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FOCUS NOTE

# Does Microcredit Really Help Poor People?

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Richard Rosenberg

Ever since microcredit first began to capture public attention 25 years ago, the usual story line has been that it is a tool of extraordinary power to lift poor people—especially women—out of poverty, by funding their microenterprises and raising their incomes. This picture has been buttressed by hundreds of inspiring stories of microentrepreneurs who used tiny loans to start or expand their businesses, and experienced remarkable gains not only in income and consumption but also in health, education, and social empowerment. But how well do these individual anecdotes represent the general experience of the hundreds of millions who have gotten microloans and other microfinance services? Is microcredit—or microfinance more generally—being oversold?[1]

## A Claim in Doubt

Unfortunately, scientific testing of the impact of microcredit is surprisingly difficult. If we find that people who got microloans are doing better than those who didn't, does this mean that the loans caused the improvement? Maybe not. There are several other plausible explanations—for instance, that the people who apply for and get the loans may have more drive and ambition, in which case they would probably tend to do better than others whether or not they get the loan.

Dozens of studies have looked at the experience of people who have received microloans. The challenge has been to identify a control group for comparison: it is difficult and expensive to find a group of people who are like the loan recipients in all relevant ways except for not having gotten a loan. Up until recently, most of the few studies that addressed this challenge seriously found that microcredit produced important economic and social benefits. But there has always been controversy about the validity of these studies.[2] A recent analysis of the most widely cited one raises grave doubts about its methodology and conclusions (Roodman and Morduch 2009). These doubts probably apply to some of the other early studies as well.

In the last three years, a few researchers have started using randomized controlled trials (RCTs) to test microfinance impact. They select a large enough group of study subjects so that when it is randomly divided, the two subgroups can be presumed to be statistically identical. The first subgroup gets loans; the second subgroup does not. If one subgroup experiences better outcomes than the other, the researcher can be reasonably sure that it is due to the loans, because the loans are the only *ex ante* difference between the groups.

So far the few published RCT studies of microfinance have been able to track short-term results only. Two that looked at standard microcredit clients over a short period (12–18 months) found no evidence of improvements in household income or consumption, although they did find some other possible benefits (Banerjee, Duflo, Glennerster, and Kinnan 2009 and Karlan and Zinman 2009). Interestingly, the only RCT study of microfinance so far that

1 The term "microfinance" refers to the full range of financial services that low-income people use, including not only credit but also savings, insurance, and money transfers.

2 For a summary of research on microloan impact up to 2005, including the methodological limitations of the studies, see Goldberg (2005).

found short-term welfare improvements looked at microsavings, not microcredit (Dupas and Robinson 2009). A South Africa RCT found income improvements from small, high-interest consumer loans, but such loans are not usually thought of as microfinance (Karlan and Zinman 2008). (See the Annex for a brief summary of these four RCTs.) Many more of these studies, including especially longer term ones, will be needed before general conclusions can be drawn. For now, it seems an honest summary of the evidence to say that we simply do not know yet whether microcredit or other forms of microfinance are helping to lift millions out of poverty.

## But are we looking for impact in the right place?

If the only value proposition in microfinance were the claim that it raises poor people's income and consumption by funding their microenterprises, then perhaps it would be best for donors, governments, and social investors to declare a moratorium on microfinance support until there is better evidence to think that the claim is true. But before reaching that conclusion, we need to step back and take a broader look at how poor people actually use financial services like credit and savings, and why they value them. A remarkable new book, *Portfolios of the Poor: How the World's Poor Live on $2 a Day* (Collins, Morduch, Rutherford, and Ruthven 2009), presents the results of year-long financial diaries collected about twice a month from hundreds of rural and urban households in India, Bangladesh, and South Africa.[3] These diaries reveal that financial instruments are critical survival tools for poor households—indeed, that these tools are even more important for the poor than for richer people.

*Portfolios* begins with a central observation: "[o]ne of the least remarked-on problems of living on two dollars a day is that you don't literally get that amount each day" (p. 2). In other words, economic poverty is not just a matter of *low* incomes, but also of *irregular* and *uncertain* incomes. To put food on the table every day, and to meet other basic consumption needs, poor households have to save and borrow constantly. "For all the households we came to know through the diaries, living on under two dollars a day requires unrelenting vigilance in cash-flow management…" (p. 17). Whether or not financial services lift people *out of* poverty, they are vital tools in helping them to *cope* with poverty. The poor use credit and savings not only to smooth consumption, but also to deal with emergencies like health problems and to accumulate the larger sums they need to seize opportunities (occasionally including business opportunities) and pay for big-ticket expenses like education, weddings, or funerals.

