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MANAGING EXPECTATIONS FOR MICROCREDIT

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OVER THE PAST few years, international development circles and popular culture have embraced the concept of “microcredit,” the lending of small amounts of money to needy individuals. The United Nations dedicated a year—2005—to it, and the Nobel Prize committee called it “an important liberating force.”¹ Celebrities endorse it, big-name companies, such as eBay and Morgan Stanley, invest in it, and prominent websites, like Kiva.org, support it.

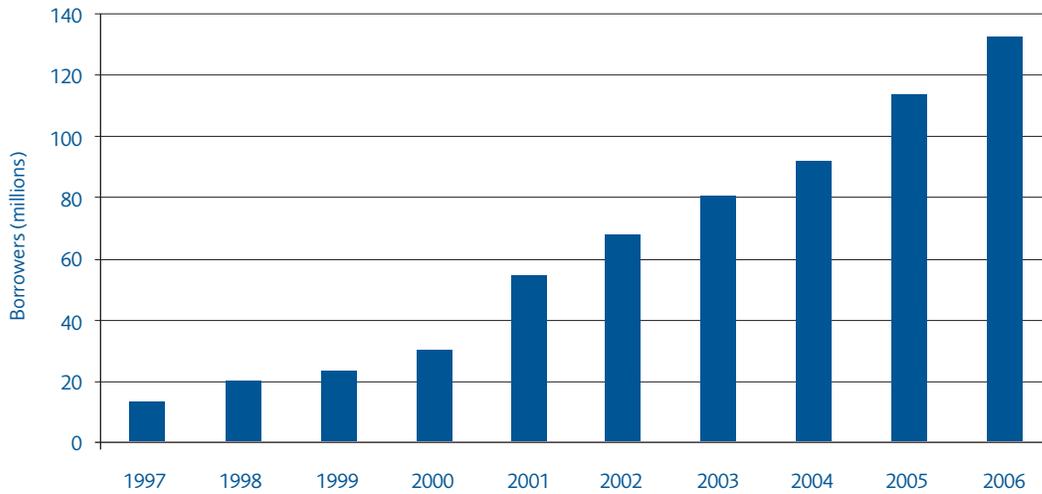
All this attention creates the illusion that microcredit is a silver bullet for ending poverty. Such is not the case: microcredit’s ability to fight poverty is more limited than the hyperbole suggests. In spite of the private sector’s large investment—it lent almost a billion dollars to microcredit in 2005—microcredit’s actual impact is less dramatic than some of its celebrity supporters may realize. While it is not the silver bullet that will slay poverty, microcredit does help many people in some unexpected ways.

TRENDS IN MICROCREDIT LENDING

THE STORY OF microcredit began thirty years ago, when Muhammad Yunus—an economics professor in Bangladesh—lent \$27 to a group of nearby villagers. The villagers used the money to develop informal businesses to produce products—such as soap or baskets—which they would then sell at the local market. After initial successes lending to poor entrepreneurs, Yunus founded the Grameen Bank in 1976 with a goal of helping even more poor women in his country.² Grameen Bank has since become the largest microcredit institution in the world and was co-recipient, with Yunus, of the 2006 Nobel Peace Prize.

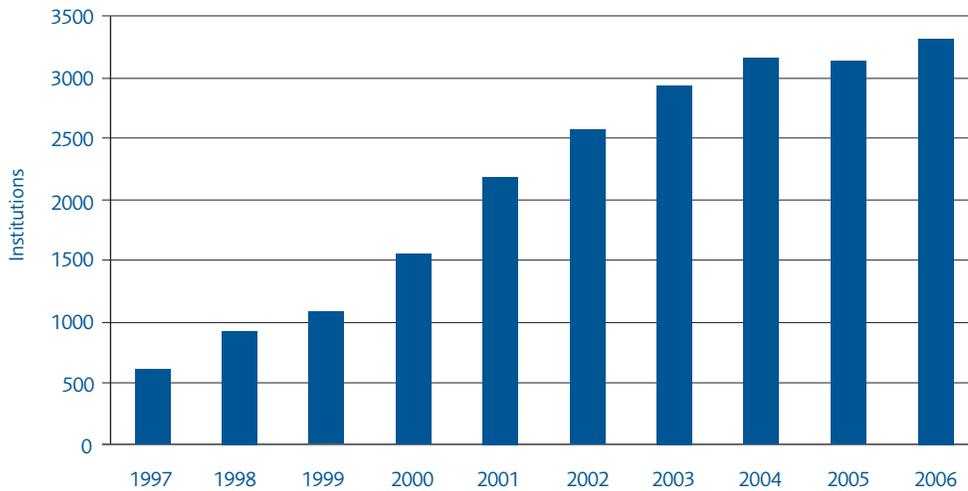
In 2006, roughly 133 million people received microcredit—an 886 percent increase over the 13 million borrower figure of

FIGURE 1: GROWTH IN THE NUMBER OF PEOPLE SERVED BY MICROCREDIT (1997–2006)



Source: Microcredit Summit Campaign Report 2007, <http://www.microcreditsummit.org/pubs/reports/socr/EngSOCCR2007.pdf>

FIGURE 2: GROWTH IN THE NUMBER OF MICROCREDIT INSTITUTIONS (1997–2006)



Source: Microcredit Summit Campaign Report 2007, <http://www.microcreditsummit.org/pubs/reports/socr/EngSOCCR2007.pdf>

1997 (Figure 1). Over three thousand microcredit institutions lent small amounts of money to people for short periods (six months to a year) (Figure 2).³

