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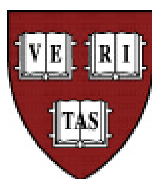

The Microfinance Schism

Jonathan Morduch*

Abstract

Leading advocates for microfinance have put forward an enticing "win-win" proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty. A key tenet is that poor households demand *access* to credit, not cheap credit. This vision has been translated into "best practices" that have been circulated widely. The argument falls apart, however, on closer inspection. It rests on misinterpretations of evidence and faulty extrapolations of logic. While petty traders and a few others with high-margin, quick turnaround businesses *can* pay high real interest rates, most poor households cannot. Contrary to common assertions, moderately-subsidized credit can be well-targeted, delivered efficiently, and can be compatible with savings mobilization. Recognizing the limits to the "win-win" proposition opens up consideration of the costs and benefits to subsidization. It also provides a basis for constructive dialogue between microfinance advocates that privilege financial development and those that privilege social impacts.

Key words: Microfinance, poverty alleviation, credit markets, savings, subsidies.

JEL codes: O16, O17, I38

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Introduction

Few recent ideas have generated as much hope for alleviating poverty in low-income countries as the idea of microfinance. Microfinance promises both to combat poverty and to develop the institutional capacity of financial systems through finding ways to cost-effectively lend money to poor households.[1] Poor households are typically excluded from the formal banking system for lack of collateral, but the microfinance movement exploits new contractual structures and organizational forms that reduce the riskiness and costs of making small, uncollateralized loans. Microfinance programs have also demonstrated that even poor households can save in substantial quantities. Success stories are being written around the world, from Jakarta to Dhaka to Nairobi to La Paz. Advocates have broadcast these successes widely, and donors have been quick to pledge billions of dollars to support the expansion of programs in the next decade.

Much of the enthusiasm rests on an enticing "win-win" proposition: microfinance institutions that follow the principles of good banking will also be those that alleviate the most poverty. By eschewing subsidies and achieving financial sustainability, microfinance institutions will be able to grow without the constraints imposed by donor budgets. In the process, according to the argument, these institutions will be able to serve more poor people than can be served by programs fueled by subsidies. A key tenet is that poor households demand *access* to credit, not cheap credit, and that many are able to repay loans at real interest rates above 30% per year or more.

If the argument is right, much poverty alleviation can be achieved at no cost to governments and donors -- or perhaps even at a small profit. The vision has been translated into a series of basic "best practices" circulated widely by the Consultative Group to Assist the Poorest (CGAP), a donor consortium housed within the World Bank; the U.S. Agency for International Development; the United Nations Development Program; and other key donors.

The argument falls apart, however, on closer inspection. It rests on misinterpretations of evidence and faulty extrapolations of logic. The argument is correct enough to warrant re-thinking the received wisdom about publicly-provided credit programs. But it is incorrect enough to risk leading practitioners as far astray as many went in pushing the over-subsidized credit failures of the 1960s and 1970s. While many poor households *can* pay real interest rates of 30% per year (or even 50% and higher), most cannot.

Those that can pay high interest rates are most often petty traders and a few others with high-margin, quick turnaround businesses.[2] Others may borrow from money lenders at rates above 100% per year, but they are generally doing so to meet short-term consumption needs, not to make long-term productive investments.

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[1] See, for example, Brugger and Rajapatirana (1995), Hulme and Mosley (1996), Morduch (1997), and Otero and Rhyne (1994) for broader discussions of microfinance programs.

[2] Petty traders, for example, form the main client base of Bolivia's BancoSol and Indonesia's Badan Kredit Desa, two well-known, financially-sustainable programs that charge annual real interest rates above 45% per year.

In Las Vegas, pawnshop owners charge borrowers effective annual interest rates of 120%, while in the gambling town of Biloxi, Mississippi, typical rates are 300% per year (*New York Times*, December 13, 1997). Demand remains high in both settings. But no one would argue that the typical small entrepreneur in the U.S. can repay loans at those rates. This, though, is the sort of argument that is commonly made in the microfinance context.

