The Current Column
of 15 March 2010

The microfinance crisis

By Dr. Peter Wolff,
German Development Institute /
Deutsches Institut für Entwicklungspolitik

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Bonn, 15 March 2010. Microfinance has in recent years evolved into a popular instrument of poverty reduction. At the latest since the Nobel Peace Prize was awarded to Muhammad Yunus and the Grameen Bank in 2006, even the broad public has been aware that microcredit may offer even the poorest of people a chance to escape absolute poverty.

However, the image of microfinance, often shaped by a certain social romanticism, has developed cracks in recent years. What has happened?

First of all, in some countries there have been problems with the huge growth of microfinance institutions (MFIs). The latter are often non-state institutions that in some countries have shot up like mushrooms since the 1990s. These institutions, some of them not managed with the necessary professionalism, have often grown too fast. Outside financing, provided by official and private donors, and for the most part not by mobilising local savings, has often set incentives for an expansion with which manpower capacities have been unable to keep pace. This has led, in Morocco, for instance, and in Bosnia-Herzegovina, to difficulties in a good number of MFIs. The outcome has been closures, mergers, and intensified government regulation.

There have also been problems in South Asia, the region with the widest dissemination of microcredit. In some regions in India, Bangladesh, and Pakistan, microcredit is now so widespread that MFIs, under competitive pressure, have shown a propensity to lower their credit standards, a practice that has had adverse effects on the quality of their credit portfolios. For their part, borrowers have shown a growing inclination to repay their microcredit by taking out another loan with a different MFI or from a money lender. This is one reason for the high repayment rates reported for MFIs, over 95 %, although these figures have started to decline in South Asia.

To come to grips with the problem of multiple borrowing from multiple MFIs and the overindebtedness of many borrowers associated with the practice, there is talk now of setting up credit information offices with which all loans, including microcredit, would have to be reported.

And finally, a contentious discussion has emerged in recent years on the poverty impact of microcredit. A good number of studies and evaluations have, to be sure, come up with positive results. They indicate that the incomes of borrowers have risen, with the levels of education and health of families that have received microloans showing signs of improvement. But only in rare cases is it possible to prove that this effect is due, unambiguously, to microloans. More recent, methodologically rigorous studies do not come up with a clear picture; indeed they are unable to prove any convincing positive effects on poverty reduction. Why is that?

More often than assumed, microloans are used not for microbusiness investments but for a multiplicity of needs that may emerge, almost daily and always unanticipated, in the imponderable life of a poor household that lacks any regular income: illness, crop failure, sudden price hikes, and so on. However, the fact that microloans contribute to steadying household incomes must be seen as positive. This may make it possible for the children of such households to attend school regularly. But it does not entail any durable increase in incomes, to say nothing of economic transformation towards the higher productivity levels that could serve as a durable basis for higher incomes. The sewing machine financed with a microloan is, as a rule, unlikely to develop into a garment company; the pig in the back yard is unlikely to serve as the foundation for a competitive farm. Still, microcredit does have the potential to alleviate the effects of poverty and often to improve people's chances, and precisely those of women, to lead to lead a self-determined life. While that no doubt is a valuable contribution to poverty reduction, it does not mean escape from poverty for millions, let alone the foundation for an economic transformation of the kind that took place, say, in East Asia – without microcredit.

There are critics of microfinance, including e.g. Ha-Joon Chang, a Korean development economist teaching at Cambridge, who see in microfinance an economic misuse of capital, which would be better invested not in unproductive microbusinesses but in dynamic medium- and large-size companies, as was done in Korea's model for success. In fact, though, this is not a matter of either-or. But it is correct that the "transformative" impact of microfinance is widely overestimated. The object of a poverty-reduction strategy must be - alongside microfinance - to finance larger-size, competitive firms as well as infrastructure. Otherwise poverty reduction is likely to remain very modest indeed.

By Dr. Peter Wolff,
German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE).