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Can Microfinance Reduce Economic Insecurity and Poverty? By How Much and How?*Nazrul Islam*

Abstract

The paper suggests that, rather than through its *narrow*, direct financial impact, microfinance may prove to be more potent in reducing insecurity and poverty through its indirect, *broader* impact conducting to a more egalitarian initial endowment distribution that is necessary for the “take-off” of an equitable growth process. The paper begins by examining the distinctive roles of micro credit, micro savings, and micro insurance programs in dealing with poverty and insecurity, and highlights the complementariness that exists among these programs and how this complementariness can be used to overcome the weaknesses of the individual programs.

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Can Microfinance Reduce Economic Insecurity and Poverty? By How Much and How?

*Nazrul Islam*¹

1. Introduction

Though economic insecurity has now come to characterize life in developed countries too, it is the chronic insecurity rooted in poverty and widespread in developing countries that is more damaging from the viewpoint of the overall human welfare. Because of the interconnections between them, economic insecurity and poverty form a vicious circle.

Since the World War II, a variety of ideas and strategies have been tried out to break this circle, with however limited success. While most of these ideas and strategies were donor-supported public sector efforts, microfinance arose in late 1970s as a novel private sector idea advocating collateral free lending to the poor organized in groups in order to let peer pressure substitute for collateral and also reduce transaction costs. Since its modest beginning in Bangladesh, microfinance has now spread to far corners of the globe, including some developed ones, and in the process has expanded to include micro savings and micro insurance programs too.

A detailed examination of the impact of the various types of micro finance programs indicate that each of them hold significant potential for reducing insecurity and poverty, though an exact quantification of the impact of microfinance has remained difficult and contentious. The examination in this paper also reveals important complementariness among the roles of different types of micro finance programs and the possibility for these programs to benefit from the complementariness to overcome many weaknesses and criticisms they face in operating separately.

Scholars of micro finance have generally taken two opposing views. On the one hand are those enthusiastic about the potential of micro finance and arguing for subsidies for it. On the other hand are those taking a critical view and discounting the potentiality of microfinance. The difficulty in quantification of the impact of microfinance programs makes it hard to judge the relative merits of these two opposing viewpoints, though the remarkable and continuing expansion of microfinance programs provides strong *prima facie* evidence of its appeal. At the same time, the international experience showing that countries with significant presence of microfinance have not been the leaders in poverty and insecurity reduction, while East Asian countries that had little or no microfinance have had dramatic success in this regard, suggests that the poverty and insecurity reduction impact of microfinance may not be of first order importance.

1 This paper is based on a larger paper entitled, "Alternative Approaches to Dealing with Economic Insecurity of the Poor," prepared as a background paper for the *World Economic and Social Survey 2008* (United Nations 2008) devoted to the issue of economic insecurity. The author is thankful to Beatriz Armendariz, Stefan Dercon, David Hulme, Richard Kozul-Wright, Paul Mosley, and Robert Vos for helpful discussions. Thanks are also due to the participants of the internal workshops of DESA/DPAD/DSP where the background paper was discussed. None of the above is however responsible for the errors and shortcomings that remain. The views expressed in this paper are author's own and need not be ascribed to the United Nations or any other organizations. Send your comments to islamn@un.org.

In considering the overall impact of microfinance, this paper therefore draws a distinction between its narrow impact in terms of the direct financial outcome for the clients, and the broader impact with regard to the general socio-economic position of the poor and their access to private and public sector opportunities. The paper suggests that, rather than in its direct impact, a more potent role of microfinance may be seen in its indirect broader impact conducing to a more egalitarian initial endowment distribution that is necessary for the take off of an equitable growth process.

The paper is organized as follows. Section 2 presents the poverty-insecurity vicious circle and presents the policy dilemma concerning from which side to attack this circle. Section 3 provides the historical and policy backdrops against which to examine microfinance's role. Section 4 discusses some of the general features of microfinance. Sections 5, 6, and 7 examine the poverty and insecurity reduction role of micro credit, micro savings, and micro insurance programs, respectively. Section 8 discusses the complementariness among these three types of programs. Section 9 takes up the issue of overall impact of microfinance. Section 10 concludes.

2. The vicious circle of insecurity and poverty

It is generally agreed that economic insecurity has increased over the last few decades, despite the attendant rise in the average income. Broadly speaking, economic insecurity in the contemporary world has two faces. One is the insecurity faced by the relatively well off part of the world's population. For them it is mainly an issue of risk of downward movement in income, while the average level remains far above the poverty level. This type of insecurity may therefore be termed as *episodic insecurity*, because such downward movements occur only occasionally. Nevertheless, episodic insecurity is welfare reducing, and hence appropriate measures need to be taken to reduce it as much as possible.²

However, people facing episodic insecurity are lucky compared to the other part of the world's population who suffer from *chronic insecurity*. These are people who are either already below the poverty line or so close to it that even small negative income shocks push them below it.³ For them poverty, deprivation, and insecurity are a constant factor of life.⁴ According to the recent estimates of Chen and Ravallion (2008), about 1.4 billion people (25.7 percent of the population) were poor in 2005 as measured by the international poverty line of \$1.25 per day per person in purchasing power parity (PPP) terms. According to the same study, another 1.751 billion people (32.1 percent of the population) were between \$1.25 and \$2.50 income lines, who are therefore very much at risk of getting pushed down to poverty by negative income shocks of even small order. Using the \$2.50 yardstick, a total of 3140.2 million (or 60.1 percent of the population) are suffering from the scourge of chronic economic insecurity and poverty. The magnitude of the problem of chronic economic insecurity is therefore overwhelming.

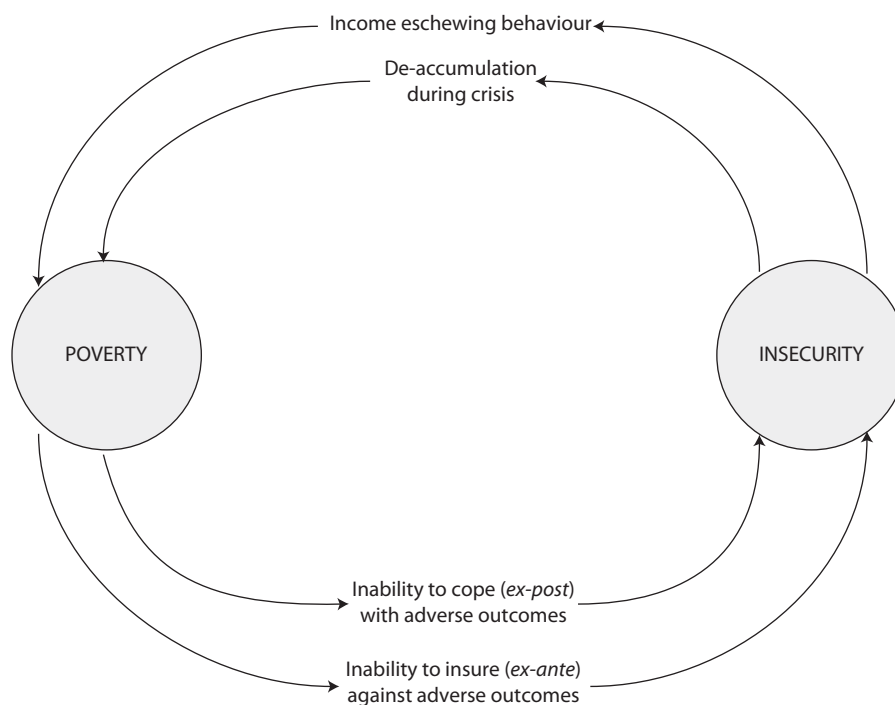
2 See the relevant discussion in WESS (2008).

