

In the pages to come, I will share the fruits of my own search for a full, balanced understanding of the impacts of microfinance. If you, like me, have been confused by the sunny and sour messages about microfinance, then the results of my search are the main thing I have to offer you. For me, this book has been a medium of thought, a source of discipline, and a vehicle for sharing my views with you. I wrote it in public—something rarely done before—by sharing drafts, questions, and discoveries through an “open book” blog.[[10]](#footnote-10) Working this way garnered me feedback on drafts, helpful leads, a sharper sense of audience, and, I must say, a more personal voice. This book records my intellectual journey. If you did not join me on that journey, through the blog—or even if you did—I hope you will join me vicariously through this distilled record of it.

Here is the destination I reach: Murshida’s story is not the whole story of microfinance. But neither is every borrower a Razia. The success of microfinance is real, if subtler than generally understood. Its strength lies not in lifting people out of poverty—industrialization and jobs do that better, nor necessarily even in empowering women, but in *leveraging modest subsidies to build financial institutions and industries that give millions of poor families more control over their finances*. Maybe that truth disappoints relative to the myth. But the good that microfinance can do is respectable by the standards of foreign aid and philanthropy, in which failures are common and successes hard-won. And whether microfinance lives up to the expectations of those too rich to need it is less important than whether microfinance does reasonable good at reasonable cost. As Pankaj Jain and Mick Moore have written, “To properly appreciate the great achievements of the microcredit movement, one has to be more skeptical of its self-image than is normally considered polite or respectful.”[[11]](#footnote-11)

If your daughter shows a flair for guitar, you don’t force her to paint instead. Just so, my evaluation leads to a prescription: help microfinance play to its strengths. Instead of shoving it in the direction of putting capital in the hands of as many poor people as possible, on the hope that this will launch them all into entrepreneurship and out of poverty, focus on mass-producing services to help people manage the uncertainties of being poor. To the extent practical, deemphasize pure credit—which after all is leverage, and amplifies risk—in favor of savings and insurance, which can cushion in times of trouble. Deemphasize subsidized credit to the poorest, since dependence on limited subsidies throttles growth, and since common sense says that the poorest are the most vulnerable to the downside of debt. Instead, favor the building of permanent, dynamic, customer-oriented institutions that cover most or all of their budgets with fees and interest. For microfinance insiders, I side with the philosophy of the American network group Acción International and the German ProCredit holding company of microfinance banks; and I question the Microcredit Summit Campaign in its push to get microcredit to 175 million of the world’s very poorest by 2015.[[12]](#footnote-12) For potential funders of microfinance, ranging from my mother to the Gates Foundation, I advise against directly financing microcredit portfolios. (I’m happy to report that neither does.) Instead, donate to organizations such as Acción and Freedom from Hunger which have track records in institutional midwifery using adaptive blends of advice, training, and investment.[[13]](#footnote-13) Finally, I express hope that modern communications technologies such as mobile phones and card readers will economically link poor people to the formal financial system in radically different ways, reducing the need for group microcredit.

Perhaps you noticed my caution a few of paragraphs back in referring to the “good that microfinance can do.” The strengths that I identify in microfinance are no more automatic than the alleged ones I debunk. The greatest threat I see to the success of microfinance is the easy supply of cheap capital for the business, which has been drummed up by the mythologizing and is corroding its core strength in building durable institutions to serve the poor. Microfinance, or at least microcredit, needs less money, not more. A truth too easily ignored until the Andhra Pradesh crisis is that markets in credit are susceptible to bouts of mania and depression. If companies try to sell more soap or fertilizer than the market can absorb, prices fall and inventories bulge. If companies try to sell too much credit, demand can seem to keep up with supply for years. Oversupply covers its own tracks as people use new loans to repay old loans. Put otherwise, microcredit is a prescription drug—useful in moderation, but dangerous and even (metaphorically) addictive in large doses. Yet as the global financial crisis has exposed, when the money is easy, investors and their intermediaries have strong incentives *not* to worry about whether the money is well lent. The recent microcredit crashes are perhaps the first bubbles in history fueled more by generosity than greed. Some of the bubbles appear to have popped of their own accord in the classic, inevitable manner of financial manias; others were popped by populist political backlashes. Either way, they point to a pressing need for the global microfinance industry, from Kiva users to big investors and lenders, to recognize and tackle the challenge of moderation. It is tough, because it calls for cooperation among competitors: even when individual lenders exercise discipline in how much they lend to a person, an industry with several lenders can collectively prescribe an overdose. Of course, just as bubbles are a fixture of financial history, the microfinance industry will never perfectly balance prudence and expansion. But it can do better.

