

Applying the Concept: Helping the Poor with Microfinance

Over 20 percent of the world's population lives in extreme poverty. That's more than one billion people living on less than \$1 per day. Raising the extreme poverty threshold to \$2 per day more than doubles the number of poor people to 2.7 billion. These people live in South Asia, Sub-Saharan Africa, and East Asia. Together, India and Bangladesh have more than 400 million people living on less than the equivalent of \$1 per day.

Many of the more fortunate among us have a clear desire to help. Traditionally aid was provided in the form of grants and loans to governments. This hasn't worked well. Instead of building institutions capable of supporting productive economic activity, funds have often be diverted into projects that aid very few of a country's inhabitants. In other cases, aid funding was simply stolen outright by corrupt bureaucrats and leaders.

Attempts at traditional bank lending failed as well. It cost too much to lend to poor households. They saved too little to repay loans and had no collateral to pledge in the case of default. In the end, the poor have remained very poor.

Recently, a new type of financial institution has developed. Started in Bangladesh in the late 1970s and since imitated around the world, these banks lend directly to the poor in very small amounts. Loans as small as \$75 repaid over several months or a year are made with no collateral. Borrowers use the funds to support self-employment activities for things like buying materials to produce bamboo furniture. Critically, the typical loan is made to a group rather than to an individual. The members of the group are collectively responsible for the repayment. Collective responsibility helps overcome the information asymmetries – adverse selection and moral hazard problems – that plague lending agreements. And while real interest rates of 20 percent plus are needed to cover the fixed costs of making and monitoring the loan, repayment rates are typically over 90 percent.

By 2005, the World Bank estimated that there were seven thousand microfinance institutions serving 16 million people. The oldest of these is the Grameen Bank in Bangladesh. In 2003, the last year for which data are currently available, they reported making over \$3 billion in loans to

3.7 million borrowers with an average loan amount equal to more than twice per capital annual GDP. In a culturally conservative, traditionally male-dominated country, 96 percent of borrowers are women with loan repayment rates of 98 percent. Their average loan amount equals more than twice per capital annual GDP in the country.

Some people have noted that microfinance institutions are unlikely to be profitable. In fact, the Banco Solidario in Bolivia that runs on a for-profit basis has moved away from small loans and now focuses on automobile and mortgage lending – bigger, collateralized loans. But maybe the point of microfinance shouldn't be about turning a profit in a conventional sense. Maybe it should be the focus for the aid that rich countries provide to the billions of people living in extreme poverty who do not have access to the traditional financial system. Today microfinance institutions are helping people not only in Bangladesh and Bolivia, but in China, Ethiopia, Honduras, Thailand, and even Arkansas. And while it is too early to tell conclusively, there are indications that small loans have contributed to lower rates of poverty as well as healthier and better educated children.