3 If economic insecurity is defined as *the vulnerability to negative income shocks that may reduce the welfare of affected persons to below poverty levels*, then it is clear that for those who are already poor, it is no longer an issue of being vulnerable to reaching the poverty level; they are already at that level.

4 It should also be noted that despite the distinction between chronic and episodic insecurity, there are important connections between the two. First, poor people suffering from chronic insecurity are also impacted by factors that cause episodic insecurity. In such situations, the poor suffer from 'double whammy,' so to speak. Second, sometimes factors causing episodic insecurity may push affected persons so far below the poverty line that they may find it difficult to rise up, and thus get entrapped in chronic insecurity. Similarly, quick succession of episodic insecurity may leave affected households too exhausted to bounce back from poverty and thus entrap them in chronic poverty and insecurity. For further discussion of these connections, see Clarke and Dercon (2008) and Dercon (2005).

Chronic economic insecurity is thus rooted in poverty, and the two are interlinked, reinforcing each other and often forming a vicious circle (Figure 1). Why and how poverty causes economic insecurity is quite clear. Poverty makes it difficult for the poor to take *ex-ante* measures against possible misfortunes. Poverty also makes it difficult for them to cope with misfortunes *ex-post* when these actually befall them.

Figure 1: Poverty—Insecurity Vicious Circle



Less clear is how economic insecurity causes poverty. One route of this causality runs through capital de-accumulation that the poor are forced to undertake when misfortunes strike them. The resulting depletion of productive assets worsens their long-run income situation, pushing them often below the poverty line. Another route of this causality passes via income-eschewing behavior, whereby poor households avoid high-risk but high average return activities and cling to those which are of low-risk but also have low average return. Often the risk avoidance behavior leads the poor to excessive diversification and thus to a failure to reap benefits of specialization. As a result of this risk-avoiding, income-eschewing behavior, the poor remains stuck to low income levels, thus becoming victims of the poverty-insecurity vicious circle.⁵

In view of the close link between poverty and insecurity, many have actually suggested that poverty should be redefined to include the insecurity aspect of a person’s situation.⁶ There was some reflection of this suggestion in the World Bank’s (2000) *World Development Report 200/2001* that adopted a somewhat expansive view and identified provision of ‘security’ as one of the three lines of attack on poverty.⁷

There is often a debate about from which side to attack the poverty-insecurity vicious circle. Some researchers have offered in this regard a distinction between the “asset approach” and the “risk approach.” The “asset approach” refers to attacks from the poverty side using programs aimed primarily at raising

5 For further elaboration of and empirical evidence regarding poor’s income eschewing behavior, see, among others, Clarke and Dercon (2008) and Morduch (1995).
 6 See, for example, Morduch (1994, p. 224).
 7 The other two suggested lines of attack were provision of ‘opportunity’ and ‘empowerment.’

income and asset position of the recipients. Proponents of this approach suggest that increased income and asset will allow the poor to deal with insecurity too. By contrast, the “risk approach” refers to attacks from the insecurity side using programs geared to primarily amelioration of risks faced by the poor. Proponents of the “risk approach” argue that once risks are addressed, people will be able to raise income by escaping forced de-accumulation and by avoiding income-eschewing behavior mentioned above. They also point out that, unless people are protected against risk, the assets built up can get easily washed away by downward shocks, nullifying thereby the impact of “asset approach” programs. Furthermore, they observe that without risk minimizing arrangements, “asset approach” programs can in fact make the poor more vulnerable because of the payment liabilities they face when negative shocks actually hit them.⁸ The potential trade-off between the “asset” and “risk” approaches remains therefore an important issue.

3. Poverty and insecurity in development thinking and policies

Since the World War II many different ideas and strategies have been tried out to overcome insecurity and poverty. These efforts, mostly relying on public sector efforts undertaken on the basis of loans and grants from bilateral or multilateral lending agencies, may be said to represent the “official” development thinking. A quick recounting of these ideas can provide the historical and policy perspectives necessary for the discussion of the role of microfinance.

Trickle Down Benefits

The initial post-World War II development efforts were inspired by the ideas of “Big Push,” “Critical Minimum Effort,” and “Take off,” which focused on raising aggregate growth rate through increased investment in physical capital.⁹ Neither poverty nor insecurity appeared as separate objectives in these ideas. The belief was that aggregate growth would create employment, which would in turn address problems of poverty and insecurity *indirectly*. Unfortunately, this “Trickle Down Benefits (TDB),” as the approach later came to be called, did not prove that effective, because, first, the expected high aggregate growth rates did not materialize, and, second, whatever growth was achieved did not create employment sufficient enough to outpace the growth in labor force and to make a significant dent into the problems of poverty and insecurity.¹⁰

Basic Needs Strategy

The disappointing experience with TDB strategy led to a second stage of development effort influenced by the Basic Needs Strategy (BNS), which made poverty reduction a separate, distinct goal and urged resources to be channeled more *directly* toward achieving this goal. To the extent that a focus on poverty invariably brings up issues of insecurity, BNS development efforts had to confront the insecurity issue too.¹¹ Unfortunately, BNS also proved to be disappointing, because, first of all, programs designed to eradicate poverty often failed to reach the poor, and second and more importantly, these programs often failed to provide a durable solution to problems of poverty and insecurity. Third, BNS poverty reduction programs often proved to be a fiscal burden, which became difficult to bear when global economic conditions worsened.

8 See Clarke and Dercon (2008) for more on “asset” and “risk” approach to the reduction of economic insecurity.

9 See Rosenstein-Rodan (1943) and Nurkse (1953) for the ideas of “Big Push,” “Balanced Growth,” and “Critical Minimum Effort,” and Rostow (1960) for the idea of “Take-off.”

10 It is interesting to note that this debate concerning efficacy of Trickle Down Benefits strategy, once thought to be applicable mainly to developing countries, has figured very prominently in the US presidential election of 2008, in which Barack Obama argued that the economic policies of George W. Bush administration were inspired by the TDB philosophy and that the experience showed that these did not work.

11 For example, Rural Works Programs, inspired by BNS, had to decide in which season of the year to time them and thus take into account the fact that the poor were more insecure in the lean season.