For the diary households, flows into and out of financial instruments (mainly loans and savings) ranged from 75 to 500 percent of annual income. The poorer the household, the higher that percentage tended to be. On reflection, this is not surprising: the closer a household is to the edge of subsistence, the more it will have to scramble to keep basic consumption stable and to accumulate larger amounts when it needs them. Over the year, the average diary household used 8 to 10 different types of financial instruments, and most types were used multiple times. (The notion that microcredit brings loans to people who previously had no access to them is widespread but mistaken, as is the notion that the strong majority of microloans are used for business purposes.)

3 Many of the same points were made in Rutherford (2000) and Rutherford and Arora (2009).

If poor people have so many financial tools available to them already, does formal microfinance add much? Informal instruments (e.g., informal savings and loan clubs, or loans from family, friends, or the local moneylender) are usually more flexible than microfinance from formal providers, so the poor continue to use these informal tools even when they have access to microfinance. But the informal instruments have severe shortcomings, the greatest of which is their unreliability. When poor people need to get a loan, or to "withdraw" money that they have deposited with (i.e., lent to) someone else, that someone else may not have the money on hand, or may be unwilling to provide it for some other reason.

By contrast, diary households found formal microfinance a much more reliable tool. The importance of this reliability is obvious when one considers that their main use of financial instruments is to cope with the unreliability of their income and their lives. As the authors of *Portfolios* concluded,

> Whether or not the microfinance movement was right to stress loans for microenterprises, or has been too slow to embrace savings and other services, its greatest contribution is, to us, beyond dispute. It represents a huge step in the process of bringing reliability to the financial lives of poor households….
>
> It is hard to exaggerate the importance of these developments, which we saw clearly when we looked at microfinance through the eyes of the Bangladeshi diarists [who had better access to microfinance than households in the other study countries]. Irrespective of how microcredit loans were used, borrowers appreciated the fact that, relative to almost all their other financial partners, microfinance providers were *reliable*. That is, loan officers came to the weekly meetings on time, in all kinds of weather; they disbursed loans in the amount they promised and at the price they promised; they didn't demand bribes; they tried hard to keep passbooks accurate and up-to-date; and they showed their clients that they took their transactions seriously.
>
> In return, we noticed that these Bangladeshi microfinance clients often prioritized the repayment of microcredit loans above those of other providers. (pp. 26–27)

*Portfolios* shows us that poor households value microfinance because it is very helpful in dealing with their vulnerability, even though the nature of that help may differ substantially from the widespread story line about microloans funding investment in microenterprises that lift their owners out of poverty. But is *Portfolios* just another set of anecdotes, or does it paint a picture that is generally true for vast numbers of microfinance clients around the world?

## Does microfinance improve their lives? Poor people say yes

There are strong reasons to believe that clients around the world value financial services as coping tools the same way that the financial diary households described in *Portfolios* do. The evidence comes mainly from the observed behavior of hundreds of millions of clients who demonstrate how important microfinance is to them by "voting with their feet."[4]

1. The experience over three decades has been that when providers make microfinance available to clients who haven't had it before, there is hardly ever a need to advertise. Customers arrive in droves, propelled by word of mouth.

4 This section relies on observed behavior, not RCTs or other econometric studies. But there is no intent to suggest that such studies are unnecessary. The *behavior* of clients presents a strong case that microfinance is providing, at a minimum, highly valued coping benefits. That case is persuasive but not conclusive, and it should be further tested and quantified by econometric and qualitative studies.

2. People not only take out loans, but they repay them with high reliability. Why do they do this, when the lender holds no collateral? The strongest incentive to repay is usually not group pressure, but rather *the borrowers' desire to keep access to a highly valued service*, one whose future availability they can count on as long as they keep their end of the bargain.[5] MIX Market offers 10-year time-series data on many hundreds of microfinance institutions (MFIs), including most of the ones where the bulk of the customers are concentrated. Annual loan loss rates have generally averaged at or below 2.5 percent of portfolio during the whole period. This represents extremely high repayment: for example, to achieve that loan loss rate, an MFI that makes six-month loans repayable weekly has to collect about 99.3 cents of every dollar it lends out.[6] During Indonesia's financial and economic meltdown in the late 1990s, loan repayment plummeted almost everywhere, except for microcredit loans, where repayment stayed very high.[7] In especially tough times, it seems that low-income borrowers were particularly anxious to preserve their continued access to microcredit and other financial services they might need to cope with shocks that might be coming.