It has become popular to bust the myths of microfinance. Milford Bateman of the Overseas Development Institute in London published *Why Doesn’t Microfinance Work?* *The Destructive Rise of Local Neoliberalism*. Newspaper articles and blog posts announcing that microfinance is not a panacea, not a silver bullet, are a dime a dozen. I wonder now whether it is the *hype* that is overhyped….Still, the case against microfinance as a proven anti-poverty tool needed to be made.[[14]](#footnote-14) This book also makes the case, with a demanding tour of the relevant academic literature in chapter 6. Still, I tend to lose patience with those who get excited about what microfinance does *not* do while exhibiting little curiosity about what it *does* do. It is a trap to equate myth-busting with evaluation. That is why this book’s contrarianism is also aimed at the threats to microfinance’s real strengths, above all the overenthusiastic flow of capital into microcredit. Ironically, while I distance myself somewhat from the icon smashers, they may be my best allies. By demolishing the assumption that more money for microcredit is always better, they may slow the flow. Their deflation of expectations may stop the inflation of bubbles.

So that is the destination I have reached through the blog and this book. Now that I have completed the journey, heard from blog commenters and peer reviewers along the way, and returned to edit this opening chapter, I realize I have something more to offer: a conviction that my journey is a destination too. That is to say, there is a lesson beyond *what* I learned, about *how* I learned. It is in the nature of modern society that talented people specialize. As a result, the global microfinance conversation is carried on by a wealth of experts each approaching the subject from a narrow angle. But if you want to understand something as variegated as microfinance, you can’t just think about it one way. You can’t only listen to the economists running randomized trials or the anthropologists living in the villages or the Wall Streeters syndicating loans—though all have insight to share. You must be open-minded and patient enough to break down the walls between world views. Like Mahajan on his journey, you must visit many villages and listen to many voices.

In particular, I tweak a hot and good trend in development economics over the last ten years: doing randomized experiments to find “what works.” Leaders of this movement such as Dean Karlan, Esther Duflo, and Abhijit Banerjee have just popularized the trend with enticingly subtitled books: *How a New Economics Is Helping to Solve Global Poverty* and *A Radical Rethinking of the Way to Fight Global Poverty*.[[15]](#footnote-15) But as with microfinance in its reputational heyday, now that experimentation is ascendant, the public may overestimate its power. Consider: would a randomized study of the impact of mortgages on borrowing households in the United States in 2005–07 have told you everything you need to know about the mortgage industry’s contributions to the welfare of human being and progress of nations? No. For that, one should also study the dynamics of industry that makes the loans and the dynamics of households that take them. This book does both for microfinance.

I divided this final, frozen text into two main parts. The first part, chapters 2–5, approaches our subject obliquely, asking not what microfinance can do for the world, but how the world has shaped microfinance. I hope this sustained indirection does not try your patience. I think that before we impose upon microfinance the outsider’s question, “What good does it do?”, we ought to take it on its own terms. To start, chapter 2 talks about the financial challenges faced by the poor people whose patronage has allowed microfinance to thrive. In particular, it emphasizes that people who live on, say, $2 a day, *don’t* live on $2 a day, but rather on $4 one day, $1 the day after, $0 the day after that…. Their incomes are not just low but volatile. They suffer more often from injury and illness yet depend more on their physical vigor for their livelihoods. As a result, the global poor need financial services—ways to put aside money in good days and seasons and draw it down in bad—*more* than the global rich, a group I take to include the salaried classes of rich countries.[[16]](#footnote-16)

Chapter 3 traces the history of what I call financial services for the masses, starting in Ancient Athens. It turns out that microcredit and microsavings come from long lineages. The rationales put forward for these services have varied over the centuries; constant are the evident demand for the services and the search for institutional forms to deliver them in bulk. Chapter 4 brings the family history up to date and surveys the diversity of microfinance today. Chapter 5 takes an evolutionary perspective, asserting that the dominant characteristics of modern microfinance, such as the emphases on credit, women, and groups, dominate mainly because they confer survival advantage on microfinance institutions. They solve the tough business problem of mass-producing financial services for the poor without losing one’s shirt. On the one hand, this thesis undercuts the assumption that microfinance is the way it is because that is what is best for the poor; on the other, it shows that it is much easier to propose alternative approaches, such as microsavings and mobile phone–based banking, than to execute them.