Structural Adjustment Programs (SAP)

A combination of oil shocks, inflation, rise in the US interest rates, and economic recession in later half of 1970s and early 1980s led to serious macroeconomic imbalances in many developing countries. Responding to the situation, multilateral lending agencies, such as the World Bank and IMF, opted for deeper interventions in client economies and promoted, what came to be known as Structural Adjustment Programs (SAP), aiming mainly at stabilization, liberalization, and privatization, and constituting another stage of international development efforts. With SAPs, the goals of poverty and insecurity reduction receded from the forefront of policy attention. In fact concerns for poverty and insecurity even met with some disdain from the SAP enthusiasts, who once again thought that aggregate growth would by itself take care of issues of poverty and insecurity.¹² Unfortunately, like the TDB strategy before, SAP also failed to deliver on the promises. First, countries implementing SAP often failed to generate projected aggregate growth rates. Second, actual growth was not associated with desired employment expansion. Third, SAP programs often meant reduction in public programs of investment and welfare, so that poverty and insecurity in many cases increased.

Poverty Reduction Strategy Papers (PRSP)

Responding to the disappointing performance of SAPs, the World Bank and IMF launched in 1990s the idea of Poverty Reduction Strategy Paper (PRSP), the very name of which indicates a return to the recognition of poverty reduction as a distinct policy goal.¹³ In addition, PRSPs are supposed to be domestically generated and nationally owned.¹⁴ Critiques have however pointed out that the very fact that WB and IMF made preparation of the PRSP document as a precondition for receiving loans shows that the process is not homegrown. They further maintain that proclamation of poverty reduction in the title of the program is actually an “eye wash,” and the main goals of PRSP remain the same as those of SAP. The experience so far does not bode well for PRSPs, as was evidenced by the recent evaluation report by the UN Committee for Development Policy (CDP) stating that “the existing framework of the global partnership, using the Poverty Reduction Strategy Papers (PRSP) as the main instrument, appears to be neither adequate nor effective.”¹⁵

Millennium Development Goals (MDG)

Until recently the world development agenda was dominated by the World Bank and the IMF, as the above ideas of SAP and PRSP indicate. The situation in this regard changed somewhat on the eve of the new millennium, when the United Nations entered the scene through the formulation of the Millennium Development Goals. If BNS and PRSP treat reduction of poverty and insecurity as a separate and independent goal, MDGs move further in this direction and define development goals almost entirely in terms of specific targets regarding reduction of poverty, hunger, malnutrition, etc., without any reference to income level or aggregate growth rate.¹⁶

12 For example, Banerjee, Benabou, and Mookherjee (2006, p. xxi) note that the “the Washington Consensus reflected an approach *contemptuous of equity issues* popular in Washington D.C. policy circles in the 1980s (italics added).”

13 In this sense PRSPs may appear to be a return to Basic Needs Strategy, which also focused on poverty rather than aggregate growth. In fact, under PRSP, poverty reduction itself becomes the entirety of development strategy. In that sense the swing is even further in the direction of BSN.

14 Another difference between SAP and PRSP is that while the former was more a name used to refer to a set of policies than a well worked out integrated development strategy, the latter took the form of a single document, preparation of which was a condition set by the World Bank and IMF to receive loans from these institutions.

15 See also Vos and Cabezas (2006) for a more detailed discussion of the PRSP experience.

16 The formulation and announcement by the United Nations of MDGs (with their heavy focus on poverty) might have had some influence on PRSPs’ giving primacy (at least in name) to the poverty issue.

A return to growth orthodoxy?

The TDB-BNS-SAP-PRSP/MDG sequence reviewed above shows that development ideas have oscillated between an emphasis on aggregate growth and an emphasis on poverty and insecurity, and it may therefore not be surprising if the pendulum now moves back to a renewed emphasis on aggregate growth and its indirect effect.¹⁷ Recent international experience has indeed vindicated the importance of fast aggregate growth in combating poverty and insecurity. According to Chen and Ravallion (2008), while the total number of world's poor (using \$1.25 poverty line) has *increased* by 113.6 million over 1981-2005, it has *decreased* in China by 627.4 million during this period.¹⁸ Clearly China's almost 10 percent per year GDP growth had much to do in making such wide scale poverty reduction possible.

However, the international experience also shows that while fast aggregate growth may be a necessary condition for poverty and insecurity reduction, it is not a sufficient condition. Many countries enjoying high aggregate growth rate have not been able to reduce poverty and insecurity to the desired extent, so that a simple return to growth orthodoxy is unwarranted. It is therefore important to know what policies can be more effective in reducing poverty and insecurity.

Typology of policies with regard to poverty and insecurity:

Experience so far suggests that policies necessary for reduction of poverty and insecurity may be classified into the following three categories. The first is "aggregate growth" enhancing policies, which are aimed at increasing the aggregate growth rate without any particular concern for distribution issues. To the extent that aggregate growth is not sufficient to ensure reduction of poverty and insecurity, two other types of policies are needed. One of these is "within-growth" policies that are geared to make the growth itself pro-poor.¹⁹ An example of such policies is adoption of labor-intensive, instead of capital-intensive, industrialization in a "labor-surplus" country, so that more income flows into the hands of the poor through employment expansion. Redistribution of assets in order to ensure a more egalitarian endowment structure for an equitable growth process to take off is another example of "within-growth" policies. However, to the extent that even "aggregate-growth" and "within-growth" policies together may not be enough to deal with the problems of poverty and insecurity, there is the necessity for "outside-growth" policies, which essentially involve redistribution of income generated by the growth process. Various welfare programs are examples of "outside-growth" policies.²⁰

17 Put differently, this may also be described as an oscillation between an emphasis on *indirect* route and a *direct* route to eradication of poverty and insecurity.

18 In fact the study recognizes that while China has achieved the UN MDG regarding reduction of poverty by a great margin, the rest of the developing world is not on track to reaching the MDG.

19 There is a lively debate about the precise definition of pro-poor growth. See for example, Kakwani, Khandker, and Son (2003), Ravallion (2004a, b), Grinspun (2004), Zepeda (2004), and Osmani (2005) for details.

20 This classification of growth policies has an analogy in the environmental economics literature, which distinguishes between "within-process" and "outside-process" measures that may be undertaken to deal with pollution. The former type of measure have an *ex-ante* characteristic, though these may not be limited to plant technologies only, but encompass broader issues of production pattern, volume, etc. By contrast, the latter have an *ex-post* characteristic, because these refer to scrubbing and other efforts undertaken to clean up after pollution has already been created by the production process. Similarly, in macro-economics, inequality, poverty, and insecurity may be considered as "bad outcomes," analogous to "pollution," and there are two ways in which these problems can be overcome. The first is through "within growth" policies, which are *ex-ante* type policies, geared toward prevention of creation of poverty and insecurity in the first place. The second is through "outside growth" policies, which are *ex-post* and try (through various redistributive mechanisms) to rectify poverty and insecurity after these have been already created by the primary process of growth.