The largest client base of most existing microfinance programs comprises households investing in small-scale manufacturing and the processing of agricultural goods. These latter groups can not typically pay real rates much higher than 20% per year, but many can flourish when given credit at these rates.[3] For these households, the programs have the potential to provide appropriate incentives for effort and compliance, encourage responsibility and entrepreneurial energies, help generate a process that is dynamic and socially empowering, and allow poor households to more fully tap into the benefits of aggregate economic growth.

All of this, though, comes at a cost. Even when charging borrowers interest rates of 20% per year, most microfinance programs are far from breaking even. The next wave of the microfinance movement will profit by facing up to the holes in the cost-free, win-win vision. The questions to be taken up by the movement's next wave include: Are the costs justified by the social benefits of programs? Can innovations be implemented to help subsidize credit without overly compromising efficiency and effective targeting to households in need? Which groups among the poor are best served by which types of programs? Can subsidies instead be used more effectively in alternative social programs? How can funding be sustained over the long run?[4]

Advocacy of the win-win proposition has stood in the way of addressing these questions. Costs and benefits become irrelevant if programs are unwilling to run at a net loss, even in the name of social welfare. And social impacts become secondary to financial bottom-lines since, according to the win-win view, improving banking performance is the surest way to improve social indicators.

Advocacy of the win-win proposition has also stood in the way of recognizing a schism that runs through the microfinance movement. While a few dozen programs are likely to achieve full financial sustainability in the next decade, the hundreds of others around the world will not.[5] Even if they wanted to achieve financial sustainability, the balance of programs will need to rely on continued subsidization through the medium-term at least. This includes the movement's standard-bearer, the well-known Grameen Bank of Bangladesh. Despite exhortations about "best [financial] practices", the schism persists because many practitioners steadfastly believe that their impact and outreach will suffer if they cannot partly subsidize clients. Abandoning the win-win

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[3] Other households need much more than credit to improve their welfare. Excessive subsidies are wasted when given to households that would do much better with alternative forms of aid.

[4] A similar series of questions has been raised by van de Walle (1997).

[5] This speculation is based on discussions with CGAP officials.

proposition is necessary before it is possible to have frank, constructive discussion about these differences.

Addressing the schism also opens up the chance to address misconceptions about achieving efficiency in subsidized programs. It is not profit-maximization that makes a program efficient. Instead, what matters is having a hard budget constraint, something possible even with subsidies. Nor is it so that subsidization necessarily leads to mis-targeting. Fear of mistargeting may put a floor on subsidies, but it need not limit them. Nor is it so that savings mobilization is necessarily held down by charging interest rates on loans that are below levels needed to break even.

Addressing the schism may also mitigate the emerging backlash against the microfinance movement. The insistence on the win-win proposition has alienated many potential supporters. Those willing to trade off costs for benefits have become frustrated as microfinance institutions stretch accounting data in order to claim profitability while simultaneously eschewing social evaluations. Perhaps more problematically, those interested in replicating the well-known success stories have only had partial and unreliable evaluations on which to base their plans.

The aim of this paper is not to argue for one type of program over another. To the contrary, evidence suggests that achieving the richness of programs appropriate for broad and changing populations will require a diversity of programs at varying levels of outreach and financial sustainability. The aim is to help clarify discussions, to examine the logic of critical arguments, and to highlight salient tensions. The next section briefly reviews lessons and inferences from subsidized credit programs of the 1960s and 1970s. The following section takes apart the arguments underlying the "win-win" proposition. The final section puts forward an agenda for research on issues at the heart of the microfinance schism.

The Subsidy Trap

All sides agree on the importance of avoiding mistakes of the past. Earlier attempts to address gaps in financial markets focused on a now-familiar set of problems: First, banks face high transactions costs per loan when lending at small scales. Second, determining the riskiness of potential borrowers and monitoring the progress of clients is particularly difficult when clients are poor and in the informal sector. And, third, many low-income households lack assets to put up as collateral.

