Cheap money


Ron Giling / Lineair

Few topics in the broad domain of 'development' are as sexy as microfinance. Rock stars, royalty, the Nobel prize committee – almost everyone seems to have embraced it. Public relations for microfinance has been awesome.

Unfortunately, the public's image of microfinance bears little resemblance to what is happening in the field. The public's idea of microfinance is small groups of women jointly managing their financial affairs under village trees, carefully converting favourable loans into productive assets that will eventually lift them out of poverty. That image does not capture the reality of money lending to the poor.

Most parties in the microfinance sector believe that they should focus on fully recovering all costs in order to expand their services to as many needy customers as possible, and perhaps even make some profit along the way. As a result, interest rates for microcredit have shot up since the early days when Muhammad Yunus started pioneering small loans for village women.

Interest rates of 20%–70% per year are normal. Not surprisingly, this has attracted the attention of some financers, who smell an opportunity to make money. Indeed, the first microfinance millionaires have cropped up. To be clear: these millionaires are lenders, not borrowers.

Of course, there is absolutely nothing wrong with making money while saving the planet and eradicating poverty. But the current situation raises an uncomfortable question. Are microfinance institutions still reaching the poor? If so, do their loans help the poor to move up?

Microfinance institutions and economists have been reluctant to address these issues. The popular story regarding the first question typically goes as follows. 'The poor need access to finance, and are not looking for handouts. The marginal returns on capital are very high when capital is scarce, so it still pays to borrow, even when interest rates are high. The fact that informal moneylenders have been in business for such a long time (charging similar rates, and often even higher ones) proves there is great demand for money, even if it is expensive.' In economics jargon: demand for capital is very price inelastic. But is it really?

Recent evidence suggests it is not. Raising interest rates simply depresses demand for loans, especially among the poorest (the poor are much more responsive to high interest rates than the not-so-poor). While charging higher interest rates is generally good for the MFI – as it translates into greater profits – it compromises the MFI's ability to reach the poor. There is a clear trade-off between financial sustainability and poverty alleviation.

What about the second question – do microloans still enable the poor who manage to obtain a loan to invest it and become not-so-poor? The evidence here is much less clear. But again, reality is often at odds with the public's concept of microfinance. Few investments are profitable at an annual interest rate of 30%. Many loans are used for consumptive purposes or emergencies – think of funerals or medical expenses. In other cases, loans are used to finance cash-and-carry trading activities, generating immediate revenues.

Some observers argue that the massive flow of funds made available for expensive microloans crowd out funding for productive investments in the manufacturing sector – but these are exactly the technologies (with economies of scale, so that expanding production implies lower per unit costs) needed to kick-start a process of sustainable economic growth. If this is the case, instead of helping countries to develop, the microfinance hype and hoopla could actually achieve the exact opposite – promote the creation of a large flea market that sells little of value.

Undoubtedly some of the statements about the counter-productive nature of microfinance are speculative and premature. However, the microfinance myth that dominates the media is wrong, too. Microfinance could do much more to help the poor if it abandoned its focus on financial sustainability. There is nothing wrong with subsidized credit if it alleviates poverty. A multi-pronged plan of attack is needed. ■

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