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Microfinance

Big trouble for microfinance

The woes for small-scale lending continue

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OVER the past month, we've covered (http://www.economist.com/node/17420202?story_id=17420202) the ongoing crisis in the microfinance industry in Andhra Pradesh, the state in India where microfinance—especially, but not only its for-profit variant exemplified by recent stock-market debutant SKS—has grown most rapidly and has the largest number of borrowers.

The situation on the ground seems to have remained largely unchanged since we covered the story here (http://www.economist.com/node/17522350?story_id=17522350) : collections in Andhra Pradesh are still on hold, the MFIs remain on the defensive (it seems that SKS's "voluntary" interest rate cap approach is now being more widely adopted), and the scope and nature of regulation in the Indian market remains vague. This is so far an Indian story (though there are also unrelated worries in Bangladesh) but it raises a lot of questions about what we can or should expect from microfinance and what the right way to regulate what is now a pretty big market, with a whole lot of poor borrowers, is.

We argued (http://www.economist.com/node/17522606) a couple of weeks ago that crude interest caps were a bad idea but also that letting MFIs take deposits establishing a credit bureau to track overall client indebtedness were good ideas. Some of these ideas and more detailed suggestions on how to regulate the sector are to be found in this long piece (http://www.indianexpress.com/news/help-microfinance-dont-kill-it/716105/0) by Abhijit Banerjee, Esther Duflo, Erica Field, Raghu Rajan, Dean Karlan, Pranab Bardhan, Rohini Pande, Asim Khwaja, and Dilip Mookherjee, all leading development economists with a strong interest in microfinance. The piece is well worth reading in its entirety.

It concludes:

> *"When it works well, microfinance can be a win-win situation, as the poor can borrow money at rates that may look high, but are much lower than those offered by moneylenders; and banks can make a sustainable business in lending to the poor. All this rests as much on a social contract as on a legal contract. MFIs need to be more diligent in their lending and screen borrowers better — if too many borrowers can't repay their loans, the social obligation will start to fall apart."*

It's worth noting that Abhijit Banerjee and Esther Duflo, who have pioneered rigorous evaluations of the true impact of microcredit, are hardly cheerleaders for the industry, as the rest of the article makes clear. However, their own research (http://www.economist.com/node/14031284) , which is often pegged as "debunking" microfinance, more accurately shows that its benefits are more modest (and less uniform—microfinance doesn't work for everyone) than some suppose—but not non-existent. However, not every economist is as convinced that microfinance is worth supporting. In a piece (http://economictimes.indiatimes.com/opinion/comments--analysis/Getting-it-right-on-microfinance/articleshow/6979476.cms) in the Economic Times, Columbia University economist Arvind Panagariya takes a much harder line. He reckons that microcredit—and other forms of "subsidised credit" to the poor, are only being kept afloat by repeated government loan waivers, and that something with high default rates coupled with repeated loan forgiveness amounts in the end to a handout: so why not replace it with actual handouts, rather than pretend it's credit?

What I found puzzling about Mr Panagariya's argument is that there is no evidence that commercial microcredit in India had a genuine default/non-repayment crisis. There is no evidence borrowers as a whole wanted a loan waiver. Before the government made it impossible for MFIs to collect their dues, repayment rates remained as high as ever, and default rates were not on the rise.

I think part of the problem with Mr Panagariya's argument is that he seems to be assuming that there are only two possiblities: either microcredit finances enormously profitable businesses, or it is a handout. In fact, I suspect (and research, I think, supports this) that while some microcredit does finance business ventures, a lot of it is mainly used by the poor to smooth consumption—to tide them over between periods when income is coming in and when it is scarce. This would explain the not-too-impressive anti-poverty effects researchers find while also explaining why the poor take and repay microloans—it fulfills a useful role, just not necessarily the one that MFIs would like us to believe it does, at least not all the time.

What taking this view of microcredit does, I think, is to make us think more deeply about exactly the issue Mr Panagariya identifies: is credit the right instrument for the goal in mind? But it leads to a less clear-cut conclusion than his. Credit in this reading may not always be the best way to solve a particular problem, but it is not necessarily a bad way. So, yes, if profitable ways to extend savings accounts to the poor could be devised then it's quite possible that some part of what microcredit does at the moment could be done via savings. But there is probably also a role for fairly expensive but readily available and short-term credit as part of a system of financial instruments that allow the poor to manage risk, smooth consumption, etc. While the fact of regular repayment and low default does not mean that microcredit is necessarily helping people get out of poverty, it does suggest that MFIs have found a sustainable way to let poor people use financial instruments to achieve some of their aims, however imperfectly.

Put differently, unlike straightforward transfers to the poor, which by definition could not possibly "recover their costs", microfinance in developing countries did indeed allow funds to be cycled to the poor and yet for lenders to break even. It would be one thing to supplement it with other instruments. It would also be eminently sensible to think about how to change the microcredit model to make it more useful for those who really can use it to get out of poverty by starting businesses. Research suggests this is a subset of the poor, who have the entrepreneurial talents needed, but also that they often need larger loans and more flexible terms than microfinance provides. And there may well have been cases of over-lending, and it's entirely possible that the industry has been overheating. But as Mr Banerjee and his co-authors conclude:

> *"But politicians also need to be wary — in taking aim at the occasional overstep, they may find themselves inadvertently destroying the whole business, at great cost both to the poor, and the financial institutions that have stepped in to work with them. If we are not careful we may end up in the pre-microfinance world. That would be a great disservice to the poor, and their hope of climbing out of poverty."*

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