Yet, the early programs recognized that many households could generate high returns if given credit and that, by starting small enterprises, the households could earn enough income to exit poverty, expand their businesses, and improve the quality of their lives. As a result, governments subsidized banks' loans to poor households, providing incentives to overcome banks' reluctance to lend. Recognizing the social mission of the project, interest rates were also kept below market-clearing levels.

Despite the promise, the subsidized credit programs of the last three decades failed nearly universally, and disaster stories are well-catalogued (Adams, Graham, and von Pischke, 1984). The costs of these programs mounted quickly and, since no way was found around the collateral problem, default rates ballooned, with many borrowers expressing ambivalence about defaulting on government-backed loans, especially when most everyone else was doing so. Either the programs quickly ran out of money or they drained government accounts.

Moreover, because banks were losing money so steadily on the lending-side, they had little incentive to mobilize savings, recognizing that re-lending the deposits would just lead to greater losses. Instead, downward pressure was put on interest rates on deposits, with the strategy of keeping interest rates paid to depositors below the rates charged to borrowers. This spread was seen as a way to obtain cheaper funds to balance against losses from lending. But the result was that real rates on deposits often turned negative and savers had little incentive to build up accounts. Ultimately, little saving was generated, and money stayed under mattresses.

Government involvement had another negative consequence. Loans often ended up subsidizing well-off, politically-connected entrepreneurs rather than poor households, and few mechanisms were in place to stem the leakages. The ultimate result was high costs and little benefit for the intended beneficiaries.

The new programs have set out to avoid these traps. Foremost, they have seen the importance of maintaining high repayment rates. By employing contractual innovations like group-lending and by exploiting dynamic incentives, most programs have achieved repayment rates above 90% (Stiglitz, 1990; Otero and Rhyne, 1992; Morduch, 1997). They have also kept an arm's length from government involvement, and most programs are run by non-governmental organizations (NGOs).

The experience has also bred false generalizations. The first is that effective savings mobilization is incompatible with subsidized credit. The second is that subsidization, inefficiency, and limited scale go hand in hand. The third is that government involvement means trouble. As described below, none of these is ideas is fully consistent with logic or experience.

The Logic of the Win-Win Proposition

The win-win proposition rests on a series of supporting arguments. The most important is the argument that households desire access to credit, not cheap credit. This rests on the claim that raising interest rates does not diminish credit demand. A second claim is that due to their scale, financially sustainable programs can make the greatest dent in poverty. A third claim is that, since they come at no cost to donors, financially sustainable programs are superior weapons for fighting poverty. A fourth claim is that subsidized programs are inefficient and thus bound to fail. A fifth claim is that subsidized credit most often ends up in the hands of the non-poor. A sixth claim is that successful microfinance programs must be non-government programs. And a seventh claim is that subsidizing credit undermines savings mobilization.

Not all of those who believe in the importance of financial sustainability will accept each claim. But the claims are heard often together, and they form a core set of ideas. Each seems plausible, but all are based on either problematic logical extrapolation, inappropriate assumptions, or misreadings of evidence.

Claim 1: Raising interest rates does not diminish demand for loans.

The distinction between *which* poor households are served by microfinance programs is obscured by some arguments that financially sustainable programs reach poor households. For example, it is asserted in CGAP (1996; prepared by Richard Rosenberg):

> CAN microborrowers pay high interest rates? ...[Microfinance institutions] charging very high interest rates almost always find that demand far outstrips their ability to supply it. Most of their customers repay their loans, and return repeatedly for new loans: this pattern demonstrates the customers' conviction that the loans allow them to earn more than the interest they have to pay....Thus, there is abundant proof that poor people's tiny businesses can often pay interest rates that would strangle a larger business. Still, this proposition strikes many as counterintuitive.

