Bringing Development Back, into Microfinance

by Maria Otero

Microfinance is the provision of financial services to low-income, poor, and very poor self-employed people. From its inception in the 1970s, microfinance has evolved in astounding ways, incorporating into its practice social and economic development concepts, as well as principles that underlie financial and commercial markets. This combination has led to the creation of a growing number of sustainable microfinance institutions around the developing world. As microfinance continues to evolve as a development strategy, it will be successful only if it is able to strike the right balance between the two frameworks--development and finance--that underlie its practice.

The purpose of this paper it to explore three points at which microfinance intersects with development, to argue why these three intersections make microfinance compelling from the perspective of development, and to explain why practitioners, donors and others involved in the microfinance field tend to forget the connection between the two.

As the approach to development has shifted over the last decades (from the emphasis on developing infrastructure and financing large capital intensive projects in the 1960s, to the focus on meeting the basic needs of people in poor communities in the 1970s, to the priority on structural adjustment and stabilizing economies in the 1980s, to today's attempt to construct a sustainable development framework against the background of increasing globalization) two related and underlying debates have remained constant:

- First, are development efforts affecting poverty levels? Are they reaching the poor? All development approaches, regardless of their shortcomings, have attempted to address poverty, to alleviate it, to eradicate it. While spirited, and at times fierce, debates on the relative merits of various development approaches prevail, no task has commanded a higher priority for development institutions and professionals than that of reducing global poverty.
- Second, what is the role of foreign assistance (i.e., donor funds) in development? The major issue has focused on when external resources--in the form of capital or technical expertise--should be introduced into a development project to make it work. The dominant approach throughout development has been to introduce donor money at the beginning, the middle, and the end of any project--to inject it whenever possible, and to bring in the expert to solve the problem.

These two areas of debate that have dominated development are also very applicable to microfinance and help frame the discussion below.

As a way of defining the relationship between microfinance and development, it is useful to identify how microfinance directs itself toward development objectives. This paper suggests that there are three points at which development and microfinance intersect, and that it is microfinance's ability to connect in all three of these points that make it so compelling as a development strategy.

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Reaching the Poor

The first point of connection is microfinance's objective to alleviate poverty, that is, at the client level. Indisputably, microfinance, at its core, combats poverty. Clients of microfinance institutions are poor city dwellers housed in slums or squatter settlements, often living in appalling overcrowded settings, lacking access to basic services such as health. Their survival tool kit lacks education or skills that are essential to enter the mainstream economy. Many of them are women, poorly trained and playing dual roles of provider and caregiver. These poor people are more exposed to the threats of contamination, bad sanitation, and disease than the rest of the population. When disaster strikes, in the form of inflation, earthquakes, or other outside forces, they are the most exposed.

Rural clients are landless or land poor; Their land is often unproductive or lies outside irrigated areas. Many farm in arid zones or on steep-hill slopes land, that are ecologically vulnerable. Opportunities for off-farm employment are few and must be self-generated, with many rural poor mixing, many earning activities to generate the cash they need to survive. They live in large households, their children are especially susceptible to disease, and many suffer from malnutrition. Many poor depend on their children for work and must weigh the opportunity cost of sending children to school today against present and future benefits.

Conceptually, microfinance addresses one constraint faced by the poor: their shortage of material capital (i.e., the input necessary to generate income). Capital investment, from savings or borrowed money, takes a critical place in the economy of all human actors, regardless of their level of income. Microfinance creates access to productive capital, which together with two other forms of capital--human capital, addressed through education and vocational training, and social capital, built through creating representative, local organization building, promoting democratic systems, and strengthening human rights--enables people to move out of poverty.[1] Microfinance enables poor self-employed people to create productive capital, to protect the capital they have, to deal with risk, and to avoid the destruction of capital. It attempts to build assets and create wealth among people who lack them. For the very poor, microfinance becomes a liquidity tool that helps smooth their consumption patterns and to reduce their level of vulnerability.[2]

At a more subtle but no less important level, which is much harder to measure, increasing material capital strengthens the sense of dignity a poor person possesses, and contributes to empowering him or her to participate in the economy and society. With a source of income, a person can provide for the family, improve the household's access to basic needs, and plan for the future. When these conditions are present, a person who was part of the marginalized sector of the society becomes better equipped to be an active citizen.

Building Institutions

The second point of intersection between microfinance and development occurs at the institutional level. Microfinance seeks to create private institutions that deliver financial services to the poor. These institutions become part of the infrastructure of the country; that is, they are distribution channels for deploying services that respond to the material capital needs of poor. Creation of such distribution channels that provide access to services to the poorer sectors is one of the greatest challenges that governments face. Even governments that want to allocate increased resources to address the needs of the poor encounter a daunting challenge: the lack of effective distribution channels or the infrastructure necessary to convert economic growth into improved well-being among the poorer sectors.

In this setting, microfinance proposes to create private, sustainable institutions that specialize in delivering financial services to the poor. Against a broader development backdrop, these institutions become a means to an end, not an end in and of themselves. They constitute part of the not-yet-attained and long-sought-after instrumentalities needed to incorporate the poorer sectors into the economy. They put capital in the hands of those who otherwise would not have it, and they enable people with few assets to save.

