The Economist

Finance for the poor

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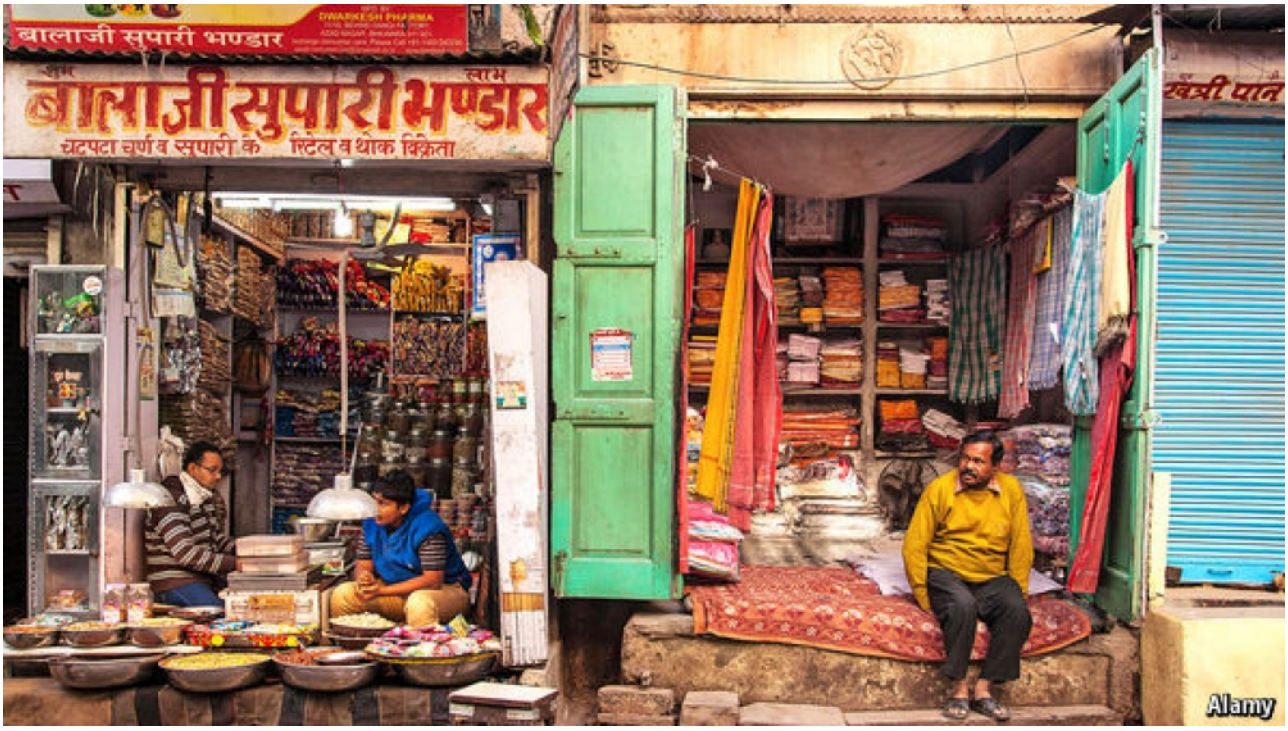
Microlending is booming once again. If it is to help people out of poverty, though, it needs to work much better



Print edition | International Oct 6th 2016 | LUCKNOW

ON A shelf in Buland Iqbal's tiny roadside shop, cassette tapes are slowly turning pale in the sun. Nobody wants them these days, even in a dusty suburb in one of India's poorest states. So Mr Iqbal has branched out. First he moved into renting DVDs, then, more boldly, into pay-television. A loan of 31,000 rupees ($465) from Sonata, a microfinance firm, helped him acquire a few satellite dishes and decoder boxes. It seems like a clear-cut success for microlending. In fact, Mr Iqbal's loan illustrates why microlending does not work all that well, and how it needs to change.

The idea of springing people from poverty by advancing them small amounts of money is old: in the 1720s the author Jonathan Swift was lending to "honest, sober and industrious" men in Dublin. But the modern template was created in the 1970s.

Grameen, a Bangladeshi outfit, encouraged poor women who lacked collateral to form small groups in which each borrower was liable for all the others' debts. Groups met weekly and handed their payments to a loan officer. Astonishingly few defaulted. By transferring tasks normally done by well-paid bankers to poor people, Grameen had brought costs down so much that it could afford to lend tiny amounts.

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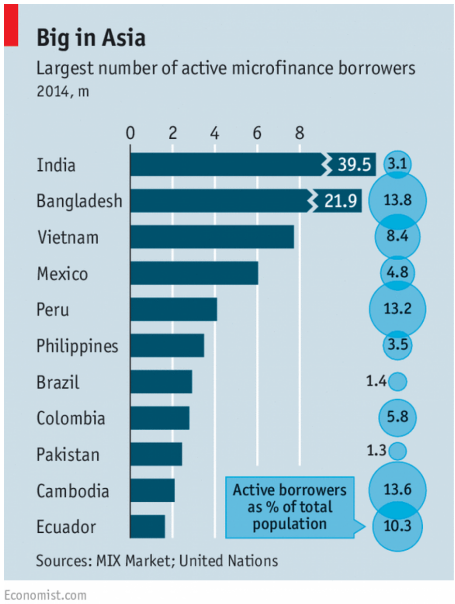
Grameen Bank and Muhammad Yunus, its founder, were jointly awarded the Nobel peace prize in 2006. Almost immediately, microlending ran into trouble. The poor women in the borrowing groups proved as ruthless as any bailiff: researchers turned up stories of delinquents forced to sell livestock and cooking pots to make weekly payments. Soon came over-indebtedness and mass defaults in the Indian state of Andhra Pradesh, in Pakistan and in Nicaragua, where the president, Daniel Ortega, sided with the "no pago" movement.