The argument above makes the point that there are many poor households that are able to pay high rates. The concern of subsidized programs like the Grameen Bank, however, is that there are also many borrowers who *cannot* pay high rates. These latter households tend to be poorer and harder to reach with traditional programs, and they constitute a large fraction of the Grameen Bank's client base. They are not the petty traders that can repay at rates above 50% per year. If the Grameen Bank raised interest rates it might not suffer for lack of demand either. But that is not the point. It would likely lose much of its current client base, including the particularly vulnerable and under-served segments of poor populations that appear to be served well by moderately-subsidized microfinance programs versus other economic development initiatives. Considering aggregate demand is not enough for programs seeking to maximize social welfare.

The argument is allied to another logical stretch. The assertion above implicitly invokes the principle of declining marginal returns to capital as a defense of charging high interest rates to poor clients while charging lower rates to richer clients.[6] The idea is that there are a limited number of great projects in which to invest. The first units of capital go to the best projects and subsequent units go to projects with increasingly lower returns. The principle is generally right, but its application is wrong. (Even the principle is unclear, however, since projects with substantial scale economies may have higher marginal returns to later increments of capital than earlier increments.) The principle applies to a single firm, holding all else fixed. It does not necessary hold across firms (or across household microenterprises) as in the application here.

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[6] The idea is related to Hulme and Mosley's (1996) idea to charge "tapered" interest rates that fall with loan size. Their evidence shows that poorer households do not in general receive higher returns than richer household, but they argue that there is still "headroom" to taper rates.

Producing and selling goods requires more than capital. It requires skills, other materials, information, connections, transportation, etc. Since richer households tend to have more of these inputs, marginal returns to capital are often far higher for them than for poorer households. These richer households will thus be willing to pay far higher interest rates than poorer households. The ability to pay high interest rates is thus an empirical issue, dependent on the amount of capital being used, as well as the amount of all other inputs available. There can be no inference that because one group of poor households can pay high rates then even poorer households can pay those interest rates as well.

Claim 2: Financially-sustainable programs can achieve greater scale than subsidized programs. Thus, they can make a bigger dent in poverty.

The diversity within poor households is similarly obscured by common arguments on the advantages of achieving a broad scale of operations. Again, the argument is put well in CGAP (1996):

> Some people treat [the question of how high to set interest rates] as if it comes down to a value judgement: which do you care more about -- poor people or profits (...or financial system...or neoliberal ideology). To avoid any such confusion, let's assume that the only objective we care about is maximizing benefit to poor people. From this perspective, the argument for high interest rates is straightforward. In most countries, donor funding is a limited quantity that will never be capable of reaching more than a tiny fraction of those poor households who could benefit from quality financial services. We can hope to reach most of those households only if [microfinance institutions] can mobilize relatively large amounts of commercial finance at market rates. They cannot do this unless they charge interest rates that cover [total costs].

The argument has greatest power if concern with poverty rests exclusively with minimizing the *number* of people below the poverty line (making no distinction between groups within the working poor population). But it loses power if we also consider the distribution of income below the poverty line -- and this makes value judgements paramount. Value judgements cannot be so easily swept away.

Consider trade-offs in scale and outreach when the objective is to minimize a poverty measure that is sensitive to the distribution of incomes below the poverty line. Since clients in subsidized credit programs tend to be much poorer than those in sustainable programs, for illustration assume that the typical client in a subsidized program has an income of, say, 50% of the poverty line, while the typical client of a sustainable (high interest rate) program has an income of 90% of the poverty line. To clarify the comparison, assume that the net impacts on income per borrower are identical for the programs (after repaying loans with interest).[7]

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[7] Hulme and Mosley (1996) suggest that impacts may be greater for less poor households. This provides additional support for sustainable programs in the calculation.