While the above classification of policies into “aggregate-growth,” “within-growth,” and “outside-growth” is conceptually helpful, it is not always easy in practice to compartmentalize actual economic policies neatly into these three different types. First of all, they are themselves closely interconnected through both direct and feedback relationships. For example, the necessity and feasibility of “outside-growth” policies to a large extent depends on the nature and success of “aggregate-growth” and “within-growth” policies. On the other hand, many policies, which are apparently “outside-growth,” can be, in an extended sense, “within-growth” too. For example, welfare policies directed toward education and health care may help to improve the labor input necessary for labor-intensive industrialization. On the other hand, both “within-growth” and “outside-growth” policies can help a country to achieve faster aggregate growth. For example, the choice of the labor-intensive route of industrialization by a labor surplus country may actually help it to attain faster growth than would have been possible if it had chosen the capital-intensive route. Similarly, various redistributive policies may help improve social cohesion and thus conduce to a better investment climate and hence to faster aggregate growth. Second, in many cases, policies may be intrinsically of broader scope, encompassing characteristics of all three types of policies mentioned above. For example, policies regarding trade, aid, remittances, etc. all seem to have such broad scope. In examining the role of microfinance, it will be important to check how it relates to these three different types of policies.

4. Some general features of microfinance

The historical and policy perspectives discussed in the section above help to notice the following general features of microfinance and its potential role in reducing insecurity and poverty.

First, as briefly mentioned earlier, from the very beginning micro credit has been a private sector idea, and to this day microfinance remains primarily in the domain of the private or the Non Government Organizations (NGO) sector. This feature of microfinance contrasts sharply with the “official” development ideas and efforts reviewed in the previous section.

Second, looked at from the “asset-vs.-risk” controversy noted earlier, it may be observed that microfinance offers the possibility of attacking the poverty-insecurity circle from its both ends. First of all, micro credit has been generally viewed as an “asset approach” program, as a way of lifting the poor out of poverty by enabling them to acquire assets and engage in income-earning opportunities using those assets. However, as we shall see, even conventional micro credit can play insecurity alleviating role. Second, now that microfinance has expanded to micro saving and micro insurance programs, which are more directly targeted on insecurity, it is clear that microfinance can directly address the “risk” issue too.

Third, it may be noted that microfinance programs encompass all three different types of policies mentioned above. First of all, to the extent that micro credit finances production activities, it may be “aggregate growth” enhancing. Second, to the extent that micro credit finances production processes which are generally labor-intensive, it can be regarded as a type of “within-growth” measures. Third, to the extent that micro saving and micro insurance programs help the poor in dealing with risks and situations of distress, these may be viewed as “outside growth” measures too.

Fourth, because microfinance is by and large a private and NGO sector activity, it does not pose any financial burden on the government, making it easy for the government to include microfinance in its overall development and poverty and insecurity reduction strategy.

Fifth, though micro credit emerged and spread during the SAP phase of the official development thinking, it did not have much of a role in SAP. By the time of PRSP, however, the situation changed, at least in two aspects. First, micro credit by that time has acquired a much larger role. Second, because of PRSP's explicit focus, at least formally, on poverty, it was difficult to ignore microfinance, a program that was firmly grounded among the poor. As a result, PRSPs now try to co-opt microfinance as a component of the official strategy for alleviation of poverty and economic insecurity. Of course, the above mentioned non-government financing feature of microfinance is also a reason of its recent popularity with PRSPs.

While different types of microfinance program share the above general features, each of them have its unique features, niche, and role to play. In order to assess the role of microfinance as a whole, it is first necessary to understand these specific roles.

5. Micro credit programs and economic insecurity

Since its beginning in Bangladesh, micro-credit has expanded to scores of other developing countries and even to some developed countries. According to the Consultative Group to Assist the Poor (CGAP)'s micro-finance gateway (www.microfinancegateway.com), there were in 2006 more than 7,000 micro credit institutions, serving about 500 million people in more than 50 countries, including some developed countries. Clearly, the role of micro credit is an important issue.

Insurance role of micro credit programs

Though micro credit programs are not insurance programs *per se*, the poverty-insecurity vicious circle already implies that they can play an insurance role too. In fact, according to some researchers, the insurance role of micro credit outweighs its income generation role.

There are several channels through which the insurance role of micro credit works. The first is through the *timing effect*. Because the loan is provided in the form of cash, recipients can easily divert it toward consumption purposes, if times are bad. Of course, such diversions cause reductions in the investments planned to be carried out under the loans. However, as long as the diverted money is reimbursed at a later point in time, the planned investments can still be carried out, and meanwhile the households may avoid serious consumption deprivation, forced de-accumulation, and/or traps of pernicious borrowing.²¹

Certain aspects of micro credit *modus operandi* facilitate its insurance role via the timing effect. Usually the link between credit, planned investment, and repayment is not that tight under micro credit as it is under conventional bank credit. For example, the repayment process under micro credit programs usually starts even before the investment has had time to yield income, indicating that switches of funds for other purposes are actually assumed by lenders.²²

However, micro-credit can also serve an insurance role via the *income effect*. First, by raising the mean income level, micro credit may make a household more capable of withstanding shocks on the basis

21 This route of micro credit's serving as insurance therefore works via fungibility of resources and relatively loose link between investment carried out under the credit and repayment of loan.

22 Some researchers have however seen ominous signs in the consumption-diversion of micro credit, characterizing the phenomenon as the manifestation of "micro credit trap," whereby client households, in absence of any augmentation of income through productive use of micro credit, need more micro credit just to pay off the installments of the previously received micro credit.

of its current income. Second, a higher average income may enable a household to build up savings, which it may then draw upon in coping with risks, if it cannot do so out of its current income. Third, a rise in income may also help a household to abandon income-eschewing behavior, and thus raise its income further. Fourth, a higher income level may make it easier for a household to access other insurance services too, allowing it to avoid usurious borrowing and to escape forced de-accumulation of assets. Thus a virtuous cycle may result, whereby a slight rise in income leads to further rise in income and decrease in insecurity, enabling a household to ultimately break the poverty-insecurity circle.

Evidence of the insurance role of micro credit

Empirical research has generally supported the above noted insurance role of micro credit. One of the major studies of micro credit programs carried out by researchers not belonging directly to the MFIs themselves is by Pitt and Khandker (1998). Reviewing this study, Morduch (1999b, p. 1606), an eminent microfinance scholar, concludes that “Microfinance borrowing is shown to improve the ability to smooth consumption across seasons, and *entry into the programs is partly driven by insurance concerns* (italics added).” Morduch further reports that his own investigation vindicates the consumption smoothing effect of micro credit programs and concludes that “Substantively, the results suggest that benefits from *risk reduction may be as important (or more important) than direct impacts on average levels of consumption* (ibid, italics added).” Dercon, another prominent scholar of insecurity and vulnerability issues, concurs with Morduch regarding the insurance role of micro credit, suggesting that while the income effect of micro credit still remains to be documented conclusively, there is no doubt about its insurance role working via the timing effect.²³ Reviewing studies by Hashemi et al. (1996), Montgomery et al. (1996), and Morduch (1998), Clarke and Dercon (2008, p. 11) inform that “most studies do find strong evidence that access to micro credit facilities leads to reduced vulnerability, in the sense of a lower threat of fluctuations in the incomes or consumption.” They therefore conclude that “Micro credit may then offer a means for reducing risk exposure, while keeping costs and incentives aligned (ibid).”