3. Clients find microfinance services so valuable that they are typically willing to pay high interest rates on loans, and accept minimal or no return on savings.

4. Clients return again and again for microfinance services. Even in institutions that have high "desertion" rates, most of their business is from repeat customers.

5. Of course, repeated use does not by itself prove that a service is benefitting users. No one would make this argument about repeated use of heroin, for instance. People do not always borrow wisely. With microloans or any other loans, some borrowers will inevitably over-indebt themselves and be worse off as a result. As long as the number who do so stays relatively small, it is better to live with the over-indebtedness than to deny the loan product to the great majority who are helped by the borrowing. But could it be that large numbers of repeat microborrowers are caught in a debt trap, able to pay off one loan only by taking out another? Probably not. When significant numbers of customers are taking on more debt than they can handle, it is highly likely that many of them will *eventually* default on their loans, and the lenders' collection rate will plunge. To the contrary, MIX Market data show that, among the MFIs that account for the vast majority of borrowers, most maintain very high collection rates over the long term. While it does not settle the matter conclusively, this general pattern of high repayment over the long term justifies a strong presumption that microfinance is not over-indebting large proportions of its clients. At the same time, this presumption needs to be tested by further research.

## Moving the goalposts?

If it eventually turns out that microfinance is not moving people out of poverty as its proponents have claimed, are its other benefits worth bothering with? When we hear that the evidence about microfinance raising poor people's incomes is unclear, and that many

5 Group guarantees are seldom enforced, and default is not much higher in individual microlending than in group microlending. Both kinds of microlending depend on an implicit contract that if a borrower repays faithfully, the microfinance provider will give her another loan (or other services) when she wants it. This is borne out in practice: whenever anything happens to shake clients' confidence in the provider's ability to honor its implicit promise, loan repayment plummets precipitously. Cf. Chapter 5 of Armendariz de Aghion and Morduch (2005).

6 For an explanation of this surprising result, see Rosenberg (1999, pp. 4–5).

7 E.g., Seibel (2005).

(sometimes most) clients use microloans and savings to smooth consumption rather than to grow enterprises, we tend to be disappointed, and to view consumption smoothing as a mere palliative. "If that's all it is, why bother?" we ask.

But we react this way only because our own minimum consumption levels are seldom if ever threatened. As we see in financial diaries and in the observed behavior of hundreds of millions of microfinance clients around the world, poor people think this "palliative" is enormously important in helping them deal with their circumstances.

Based on what we know now, it seems unlikely that a year of microlending helps poor people as much as a year of girls' primary education (for instance). The true advantage of microfinance is not that each "dose" is more powerful, but rather that each dose costs *much* less in subsidies. Social programs like primary education and health care usually require large continuing subsidies, using up scarce tax dollars year after year. Microfinance is different: when it is done right, relatively small up-front subsidies lead to permanent institutions that can continue providing services year after year with no further subsidy needed, and can expand those services to reach many millions of low-income clients.[8]

For instance, BancoSol in Bolivia represents a few million dollars of donor subsidies in the mid-1990s that turned into a loan portfolio of over $200 million and services for over 300,000 active savers and borrowers by the end of 2008, funded almost entirely from commercial sources. This is not an isolated exception. Among microfinance providers reporting to MIX Market, the ones that are profitable and need no further subsidies already account for 71 percent of all the clients, and MFIs that are close to profitability account for another 22 percent.[9]

Small one-time subsidies

leverage large multiples of unsubsidized funds

producing sustainable delivery year after year of highly valued services

that help hundreds of millions of people

keep their consumption stable, finance major expenses, and cope with shocks

despite incomes that are low, irregular, and unreliable.

All and all, isn't this a pretty impressive value proposition, even if we eventually find out that microfinance doesn't raise incomes the way some of its proponents have claimed?

8 Not all microfinance funders "do it right." Some agencies fail to produce much sustainable return from their microfinance subsidies because they routinely ignore well-established principles of sound practice , e.g., CGAP's "Good Practice Guidelines for Funders of Microfinance" (2006).

9 Calculated by Adrian Gonzalez from MIX data. The analysis excludes five state banks that are not trying to reach financial sustainability.

