Why finance matters*

Jonathan Morduch
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Roughly half the adults in the world, about 2.5 billion people, have no bank account nor even access to a "semi-formal" financial service like microcredit (1). But what if they did? Muhammad Yunus, the 2006 Nobel Peace Prize winner and founder of Bangladesh's Grameen Bank, argues that this lack of financial access means that the poor, especially poor women, can't obtain the tiny loans (known as microcredit) that they need to build their businesses and get on a path out of poverty (2). The idea has taken hold: in 2009 Grameen Bank served 8 million customers (the average loan balance was just $127). (3) World-wide, microcredit advocates claim over 190 million customers (4).

But proof of concept is not proof of impact, and the surprisingly weak results from recent impact studies suggest we need to rethink microcredit. In the June 10, 2011 issue of *Science*, Karlan and Zinman report on a randomized evaluation of microcredit in the Philippines (5). The study joins a handful of other recent studies that convincingly address the concern that success stories may overstate impact because of selection bias (6, 7, 8). The studies carefully account for the fact that borrowers may be atypical members of their communities. Borrowers may be more entrepreneurial, for example, or better connected to markets, or more focused by nature. The randomization process used in these studies creates comparison groups that are truly comparable.

Karlan and Zinman first show that access to microcredit does indeed expand financial access (it doesn't merely substitute for other banking possibilities). Still, even with greater financial access, positive impacts on business are elusive. After roughly 1-2 years of borrowing, household business activity of microcredit borrowers actually falls slightly relative to the control group (data on profit, which we ideally want, is too noisy to examine here), and an index measuring subjective well-being worsens.

These results matter because they are not isolated. The handful of other careful studies has also yielded a mixed bag of results that fall far short of the expectations set up by advocates of microcredit. None of the studies is perfect (unlike the other studies, for example, Karlan and Zinman work with a bank that does not focus on the poor, making explicit evaluation of poverty reduction impossible). But the studies deserve serious attention because they test microcredit while addressing selection bias so much more credibly than past studies.

The accumulating results should hasten efforts to rethink microcredit. Not with the aim to dismiss it, but instead to reformulate understandings. The original vision of microcredit is

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enticing but too simple: advocates have argued that the poor seek capital for business investment above all else. The idea that microcredit creates a new class of hard-working, independent entrepreneurs sells well with investors and donors. But in the end, the argument risks undermining support for what may be a more important reason to care about access to finance. To appreciate the revolution that Yunus launched, it is necessary to think beyond Yunus.

To see that, we need to read between the lines. Microcredit offered by the bank studied by Karlan and Zinman is not cheap: the bank charges an annualized interest rate of 60 percent for loans with 3-month terms (Grameen Bank, by comparison, charges 20 percent). The unspoken question here is why are people taking business loans if gains to business are hard to detect?

Perhaps borrowers fool themselves into imagining much bigger gains than they get. Or perhaps impacts will need 3 or 4 years or longer to emerge, not the 1-2 year window that researchers investigate.

New research emerging most strongly from small-scale descriptive studies of poor families (rather than from structured statistical evaluations) suggests a different answer—and, more importantly, a different question (9). The studies show that borrowers turn to microcredit for a range of uses beyond what they tell lenders. There are also health problems to address, school fees to pay, food to buy, and other (more expensive) loans to repay. A large study in Indonesia found that about half of the volume of loans to poor borrowers went to purposes unrelated to business (10). A similar result holds in Bangladesh for a small sample of Grameen Bank borrowers (9). In the Philippines, a broad survey revealed that only 37% of major expenditures from microcredit loans went to business purposes (11). (The survey asked only about expenditures larger than $20; another 39% of spending was unaccounted for, presumably pertaining to expenses under $20, some of which likely went to business.)

This gives us a very different frame. Microcredit emerges as a tool that largely helps families cope with ups and downs and make big-ticket purchases (some but not all of which are related to business). In itself, having better ways to borrow will not rid the world of poverty, but it can give important measures of stability and liquidity to families near the edge. Managing money becomes vital when you have little of it.

The argument accords with an emerging body of research from around the world that irregularity and insecurity of income is as challenging for the poor as having low income (9). It also helps explain a secondary set of results of Karlan and Zinman; they find that borrowers buy less formal insurance in a pattern that suggests that microcredit loans are indeed used as an alternative mechanism to cope with ups and downs.

Helping poor families borrow and manage cash flow--reliably and flexibly and for a range of uses—will likely end up as the truly big idea behind microcredit, even if it's not the big idea that inspired the global movement.

References and Notes

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12. I’m grateful for comments from Dean Karlan, Barbara Kiviat, Amy Borovoy, and Tim Ogden.