

...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

Chapter 1. Searching for the Story

Most popular accounts of microfinance—the businesslike provision of financial services to the poor—begin with a story. And with good reason. As artificial intelligence pioneer Roger Schank discovered while laboring to make machines mimic the mind, human memory is not a shelf of encyclopedias. Rather, people encode knowledge in stories. Much of what we call comprehension, Schank says, is the projection of our own stories onto others. I understand your plight, your triumph, your dream, when I can map it onto my own. Sensing this power, promoters of microfinance and much else seek to tell stories that resonate with narratives already embedded in the mind of the listener.² As communications consultant Andy Goodman puts it, “People do not march on Washington because of pie charts.”

So I think it is fitting to begin this book about microfinance with stories. Here are two, about the most well-known kind of microfinance, *microcredit*, in which loans of \$50–500 or so are made to poor people, often in groups. Both, I assume, are true. 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 a thunderstorm, and as her husband had sold the roof of their house to pay gambling debts, Murshida and

¹ Wolff (1896), 12.

² Schank (1990).

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.³

The second story comes from the pages of *BusinessWeek*, and tells of a customer of the fast-growing

Compartamos bank in Mexico:

In a glossy promotional book entitled *Historias de Exito*, or *Stories of Success*, [Compartamos] boasts: “Our clients are agents of change who are building a better country and world.” Among the inspiring narratives is that of Eva Yanet Hernández Caballero. She poses in one photograph behind a sock-knitting machine in her unassuming home near San Martin Texmelucan. A visit reveals a tale more complicated than the one Compartamos tells.

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 sur-

³ Yunus (2003), 199–201.

faced. Soon after Compartamos trumpeted her story in 2005, Hernández and her family were banished from the group.

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.”⁴

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 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. For instance, 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 investors.⁵

But while Murshida’s and Eva’s stories are each powerful alone, their juxtaposition creates cognitive dissonance. Murshida’s ascent offers us hope while Eva’s descent plays to our cynicism. I set up the contradiction in order to force you to think critically. When *does* giving small loans to the poor entrap them and when does it give them freedom? Is Murshida’s story the rule that proves the exception or is Eva’s? Presumably Yunus and his staff sifted Murshida’s from the biographies of thousands of Grameen members. Likewise, Keith Epstein and Geri Smith, the *BusinessWeek* reporters, 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 comprehend the world only by simplifying it. But almost

⁴ Epstein and Smith (2007).

⁵ Bruck (2006).

all generalizations in the social realm (as distinct from physics, with its pristine laws) are partly untrue—just how much so is often hard to tell. The truth turns out to be an elusive thing.

Through this book, I aim to probe and limn the truth of microfinance as far as one can, and draw out the implications for all those who back microfinance or contemplate doing so—which, these days takes as little as \$100 on a peer-to-peer microcredit web sites. And I write for anyone else who wants to better understand this storied intervention. I proceed by viewing microfinance through the perspectives of history, economics, and ethics; through the eyes of poor clients struggling to improve their lot and microfinance managers struggling to break even. Each perspective offers a piece of the truth about microfinance. Many books have been written about microfinance, but no other has quilted together so many perspectives for such a comprehensive view.

The need to understand whether and how microfinance affects the lives of clients and the development of nations only grows as the approach attracts more money. Today, microfinance institutions (MFIs) receive investment from a panoply of actors—domestic banks, foreign (rich-country) governments, international agencies such as the World Bank, pension funds, philanthropies such as the Bill & Melinda Gates Foundation, “high net worth individuals,” and regular folks using peer-to-peer sites such as Kiva.org. Companies with names like Grey Ghost and Blue Orchard have floated vehicles to pool and channel funds from groups of investors, public and private. By the end of 2008, foreign investment commitments in microfinance stood at nearly \$15 billion according to the Consultative Group to Assist the Poor (CGAP) in Washington, DC.⁶ Almost all this money is financing *microcredit*, which needs capital for fuel. More than 90 percent of that is public money, coming from such government development lenders as the World Bank and Germany’s Kreditanstalt für Wiederaufbau (KfW). The private money comes mostly from foundations and investment funds with social mandates. Pierre Omidyar gave \$100 million to his alma mater Tufts University, requiring that it be invested in microfinance. New Zealand