Minimizing poverty as measured by the Watts measure or "average exit time" of Morduch (1996), for example, suggests that raising the poorer borrower's income by one dollar has 15 times greater impact than doing the same for the less poor borrower. The same calculation for the commonly-used "squared poverty gap" of Foster, Greer, and Thorbecke (1984) gives a ratio of 25 to 1. The "cubed poverty gap" yields a ratio of 125 to 1.

The numbers can be put in perspective by comparing the required scale of subsidized and sustainable programs that would have equivalent impacts on measured poverty. Say that the sustainable program has 63,000 clients (roughly the size of Bolivia's BancoSol). How large would the subsidized program need to be to have an equivalent impact (under the assumptions above)? When measuring poverty with the Watts measure, the subsidized program would need to reach at least 4200 clients. When measuring poverty with the squared poverty gap, the subsidized program would need to reach 2520 clients. And it would need to serve just 504 clients as measured by the cubed poverty gap.

The exact comparison is a matter of value judgement -- which poverty measure best captures the social value of poverty reduction? The initial claim above makes sense only under specific assumptions about objective functions, relative outreach, and the elasticity of credit demand with respect to interest rates. Under plausible assumptions, the claim could hold, but it is not a general proposition. Well-targeted programs can often do more for poverty reduction than much larger programs reaching only better-off households.

Claim 3: Since sustainable programs do not require outside funding, consideration of costs and benefits is irrelevant. There are no costs borne by governments or aid agencies -- there are only benefits. Sustainable programs are thus superior to subsidized programs.

The idea of cost-free poverty alleviation is appealing, but consider this simple analogy. When diners go to a restaurant, they have the option of drinking water or purchasing a beverage. The water is free and adequate, but most diners also buy wine, beer, or soft drinks to complement their meal. To them, the zero-cost option is not always the one that leads to the greatest satisfaction, and the same logic holds here. When funding is available, subsidizing credit beats the zero-cost option as long as benefits outweigh costs.

A problem with this discussion is that it proceeds as if there be just *one* interest rate policy and one sort of program in an area. Sustainable programs have advantages in achieving scale. Subsidized programs appear to have advantages in outreach. Just as all diners are not forced to drink the same beverages, general social welfare perspectives suggest that it can make sense to support multiple programs within the same region, some focusing on scale and others on outreach.

Claim 4: Subsidized credit programs are inefficient and ultimately bound to fail.

A much sharper criticism of subsidized credit programs is that they cannot survive over the long term. Nancy Barry of Women's World Banking (CGAP, 1995) asserts, for example, that "few low income entrepreneurs end up benefiting from subsidized programs, because these

programs fail before they reach significant numbers." She argues further that "microenterprise financial intermediaries have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding."

Barry's assertion evokes the lessons of past failures. But microfinance advocates have argued strenuously that the new programs are radically different from those of the past. The Grameen Bank, for example, has reached over 2 million borrowers and is still growing and gaining strength. Barry's first assertion is hard to reconcile with the Grameen Bank experience to date.

The second issue is whether subsidized funding will dry up. Since donors and governments remain committed to poverty alleviation as a top priority, advocates are not unreasonable in arguing for allocating some poverty-alleviation funds to support innovative and effective microfinance programs over the long-term. How this will play out exactly is a matter of speculation, but there is no reason to think that concern with poverty alleviation will quickly whither. Nor is there reason to think that support for subsidized microfinance programs will whither -- as long as they remain vigilant in containing costs and maximizing outreach.

A third issue is whether subsidized programs can be efficient. Barry (CGAP, 1996), for example, argues that "efficient financial intermediaries need to charge high rates to cover the costs of making small loans."

Typically, judging institutional performance by profitability gives managers the right incentives. But appropriate incentives can also be provided in non-profit enterprises. Maintaining "hard" budget constraints is the key, not maximizing profits. The two mechanisms are often confused, but it is the former that is critical for efficiency, not the latter. If budget constraints are soft and performance criteria are not carefully specified, managers can expect to be bailed out after poor performances. If constraints are kept hard and performance criteria are made clear, managers must cope with failures, and efficiency can be maintained, even in non-profits.