Then the "randomistas" put the boot in. In 2015, after examining the results of randomised controlled trials in Bosnia, Ethiopia, India, Mexico, Morocco and Mongolia, American researchers questioned whether microlending worked at all. As expected, offering small loans increased business investment. But it had a negligible effect on poor people's fortunes. Borrowers seemed to cut back on wage work in order to spend more time bent over their sewing machines or running their small, not terribly profitable shops.



These days international donors and charities are
much more excited about other approaches, including mobile money and "graduation" programmes, which give livestock to indigent people and teach them how to take care of them. As the development caravan rolls away, though, microlending is booming. MIX, which collects data on the industry, estimates that the number of borrowers worldwide grew by 16% between 2014 and 2015, to 130m. The total loan portfolio is now worth about $96 billion. In India, which has more microborrowers than any other country, lending was 64% higher in the second quarter of this year than a year earlier, according to MFIN, a national industry body.

In Latin America (the biggest market for microloans by value, though not by number of borrowers) and Africa, much microlending is funded by deposits. That slows its growth, as raising deposits from people quickly is hard. But Indian microloans are funded largely by bank debt. Microlenders borrow at an average cost of just under 15% and usually charge interest of 20-25%. By law, the large ones may not lend at more than 10% above their cost of funds.

Succeeding in such a constrained market means becoming big and efficient. The large lenders increasingly sign up clients using tablet computers and allow repayments through terminals in local shops. They can reach more remote districts that way, and need not open so many branches. They still have plenty of room to grow. Only 6% of Indians borrowed from a formal lender in 2014, according to the World Bank, whereas 14% went to a loan shark.

If capturing new clients is essential to success in microlending, creating new loan products is not. "There is zero innovation," says Ratna Vishwanathan, the head of MFIN. "It's a vanilla product". That is a shame because, although small loans are plainly popular and do no economic harm to the average borrower, they could equally plainly do a much better job of helping people become less poor.

Like many tiny businesses, Mr Iqbal's shop swings up and down. He can be extremely busy around Hindu festivals, when people like to shop, but is idle at other times (when your correspondent arrives at his shop, he is napping). In the slowest months, he cuts back spending on himself and his family until he can scrape together enough for the monthly payment. And he knows to take on only as much debt as he can service in the lean season. At this rate, he is no more likely to prosper than he is to default on his loan.

Mr Iqbal enjoys more freedom than most. He repays monthly rather than weekly and has borrowed not in a group but individually, with two friends as guarantors. His loan might be unusually large as a result. Anup Kumar Singh, Sonata's managing director, says that peer pressure in groups tends to shrink loans: many people doubt their acquaintances will repay large debts. Individual microloans have long been common in Latin America, and seem to be spreading in South Asia. But assessing individual borrowers is expensive. Lenders cannot afford to do much of it until technology brings the cost down (see article (http://www.economist.com/news/international/21708254-microlending-might-work-better-if-it-were-more-impersonal-cash-call)).

An excess of caution

What tiny entrepreneurs like Mr Iqbal really need are microloans that can be repaid when their businesses start bringing in more money. An experiment in Kolkata by two American researchers, Erica Field and Rohini Pande, found that offering borrowers a grace period of just two months at the beginning of a microloan doubled the rate at which new businesses were created. Borrowers were able to take bigger risks, which brought bigger rewards on average. After three years business profits were 41% higher and household incomes were up by 19.5%. If microlending could routinely deliver results like that, it would still be the height of fashion.

IFMR Lead, a research organisation based in India, is now testing an even more flexible loan. In conjunction with Sonata, it is offering a few hundred people microloans with two three-month "holidays". Borrowers will still have to pay something each month, but much less than usual. So far, about a third of borrowers offered these loans have taken them up, even though they carry a slightly higher interest rate. Encouragingly, the more competent entrepreneurs seem keenest on them.

Lenders will want to know one thing above all: does more freedom cause more loans to go bad? In Kolkata, default rates for borrowers who were given two months' grace went up from 2%—fairly standard for a microloan—to 9%. If further research confirms that flexible loans are risky, microlenders will struggle to offer them: they cannot cover their increased costs by raising interest rates because these are often capped. The loan officers will probably keep turning up in new villages with their tablet computers, hawking the same old products.

One hint that microlending can get out of its rut comes from the fields of Africa. One Acre Fund, a charity, offers small farmers a bundle of seeds, fertiliser, crop insurance and training, all on credit. Its loans are extremely flexible. Although the charity expects some repayment before it hands out seeds and fertiliser, farmers can pay off the balance at any point in the year. With no weekly or monthly payments looming, they might play the market, holding back crops from sale until prices rise. One Acre Fund boasts a low default rate, and calculates that it boosted its clients' farm incomes by 55% in 2015. But the parallel is not perfect. One Acre Fund offers more than just loans—and it depends on donations.

In many countries, lifting restrictions on interest rates would encourage lenders to create better products. A calibration of expectations would help, too. Microlending has gone from being the silver bullet to end poverty, to the poor man's snare, to largely ignored. It would be better to think of it as a vital work in progress.