Despite the above wide confirmation of the insurance role of micro credit, there are also certain limitations to the insurance role of micro credit. As Clarke and Dercon (2008) note, micro credit programs are not primarily geared to be insurance programs, so that their insurance role is only an unintended consequence, so to speak. Second, micro credit does not represent an efficient way to pool risk, because though it allows an individual to spread the effect of a shock over time, she still bears the full brunt of it. The shock is not actually shared by other members of the group, so that micro credit provides only a crude method of risk pooling. Third, micro credit can even aggravate insecurity by requiring the loan repayments be made even when negative shocks hit the borrower.²⁴

The presence of and combination with other microfinance programs can help mitigate some of these limitations of the insurance role of micro credit. However, to see how that is possible we need to examine the role of micro savings and micro insurance programs.

23 On the issue of income effect, referring to (Armendariz de Aghion and Morduch, 2005), Clarke and Dercon (2008, p. 11) expresses the view that “It is however still difficult to get reliable empirical justification for the basic assertion that access to micro credit induces any income growth. To date there is no study investigating the effect of access to credit facilities on income levels that has achieved wider consensus as to its reliability.”

24 See Clarke and Dercon (2008, p. 11) for further details.

6. Micro savings programs and economic insecurity

Savings needs and potentiality of the poor

The insurance potentiality of savings is not a new discovery. One of the primary motives of savings is ‘precautionary,’ and savings have long been identified as a method of ‘self-insurance.’ In fact, Hulme, Moore, and Barrientos (2008) are somewhat rueful about the switch of attention from savings to (micro) credit in recent years. They see in this switch a historic shift from thrift as the foundation of finance for the poor in the early 20th century to debt in early 21st century. They point out that, as a result, despite a long and global history of community-based savings groups and other informal savings systems, micro-credit organizations and institutions were for a long time barred from accepting savings from their clients beyond what were deductions from loans in order to guarantee the repayment of loans.

With time however things have changed, and more people have come to recognize that even the poor want to and can save, but are prevented from doing so by formalities, distance, costs, indivisibility of available saving instruments, etc. of formal/modern savings/banking institutions. In general, however, the poor have multiple vulnerabilities and multiple priorities, finding reflection in different aspects of their saving behavior.²⁵

To the extent that micro-credit programs have proven relatively successful in reaching the poor, it is quite natural that the micro credit delivery mechanism is now being used to deliver saving services to the poor. The process has led to the emergence of two types of micro savings related MFIs. The first consists of those engaging in both micro-credit and micro-savings, producing thus joint products, so to speak. An early leader in this regard is Bank Rakyat Indonesia (BRI), which by 1996 was offering saving services to over sixteen million households. Though deposits were small, the total volume of savings amounted to over \$3 billion, giving BRI a cheap source of fund for re-lending.²⁶ The second type consists of “stand-alone” institutions, engaging in micro savings services only. An example of this type is Bangladesh’s MFI named “Safe-Save,” whose staff solicits savings from members on a daily basis, helping poor households “convert their ability to save in regular but small amounts into a useful lump of money (Morduch 1999b, p. 1607).”

Advantages of micro savings as an insurance mechanism

There are many desirable properties of savings as a way to cope with economic insecurity. First of all, savings can provide households resources to smooth over bad times without suffering debilitating loss of their productive assets, reflecting thus the “timing-effect,” mentioned earlier. Second, while insurance can generally be used to cope with only certain pre-specified types of risks, savings can be used to deal with any type of risk, so long as damages involved do not exceed the amount of savings. Third, whereas insurance helps only *ex-post*, savings can be used to undertake both *ex-ante* and *ex-post* measures to deal with risks, so that savings can be a much more flexible insurance mechanism. Fourth, the use of savings does not require any approval by anybody, allowing thus independence in deciding about how to deal with risks. Fifth, savings also allows

25 For example, prevalence in many communities, particularly in West Africa, of money collectors who charge a fee to collect savings frequently and then return savings at the end of a period of time show that for many poor people, perceived security and the opportunity to ‘choose to be forced’ to make regular small deposits are more significant than *returns* or *liquidity*. On the other hand, the practice of saving in assets – some, like a goat, productive, and others, like jewelry or a tin roof, with other benefits—suggests that proximity and control are more crucial than is liquidity

26 The average savings balance in 1996 was only \$184, suggesting that average depositor was less well off than average borrower, who had an average loan balance of over \$1000 (See Hulme, Moore, and Barrientos 2008).

households to engage in productive investment raising their income and thus exert an insurance role via the “income-effect,” mentioned earlier.²⁷ Noting the above, many have termed micro savings programs as *quasi insurance* programs and in fact argued that savings is a superior form of insurance.

Impact of micro savings programs

Quantifying the impact of micro savings programs is however challenging, as is the case for other types of microfinance programs. In their recent attempt at such quantification, Hulme, Moore, and Barrientos (2008) define micro savings to mean savings accounts with MFIs, and use the survey data collected as part of the USAID project on “Assets and the Impact of Microenterprise Finance Programmes (AIMS)” from India (urban Ahmedabad), Peru (metropolitan Lima), and Zimbabwe (greater Harare, Bulawayo, and Mutare). Analyzing the data, the authors find that using savings to address hazards is a very common strategy among respondents, providing thus evidence of micro savings programs’ insurance role via the “timing-effect.” To gauge the insurance role via the “income-effect,” the researchers examine the use of micro savings for investment purposes. The analysis shows that saving/earning was the dominant source of finance for investment in fixed productive assets among the sampled households, providing thereby evidence of robust “income-effect.”²⁸ Overall, the study by Hulme, Moore, and Barrientos (2008) vindicates the insurance potentiality of micro savings.

Huge unmet need of savings services

Despite the advantages of micro savings, evidence suggests that a huge demand for micro savings services remains unmet. For example, Country Level Savings Assessment (CLSA) data gathered by the Consultative Group to Assist the Poor (CGAP) show that a high proportion of both rural and urban households presently have no bank accounts, so that many of them keep savings in cash or in other informal and semi-formal institutions.

Hulme, Moore, and Barrientos (2008) in fact think that micro savings is “the neglected element of micro financial services.” According to these authors, in response to the vast unmet demand for formal micro finance services from the poor, it is mainly micro credit that is getting the attention, and micro insurance is the “new kid on the block.” Micro savings, by contrast, remains neglected, and there is much less concerted effort to experiment and innovate with micro savings services and regulation than for micro credit and micro insurance. The authors further think that national governments and donors have contributed to this neglect by highlighting micro credit in their PRSPs, when in fact a more complete range of micro financial services, including credit, saving, and insurance, are needed. Hulme, Moore, and Barrientos view this omission as a serious error, given the capacity of micro savings to serve as an insurance mechanism for all sorts of shock and vulnerability and as a means for creating lump sums for investment. The authors therefore suggest a vigorous high profile campaign to popularize micro savings programs, similar to the ones done recently to popularize micro credit.

27 Hulme, Moore, and Barrientos (2008) refer to the above as ‘protective function’ and ‘promotive function’ of savings, respectively.

28 Hulme, Moore, and Barrientos (2008) however find that membership of SEWA did not make a significant difference to investment propensities.

