Editorial: Don't expect too much of microfinance

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HOW IS MICROFINANCE PORTRAYED to borrowers and to the interested public? A route out of poverty? Easy money? Donor organizations often portray microfinance as business loans that provide the first step out of poverty. And in the UK and other developed countries, the payday lending industry has often advertised loans as easy money without the hurdles imposed by formal banking.

Our view of microfinance should be more qualified. Microfinance is just a service, one that can be used at critical times such as to pay for food before the next pay cheque comes in or for medicine when the breadwinner falls ill, but nevertheless just a service that does not make the actual pay cheque any bigger or lessen vulnerability to illness. If we accept these more limited claims for microfinance, and forget the allure of microfinance magic, then we can begin to appreciate just how successful microfinance has been – in a limited way.

In this edition, Adams and Vogel treat us to a view of microfinance from the standpoint of a few decades. They describe the mistakes made in agricultural lending programmes in the 1960s: interest rates were set low during times of high inflation, which meant that fewer loans could be made on each cycle, leading to defaults and the eventual closure of the funds. The microfinance industry has learned from past mistakes – and they mention many more – and is now to a large degree self-sustaining, and able to serve hundreds of millions of poor people. However, most microfinance loans, even the ones that are used on businesses rather than diverted to consumer spending, do little to boost incomes significantly. Many microfinance borrowers are women trading in local markets, next to other women trading the same goods with low profit margins, and it takes more than a loan to transform this situation. Adams and Vogel write 'Loans do not make up for the lack of fertile soil or water, eradicate weeds, compensate for bad policies, cure endemic diseases, reduce road ruts, make unprofitable investments profitable, substitute for the lack of law-and-order, or compensate for bad schools.' They identify savings as more important than loans for these customers who will often prefer not to incur debt but would like to build up a small cushion for the future.

Our Crossfire debate sheds light on microfinance from a UK perspective by discussing the proposition 'Payday lenders and similar businesses provide an essential service at a reasonable price'. Russell Hamblin-Boone of the Consumer Finance Association is defending the interest of lenders trying to make a profit from a sector that attracts quite high transaction costs, and Fraser Sutherland of Citizens Advice Scotland is arguing for the protection of low-income borrowers, who often

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borrow when they can't afford to repay the high loan costs, and end up deep in debt. Interestingly both agree that there is a need for flexible, short-term loans, that aren't available to some people from banks. But they also agree that customers with insufficient income should be screened out by responsible lenders.

Remittances are another microfinance service that has expanded dramatically over the last two decades, though many still use informal methods for sending money home. Jones describes how domestic migrants from a tribal community in India often send money back home in envelopes with trusted messengers. A banking correspondent model using cellphones to remit funds has potential, but will only work if the procedures are clear and the agents are at least as trusted as the messenger with the envelope.

Hoback and Ulrich provide a rare glimpse into the microfinance scene in Nigeria. Microfinance in this country is unusual for being dominated by deposit-taking microfinance banks, regulated by the Central Bank of Nigeria, rather than by NGO-MFIs. At first sight the presence of institutions within the formal banking sector that will accept deposits as well as offering microfinance loans looks positive, in line with what Adams and Vogel are calling for. However, the authors' research reveals that many of the banks do not yet live up to their social goals of serving low-income people, and the motivation and orientation of staff as well as governance are key areas that must be addressed.

In contrast to the papers on microfinance, Mugova and Cornish describe a loan-guarantee scheme to facilitate larger loans to small and medium enterprises, this time in the road-building sector of Uganda. Inducing banks to lend to SMEs is at least as difficult a task as lending to microfinance clients. Even so, Mugova and Cornish point to significant changes in the road building sector, including 'crowding in' of both SME road-building firms and banks willing to lend to them. Doubtless there are also benefits in terms of jobs in road-building as well as new infrastructure that will benefit everyone.

The next edition of *EDM* is devoted to SME financing – an area that has not expanded to the same extent as microfinance, but arguably has a greater potential to provide a 'route out of poverty' for owners and employees.

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