

Microfinance Meets the Market

Debating about a single vision for microfinance misses the reality that it flourishes thanks to a diversity of strategies

When Muhammad Yunus and Grameen Bank won the Nobel Peace Prize in 2006, the world community celebrated the ways that expanding financial access can improve the lives of the poor. Many microfinance “insiders” have been working toward a second goal as well: to find ways to provide microfinance on a commercial basis, without long-term subsidies. Relying on subsidies, they argue, can reduce efficiency and hinder the massive expansion of services necessary to reach hundreds of millions of additional “unbanked” customers.

So it should have caused broad excitement when Mexico’s Banco Compartamos held a public offering of its stock in April 2007. Here was a microfinance institution serving low-income women with small loans—and earning profits sufficient to attract outside investors on a big scale. At the conclusion of the public offering the bank was worth \$1.6 billion.

In a new paper Cull, Demirgüç-Kunt, and Morduch clarify what’s at stake when the worlds of nonprofit microfinance and commercial banking intersect. They use a data set that includes 346 of the world’s leading microfinance organizations and covers nearly 18 million borrowers. The data suggest that while commercialization is a powerful trend, banks like Compartamos and avowedly “social businesses” like Grameen Bank are not substitutes for one another. The data show that microfinance is not taking a single path, nor should it. The authors put forward eight basic findings that frame debates.

- Licensed commercial banks with for-profit status serve a growing share of microfinance customers and garner media attention, but the share remains relatively small. Globally, microfinance continues to be dominated by nongovernmental organizations (NGOs), government-owned

banks, and nonbank financial institutions that are a cross between banks and NGOs.

- Being a nonprofit institution does not mean being unprofitable. A large share of microfinance institutions with nonprofit status in fact earn steady profits—but they reinvest their profits in the institution and cannot legally distribute earnings to shareholders. Earning profits (and thus limiting dependence on subsidies) and becoming a commercial entity are thus distinct activities. Neither implies the other.

- Microfinance institutions have found reliable ways to get customers to repay loans. The group-lending methods pioneered by Grameen Bank are best known but far from universal. Microfinance institutions using standard individual-based loan contracts also boast high rates of loan repayment and gain added flexibility.

- Commercial microfinance banks as a group make loans that on average are about four times as large as loans from NGOs. Since poorer customers generally demand smaller loans, average loan size is a rough proxy for the poverty level of customers. On average, microfinance banks thus tend to serve a substantially better-off group of borrowers than do NGOs. Banks also serve fewer women as a share of their customers.

- Most microfinance institutions charge inflation-adjusted interest rates between 20 and 40 percent a year. Despite the evidence from Mexico’s Compartamos, NGOs as a group charge interest rates that are roughly twice the rates charged by commercial microfinance banks. Thus the poorest customers tend to pay the highest interest rates on loans. The high interest rates are necessary to cover the added costs of making small loans, and the NGOs’ record of expansion and high loan repayment rates over time suggests that customers value the services, even at high costs.

- Despite the high interest rates, most of the institutions serving the poorest customers earn profits too small to attract profit-maximizing investors.

- Thus subsidies and noncommercial funding continue to be important to NGOs, while banks rely mainly on social investment and commercial sources of capital.

- Data on the financial side of microfinance are of greater quality and quantity than data on social outreach and impacts, but even data on financial basics such as “profits” and “subsidies” are inadequate. Current reporting practices tend to overstate profits and understate subsidies.

The microfinance sector has grown tremendously, and institutions are continually reducing costs, improving quality, and expanding services. Debating about a single, correct vision for microfinance—whether a nonprofit approach or a commercial model—misses the reality that microfinance flourishes thanks to a diversity of strategies. Improving and refining those strategies will require better data and the continuing embrace of experimentation.

Robert Cull, Asli Demirgüç-Kunt, and Jonathan Morduch. Forthcoming. “Microfinance Meets the Market.” Journal of Economic Perspectives.

Unpredictable Aid

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of implementing IMF-supported programs, receive more predictable aid. This relative stability of relations could reflect greater trust or sound macroeconomic policy implementation by the recipient country.

Finally, to more accurately measure the impact of low predictability, data collection should be improved. Recording the mutual expectations of donors and recipients is critical to capture aid flows expected by recipients. Better data would help explain, for different types of aid, low predictability caused by conditionality, administrative delays, and sudden adjustments by donors.

Oya Celasun and Jan Walliser. 2008. “Predictability of Aid: Do Fickle Donors Undermine Aid Effectiveness?” Economic Policy 23 (5): 545–94.