Authors
Leah Stern

What do we really know about microfinance?

Depending on whom you ask, with almost 200 million borrowers around the world, microfinance might be the best thing ever to happen to international development or an overhyped and dangerous intervention. Microfinance, the largest trend in international development in years, remains mostly unproven; it's a realm of heartwarming stories and vague ideas about why and how it should work – and for whom. And after a spate of stories in 2009 and 2010 about the potential pitfalls, many people involved with international development are wary of unexpected consequences.

In the interest of figuring out exactly what we know – and don't know – about microfinance, IPA has partnered with the Abdul Latif Jameel Poverty Action Lab (J-PAL) at the Massachusetts Institute of Technology (MIT), the Financial Access Initiative (FAI), and Consultative Group to Assist the Poor (CGAP) to publish a new paper on the topic. The paper takes a broad view of emerging patterns in what we know about microfinance thus far, based on a survey of randomized trials in microfinance in the last several years.

The evidence suggests that the truth lies in the in-between: Microfinance works really well sometimes – but not always. It works for some people the way we thought it might, and for others in ways we didn't anticipate. For some people, microfinance doesn't seem to have any measurable effect.

It reminds me of the frequent features in tabloids: "Stars, They're Just Like Us." Perhaps the international development field should start inverting this saying: instead, it should be "Poor People, They're Just Like Us." People in developing countries seem to use microfinance in many different ways, depending on a variety of factors in their lives including what business they're in and whether they want to start a business, whether they have family support, how much money they make, and what kinds of products they're being offered. Microcredit has different implications than microsavings and microinsurance, and each of these products may be appropriate in different situations. And it's easy to see that the same is true in the lives of people in the US. We make decisions based on the available products, but also based on our personal temperaments and situations.

Here are just a few of the lessons learned so far.

As the paper says, "Not every borrower is a microentrepreneur." Microcredit as it is typically formulated seems to work in two different ways. First, it works well, and as it was predicted to work, for people who successfully grow businesses. When they have access to microcredit, those people tend to reduce personal spending and invest more in their businesses, and they tend to see their businesses grow. However, most people don't use microcredit, even when it's readily available: in Hyderabad, India (**Banerjee, Duflo, Glennerster, & Kinnan 2010**) and in rural Morocco (**Crépon, Devoto, Duflo, and Pariente 2011**), less than one in five people took out a loan, even when they had new branches of microfinance banks in their communities.

Second, microcredit works as consumer credit to help people who are not entrepreneurs make different decisions on how to spend their resources. Microcredit can help some people spend more money on food and other important household consumables, absorb shocks like an illness or injury, and make household investments in education, durable goods, or home improvements. These are still valuable ways for people to use financial services, even if they're not the ways we expected to see the funds used, and they can make people's lives better. (**Banerjee, Duflo, Glennerster, & Kinnan 2010**, and **Karlan & Zinman 2010**)

Access to microcredit seems to increase access to other sources of credit, including informal credit, because it allows people to build up a history of paying back loans on time and in full. The same mechanisms are at play in credit scores in developed countries. (**Karlan & Zinman 2010 and 2011**)

Poor people need access to savings accounts in addition to credit opportunities. In Bumala, Kenya, a village bank offered a savings account with no interest on deposits and substantial withdrawal fees. This would be an unappealing option in a developed nation, where most citizens have access to interest-earning, low-fee savings accounts, but in Bumala, more than half of the community opened an account and made at least one deposit. And those women in the community who used the account saved more, invested more in their businesses, and were better able to cope with serious illnesses. The effects here were much stronger for women, unlike the studies mentioned above, which had no specific effects on women's empowerment or finances. (**Dupas & Robinson 2011**)

Design of financial products matters. Many microfinance recipients don't use their loan – or don't use the full amount – for business expenses. Particularly for women, giving them equipment or inventory may help them more than a cash loan, but it seems to help larger businesses more than smaller ones – as did the loans in the Hyderabad study. For some borrowers, a grace period seems to help them increase their profits, but for others, grace periods merely increase the chance that they'll default. It may be more important to figure out how to identify what kind of borrower a client will be, and to tailor services accordingly, as do banks in developed countries. (**Field, Pande, Papp, & Rigol 2011**)

People in developing countries don't always make what we might think are rational savings decisions, just like people in developed countries. They may not save because the future is unknown, because they don't have the self-control to follow through, because they don't always foresee their future needs, or because they don't see the point when they'll just have to share their money with family and community members. All of these reasons sound familiar to anyone who has had trouble making a decision whether to save or spend – be it on budget, diet, or time and energy.

Timing of reminders, coupons, and other instruments can help people make good decisions at the right time. And some potential clients for important financial services such as rainfall insurance don't buy the product because they don't have the funds when they need to spend the money, or because they don't trust the provider – both relatable reasons for anyone contemplating a major purchase, even if they know that the item will pay off in the long run. (**Giné, Menand, Townsend, & Vickery 2010**)

A group of researchers and writers combed through recent and ongoing randomized studies on microfinance to produce this overview of what we know about how to make microfinance work. The studies were done by IPA, FAI, and our partner, J-PAL, and IPA's own Nathanael Goldberg and Dean Karlan contributed to the report.

We hope that this paper will provide a summary of the existing groundwork laid by these studies, and that the field will continue to build on our knowledge to understand why microfinance works for some people but not for others.

Want to know more about research and results on microfinance? Download the paper to read about each of the studies mentioned above in more detail. Check out IPA's work on microsavings on our website and proven solutions for commitment savings and reminders to save. You can also find more information on CGAP's website.

December 06, 2011