It is for this reason that institutional sustainability becomes so crucial to microfinance. If microfinance institutions are not financially solid, unable to cover their costs, and incapable of delivering financial services over the long term, they become a transitory means of reaching the poor and lose their punch as a component of a broader development strategy in any setting. This major link between microfinance and development begins to unravel, unless microfinance institutions attain self-sufficiency in their operations.

Deepening The Financial System's Reach

The final intersection between microfinance and development occurs at the intersection between microfinance and the financial systems in a country, accomplished when a microfinance institution becomes a regulated institution that is part of the financial system. This connection is made possible by the recognition in the last decade that healthy financial systems are an important piece of the development puzzle, and that financial sector improvement and reform should be a priority in all developing countries.[3]

When microfinance institutions become part of the financial system, they can access capital markets to fund their lending portfolios which allow them to increase dramatically the number of poor people they reach. They can also capture savings, providing another important financial service to the poor, and access deposits as another source of capital.[4]

By inserting themselves into the financial systems of their country, microfinance institutions deepen dramatically the reach of financial systems to populations previously excluded from banks and other financial institutions. One essential means of alleviating poverty becomes the creation of a broader and deeper financial system which does not restrict the allocation of capital to a tiny group of elites, but instead integrates the poor as a market segment and reallocates resources from other sectors.

This last intersection with development is, in relative terms, a recent one for microfinance, made possible only after attaining the creation of financially viable institutions. Once it was demonstrated that microfinance institutions could manage risk effectively and that they would not become a systemic risk to the system, their incorporation into financial systems became possible.

When microfinance intersects with development at the three points suggested above, it has the capacity to create structural changes in the way in which capital is made available to a population. It is addressing the seemingly intractable problem of creating the infrastructure to reallocate resources and to create wealth among poorer sectors. More than that, it is changing the dimension of a system within an economy--the system that moves and reallocates capital in the economy. Microfinance operates at its best when it intersects with development in these three points. Many microfinance institutions, either because they have not become sustainable, or because they operate in an unfriendly regulatory environment, are not able to complete these three points of intersection.

Within the field of microfinance, observers, donors, and practitioners often tend to forget that the three above dimensions of microfinance are the essential points of intersection with development, and that all three must be present to make microfinance a powerful development tool. There are several reasons why this relationship between microfinance and development is often forgotten.

First, some of the key debates within the microfinance field are focused on the wrong issues. Perhaps the best example is the ongoing controversy between reaching the poor and the sustainability of microfinance institutions, a debate that has polarized the field along these two dividing lines. Elisabeth Rhyne calls this the ying-yang of microfinance, and rightly points out that "only by achieving a high degree of sustainability has microfinance gained access to the funding they need over time to serve significant numbers of their poverty-level clients. This image reveals that there is in fact only one objective--outreach. Sustainability is but the means to achieve it."[5] By focusing our debate in this way, one is pitting one point of intersection of microfinance to development (reaching the poor) against another (creating sustainable institutions). The basic flaw to this debate is that it ignores that microfinance needs both points of intersection to development--reaching the poor and achieving sustainability. Otherwise, it begins to disintegrate as a compelling development approach.

The second reason microfinance forgets its relationship to development is that many of the biggest challenges in microfinance remains at the institutional level. Building permanent, sustainable institutions that deploy financial services to the poor and the very poor, and are directly linked to or are part of the financial systems remains an enormous undertaking which has not been achieved by many microfinance institutions. For this reason, the focus in the last few years has been on developing the managerial, technical, and systems capacity within institutions to move them towards sustainability. The focus has been on the means, not the end. The level of urgency regarding institutional viability is visible in the priorities set by donors, the focus on tools, the establishment of performance standards, and other interventions designed to advance the field in this area. Whether these institutions come out of the NGO experience, involve traditional banks, or introduce new approaches such as joint ventures, is not the important issue. What is important is that the focus remain on creating microfinance institutions that reach the poor sectors of society and at the same time achieve financial permanence.

One of the reasons attaining institutional viability has been difficult is because many microfinance practitioners have become entrenched in the methodology or approach they have developed to reach the poor. As such, many have focused on defending their approaches and have diverted their attention from the essential component of advancement: innovation. Breakthroughs in any human activity have been achieved when new ideas have been introduced and have been accepted by society. However, in microfinance, the current receptivity to innovation has been severely constrained because of the widespread efforts to defend existing approaches, or because replication is occurring using models that have not evolved. Yet for the field to advance, continued innovation is a necessity.

The microfinance field's lack of focus on innovation is reminiscent of the example of how typewriter keyboards were designed. The QWERTY keyboard that we use today is named after the six letters in the upper row of the keyboard. These were laid out in 1873, employing a whole series of tricks that would force typists to type as slowly as possible, such as scattering the most common letters over all keyboard rows and concentrating them on the left side. These counterproductive features were purposely designed by manufacturers because typewriters in 1873 jammed if adjacent keys were struck in quick succession.