These institutions and lenders are located all over the world. Seventy percent of microcredit lenders operate in Asia, fourteen percent in South America, and ten percent in Sub-Saharan Africa. The United Nations estimates that over three-quarters of microcredit borrowers are women. In Asia, the proportion is even higher—ninety percent of the borrowers are women.⁴ The sizes of the loans also vary by region and in poorer countries, such as Rwanda, loans are smaller than in

transition countries, such as Romania. Worldwide, the average microloan size is \$1,026.⁵

WHAT MICROCREDIT IS AND WHAT IT ISN'T

MICROCREDIT BORROWERS DO not need collateral to get a loan. Instead, microcredit institutions use peer pressure to ensure repayment. Small groups of about five people take out a loan, and the group then schedules meetings (often on a weekly basis) at which the borrowers will repay their shares of the loan. If one borrower cannot make her payment at a mandatory meeting, the rest of the group will press her to come up

with the money, because the remaining borrowers will have to pay the delinquent's share. If a borrower repeatedly misses her payments, the group may resort to taking a radio, kettle, or another piece of property from the languishing borrower, or they might refuse to borrow with that person again.

Microcredit rarely creates businesses

MANY PEOPLE THINK that microcredit provides loans for poor people to start businesses. They view this as a positive benefit, because they believe starting more businesses in the developing world will lead to economic growth. In reality, most microlenders will not lend money for startups: they issue loans only if a borrower's business is already up and running—if the borrower already has a track record as a business person.

However, if a business already exists, it is probably already sustainable. By funding mostly sustainable businesses, microcredit is unlikely to lead to the dramatic decrease in poverty for which supporters hope.

Microcredit does finance spending and consumption

IF THEY ARE not starting businesses, why do people take out microcredit loans? Many borrowers take out loans to meet the financial needs of their families without having to take money out of their business. In India, borrowers often use microloans to pay for a doctor's visit; in Tanzania, approximately sixty percent of loans are used to send children to school. The remaining forty percent is invested in businesses.⁶

Microcredit loans also finance goods that do double duty: They can be used at home and in the business. For example, if a borrower uses a loan to buy a cell phone or a motorbike, she can use these items to improve her business, but she can also use them to call her sister or visit her friends. In such cases, microcredit is funding consumption at the same time that it funds the expansion or improvement of a business. This is not necessarily a bad thing as consumption supports some local entrepreneurs, but it does mean that microcredit is not all about investing in the borrower's business.

THE UNEXPECTED BENEFITS OF MICROCREDIT

Choice

MICROCREDIT'S GREATEST BENEFIT is that it gives borrowers more choice. Microcredit institutions offer people legal, less costly alternatives to moneylenders, who may charge between 200 to 400 percent interest and demand quick repayment.⁷ Without microcredit institutions, once banks have rejected people, moneylenders may be the only non-family lender willing to work with people in the informal sector. Compared to moneylenders, microcredit is a good deal for borrowers. It is

less risky and less costly, and it may free family members from the obligation to provide financial support to relatives.

A learning experience

FOR PEOPLE WHO have no experience using the formal banking systems, microcredit loans provide a way to establish a credit history. This, in turn, provides borrowers with a way to increase their scale of trade and business organization. Borrowers gain valuable experience in working within a formal institution, learning what to expect from a commercial relationship that involves other borrowers and the credit institution.

Microcredit does improve the lives of many of the world's poor, but, by itself, it is not the answer to global poverty.

Savings

IN PLACES WHERE microcredit is common, saving money is a real challenge. Social norms may require someone who can save her money to help family and friends or finance a local celebration. A typical saver may only be able to keep a quarter of every dollar. Borrowing from a microlender and investing the money in valuable non-business assets can be another unexpected benefit of microcredit.

For example, if it is difficult to save in cash, buying a cow (or a goat or a pig) is a better way to save. Animals are sturdier than paper money, and friends and relatives cannot ask for small pieces of them. A cow provides milk, can plow the fields, and produces dung that can be used as fuel or fertilizer. In a pinch, the owner can slaughter it and sell or eat the meat. By increasing opportunities for investing in tangible goods, microcredit provides an alternative way for the poor to save.

CONCLUSION

MICROCREDIT OFFERS REAL benefits to people in developing countries. It can help educate children and offers the poor an alternative to moneylenders, instruction in formal financial systems, and a strategy for saving money. Microcredit makes

life more bearable and easier to manage, a benefit people in the developed world should not underestimate.

However, microcredit's supporters overestimate its benefits. While some borrowers use microcredit loans to start business, most borrowers use the loans to keep a current business in operation. And few borrowers are able to turn their small businesses into large-scale firms, which would provide jobs for other poor people. Instead, the benefits of microcredit loans often extend only to the borrower and her family—a good outcome, but perhaps not the solution to poverty for which some hope. Microcredit does improve the lives of many of the world's poor, but, by itself, it is not the answer to global poverty.

ENDNOTES

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2. Muhammad Yunus, *Banker to the Poor: Micro-Lending and the Battle against World Poverty* (New York: PublicAffairs, 2003).
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4. Manohar Sharma, "Microfinance," *2020 Focus 6*, Brief 10 (Washington, DC: International Food Policy Research Institute, 2001), http://www.ifpri.org/2020/focus/focus06/focus06_10.asp.
5. "Microloans Pay Off for Planet, Investors," July 28, 2008, Worldwatch Institute, <http://us.oneworld.net/article/microloans-pay-off-planet-investors>.
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7. Beatriz Armendariz de Aghion and Jonathan Morduch, *The Economics of Microfinance* (Cambridge, MA: MIT Press, 2005) 28.

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