7. Micro insurance programs and economic insecurity

Extent and types of micro insurance programs

Earlier attempts to provide insurance services to the poor have generally foundered in the face of various problems, including difficulties in administration, high transaction costs, and the usual problems of moral hazard and adverse selection. Yet a “repressed demand” from the poor for insurance was clearly felt.²⁹ It was therefore not surprising that the organizational innovation that allowed (micro) credit to reach the poor proved attractive as a delivery mechanism for insurance services too. As a result, many micro insurance programs have now emerged.

As noted earlier, there was an insurance element in some micro credit programs from the very beginning. However, it generally took the form of *credit life insurance*, meant to ensure the recovery of the loan in case of death or incapacitating injury suffered by the borrower. Thus, the “credit life insurance” was meant to cover risks of the micro lender and not of the borrower. Meanwhile, the poor remained vulnerable to a wide range of risks.

With time however micro insurance programs meant to address various risks directly have spread. Churchill (2006) for example presents a large compendium of micro insurance programs listing 74 programs from across the world. There are many different dimensions along which these programs may be classified. The most straightforward is in terms of the type of risk covered, such as risk related to life, health, funeral-burial, weather, etc. An important distinction in this regard is between programs focusing on a “single risk” and programs focusing on “multiple risks.”³⁰ So far, the majority of micro insurance programs have focused on life and health risks. Unlike previous attempts to provide crop insurance to the poor and farmers, micro insurance programs have generally shied away from it. Some micro insurance programs have instead tried to address the crop loss risk by focusing on weather variability using objective measures, such as the rainfall index, in order to avoid the informational problems.

Another way to classify micro insurance programs, as was the case with micro savings programs, is to focus on providers, and distinguish between those offering micro insurance as the “single product” and those offering micro-insurance as one of its “products”. In fact, just as was the case with micro savings programs, many micro insurance programs arose as a side activity of MFIs otherwise focused on micro credit. However with time “stand-alone” micro insurance organizations have also emerged. Institutions offering micro insurance may be classified also on the basis of their motivation. From this viewpoint, micro insurance programs, as are microfinance programs in general, may be grouped into either “for profit” or “non-profit” categories. The former are similar to commercial companies, while the latter may operate either as non-profit companies or as non-government, social, and cooperative organizations.

Evidence of impact of micro insurance

To the extent that micro insurance programs are relatively new, enough evidence on their impact has not yet accumulated. In a preliminary attempt at evaluation of the impact of micro insurance programs, Mosley (2008) tabulates findings from case studies of the following five programs: (i) FINCA, (ii) BRAC,

29 For example, Mosley (2008) mentions about “substantial thwarted demand for insurance services”, and the gender aspect of the “repressed demand” for insurance.

30 For example programs providing benefit only in the event of death of the client are single risk programs. On the other hand, programs providing benefits in the event of either death or disease or accident injuries are multiple risk programs.

(iii) *Grameen Kalyan*, (iv) SSS, and (v) BASIX, India.³¹ The first four are health schemes, while the fifth is a weather scheme. The author, in general, finds positive impact of the insurance programs.³² In assessing the impact of micro insurance, many researchers have emphasized its positive external effects. Mosley (2008) in fact thinks that much of the benefits from insurance programs accrue to those who are not their direct buyers.³³ This externality feature however implies that there is likely to be a “market failure,” and micro insurance will be under supplied relative to the socially optimal level. In view of the positive externalities and the initial (i.e. until they reach the break-even uptake level) survivability problem of micro insurance programs, many have argued for subsidy to be given to such programs.³⁴ However, micro insurance is still new as an insecurity alleviation program, so that substantial additional research is needed to validate the tentative and incomplete impact assessments provided by researchers so far.

Hurdles to the spread of micro insurance

Despite its positive impact, the extent of micro insurance still remains very limited, particularly when compared with that of micro credit.³⁵ There are many reasons for this limited expansion. First of all, insurance is inherently a more complicated service than credit, and hence the uptake is slow.³⁶ However, as Clarke and Dercon (2008, p. 10) note, low uptake levels increase the cost of insurance, keep the insured risk pools smaller, and make reinsurance costlier. Similarly, Mosley (2008) emphasizes the inverse relationship (or trade-off) between break-even premium and the portfolio size. This trade-off suggests that there are basically two routes to overcome the problems faced by micro insurance programs. One is to raise premium and thus limit access by the poor. This is however a self-defeating route, so far as providing insurance to the poor is concerned. The other is to increase participation by the poor by keeping the premium low and reach the uptake level at which the program becomes financially viable. The latter is obviously the more desirable direction to take. The problem, however, is that the programs have to survive until they can reach the breakeven point. How micro insurance programs can expand in a pro-poor direction without meanwhile becoming bankrupt is therefore the crux of the problem.³⁷

In face of the hurdles above, micro insurance programs in different parts of the world are experimenting with different options. As noticed earlier, most of them are indeed focusing on single and easily observable risk, such as risk to life and health. Those programs that want to address risk to crop, do so via

31 BRAC: Bangladesh Rural Advancement Committee; FINCA: Foundation for International Community Assistance (Uganda); BASIX: Bharatiya Samruddhi Finance Limited (India); SSS: Society for Social Services (Bangladesh).

32 Mosley (2008) distinguishes the following five lines of influence of micro insurance: (i) individual well being, (ii) stability of income and expenditure, (iii) social capital and interpersonal relations, (iv) downward extension of the market for social services, and (v) provision of an institutional model.

33 In particular, Mosley (2008) provides the following list of channels along which the positive externalities flow: (a) Knowledge achieved by experimentation; (b) ‘Bonding social capital’ benefits achieved through lower individual and group vulnerability; (c) ‘Linking social capital’ benefits achieved through an improvement in clients’ awareness of service quality; and (d) ‘Beneficial contagion.’ In fact, he thinks that much of the demand for insurance comes from them (non-buyers) too.

34 Mosely (2008), for example, strongly advocates for subsidy to micro insurance programs.

35 See Clarke and Dercon (2008) and Mosley (2008) for more on the unmet need for insurance demand.

36 As Clarke and Dercon (2008) note, “insurance is always sold, never bought.” The general problems with insurance, according to these authors, are: (i) information asymmetry, (ii) transaction costs, (iii) enforcement constraints, and (iv) ambiguity aversion.

37 It may be noted that such a trade off is true in a generic sense for all micro finance programs. For example, micro credit programs face a similar trade off between the interest rate charged and the extent of coverage. Similarly micro savings programs face a trade off between the service charge and the extent of coverage. In a broader sense such a trade off between price and quantity is very general. However, the trade off is particularly acute for the insurance service because of the relatively complicated nature of the service and the lack of familiarity with it on the part of the potential clients.

focusing on rainfall index rather than crop loss *per se*. Similarly, many successful insurance programs are indeed piggybacking on the pre-existing infrastructure of MFIs offering micro credit.³⁸ Further creativity and experimentation are nevertheless needed to devise more successful poverty-focused insurance programs. However, the evidence and analysis in general indicate that micro insurance, if appropriately combined with complementary policies and designed with right features, may be an additional instrument against poverty and insecurity.

8. Complementarities among various microfinance programs

While showing their specific features and roles, the above review of three different types of microfinance programs also pointed to important complementariness, some of important dimensions of which are as follows.