When improvements in typewriters eliminated the problem of jamming, experiments with an efficiently laid out keyboard in 1932 showed it could increase the typing speed by 95%. But by then the QWERTY keyboards were securely established, as typists, teachers, and manufacturers crushed all moves toward keyboard efficiency. These lessons of efficiency and innovation should not be forgotten in the field of microfinance.[6]

The final reason behind the disconnect between development and microfinance occurs because the best practice in microfinance has fused two separate fields into one: development and finance. These two disciplines operate from separate paradigms, communicate using different terminology and concepts, and have previously not been asked to exist together in an approach that attempts to deliver services to the poor.

Merging these two ways of thinking and creating a level of compatibility between them that arrives at a good marriage and that unites them to form a new way of thinking is the challenge microfinance is facing today. Those who come from a finance discipline pull hard in their direction; those working from a development framework pull hard in theirs. The first point of intersection between, development and microfinance--reaching the poor--is familiar and comfortable to the development camp, while the last point of intersection--integrating into the financial system--is logical thinking for those from finance.

Using a literary analogy helps illustrate the difficulty microfinance faces in addressing this issue. In his novel *Anna Karenina,* Leo Tolstoy says that happy families are all- alike, but every unhappy family is unhappy in its own way. In order to be a happy family, it must succeed in many different respects. The marriage must work, there must be agreement about money, there must be agreement about raising the children, religion, in-laws, and other vital issues. Failure in any one of those essential respects can doom a family to unhappiness, even if it has all other ingredients needed for happiness.

This *Anna Karenina* principle can be extended to understanding why the linkage between finance and development will be possible only if it avoids many separate possible causes for failure.[7] In other words, if these two are not combined in a way that effectively integrates the major principles of each, microfinance efforts will fail, each in their own way. One will fail because it will gradually forget its target market as it seeks quick profits; another will fail because it ignores the basic principles of finance; still others will insist on only one model to achieve these intersections. Microfinance will be strengthened if it recognizes that the answer to the capital needs of marginal populations is developing cumulatively, based on innovative efforts centered in the three intersections between microfinance and development, rather than on isolated, heroic acts that engage one or two experiences. If microfinance professionals lose sight of these intersections and neglect to focus microfinance on all three, the field will drift toward the landfill of failed development efforts.

Microfinance professionals know more about how to make capital available to poor people than they did fifteen years ago. They have taken the bold step in the last five years of adding one crucial intersection point between microfinance and development: integration into the financial system. While one can never avoid all crises microfinance institutions will confront in delivering credit and savings services, one can make these less frequent and less severe. Additionally, one can use the knowledge being acquired to meet and address new situations that will continue to arise.

For microfinance to continue its path toward becoming a successful development strategy, it must display these three dimensions: a relationship to the poor, a reliance on permanent institutions, and a connection with the financial system of a country. These three dimensions of microfinance are not a discussion about the trade-offs of one over the other; without all three, the strong points of intersection between microfinance and development will fade into oblivion and microfinance will become either a set of highly profitable financial institutions that have abandoned their market, or a set of insignificant donor-dependent and localized credit programs. Keeping the collective eyes of microfinance professionals on these intersection points is the huge challenge of this field today.

Notes

1. See Vernhagen, K. (1999). *Towards a Misereor Sector Policy: Financial Systems Development.* Draft. Vernhagen distinguishes these three types of capital and their shortage for the poor. Combating poverty is a battle against these three shortages of capital. Microfinance directly addresses one of these, the shortage of material capital.
2. These findings are emerging from work conducted by Jennefer Sebstad and Monique Cohen, “Microfinance, Risk Management and Poverty,” prepared for the *World Bank’s World Development Report 2000 on Poverty,* 1999. Data from four countries demonstrate that finance for the poor serves to reduce their risk, especially when they face personal emergencies.
3. It was not until 1989 that the World Bank dedicated its *World Development Report* to financial systems in developing countries.
4. There are countries where the regulatory system is not conducive to the regulation of microfinance institutions. Issues related to the supervision and regulation of microfinance have become a leading topic of research and analysis in the microfinance field. See especially Valenzuela, L. &

Young, R. (1999, September). *Consultation on Regulation and Supervision in Microfnance: A Workshop Report*. DAI. Microenterprise Best Practices Project. Draft.

5. See Rhyne, E. (1998, July). "The Yin and Yang Microfinance: Reaching the Poor and Sustainability." *The Microbanking Bulletin,* Calmeadow. pp. 6-8.

6. The QWERTY example is widely as' an example of what kind of circumstances crush innovation in business. See Diamond, J. (1999). *Guns, Germs and Steel: The Fates of Human Societies.* Norton and Co, pp. 248-249. See also Liebowitz, S.J. & Margolis, S. (1999). *Winners. Losers and Microsoft: Competition and Antitrust High Technologies.* The authors argue that the QWERTY keyboard is efficiently laid out.

7 See Diamond, J. Guns, *Germs and Steel,* pp 131-156. The author develops the *Anna Karenina* principle to explain why some animals were domesticated and why some remained wild.