The heart of this book, part II, directly confronts the question of impact. Its three-chapter structure came to me in 2008 during a tour in northern Bangladesh of credit groups run by BRAC, the largest non-profit in the developing world. At the time, I was engrossed in the complex mathematics and computer programming that would eventually upend what were then the most influential studies claiming that microcredit reduces poverty. (This was before higher-quality randomized studies appeared.) There in Rangpur District, as in Cairo two months before (see chapter 6), I imagined the absurdity of my pointing to the grids of numbers on my laptop screen and telling these women that taking microcredit *might not* *be such a good idea after all*. That forced me into a paradox. I believed in the importance of rigorous evaluation of microfinance and other programs. Yet the women knew their business better than I did. What then was the value of scientific studies of microfinance? Pondering all that I had read, I realized that several notions of success—really, conceptions of “development”—were at play in the grand global conversation about microfinance.[[17]](#footnote-17) They were not incompatible, and each had validity. Each raised its own questions and tended to send one for answers to different kinds of evidence. In the three chapters of part II, I take them on one at a time. Really, they are different definitions of “development”: development as clients’ escape from poverty, development as freedom, and development as industry building.

The first notion, explored in chapter 6, asks: if microfinance is so worthy of acclaim and funding, shouldn’t the benefits be measurable in the rise of a client’s income, in the quality of the roof over her head, in how many of her children are in school? As Susy Cheston of Women’s Opportunity Fund and Larry Reed of Opportunity International put it in 1999, “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]](#footnote-18) This definition of success relies for proof on academic researchers who are trained to collect and analyze data to study cause and effect. But their job turns out to be hard—more so, in fact, than many of them have realized. If someone shows you a rich microcredit borrower and a poor non-borrower, you can think of several stories to explain that pattern. Maybe, as we hope, microcredit made the rich one rich. On the other hand, the MFI may have lent only to entrepreneurs who were already well-off. Or unlucky entrepreneurs may have tried credit and quit, dropping off the scientific radar. Perhaps microfinanciers only operate in more-affluent provinces, ones linked by good roads to the cities. Or perhaps the pivotal choice is the borrower’s: only households with good, going businesses dare take on the obligation of credit. No matter how fancy the statistical machinery brought to bear, it is extremely difficult to rule out such competing explanations. Indeed, I have found that fancy mathematics more often obscures than resolves the statistical challenges.[[19]](#footnote-19) As a result, though microfinance groups have commissioned hundreds of assessments over the years, few convincingly rule out these other explanations for any positive association between borrowing and betterment.

As I wrote this book, the scholarship on microfinance broke with its past. Economists released results from the first tests of microfinance that were randomized in the manner of the best drug safety tests. By introducing a source of variation effectively uncorrelated with anything else in the universe—randomly offering some people microfinance and not others—these researchers are getting a firmer fix on impacts. So far, the tests of micro*credit* have conformed to the Stainless Steel Law of Evaluation coined by the late sociologist Paul Rossi: “the better designed the impact assessment of a social program, the more likely is the resulting estimate of net impact to be zero.”[[20]](#footnote-20) Although microcredit led to more new microenterprises among better-off clients within the approximately 18 month periods of the studies—the story of microcredit stimulating microenterprise is more than a myth—poverty did not fall on average.[[21]](#footnote-21) The one randomized study of micro*savings*, however, *did* find it reducing average poverty, among female vendors in a rural Kenyan market.[[22]](#footnote-22)

Thus, people wanting to understand the impacts of microfinance should mind the gap between upbeat rhetoric and rigorous evidence. But they also should not fall into the trap of judging microfinance by such studies alone. As I did, they should turn for wisdom to alternative theories of how microfinance (or any other intervention) can contribute to development.

One of those has been most famously articulated by Amartya Sen, another native of Bengal territory who won a Nobel, his in economics. In chapter 7, I pursue the implications of his theory, as laid out in his book *Development as Freedom*. Sen argues that processes of economic, political, and social development are essentially about increasing freedom. By “freedom,” he means not merely the libertarian’s freedom from interference, but greater agency in one’s life. High income, education, health, protected human rights, and democracy all give people more control over their circumstances. These freedoms reinforce one another, so that each is a means and an end. Sen buttresses this general theory with bits of compelling evidence. He notes, for example, that no democracy has suffered a major famine: freedom from tyranny begets freedom from want. He also cites findings that within India, better-educated women have fewer children: again, one kind of control over circumstances leads to another.[[23]](#footnote-23) And he has suggested that microcredit increases freedom since it gives the poor a new way to navigate tricky financial currents.[[24]](#footnote-24) By Sen’s logic, expanded financial freedom, i.e., better management of household finances, can reasonably be expected to increase other freedoms in the long run, such as education and income. With safer ways to save, a family can more easily set aside money for school fees.