One important mechanism for achieving efficiency in subsidized programs is to use socially-determined transfer prices and to be rigid in evaluating performance according to those prices. Transfer prices are the internal prices used by institutions to value capital and determine relative performance at branch levels. In a profit-making enterprise, the transfer prices reflect the full value of capital. In a subsidized program, they are shadow prices, adjusted downward so that prices reflect the social gains delivered by lending. The transfer prices can be used to calculate shadow profits. Thus, while bank managers may not be able to lend at an actual profit, they may be able to lend at a net social gain, and efficiency can be achieved by tying their compensation to performance on the basis of transfer prices and shadow profits.

Translating the theory into practice may take creativity and experimentation, but the basic idea can be implemented with simple rules of thumb. This is not an academic dream: most universities and many hospitals run on a not-for-profit basis with purely social objectives. Managers of not-for-profit microfinance institutions can learn from their weaknesses and build on their successes.

Claim 5: Subsidized credit most often ends up in the hands of non-poor households.

A common experience in the credit programs of the 1960s and 1970s was that subsidized credit was often diverted away from poor households. Since the subsidies were valuable, politically powerful groups, usually not poor, muscled their way in and managed to grab a share. The problem was compounded by the fact that most programs were government-run, providing further incentives for misfeasance as the granting of loans was often partly a political payoff (this is discussed further below).

These problems are fully avoided when subsidies are eliminated. But the problems may also be greatly reduced by just partial elimination of subsidies. The concern with targeting introduces a floor to interest rates -- it does not mean that interest rates need be at break-even rates. The floor is determined by the rates at which others (the politically-powerful, say) can get loans. Loans at 0% real rates will seem appealing to them when their alternative, formal sector sources charge 15% per year or less. Loans around 15-20% will seem much less appealing. Rates around 15-20% provide meaningful subsidies for poor households, but they are not seen as gifts. Mis-targeting has thus not been a major concern for those programs providing moderate-sized subsidies. The lesson from the failures of the 1960s and 1970s is to avoid excessive subsidies. The lesson is not to avoid subsidies altogether.

Claim 6: Microfinance has been and should continue to be a movement with minimal government involvement.

Governments in low-income countries have played very little direct role in the microfinance movement, and this has been no accident. The movement is fundamentally an NGO movement, free of many of the political biases of earlier subsidized programs. This creates its own problems, of course. There are good and bad NGOs and often little apparatus for effective oversight, but so far the microfinance track record has allayed most fears.

Governments, though, have played critical indirect roles. The Bank Rakyat Indonesia and Thailand's Bank of Agriculture and Agricultural Cooperatives, for example, are state-owned although run as standard commercial banks. The Grameen Bank, which sometimes finds itself at odds with Bangladeshi politicians, nonetheless obtains loans at concessional rates from the Bangladesh Bank. The spread of microfinance in China will also of necessity proceed with heavy government involvement, at least in the near term (Morduch, Park, and Wang, 1997).

While sustainable programs can afford to eschew government involvement, subsidized programs cannot. Subsidized programs need NGOs, foundations, international donors, or their own governments for funding. If subsidized programs are to continue at current funding levels, they will likely need to rely increasingly on their own governments. Rather than backing away from governments, subsidized programs will need to find modes of constructive engagement. Lessons from past failures suggests that this will require clear understandings of the (sharp) limits to direct government involvement and a commitment to the transparency and accountability of programs.

Claim 7: Mobilizing savings is not likely to make sense for subsidized credit programs.

Household welfare can be greatly improved through the chance to mobilize savings. Early microfinance programs were not effective in mobilizing savings and showed little interest in doing so. Partly, it was thought that poor households were too poor to save. One of the lessons from the recent microfinance experience, however, is that, even poor households are eager to save if given appealing interest rates and/or flexible accounts. The Bank Rakyat Indonesia, for example counted over 16 million low-income depositors by the end of 1996.