⁶ [cite 2010 report to come]

billionaire Christopher Chandler took a majority interest in India's Share Microfin in 2007, acquiring some \$25 million in equity.⁷ As the global financial system seized up in late 2008, venture capitalists still found \$75 million for Share's competitor, SKS microfinance.⁸ A sweetener for these Indian deals is India's ample supply of *domestic* capital for social purposes, mandated by "priority sector" rules that require banks to dedicate 40 percent of their lending to people and activities deemed deserving and underserved. Indian's MFIs have leveraged each dollar of risk-absorbing equity capital—from Legatum, Silicon Valley venture capitalists, and others—into several dollars of local bank loans.

Thus despite the hubbub over Wall Street-style commercialization, virtually all the money going into microfinance still seeks "social return" in the form of empowerment, poverty reduction, and growing financial businesses serving the "bottom of the pyramid." Investors want to give the young micro-credit-using woman in an Ethiopian village more say in how her family spends money. They want to solve a problem like Maria's, she being a documentary-featured woman in the Bolivian Alto Plano who used credit to start a business charging lamps batteries for men who scratch a living out of a silver mine.⁹ The investors want Maria's children never to go to bed hungry. More broadly, investors want to build thriving financial institutions that multiply such perceived successes a millionfold globally.

Through bitter experience over the decades, financial markets have developed disclosure conventions and rules to improve the information reaching investors about *financial* return. But high-quality information about *social* return is scarce in microfinance, especially when it is defined, as is usual, as helping borrowers out of poverty. The underlying problem is that impact on clients' lives is much harder to measure than financial return. Improvements along dimensions such as health, education, and income cannot be naturally denominated and summed in a single unit of measure the way financial return can

⁷ "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

⁸ [cite]

⁹ EMF films, How Do You Solve a Problem Like Maria's?, j.mp/a8fpj8.

(in money terms). And such gains often play out over years, mingling with the effects of everything from cyclones to road paving, making it nearly impossible to isolate the social return of microfinance. Then there is the fundamental difficulty of distinguishing correlation from causation, as I will explain just below: does a woman borrow because she is better off or is she better off because she borrows?

Microfinance practitioners and promoters have naturally moved to fill this breach in knowledge with success stories. At every link in the human chain from poor client to comfortable investor, incentives reinforce natural tendencies to accentuate the positive. Thus like Lyndon Johnson being briefed by the generals atop the chain of command during the Vietnam War, microfinance investors receive information that has been filtered several times.¹⁰ 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 Larry Reed of Opportunity International in a frank 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.”¹¹

In the pages to come, I will share the fruits of my own search for a full, balanced understanding of the impacts of microfinance. For me, writing this book has been a medium of thought, a source of discipline, and a vehicle for sharing my views with you. I wrote this book in public—something I have never seen done before—by sharing earlier drafts, questions, and discoveries through an “open book” blog.¹² Working this way garnered me feedback on earlier drafts, helpful leads and ideas, and a sharper sense of the audience for which I write. This book records my intellectual journey. It is a kind of trave-

¹⁰ On Johnson, see Kearns (1998 [1976]), 167.

¹¹ Cheston and Reed (1999), 8.

¹² blogs.cgdev.org/open_book.

logue. If you did not join me on that journey, through the blog—or even if you did—I hope you will now join me vicariously through this distilled record of it.

I have divided this final frozen form of the text into two main parts. The first, chapters 2–5, approaches our subject obliquely, asking not what microfinance can do for the world, but how various forces have made 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 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, \$3 the day after that.... Their incomes are not just low but volatile. And their medical expenses in particular are uninsured, another source of major uncertainty. 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 rich.¹³ Chapter 3 traces the deep history of what I call financial services for the masses, starting in Ancient Athens. It turns out that the group microcredit made famous by Yunus comes from a lineage that goes back centuries. 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, are dominant mostly because they confer survival advantage on MFIs. They solve the tough business problem of mass-producing financial services for the poor without losing one’s shirt. This thesis undercuts the assumption that microfinance is the way it is because that is what is best for the poor.