Actually, this idea should become obvious if you think about how *you* use financial services. Probably the most important financial services to you are the ones that help you hold things together in bad times and in good, in sickness and in health. Health insurance keeps a run-in with cancer from bankrupting your family. A retirement fund assures comfort in old age. Such services give you more control over your circumstances. The poor look to financial services to meet the same need for managing spending. For them it is not a matter of retiring to Palm Beach but putting food on the table (or floor) every day. Microcredit can help in a pinch, as can savings, insurance, and even money transfers (as when a rural Kenyan family calls in funds from a son working in the capital).

Viewing development as freedom leads to specific questions about microfinance. When does it give clients such as Murshida more autonomy within the household, village, or slum, what is sometimes called “empowerment”? How often does microfinance reduce freedom, as Razia seems to think it did for her? How can we tell which microcreditors operate in ways that limit the risk of the debt trap? Embedded in these questions is the puzzling one of when credit is usurious. The ancients never resolved it: Christianity used to ban interest, Islam still does, and whatever the doctrine, there have long been Christians and Muslims who charged interest by another name.

I conclude that while financial services *inherently* increase freedom—they exist to help people gain control over their finances—they do not *automatically* do so. Particularly ambiguous are the effects on freedom of credit, because of its dual nature as a source of possibilities and a *bond*. From my review of studies by people who have spent weeks or months with living among borrowers, the most famous form of microfinance, group microcredit, emerges in a surprisingly negative light—surprising, that is, for someone who was expecting a mix of good and bad news. Groups of women responsible for each other’s loans can generate “peer support” in times of difficulty—or peer pressure to pay no matter what.

The third notion of success in microfinance, and the frame for chapter 8, emphasizes the transformational nature of economic development. The spectacular reductions in poverty in the United States in the nineteenth century and in China in the twenty-first owe to processes of societal churning best labeled “industrialization” (despite its vaguely negative connotations)\

. Within economics, the interest in the *dynamics* of economic development goes back at least a hundred years to Joseph Schumpeter, who popularized the term “creative destruction.” In his view, the hero of economic development is the entrepreneur who pursues innovations that disrupt established ways of making and selling things. Development is a cascade of such economic revolutions, which save society from stagnation.[[25]](#footnote-25) Disruptive innovations need not be high-tech. Just as Sears drove small American retailers out of business with its catalog, Walmart marginalized Sears 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 visionary leaders of microfinance (some of whose stories are in chapter 4) as heroes of development-as-industry-building even though almost none has made a fortune in microfinance. He would probably see the existence of major microfinance institutions—competing, innovating, employing thousands, serving millions in a ways once thought impossible—as the essence of development. In the Schumpeterian view, the spread of microfinance is as obviously developmental as the spread of the mobile phone among the world’s poor. Notice that there is no claim here that microfinance institutions are lifting their clients out of poverty, or even turning them into Schumpeterian micro-heroes. Most microfinance clients pursue established activities such as food processing and retail. But the creation of so many businesses and businesslike non-profits that serve the poor with microfinance embodies the essence of economic development. In this respect, aid and philanthropy have rarely done so much for development as they have in supporting microfinance. Of course, if microfinance is immiserating the poor, this Schumpeterian success should not compensate in our overall appraisal. We do not celebrate the tobacco industry simply because it is an industry. But in the case of microfinance, even the good impact studies that find no reduction in poverty find no increase in it either. And we have just seen why financial services are as a general matter useful for the poor.

Accepting the definition of development as industry building and this preliminarily positive verdict, there is still room for critical inquiry. At the top of my mind now is the debacle in Andhra Pradesh that sent Vijay Mahajan on his Shodh Yatra. The way microcredit soared and crashed there is hardly a shining example of an industry enriching the economic fabric of nations. In India and beyond, the core analytical question is this: when is creative destruction more creative than destructive? When is microfinance the invasive bark beetle that razes millions of acres of forest and when is it the new variety of oak that creates habitat for a score of species? The question does not admit sharp answers, only general principles. A species is usually in a healthy relationship with its environment when its linkages to other species, such as through competition, predation, and symbiosis, are many and diverse. Just so, the microfinance industry contributes most to development when it links to its host economy in many ways, by not just making loans, but also by taking savings from customers and some capital from local investors; and when, as a result, the forces abetting and checking the industry’s growth are in reasonable balance.