Incorporating savings mobilization in microfinance programs makes sense for a variety of reasons (Robinson, 1995). First, it can provide a relatively inexpensive source of capital for re-lending. Second, today's depositors may be tomorrow's borrowers, so a savings program creates a natural client pool. Third, building up savings may offer important advantages to low-income households directly: households can build up assets to use as collateral, they can build up a reserve to reduce consumption volatility over time, and they may be able to self-finance investments rather than always turning to creditors.

Thus, a savings program may be an essential feature of both subsidized and sustainable programs. However, only sustainable programs have been aggressive in mobilizing savings, partly because mobilization can greatly aid the financial bottom line. Subsidized programs have focused on "forced saving" programs, forcing borrowers to put aside a fixed percentage of borrowed money to draw upon in case repayment difficulties arise, rather than mobilizing voluntary savings.

Part of the reason for this imbalance appears to be confusion about interest rate spreads. Part of the subsidy trap described above involved banks charging interest rates r on loans and paying depositors a rate d, which was less than r to avoid further losses. Since r was kept artificially low in the name of welfare maximization, d was kept even lower, and incentives for saving were diminished. The spread $(r-d)$ has thus been the focus of those interested in savings mobilization. Increasing lending rates is clearly helpful here as it allows deposit rates to rise as well.

But this is not the appropriate spread to maximize if the objective is to enhance welfare in a cost-effective manner. A more appropriate spread to watch is $(m-d)$, where m is the rate at which donors obtain funds. Typically, donors subsidize programs at a rate of $(m-c)$ per dollar loaned, where c is the concessional interest rate that subsidized microfinance programs pay for capital. For example, the Grameen Bank obtains funds from the Bangladesh [Central] Bank at just 5-6% while the Bangladesh Bank lending rate has been 14-16% during the 1990s.[8] If the Grameen Bank can mobilize savings at a cost below the Bangladesh Bank's opportunity cost of funds, the social cost of subsidization can be reduced. Ultimately, the spread of concern is $(m - d + a)$, where a reflects the per unit administrative costs of managing and mobilizing savings deposits.

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[8] The Grameen Bank receives funds from many sources at various concessional rates. See Khandker, et al (1995). Bangladesh Bank lending rates are from International Monetary Fund (1996).

Savings mobilization at deposit rates above lending rates can *reduce* the costs of programs, rather than add to them, if donors reward microfinance programs for generating funds at costs lower than m per dollar. One way to do this is to split the difference between donors and programs of $(m - d + a)$ per dollar of savings mobilized and re-lent -- and to reduce concessional lending by donors by one dollar for each dollar of lending thus generated.

Under earlier subsidized credit schemes, everyone lost out through savings mobilization. By implementing the proposed scheme, however, clients, microfinance programs, and donors can benefit substantially from savings mobilization.

There may be practical constraints to savings mobilization, however. Most important is that NGOs are not chartered to hold savings deposits. It is prudent that only tightly-regulated institutions are given the privilege and responsibility of holding savings. This thus creates a problem for microfinance programs (except for BRI and BancoSol, both of which are fully chartered banks). One answer is that fully-chartered savings banks could operate independently but alongside NGOs engaged in lending. The savings banks should have fully independent accounts and funds, and the saving that are mobilized should in no way be tied to lending operations. However, a contractual link to exploit the rebate opportunity above could still be used to reduce costs of subsidization on the lending side.

Both the rebate proposal and the savings bank/microcredit partnership idea need further thought before implementation. But both ideas appear sound in principle and suggest that there may be creative ways around roadblocks.

