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The Microfinance Delusion

by Milford Bateman

The optimistic beginning

Thirty years ago, it was widely thought that the perfect solution to unemployment and poverty in developing countries had been found in the shape of *microfinance*, the provision of tiny microloans used by the poor to establish an income-generating activity. Microfinance is most closely associated with the US trained Bangladeshi economist and 2006 Nobel Peace Prize recipient, Dr Muhammad Yunus. By celebrating self-help and individual entrepreneurship, and by implicitly discrediting all forms of collective effort, such as trade unions, social movements, co-operatives, public spending, a pro-poor 'developmental state' and – most of all – collective moves to ensure a more equitable redistribution of wealth and power, neoliberal policy-makers in the international development community fell in love with microfinance. The World Bank, USAID and other agencies began to aggressively push forward the concept and, in order to reduce the need for subsidies, also insisted microfinance be turned into a for-profit business. Microfinance soon became the international development community's highest profile, most generously funded and supposedly most effective economic and social development policy.

Reality finally breaks through

Unfortunately, it is now clear that Dr Yunus was wrong. The past 30 years has actually shown microfinance to be part of the *problem* holding back sustainable poverty reduction in developing countries, and not the *solution*.[1] Not only is there no solid evidence that microfinance has had a positive impact on the well-being of the poor,[2] since 1990 the microfinance sector has been increasingly marked out by spectacular levels of Wall Street-style greed, profiteering, client abuse, and market chaos.[3] It turns out that microfinance has largely been driven forward by nothing more than hype, PR, celebrity support, and a constant stream of faith-healing-like pronouncements from Yunus and his acolytes.

The problems with microfinance are deep and multi-faceted. First, right from the start it was assumed that no matter how many informal microenterprises were helped into life thanks to microfinance, sufficient local demand would always automatically arise to absorb this additional local supply of simple items and services. Yunus was clear on this. However, this understanding is fundamentally wrong: a local demand constraint *does* exist. Even in the 1970s, local communities in most developing countries were a hive of informal activity with most simple items and services pretty adequately provided by a community's poor inhabitants. An artificially-induced increase in supply was thus always likely to generate very little benefit in terms of additional jobs and incomes. Instead, cramming more and more informal microenterprises into the same local economic space typically leads to 'displacement', where new microenterprises only survive by tapping into the local demand that up to then was supporting incumbent microenterprises. Thanks to many new microenterprises, most of the hapless (and equally poor) individuals already struggling to survive in the microenterprise sector are faced with reduced turnover, leading to lower margins, wages and profits. Any employees might have to be dismissed. The additional supply also tends to depress the prices of the local goods and services in question, thus negatively affecting *all* (new and incumbent) microenterprises. In short, all too often microfinance results in promoting nothing more than an unproductive process of local 'job churn', with no real net employment, income or productivity improvements registered. Another way to look at it is that the existing community of poor micro-entrepreneurs are effectively being made to pay the price, in the form of lower incomes, for the few net jobs being created in the local community thanks to microfinance.[4] This is hardly fair and equitable.

Compounding the problem of displacement is the related problem of microenterprise failure. Even more than small or medium businesses, microenterprises are 'poverty-push' by nature, and so we tend to see a very high failure rate of such business units. This means into the longer term microfinance generates far less sustainable job creation than is typically thought. Failure also means the poor often experience the dangerous loss of important assets. Households first draw down family savings and divert remittance income to try to repay their microloan. If this is not enough, there is then the need to sell off important assets (often at fire-sale prices), such as equipment, machinery, motor vehicles, housing and land. On losing these assets, poor households all too often plunge into deeper, and often irretrievable, poverty. While the narrative of those supporting the microfinance movement (notably the World Bank's neoliberal-inspired 'Doing Business' program) focuses upon maximising the 'freedom' and 'opportunity' to do business, this deliberately overlooks the negative outcomes associated with failure that are actually the main experience for the majority of the entrepreneurial poor.

In addition, the vast bulk of microfinance is not used to fuel microenterprise development, but actually goes to support simple consumption spending. Thanks to easy availability but with interest rates typically very high – one Mexican microfinance bank, Compartamos, charges its poor clients an annual interest rate of 195% - we increasingly find that

the poor all too easily end up spending a large part of their incomes on interest repayments. This psychology also helps to account for the dramatic emergence of Ponzi-style dynamics in a growing number of developing countries, characterised by the poor gradually becoming trapped into accessing more new microloans simply to repay existing microloans. The most dramatic example of this destructive trend was in Andhra Pradesh state in India, a development that in 2010 eventually precipitated the collapse of almost its entire microfinance sector.