The first is organizational and concerns *economies of scale*. Undertaking of different types of microfinance services by the same MFI helps to economize on overhead costs, which are not limited to only costs of physical set up and logistics, but extend to costs of establishing a brand name and clientele base, networking, and experience, etc. Such a joint undertaking may also help the new programs to avoid difficult informational problems of moral hazard, adverse selection, enforcement, etc. and to reach the breakeven point with less difficulty. Also, the joint undertaking may generate synergy which may be an extra gain, going beyond the separate effects of pre-existing resources.

The second dimension of the complementariness concerns their distinctive *roles*, allowing their *extensive combinations* to cater the needs of different groups and types of households who need different types of financial services. For example, there may be households not able to benefit from micro credit programs, because they may not have members with necessary entrepreneurial qualities to make use of the credit. For such households, micro savings or micro insurance may be one of the few options left. Such extensive combination of the roles is possible even to meet the need for the same type of financial service, but of different magnitudes. For example, it was noted earlier that while insurance programs are risk-specific, savings can serve as a more general-purpose insurance. Clarke and Dercon (2008, p. 11) expand the idea further by classifying risks into “small” and “large/catastrophic” and suggesting that while “quasi-insurance” programs, such as micro savings, may be effective in dealing with the former category of risks, specific micro insurance programs can be more effective in dealing with the latter.³⁹ The actual practice indeed seems to support such a specialization, as was seen in the fact that a large number of micro insurance programs indeed focus on risk to life.

A third dimension of complementariness works via *internalization* of the externality of microfinance programs and pertains to the same individual or household participating in the programs. For example, the availability of micro insurance can help a household to avoid distress de-accumulation and thus be up to date with micro credit repayment schedule. On the other hand, micro credit, by raising the mean income, can help a household afford to pay the insurance premiums. Some researchers have argued for active use of

38 Mosley (2008) thinks that the experience so far points to the following as some of the ways to ensure success: (a) Focus on risks that are concrete and quantifiable; (b) Premiums set to broadly cover costs; (c) Additional controls against fraud and moral hazard; (d) Controls for adverse selection; (e) Piggy backing on existing micro finance operation with multiple beneficial effects, such as (i) lowered admin cost, (ii) avoiding adverse selection, and (iii) generation of externality for the parent micro finance program; (f) Obtaining reinsurance; and (g) Explicit targeting of the poor.

39 Similarly, Mosley (2008, p. 14) concludes that “micro insurance is by no means the only instrument of poverty reduction or even of risk reduction. Prima facie there is a great deal to commend Braon and Churchill’s observation that ‘savings are more effective than insurance for providing protection against common stresses (whereas insurance provides protection against larger losses that occur more (in!) frequently’ (italics added).”

this type of *internal combination* of specific roles of different types of microfinance programs. For example, Clarke and Dercon (2008) note that the “credit life insurance” component of conventional micro credit programs can be designed in such a way that it becomes beneficial both to the lender and the borrower, instead of just the lender. Such a redesigned “credit life insurance” can counteract the increased vulnerability that micro credit may otherwise create for certain borrowers in certain situations. Clarke and Dercon in fact suggest that signing up for micro insurance may even be made mandatory for micro credit clients. Implementation of this suggestion would however imply the use of complementariness along both organizational and internal dimensions.⁴⁰ The internalization of the externalities of various microfinance programs may be helpful not only for the clients, but for the MFIs themselves too. As noticed earlier, savings generated through micro savings programs provided BRI a cheap source of fund to be used for its micro credit programs.

Recognition of the above and other possible dimensions of complementariness is important, because their efficient use, as noticed above, can help overcome some limitations of different micro finance programs operating separately. At the same time, there are reasons to be cautious about some potential negative consequences of “bundling” of several microfinance programs. For example, referring to the idea of bundling of micro credit and micro insurance programs, Clarke and Dercon (2008) point out that people who are not interested in micro insurance may now feel discouraged from accessing micro credit, resulting thus in a restriction on the expansion of micro credit. In addition, allowing such bundling may also lead to collusion among microfinance service providers and give rise to market power. Judicious decisions are therefore necessary.

9. Role of microfinance as a whole

Having examined the distinctive roles of micro credit, micro savings, and micro insurance programs, and the complementariness that exists among them, we now turn to the issue of overall impact of microfinance on poverty and insecurity.

Criticisms of microfinance

The fact that microfinance programs are expanding both in their coverage and in the range of services offered can be seen as a *prima facie* evidence of their success and thereby to argue for them an even broader role. However, microfinance has also been dogged by many criticisms, including those concerning microfinance’s (i) financial viability, (ii) ability to reach the extreme poor, (iii) propensity to charge high interest rate, (iv) limited macroeconomic impact, (v) difficulty in scaling up of operations, etc.⁴¹

However, not all these criticisms can be made simultaneously, because many of them contradict each other. For example, it is difficult to complain about microfinance’s inability to reach the extreme poor while at the same time insisting that it remains financially solvent. Similarly, it is not very reasonable to demand that microfinance remains financially solvent and yet complain about high interest rates. In the same vein, it is contradictory to urge microfinance to reach the extreme poor while at the same time demanding that it scaled up the size of its loans, allowing the borrowers to engage in (relatively) large scale production and marketing operations.

Microfinance scholars may therefore be classified broadly into two groups. On the one side are those taking a more narrow financial efficiency point of view. They emphasize the necessity for being financially

⁴⁰ This amounts to conversion of multiple products into a joint product.

⁴¹ The literature on microfinance critique is huge and cannot be referenced here in detail. Interested readers may see Morduch (1999a,b) and Armendariz and Morduch (2005) and follow the references therein.

solvent and hence recommend such steps as charging break-even interest rates, scaling up of operations, etc. On the other side are those emphasizing microfinance's proven capacity to reach those who would otherwise remain outside the orbit of formal financial services (particularly women), and microfinance's various non-financial but positive benefits. Accordingly these scholars do not want microfinance to charge high interest rate or service charge and thereby neglect the poor in order to become financially viable. In fact many of them have argued that it is worthwhile providing subsidies to microfinance, at least until it reaches financial viability. Morduch (1999a, b) and Armendariz and Morduch (2005), for example, call such subsidies as "smart subsidies." Other researchers, such as Clarke and Dercon (2008), have taken this reasoning one step further and argued that micro finance programs, because of their goal to service the poor, should never be expected to be financially viable, and should therefore always receive subsidy, in particular to help them experiment and innovate.

Responding to the criticism regarding financial viability, some MFIs have claimed that they are already financially solvent, and others have maintained that they were on the way to becoming solvent. Similarly, responding to the issue of macroeconomic impact, many MFIs have conducted studies to show that microfinance does have significant macroeconomic impact. However, as mentioned earlier, independent evaluations of microfinance programs are relatively few, so that there is no consensus regarding the validity of these claims and counterclaims.⁴²

Recent trends in the evolution of micro finance

Meanwhile, microfinance itself continues to evolve in response to both the criticisms above and propelled by its own internal dynamics. Looking at this evolution, it is clear that different MFIs are moving in different directions, so that the world of microfinance is getting differentiated.

