

The Micromagic of Microcredit

The millions of tiny loans microcredit banks make to the world's poor do not work the miracles some advocates claim. But like the Wizard of Oz, microcredit does not need to be magic to do a great deal of good.

BY KAROL BOUDREAUX AND TYLER COWEN

MICROCREDIT HAS STAR POWER. IN 2006, THE Nobel Committee called it “an important liberating force” and awarded the Nobel Peace Prize to Muhammad Yunus, the “godfather of microcredit.” The actress Natalie Portman is a believer too; she advocates support for the Village Banking Campaign on its MySpace page. The end of poverty is “just a mouse click away,” she promises. A button on the site swiftly redirects you to paypal.com, where you can make a contribution to microcredit initiatives.

After decades of failure, the world's aid organizations seem to think they have at last found a winning idea. The United Nations declared 2005 the “International Year of Microcredit.” Secretary-General Kofi Annan declared that providing microloans to help poor people launch small businesses recognizes that they “are the solution, not the problem. It is a way to build on their ideas, energy, and vision. It is a way to grow productive enterprises, and so allow communities to prosper.”

Many investors agree. Hundreds of millions of dol-

lars are flowing into microfinance from international financial institutions, foundations, governments, and, most important, private investors—who increasingly see microfinance as a potentially profitable business venture. Private investment through special “microfinance investment vehicles” alone nearly doubled in 2005, from \$513 million to \$981 million.

On the charitable side, part of microcredit's appeal lies in the fact that the lending institutions can fund themselves once they are launched. Pierre Omidyar, the founder of eBay, explains that you can begin by investing \$60 billion in the world's poorest people, “and then you're done!”

But can microcredit achieve the massive changes its proponents claim? Is it the solution to poverty in the developing world, or something more modest—a way to empower the poor, particularly poor women, with some control over their lives and their assets?

On trips to Africa and India we have talked to lenders, borrowers, and other poor people to try to understand the role microcredit plays in their lives. We met people like Stadile Menthe in Botswana. Menthe is, in many ways, the classic borrower. A single mother

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with little formal education, she borrowed money to expand the small grocery store she runs on a dusty road on the outskirts of Botswana's capital city, Gaborone. Menthe's store has done well, and she has expanded into the lucrative business of selling phone cards. In fact, she's been successful enough that she has built two rental homes next to her store. She has diversified her

90 percent in Asia to less than a third in the Middle East.

While 70 percent of microcredit borrowers are in Asia, the institution has spread around the world; Latin America and sub-Saharan Africa account for 14 and 10 percent of the number of borrowers, respectively. Some of the biggest microfinance institutions include Grameen Bank, ACCION International, and Pro Mujer of Bolivia.

The average loan size varies, usually in proportion to the income level of the home country. In Rwanda, a typical loan might be \$50 to \$200; in Romania, it is more likely to be \$2,500 to \$5,000. Often there is no explicit collateral. Instead, the banks lend to small groups of about five people,

THERE'S A PUZZLE at the heart of micro-credit: How can people in new businesses growing at 20 percent annually afford to pay interest rates as high as 100 percent?

income and made a better life for herself and her daughter. But how many borrowers are like Menthe? In our judgment, she is the exception, not the norm. Yes, microcredit is mostly a good thing. Very often it helps keep borrowers from even greater catastrophes, but only rarely does it enable them to climb out of poverty.

The modern story of microcredit began 30 years ago, when Yunus—then an economics professor at Chittagong University in southeastern Bangladesh—set out to apply his theories to improving the lives of the poor in the nearby village of Jobra. He began in 1976 by lending \$27 to a group of 42 villagers, who used the money to develop informal businesses, such as making soap or weaving baskets to sell at the local market. After the success of the first experiment, Yunus founded Grameen Bank. Today, the bank claims more than five million “members” and a loan repayment rate of 98 percent. It has lent out some \$6.5 billion.

At the outset, Yunus set a goal that half of the borrowers would be women. He explained, “The banking system not only rejects poor people, it rejects women. . . . Not even one percent of their borrowers are women.” He soon discovered that women were good credit risks, and good at managing family finances. Today, more than 95 percent of Grameen Bank's borrowers are women. The UN estimates that women make up 76 percent of microcredit customers around the world, varying from nearly

relying on peer pressure for repayment. At mandatory weekly meetings, if one borrower cannot make her payment, the rest of the group must come up with the cash.