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 complex mathematics and computer

¹³ Collins *et al.* (2009).

programming that would eventually up-end the most influential studies claiming that microcredit reduces poverty. (My coauthor Jonathan Morduch and I would eventually conclude that the data used in the studies could not support a verdict positive or negative.¹⁴) There in Rangpur Province, just as in Cairo two months before (as I recount at the start of chapter 6), I imagined the absurdity of my pointing to the numbers on my laptop screen and telling these women that taking microcredit *might not* be such a good idea. The women knew their business far better than I did. What then was the value of scientific studies of the impact of microfinance? Pondering this paradox and 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. They were not incompatible, but each deserved serious consideration. Each raised its own questions and each led to different kinds of evidence. In the three chapters of part II, I take on each of what I see as the main conceptions of “development” in play: development as poverty reduction, development as freedom, and development as industry building.

The first notion, explored in chapter 6, asks: if microfinance is so worthy of public acclaim, shouldn't the benefits be measurable in the level and stability of a client's income, in the quality of the roof over her head, in how many of her children are in school? 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.”¹⁵ 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 quite hard—more so, in fact, than some of them realize. If someone shows you a successful microcredit borrower and an unsuccessful non-borrower, you can think of several stories to explain that pattern. Yes, maybe microcredit made the one successful. On the other hand, the MFI may have lent only to entrepreneurs who were already successful. Or unlucky entrepreneurs

¹⁴ Roodman and Morduch (2009).

¹⁵ Cheston and Leed (1999), 6.

may have tried credit and dropped out, disappearing from our radar. More generally, microfinanciers may only operate in more-affluent provinces, ones linked by good roads to the cities. Or perhaps the choice is the borrower's: only households with good, going businesses dare take on the obligation of credit. And can we be sure that one borrower's success selling shelled nuts in the local market is not driving non-borrowers out of business, so that the net gain is zero? No matter how fancy the statistical machinery brought to bear, it is extremely difficult to rule out such competitors for the story we want to find, that microcredit is helping overall. Indeed, in my own research I have found that fancy mathematics more often obscures than resolves the underlying statistical challenges.¹⁶ As a result, though microfinance groups have commissioned hundreds of evaluations over the years, almost none convincingly rule out these other stories.

As I wrote this book, the scholarship on microfinance broke with its past. Economists released results of the first tests of microfinance that were *randomized* in the way that the best drug safety tests are done. By introducing a source of variation effectively uncorrelated with anything else in the universe, and using that to influence who within a pool of subjects was offered microcredit, these researchers obtained a much firmer fix on certain impacts of microfinance. So far, the tests of microcredit have conformed to 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.”¹⁷ While microcredit led to more microbusiness starts among better-off clients, that did not translate into lower poverty overall within the 15–18 month study periods.¹⁸ The one randomized study of *microsavings*, however, found that serviced *did* reduce poverty on average.¹⁹

¹⁶ Roodman (2009a); Roodman and Morduch (2009).

¹⁷ Rossi (1987).

¹⁸ Banerjee *et al.* (2009); Karlan and Zinman (2009).

¹⁹ Dupas and Robinson (2009).

Thus, social investors should mind the gap between soaring rhetoric and rigorous evidence in microfinance. But they should also avoid entrapment in the idea that the worth of microfinance can be judged by such studies alone. As I did, they should turn for wisdom to alternative understandings of what it means for microfinance to contribute to development.