Rather the opposite happened in India. Much of the capital, though domestic, came from banks pushed by government quotas to lend to “priority sectors” that serve the poor and disadvantaged. Venture capitalists poured gasoline on this ample tinder in the form of equity, which was money that accepted the risk of losses in exchange for a fraction of ownership as well as the hope—indeed, pressure—for big, quick profits. Meanwhile, microfinance institutions were prohibited from deepening their relationships with customers by taking savings.[[26]](#footnote-26) “Much better,” mused blogger Felix Salmon, “that full-service banks grow organically out of local communities than monoline microlenders parachute in, flush with venture-capital funds, make a huge splash, and then implode.”[[27]](#footnote-27)

In the book’s final chapter, I derive the lessons I’ve laid out already. To repeat, those wanting to support microfinance should help it play it to its strengths, which lie in leveraging modest subsidies to build financial institutions and industries that help millions of families manage poverty—and could help billions. A particularly promising path is microsavings, which comes out well in a randomized study, does not threaten freedom the way credit does, and, as just argued, enriches the contribution of a financial institution to the local economic fabric. Potential supporters should also aggressively explore new technologies to revolutionize the economics of connecting poor people to the financial system, so that they can conduct all manner of financial business. Overall, the greatest danger to the microfinance industry has been the hubris that has come with success. The rhetoric about the power of loans against poverty got beyond the evidence, which led to backlashes, and it financing for microfinance dangerously enthusiastic, which led to bubbles. The dominant rhetoric about microfinance is not merely incorrect. It is a threat to the sustainability of microfinance itself.

1. Wolff (1896), 12. [↑](#footnote-ref-1)
2. Yunus (2003), 199–201. [↑](#footnote-ref-2)
3. Bruck (2006). [↑](#footnote-ref-3)
4. Banerjee et al. (2009); Karlan and Zinman (2009). [↑](#footnote-ref-4)
5. Roodman and Morduch (2009). [↑](#footnote-ref-5)
6. Chen, Rasmussen, and Reille (2010). [↑](#footnote-ref-6)
7. *Financial Express* (2010). [↑](#footnote-ref-7)
8. Bloomberg Businessweek, “India's 50 Most Powerful People 2009,” j.mp/hX3TnS. [↑](#footnote-ref-8)
9. Vijay Mahajan, Chairman, BASIX, “Day 1 – January 30, 2011 Sevagram, Wardha,” j.mp/hypA9M, viewed March 5, 2011. [↑](#footnote-ref-9)
10. blogs.cgdev.org/open\_book. [↑](#footnote-ref-10)
11. Jain and Moore (2003), 29. [↑](#footnote-ref-11)
12. Reed (2011), 3. [↑](#footnote-ref-12)
13. Nancy Birdsall, the president of the Center for Global Development, where I work, is a (volunteer) board member of Acción. [↑](#footnote-ref-13)
14. Dichter (2006) said it before most others. [↑](#footnote-ref-14)
15. Karlan and Appel (2011); Banerjee and Duflo (2011). [↑](#footnote-ref-15)
16. Collins *et al.* (2009). [↑](#footnote-ref-16)
17. Rhyne (2001) and Rutherford (2009a) were especially influential. [↑](#footnote-ref-17)
18. Cheston and Leed (1999), 6. [↑](#footnote-ref-18)
19. Roodman (2007a, 2009); Roodman and Morduch (2009). [↑](#footnote-ref-19)
20. Rossi (1987). [↑](#footnote-ref-20)
21. Banerjee *et al.* (2009); Karlan and Zinman (2009). [↑](#footnote-ref-21)
22. Dupas and Robinson (2009). [↑](#footnote-ref-22)
23. Sen (1999), 196–99, citing Murthi, Guio, and Drèze (1995). [↑](#footnote-ref-23)
24. Sen (1999), 39. [↑](#footnote-ref-24)
25. Schumpeter (1934). [↑](#footnote-ref-25)
26. Rhyne (2010b). [↑](#footnote-ref-26)
27. Salmon (2010). [↑](#footnote-ref-27)