As noticed above, some MFIs are trying to make use of various types of complementariness that exist among different types of microfinance programs in order to overcome the limitations of the individual programs. Many MFIs are scaling up their operations. Thus, apart from gradually increasing the size of loan given to existing successful borrowers (a common practice of micro credit programs), many MFIs' have introduced entirely new types of loans of much larger size, directed to larger undertakings, such as construction or major repair of houses, setting up of small scale manufacturing and/or marketing operations, etc.

Some MFIs are venturing into pure commercial enterprises in order to diversify their services or to generate higher profit which can be ploughed back into microfinance operations. Such expansion into commercial operations may therefore help a MFI to be financially solvent as a whole, even if its microfinance part is not. Thus Grameen Bank of Bangladesh, the pioneer of micro credit, has now expanded into manufacturing, trade, cell phone business, etc. On the other hand, BRAC, another giant MFI of Bangladesh, has even started its own conventional commercial bank.

Some MFIs are raising their interest rates so high that they are not only becoming financially viable but also so highly profitable as to attract private investors. An example is provided by Mexico's *Banco Compartamos* which charges interest rates as high as 90 percent per year on its loans, thus earning attractive profits. As a result, in April 2007, it could easily go to the stock market to both capitalize on its profits and raise capital. Its IPO offering 30 percent of the company's holding was over-subscribed by 13 times, and led

42 As Clarke and Dercon (2008) reiterate, the task of quantification of the impact of microfinance programs (for that matter of poverty and insecurity intervention programs in general) has, in general, proved difficult.

to a valuation of the company at \$1.6 billion. *Banco Compartamos* argues that high profitability based on high interest rates has enabled it to expand fast, growing from 60,000 to over 800,000 customers between 2000 and 2007, using largely its own retained earnings. Others microfinance leaders however are very critical of the commercial approach such as of *Banco Compartamos*. They think that the route to profitability via high interest rate amounts to a return to the usury that microfinance intended to eradicate and thus signifies a surrender of the basic purpose of microfinance.⁴³

On the other hand, in a move in the opposite direction, some MFIs are taking initiatives to reach the extreme poor. Thus some MFIs have devised special type of loans suitable for the purpose. Others are combining various programs of microfinance and programs of welfare benefits (in cash and kind) and training that can help MFIs to reach even the ultra poor. The Income Generation for Vulnerable Group Development (IGVGD) program of BRAC is an example of such effort.

It is therefore clear that underneath the steady expansion and stability of the world of microfinance there are many important changes going on. The world of microfinance is changing, and it will be interesting to see where these changes lead microfinance to in the coming years.

Direct and indirect impact of microfinance

One thing however is clear: microfinance alone cannot solve the problems of poverty and insecurity. This is evident from the simple fact that countries such as Bangladesh and Bolivia, which have experienced significant expansion of micro finance, have not been the international leaders in reducing poverty and insecurity. Thus whatever beneficial impact microfinance had has not proved to be of first order importance in reducing poverty and insecurity. The international leaders in poverty and insecurity reduction have been the East Asian economies, which reduced poverty not through microfinance but through labor-intensive industrialization making use of the international trade opportunities.

The international experience however also shows that fast aggregate growth alone is not sufficient for reduction of poverty and insecurity. Many countries have achieved fast macro economic growth with a lackluster record of poverty reduction. Thus, to reduce poverty, growth also needs to be pro-poor and widely shared.⁴⁴ Research has shown that one reason why growth in East Asian economies, such as Japan, Korea, Taiwan, and China, could result in significant poverty reduction is the relatively egalitarian initial distribution, achieved through radical land distribution and shared improvement in education and healthcare. The egalitarian initial distribution of endowment made it possible for people of these economies to participate in the growth process and benefit from it more widely. Countries interested in achieving fast reduction of poverty and insecurity therefore need to pay particular attention to ensuring relatively egalitarian distribution of physical and human capital endowments.

It seems that microfinance can have an important role in the creation of the necessary initial distribution. Evidence and analysis indicate that there are two dimensions of the impact of microfinance. One is the impact in the narrow sense, gauged by the direct financial outcomes of the programs for the clients. The other is the broader impact on the general socio-economic and political position of the poor, enhancing their access to the opportunities offered by the public and private sectors of the economy, and thus conducting to

43 See Cull, Demirguc-Kunt, and Morduch (2008) for more details about the debate concerning Banco Compartamos.

44 As noticed earlier, there is a lively debate about the precise definition of “pro-poor growth.” Our discussion here however does not depend on the precise definition adopted.

an improvement in their situation with regard to education, health, other social and public services, human rights, voice, awareness, enlightenment, and participation in the political process. Such an enhancement of the poor's position in the society may result in a wider diffusion of physical and human capital, conducting to a more egalitarian initial distribution that is necessary for the "take-off" of a more equitable growth process. Thus, it is the broader, indirect impact of microfinance that may prove to be more important in the long run than its direct financial impact.

10. Concluding remarks

Chronic economic insecurity is rooted in poverty, and the two together constitute a vicious circle. Since World War II, many different ideas and strategies have been tried, mostly as donor-supported public sector initiatives, to eradicate poverty and insecurity. Unfortunately, these have not had the desired effect. Microfinance, as a private sector idea, arose in the late 1970s and has since been expanding steadily. With time, it has also become diverse in terms of services offered, covering now credit, savings, as well as insurance services.

Microfinance has generated opposite responses and views. On the one hand, there are its strong proponents, who think that micro finance almost alone can do the trick, raising billions of people out of poverty and insecurity. On the other hand are the skeptics who discount the claims of microfinance as exaggerated and dismiss any significant role for it in the future.

The analysis offered in this paper indicates that microfinance does have a significant impact, though it has proved difficult to quantify this impact in a manner that would be precise and acceptable to all. This is the answer to the question "How Much?"

The analysis further shows that there exists important complementariness among different types of microfinance programs, and creative use of this complementariness offers an important way in which these programs can overcome many of their weaknesses when operating separately.

Analysis and evidence suggest that it is useful to distinguish two types of impact of microfinance programs. One is the narrow and immediate financial impact on the clients, and the other is the broader, indirect impact on the general socio-economic position of the poor. Microfinance appears to enhance the socio-political position of the poor, allowing them to have better access to the opportunities provided by both the private and public sectors.

While the direct impact of microfinance may not be negligible, it has not so far proved to be of first order importance. This is illustrated by the fact that such countries as Bangladesh and Bolivia, which have seen significant expansion of microfinance, have not witnessed sharp reduction in poverty and insecurity. Leaders of poverty reduction instead have been the East Asian economies, which had no or little microfinance, but could proceed from an egalitarian initial distribution of endowments and thus achieve fast and relatively widely shared economic growth.

It is possible that through its broader impact facilitating a wider diffusion of human and physical capital endowment, microfinance may help to ensure the kind of initial egalitarian distribution that is necessary for a take-off towards equitable growth. Thus, microfinance may play a more important role in poverty and insecurity reduction through its indirect, broader impact rather than its immediate financial impact. This provides the answer to the question of "How?"

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