Research Priorities

Programs based on banking best practices and programs that subsidize borrowers have sharply different research needs. The former have a pressing need to sort out how to incorporate microfinance institutions into broader financial systems. One issue, for example, is how to determine the riskiness of a microfinance institution's lending portfolio. Since microfinance loans are typically uncollateralized, commercial lenders would likely put microfinance portfolios in the very highest risk categories and could be reluctant to provide funds to microfinance programs. However, group-lending practices and dynamic incentive schemes have been effective in lowering the riskiness of the portfolios, and the portfolios may well be much less risky than some collateralized portfolios. The question, then, is how to quantify the risk-reducing characteristics of microfinance loan portfolios. Similar issues of a regulatory nature also need to be broached -- for example, how to achieve financial sustainability where anti-usury laws place caps on interest rates.

All types of programs may be able to learn from studies that explore the effectiveness and costliness of various lending mechanisms -- for example, weekly versus bi-weekly versus monthly payment schedules, lending to individuals versus lending to groups, intensive versus minimal group-lending operations, and increasing loan size quickly or slowly with successful repayment.

Systematic experimentation and evaluation with household-level data can be critical along these lines.

The socially-oriented programs should have careful economic and social evaluations at the top of their research list. Grameen Bank has been a pioneer in this area, with a large, comprehensive evaluation completed in 1991-92 (Pitt and Khandker, 1995). These measured benefits must then be weighed against the full costs of the program so that informed judgements can be made about social value. Some programs will likely look better than alternative uses for poverty alleviation funds and some will look worse. Only with careful impact studies can assignments be made.

It will also be critical to measure the relative incomes and credit demand of potential clients. Thus, the most useful studies will investigate the existing client base as well as those that choose not to participate. The argument about whether financially sustainable or subsidized programs have the greatest impact on poverty comes down to a question about the elasticity of credit demand with respect to the interest rate. This elasticity can only be estimated with information on both borrowers and non-borrowers.

These programs should also be concerned with cost containment and with best addressing the needs of their diverse client bases. In this context, continuing to draw lessons from financially sustainable programs will be critical.

The role of competition is an issue of growing importance. Practitioners need to know much more about problems that arise when multiple programs -- some subsidized, some not -- coexist. One priority here is to better integrate the idea of borrowers "graduating" from small scale (possibly subsidized) programs to becoming clients of larger scale commercial banks. One possible way to do this is to reduce subsidies with the scale of lending and number of loans, so that graduation is a smooth process out of subsidized programs and into commercial banks.

Conclusions

The microfinance movement offers much promise for alleviating poverty and for filling gaps in financial systems. The movement encompasses diverse programs, all of which focus on lending money to poor households. Some programs have made financial sustainability the chief goal, and others have centered on economic and social impacts. There appears to be ample room, however, for a diversity of programs, with competing lending methods and financial arrangements.

The present paper attempts to clarify one important source of the diversity, the split between programs centering on financial development and those centering on the economic and social impacts on households and communities. While there is much common ground, there are also some critical differences. The split has hindered constructive dialogues between the two groups, and it has fostered misconceptions about the potential for subsidized programs.

Running effective and efficient subsidized programs is less straightforward than running profitable programs -- although neither is ever simple. One key is that efficiency requires hard budget constraints, not necessarily profit-maximizing behavior. A second key is that problems of mis-targeting place a floor below interest rates on lending; this may be necessary even if it sharply reduces optimal subsidies. A third key is that it is possible to mobilize savings aggressively without adding to the costs of subsidized credit programs. Instead, savings mobilization can be a powerful way to reduce costs. These arguments stand in opposition to "lessons" of failed programs of the past. And the arguments suggest that there is much to learn about optimal subsidization from programs that have eschewed subsidies.

As Hulme and Mosley (1996, p.135) conclude,

> Ironically, it is the success of the `first wave' finance-for-the-poor schemes, and particularly the Grameen Bank, that is the greatest obstacle to future experimentation. Most designers and sponsors of new initiatives have abandoned innovation, and `replication' is leading to a growing uniformity in financial interventions.

This paper has mapped avenues to pursue in rethinking microfinance to date and in constructing foundations for a next wave of microfinance innovation.

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