The most important drawback to the microfinance model, however, is simple: the programmed output of microfinance – informal microenterprises – is completely the wrong foundation upon which a country can attempt to escape poverty and deprivation. A country needs a flourishing enterprise sector based upon a critical mass of enterprises possessing the capacity to achieve minimum efficient scale, deploy some state-of-the-art technologies, develop some innovative capacity, productively link with other enterprises vertically (sub-contracting) and horizontally (clustering), and with some potential to exploit non-local markets. With such prerequisites in place, long-term productivity growth is possible, and so also sustainable poverty reduction. As Chang shows,[5] this is the experience of today's rich developed economies, as well as that of the more recent East Asian 'miracle' economies. However, thanks to their growing exposure to microfinance, today's developing countries have been heading in the *opposite* direction.

The experience of Africa and Latin America illustrates the immense scale of the problem. Africa already has more micro-entrepreneurs per capita than anywhere else, and the rapidly expanding supply of microfinance is increasing this number. Yet Africa remains trapped in its poverty *precisely* because it has only evolved such a shallow enterprise structure, one that is structurally incapable of giving rise to sustainable productivity growth. The Inter-American Development Bank (IDB) also points to the same adverse dynamic to explain why Latin America's recent history is one of very high levels of poverty and unemployment.[6] Latin America has for too long channelled too much of its scarce financial resources into low-productivity informal microenterprises and self-employment, and too little into more productive formal small and medium enterprises. The IDB has blown out of the water the belief that Latin America has benefitted from the programmed expansion of microfinance.

But policy-makers still don't get it

Bad policy choices are still being made with regard to microfinance. As even a cursory glance at CNN or Al Jazeera will have shown, the brave young people behind the Arab Spring uprisings in North Africa are not just calling for the overthrow of dictators, but also for 'real jobs' – that is, jobs that are meaningful, dignified, secure and make use of their high level professional skills (often expensively acquired abroad). As one demonstrator said, the young in North Africa now *demand* a decent working life, and 'not just selling falafel on the street-corner'. However, the World Bank, USAID, EBRD and other agencies are currently planning to assist these young people mainly with microfinance programs, the aim of which is essentially to support *exactly* the type of jobs that have just been so ferociously rejected. Microfinance might actually inflame the situation in North Africa.

Similar wrong-headed thinking is found in the European Commission (EC). Through a new €100 microfinance fund, the EC hopes to promote a new raft of microenterprises in the worst recession-hit locations, and so create new jobs. With virtually all EU countries now seeing their existing microenterprise sector dramatically contracting thanks to a decline in local demand, however the vast majority of *new* micro-entrepreneurs are going to find it almost impossible to identify new sources of local demand with which to begin and to grow. In Greece, for instance, the dramatic fall-off in local demand has meant more than *half* of its existing microenterprises and small businesses - cafes, small retailers, souvenir sellers, bars, fast food joints, etc - are today unable to meet their payroll, laying off employees or closing down. The same downward spiral holds for most EU countries. It is a cruel fantasy to expect *new* microenterprises to be able to take root in the same communities.

Microfinance was for so long seen as an effective market-driven intervention that was massively reducing poverty and promoting sustainable 'bottom-up' development. Even long-standing supporters now accept this claim to have been false.[7] Even at this late stage, we urgently need to understand the drawbacks to microfinance and begin to redirect our scarce resources into much better uses, notably credit unions, financial cooperatives, community development banks, and so on. Only in this way will local communities be spared even more financial sector-driven damage than that inflicted on them already, thanks to our long-standing but fundamentally mistaken belief in the power of microfinance.

1 See Milford Bateman (2010) *Why Doesn't Microfinance Work? The Destructive Rise of Local Neoliberalism*. London: Zed Books.

2 See Maren Duvendack, R Palmer-Jones JG Copestake, L Hooper, Y Loke and N Rao (2011) *What is the evidence of the impact of microfinance on the well-being of poor people?* London: EPPI-Centre, Social Science Research Unit, Institute of Education, University of London.

3 See Hugh Sinclair (2012) *Confessions of a Microfinance Heretic: How Microlending Lost Its Way and Betrayed the Poor*. San Francisco: Berrett-Koehler

4 In 2009 the ILO argued *against* further stimulation of the informal microenterprise sector, since 'As was the case in previous crises, this could generate substantial downward pressure on informal-economy wages, which before the current crisis were already declining' – see page 8 (ILO). 2009. *The Financial and Economic Crisis: A Decent Work Response*, Geneva: ILO.

5 Ha-Joon Chang. (2002). *Kicking Away the Ladder – Development Strategy in Historical Perspective*, Anthem Press: London.

6 IDB (2010). *The Age of Productivity: Transforming Economies from the Bottom Up*, Washington DC: IDB.

7 See Malcolm Harper, M. 2011. 'The Commercialisation of Microfinance: Resolution or extension of Poverty?' in: Milford Bateman (2011) (Ed). *Confronting Microfinance: Undermining Sustainable Development*. Sterling, VA: Kumarian Press.

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