One of those has been most famously articulated by Amartya Sen, who wrote *Development as Freedom* and won a Nobel in economics. I pursue the implications of this conception in chapter 7. Sen argues that processes of economic, political, and social development are inherently about increasing freedom: not merely the libertarian's 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 circumstances. These freedoms reinforce one another, so that each is both a means and an end. Sen noted that no democracy has suffered a major famine: freedom from tyranny begets freedom from want. He has also cited findings that within India, better-educated women have fewer children.²⁰ And he has suggested that microcredit, since it gives the poor a new way to navigate tricky financial currents, also increases freedom.²¹

Actually, this idea should become obvious if you think about how *you* use financial services. 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: think of health insurance to prevent a run-in with cancer from bankrupting your family, or a retirement fund to assure comfort in old age. Such services help you procure necessities despite major life events. They give you more control over your financial circumstances, and that is freedom. 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 putting enough food on the

²⁰ Sen (1999), 196–99, citing Murthi, Guio, and Drèze (1995).

²¹ Sen (1999), 39.

table (or floor) every day. Microcredit can help them in a pinch, as can savings, insurance, and money transfers, as when a rural Kenyan family calls in funds from a son working in Nairobi.

Viewing development as freedom leads to specific questions about microfinance. When does it give clients more control over their circumstances, what is sometimes called “empowerment”? 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 of the debt trap? Embedded in these questions is the puzzling and ancient one of when interest on credit constitutes usury. The ancients never resolved the issue: Christianity used to ban interest, Islam still does, and whatever the doctrine, there have long been Christians and Muslims who charged interest if by another name.

The third notion of development, 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 that we call industrialization. Within economics, the focus on the *dynamics* of economic development goes back a hundred years to Joseph Schumpeter, who popularized the term “creative destruction.” In Schumpeter’s view, the hero of economic development is the entrepreneur who pursues innovations that disrupt established ways of making and selling things. Development is a continuing cacophony of such tiny economic revolutions, which collectively save society from stagnation.²² 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 visionary leaders of microfinance (whose stories are told in chapter 4) as heroes of development-as-industry-building. 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

²² Schumpeter (1934).

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 millions of clients out of poverty, or even turning them into entrepreneurial micro-heroes. If that was your expectation, you may find the Schumpeterian defense weak and disappointing. But, by the standards of foreign aid and philanthropy (in which failure is common and successes are hard won), the creation of so many businesses and businesslike non-profits that serve the poor with microfinance is impressive indeed.

Accepting the definition of development as industry building, as well as this positive verdict, there is still room for critical inquiry. To what extent is enthusiastic finance for microfinance healthy? Growth in credit is not always development, as the recent international financial crisis shows. Is the avalanche of socially motivated investment in microcredit cultivating a thousand flowers or is it causing a few to grow overlarge, even creating microcredit bubbles? Is the easy money distracting banks from the poor from obtaining capital in other ways, notably by taking microsavings? Does the pursuit of commercial success lead to a hard-headed style of microfinance that is less empowering of clients, even disempowering? Raising interest rates on loans might boost the bottom line even as it traps people in debt.

In part II, I evaluate microfinance as thoroughly as I can in light of these three conceptions of development, gathering, weighing, and synthesizing evidence. As is probably obvious, I will conclude that Murshida's story is not the real story of microfinance. But as may also be clear, I do not careen to the opposite extreme, assuming that every microcredit borrower is an Eva. The success of microfinance is real, if subtler than generally understood. 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.”²³ The mythology has obscured the real achievements and even, we will see, undermined them.

In the final chapter, I derive some broad lessons about how to support microfinance going forward. Among these is that microcredit is like a prescription-strength medicine: appropriate in moderation but dangerous in high doses. Of central interest is whether the medical system—the microfinance institutions together with their financiers and regulators—can be relied upon to prescribe safely. In fact, asking whether microcredit works is like asking whether home mortgages work. Microcredit, like mortgages, can be wonderfully helpful in the right contexts and doses. But in any credit system, overheating is dangerous. A major challenge in microfinance today, so far unfronted, is how to keep the development of the microfinance system on a relatively safe, even keel. Investors are central characters in this discussion since their enthusiastic funding fuels growth. A major challenge, in other words, is to prevent the microfinance movement from being undermined by its own success. I could say more, but I don’t want to give away the ending of my story.

²³ Jain and Moore (2003), 29.