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## Annex. Recent Randomized Studies of the Impact of Access to Finance

**Dupas and Robinson (2008)** conducted a randomized field experiment in Kenya where they gave interest-free savings accounts in a local village bank to a random sample of poor daily income earners (primarily microentrepreneurs). The accounts paid no interest and charged withdrawal fees, so they offered a de facto negative interest rate, but they were the only formal savings option available in the area. Dupas and Robinson found wide variation in the intensity of account usage. Some refused the accounts, and many signed up but didn't use them. Nearly 50 percent of those with accounts used them more than once but only a few used them intensively. Account ownership was associated with substantial increases in investment and increased daily expenditures for women, but no measurable impact for men. Possibly more important, the women who didn't receive accounts were forced to draw down working capital or stop working in response to health shocks (like malaria). Presumably, savers were less able than nonsavers to be able to afford prompt treatment.

Unfortunately, this study has a few shortcomings that may limit confidence that its findings will apply in other contexts. First, the study has a small sample (185 entrepreneurs), and only a small number of these used the accounts intensively. Additionally, it was limited to a single site near one market in Kenya and to a single bank branch, so it may not be representative of other settings.

**Karlan and Zinman (2008)** randomly prompted loan officers of a South African consumer lender to reconsider and approve applicants for a loan from a pool who were initially rejected but who fell just below the cut-off. Applicants who were reconsidered (many, but not all, of these were then given a loan) were more likely to keep their jobs, have incomes significantly higher (possibly because they had kept their jobs), have households that were less likely to experience hunger, and have a more positive outlook on the future. On the other hand, they also reported more depression and stress than those from the pool who were rejected and not reconsidered. Over a longer time horizon, reconsidered applicants had a higher probability of having a credit score but showed no difference in the score itself, suggesting that the intervention may have brought people into the credit system and probably did not get them over-indebted.

Their loans were consumer loans, not typical microloans. Applicants were not very poor (i.e., income averaged about $300 a month). The loans were not linked to any business activity and were administered by a for-profit consumer lender. Interest rates were considerably higher than what is typical in microfinance. Thus, the results may not generalize to many microfinance contexts. Additionally, the subjects were new borrowers observed for 6–12 months, so it's not clear how continued access to credit would impact their lives in the long run.

**Karlan and Zinman (2009)** randomly prompted loan officers at a microfinance lender in the Philippines to approve loan applicants from a pool that had been ranked marginal by credit scoring software. The loans were ostensibly intended for microenterprise development rather than consumption. The loan officers had the final say, and they turned down some of the applicants they had been prompted to approve. Applicants who got an "approve" prompt increased their formal borrowing but

not their total borrowing (implying reduced reliance on informal options). Somewhat surprisingly, increased access to microcredit led to less investment in the targeted business, to substitution away from labor and into education, and to substitution away from insurance (both explicit/formal, and implicit/informal) even as overall access to risk-sharing mechanisms increased. Karlan and Zinman conclude, "At least in a second-generation setting [individual lending at a for profit-MFI], microcredit seems to work broadly through risk management and investment at the household level, rather than directly through the targeted businesses." Finally, the results suggest that treatment effects were stronger for groups that are not typically targeted by microcredit initiatives: male and higher income borrowers.

The microentrepreneurs in the study are wealthier than average for their area, so the extent to which these results will extend to the very poor is unknown. Additionally, since borrowers' profits are self-reported from memory, there is some risk—probably not a large one—that entrepreneurs who borrowed had a bias toward exaggerating their actual profits. Finally, while Karlan and Zinman report that the loans show greater impact on the pool of male borrowers than female ones, they don't compare other characteristics that might vary by gender. For instance, if men are more educated on average, education might account for the difference in effect rather than gender itself.

**Banerjee, Duflo, Glennerster, and Kinnan (2009)** conduct a randomized evaluation on the community-level impact of new branches of a microfinance bank. Half of 104 slums in urban Hyderabad, India, were randomly selected for the opening of an MFI branch. At the beginning of the study, there was almost no microlending in the sample areas, but 69 percent of the households had at least one outstanding loan from a moneylender or family member. The authors found that the areas with branches featured more new business openings, higher purchases of durable goods and especially business-related durables, and higher profits in existing businesses (despite presumably greater competition from the new businesses). Households were scored on how likely they seemed to start a business. Those who scored high increased durable purchases and decreased purchases of luxury items, both of which are consistent with having started a business. Those who scored less likely to start a business increased consumption of nondurables. The main effects are consistent with borrower households starting businesses, but the authors can't tell whether the loans are actually used to start businesses, so these effects may come through indirect channels.

The authors find "no impact on health, education, or women's outcomes." However, the study was conducted only 15–18 months after the advent of the branches, and the questions used to measure these outcomes were not very comprehensive.

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CGAP
1818 H Street, NW
MSN P3-300
Washington, DC
20433 USA

Tel: 202-473-9594
Fax: 202-522-3744

Email:
cgap@worldbank.org
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