The achievements of microcredit, however, are not quite what they seem. There is, for example, a puzzling fact at the heart of the enterprise. Most microcredit banks charge interest rates of 50 to 100 percent on an annualized basis (loans, typically, must be paid off within weeks or months). That's not as scandalous as it sounds—local moneylenders demand much higher rates. The puzzle is a matter of basic economics: How can people in new businesses growing at perhaps 20 percent annually afford to pay interest at rates as high as 100 percent?

The answer is that, for the most part, they can't. By and large, the loans serve more modest ends—laudable, but not world changing.

Microcredit does not always lead to the creation of small businesses. Many microlenders refuse to lend money for start-ups; they insist that a business already be in place. This suggests that the business was sustainable to begin with, without a microloan. Sometimes lenders help businesses to grow, but often what they really finance is spending and consumption.

That is not to say that the poor are out shopping for jewelry and fancy clothes. In Hyderabad, India, as in many other places, we saw that loans are often used to pay for a child's doctor visit. In the Tanzanian capital of Dar es Salaam, Joel Mwakitalu, who runs the Small Enterprise Foundation, a local microlender, told us that 60 percent of his loans are used to send kids to school; 40 percent are for investments. A study of microcredit in Indonesia found that 30 percent of the borrowed money was spent on some form of consumption.

Sometimes consumption and investment are one and the same, such as when parents send their children to school. Indian borrowers often buy mopeds and motorbikes—they are fun to ride but also a way of getting to work. Cell phones are used to call friends but also to run businesses.

For better or worse, microborrowing often entails a kind of bait and switch. The borrower claims that the money is for a business, but uses it for other purposes. In effect, the cash allows a poor entrepreneur to maintain her business without having to sacrifice the life or education of her child. In that sense, the money is for the business, but most of all it is for the child. Such life-saving uses for the funds are obviously desirable, but it is also a sad reality that many microcredit loans help borrowers to survive or tread water more than they help them get ahead. This sounds unglamorous and even disappointing, but the alternative—such as no doctor's visit for a child or no school for a year—is much worse.



Bangladesh's Grameen Bank lends small amounts of money to groups of poor borrowers, who, like these women, attend weekly meetings where they repay their loans. If one cannot pay, the others make up the difference.

Commentators often seem to assume that the experience of borrowing and lending is completely new for the poor. But moneylenders have offered money to the world's poor for millennia, albeit at extortionate rates of interest. A typical moneylender is a single individual, well-known in his neighborhood or village, who borrows money from his wealthier connections and in turn lends those funds to individuals in need, typically people he knows personally. But that personal connection is rarely good for a break; a moneylender may charge 200 to 400 percent interest on an annualized basis. He will insist on collateral (a television, for instance), and resort to intimidation and some-

times violence if he is not repaid on time. The moneylender operates informally, off the books, and usually outside the law.

So compared to the alternative, microcredit is often a very good deal indeed. Microcredit critics often miss this point. For instance, Aneel Karnani, who teaches at the University of Michigan's business school, argues that microfinance "misses its mark." Karnani says that in some cases microcredit can make

IF YOUR SAVINGS ARE INVESTED in a cow, relatives can't ask for a small piece of it.

life for the planet's bottom billion even worse by reducing their cash flow. Karnani cites the high interest rates that microlenders charge and points out that "if poor clients cannot earn a greater return on their investment than the interest they must pay, they will become poorer as a result of microcredit, not wealthier." But the real question has never been credit vs. no credit; rather, it is moneylender vs. modern microcredit. Credit can bring some problems, but microcredit is easing debt burdens more than it is increasing them.

At microlender SERO Lease and Finance in Tanzania, borrower Margaret Makingi Marwa told us that she prefers working with a microfinance institution to working with a moneylender. Moneylenders demand quick repayment at high interest rates. At SERO, Marwa can take six months or a year to pay off her lease contract. Given that her income can vary and that she may not have money at hand every month, she prefers to have a longer-term loan.

Moneylenders do offer some advantages, especially in rural areas. Most important, they come up with cash on the spot. If your child needs to go to the doctor right now, the moneylender is usually only a short walk away. Even under the best of circumstances, a microcredit loan can take several days to process, and the recipient will be required to deal with many documents, not to mention weekly meetings.

There is, however, an upside to this "bureaucracy." In reality, it is the moneylender who is the "micro" operator. Microcredit is a more formal, institutionalized business relationship. It represents a move up toward a larger scale of trade and business organization. Microcredit borrowers gain valuable experience in working within a formal institution. They learn what to expect from lenders and fellow borrowers, and they learn what is expected of themselves. This experience

will be a help should they ever graduate to commercial credit or have other dealings with the formal financial world.

The comparison to moneylending brings up another important feature

of microcredit. Though its users avoid the kind of intimidation employed by moneylenders, microcredit could not work without similar incentives. The lender does not demand collateral, but if you can't pay your share of the group loan, your fellow borrowers will come and take your TV. That enforcement process can lead to abuses, but it is a gentler form of intimidation than is exercised by the moneylender. If nothing else, the group members know that at the next meeting any one of them might be the one unable to repay her share of the loan.

If borrowers are using microcredit for consumption and not only to improve a small business, how do they repay? Most borrowers are self-employed and work in the informal sector of the economy. Their incomes are often erratic; small, unexpected expenses can make repayment impossible in any given week or month. In the countryside, farmers have seasonal incomes and little cash for long periods of time.

Borrowers manage, at least in part, by relying on family members and friends to help out. In some cases, the help comes in the form of remittances from abroad. Remittances that cross national borders now total more than \$300 billion yearly. A recent study in Tanzania found that microcredit borrowers get 34 percent of their income from friends and family, some of whom live abroad, but others of whom live in the city and have jobs in the formal sector. That's the most effective kind of foreign aid, targeted directly at

the poor and provided by those who understand their needs.

Here again, microcredit does something that traditional banks do not. A commercial bank typically will not lend to people who work in the informal sector, precisely because their erratic incomes make them risky bets. The loan officer at a commercial bank does not care that your brother in Doha is sending money each month to help you out. But a microcredit institution cares only that you come to your weekly meeting with a small sum in hand for repayment. Because of microcredit, families can leverage one person's ability to find work elsewhere to benefit the entire group.

Sometimes microcredit leads to more savings rather than more debt. That sounds paradoxical, but borrowing in one asset can be a path toward (more efficient) saving in other assets.

To better understand this puzzle, we must set aside some of our preconceptions about how saving operates in poor countries, most of all in rural areas. Westerners typically save in the form of money or money-denominated assets such as stocks and bonds. But in poor communities, money is often an ineffective medium for savings; if you want to know how much net saving is going on, don't look at money. Banks may be a daylong bus ride away or may be plagued, as in Ghana, by fraud. A cash hoard kept at home can be lost, stolen, taken by the taxman, damaged by floods, or even eaten by rats. It creates other kinds of problems as well. Needy friends and relatives knock on the door and ask for aid. In small communities it is often very hard, even impossible, to say no, especially if you have the cash on hand.

People who have even extremely modest wealth are also asked to perform more community service, or to pay more to finance community rituals and festivals. In rural Guerrero State, in Mexico, for example, one of us (Cowen) found that most people who saved cash did not manage to hold on to it for more than a few weeks or even days. A dollar saved translates into perhaps a quarter of that wealth kept. It is as if cash savings faces an implicit "tax rate" of 75 percent.

Under these kinds of conditions, a cow (or a goat or pig) is a much better medium for saving. It is sturdier than paper money. Friends and relatives can't ask for small pieces of it. If you own a cow, it yields milk, it can

plow the fields, it produces dung that can be used as fuel or fertilizer, and in a pinch it can be slaughtered and turned into saleable meat or simply eaten. With a small loan, people in rural areas can buy that cow and use cash that might otherwise be diverted to less useful purposes to pay back the microcredit institution. So even when microcredit looks like indebtedness, savings are going up rather than down.

Microcredit *is* making people's lives better around the world. But for the most part, it is not pulling them out of poverty. It is hard to find entrepreneurs who start with these tiny loans and graduate to run commercial empires. Bangladesh, where Grameen Bank was born, is still a desperately poor country. The more modest truth is that microcredit may help some people, perhaps earning \$2 a day, to earn something like \$2.50 a day. That may not sound dramatic, but when you are earning \$2 a day it is a big step forward. And progress is not the natural state of humankind; microcredit is important even when it does nothing more than stave off decline.

With microcredit, life becomes more bearable and easier to manage. The improvements may not show up as an explicit return on investment, but the benefits are very real. If a poor family is able to keep a child in school, send someone to a clinic, or build up more secure savings, its well-being improves, if only marginally. This is a big part of the reason why poor people are demanding greater access to microcredit loans. And microcredit, unlike many charitable services, is capable of paying for itself—which explains why the private sector is increasingly involved. The future of microcredit lies in the commercial sector, not in unsustainable aid programs. Count this as another benefit.

If this portrait sounds a little underwhelming, don't blame microcredit. The real issue is that we so often underestimate the severity and inertia of global poverty. Natalie Portman may not be right when she says that an end to poverty is "just a mouse click away," but she's right to be supportive of a tool that helps soften some of poverty's worst blows for many millions of desperate people. ■