

IRDIP	Integrated Rural Development Program (India)
MBB	<i>Microbanking Bulletin</i>
MFI	microfinance institutions
NGO	nongovernmental organization
PROGRESA	Programa de Educación, Salud y Alimentación (Mexico)
RBI	Reserve Bank of India
ROSCAs	rotating savings and credit associations
SEWA	Self-Employed Women's Association (Ahmedabad, India)
UNDP	United Nations Development Program
USAID	United States Agency for International Development

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Rethinking Banking

1.1 Introduction

Every day about a hundred people go to work in an unassuming brick office building in the Mohammedpur neighborhood of Dhaka, the main office of ASA—the Bengali word for hope and the acronym of the Association for Social Advancement. ASA is a nongovernmental organization (NGO) that at the end of 2003 provided banking services to nearly 2.3 million customers in Bangladesh. Unlike many commercial banks, ASA's present headquarters contains no marble floors and no plush rugs. Accounting procedures are so streamlined that the accounting department is housed in a single room where thirteen staff members keep an eye on the numbers for the entire operation. If the headquarters is surprising, the clients are even more so. Target clients are the wives and mothers of landless laborers and small-scale farmers with average monthly incomes around \$50, borrowing on average around \$120 per loan. Traditional commercial banks avoid this population. First, the loans are so small that profits are typically hard to find, and, second, lending seems risky since the borrowers are too poor to offer much in the way of collateral. But in 2003 ASA reported loan recovery rates of 99.9 percent, and their reported revenues have fully covered costs in every year since 1993.¹

ASA and institutions like it challenge decades of thinking about markets and social policy in low-income communities. For many observers, microfinance—a collection of banking practices built around providing small loans (typically without collateral) and accepting tiny savings deposits—is nothing short of a revolution or a paradigm shift (Robinson 2001). To others, microfinance is still to be fully developed and tested by time. Few will disagree, though, that microfinance has already shaken up the world of international development. One of the

most striking elements is that the pioneering models grew out of experiments in low-income countries like Bolivia and Bangladesh—rather than from adaptations of standard banking models in richer countries.

Entrepreneurs, academics, social activists, and development experts from around the world have been drawn to microbanks and NGOs like ASA. They are attracted by the lessons about retail banking through microfinance, as well as by the promise that banks like ASA hold for getting much-needed resources to underserved populations.² Scores of doctoral dissertations, master's theses, and academic studies have now been written on microfinance. Some focus on the nontraditional contracts used to compensate for risks and to address information problems faced by the microlenders. Others focus on microfinance as a way to better understand the nature of markets in low-income economies—with possible lessons for how to supply insurance, water, and electricity through markets rather than through inefficient state-owned companies. Still others focus on the ways that microfinance promises to reduce poverty, fight gender inequality, and strengthen communities. This book provides a critical guide to some of the most important new ideas.

The ideas give reasons for hope. Banks and NGOs like ASA are flourishing at a time when the effectiveness of foreign aid to ease the burdens of the world's poor faces fundamental questions (e.g., Boone 1996; Easterly 2001). Governments around the world routinely face criticism for at times being corrupt, bloated, and uninterested in reform. Against this background, banks and NGOs like ASA offer innovative, cost-effective paths to poverty reduction and social change.

ASA is not the only microlender flourishing in rural Bangladesh. ASA's management could learn from the experiences of the pioneering Grameen Bank and from BRAC (formerly the Bangladesh Rural Advancement Committee), now Bangladesh's largest microlender. By the end of 2003, Grameen had 3.1 million members and BRAC had 3.9 million. In Bangladesh, microlenders collectively serve roughly 10–12 million clients, nearly all of which had been written off by commercial banks as being “unbankable.”³

The institutions anchor a movement that is global and growing. Microfinance programs have created new opportunities in contexts as diverse as villages along the Amazon, inner-city Los Angeles, and war-ravaged Bosnia. Programs are well-established in Bolivia, Bangladesh, and Indonesia, and momentum is gaining in Mexico, China, and India.

Table 1.1
Growth of microfinance coverage as reported to the Microcredit Summit Campaign, 1997–2001

End of year	Total number of institutions	Total number of clients reached (millions)	Number of “poorest” clients reported (millions)
1997	618	13.5	7.6
1998	925	20.9	12.2
1999	1,065	23.6	13.8
2000	1,567	30.7	19.3
2001	2,186	54.9	26.8
2002	2,572	67.6	41.6

Source: Daley-Harris 2003, Table 1.

Table 1.1 shows the results of a survey conducted by the Microcredit Summit Campaign. By the end of 2002, the campaign had reports of 67.6 million microfinance clients served worldwide by over 2,500 microfinance institutions. Of these clients, 41.6 million were in the bottom half of those living below their nation's poverty line (defined as “the poorest”; Microcredit Summit 2003). Between 1997 and 2002, the numbers grew on average by about 40 percent per year, and the movement's leaders expect to continue expanding as credit unions, commercial banks, and others enter the market.

Microfinance presents a series of exciting possibilities for extending markets, reducing poverty, and fostering social change. But it also presents a series of puzzles, many of which have not yet been widely discussed. One aim of this book is to describe the innovations that have created the movement. Another aim is to address and clarify the puzzles, debates, and assumptions that guide conversations but that are too often overlooked. Debates include whether the poorest are best served by loans or by better ways to save, whether subsidies are a help or a hindrance, whether providing credit without training and other complements is enough, and which aspects of lending mechanisms have driven successful performances. Many of the insights from the microfinance experience can be seen fruitfully through the lens of recent innovations in economics (especially the economics of information, contract theory, and the mechanism design approach). Other microfinance insights point to areas where new research is needed, especially around possibilities and constraints for saving by the poor and for estimating social impacts.

Another aim of the book is to tackle the myths that have made their way into conversations on microfinance. The first myth is that microfinance is essentially about providing loans. In chapter 6 we argue that providing better ways for low-income households to save and insure can be as important. But we take issue with the argument that, for the poorest, saving is *more* important. The second myth is that the secret to the high repayment rates on loans is tied closely to the use of the group lending contracts made famous by Bangladesh's Grameen Bank and Bolivia's BancoSol. (Grameen's original approach is described in section 1.4 and in chapter 4.) Group lending has indeed been a critical innovation, but we note emerging tensions, and in chapter 5 we describe a series of innovations in contracts and banking practices that go beyond group lending. We believe that the future of microfinance lies with these less-heralded innovations—along with the focus on female customers (discussed in greater detail in chapter 7) and the improved management practices described in chapter 10.

The third myth is that microfinance has a clear record of social impacts and has been shown to be a major tool for poverty reduction and gender empowerment. We believe that microfinance can make a real difference in the lives of those served (otherwise we would not have written this book), but microfinance is neither a panacea nor a magic bullet, and it cannot be expected to work everywhere or for everyone. Relatively few rigorous studies of impacts have been completed, and the evidence on statistical impacts has been mixed so far. There is not yet a widely acclaimed study that robustly shows strong impacts, but many studies suggest the possibility. Better impact studies can help resolve debates, and chapter 8 describes approaches and challenges to be confronted in pushing ahead.

The final myth is that most microlenders today are both serving the poor and making profits. We show in chapter 9 that profitability has been elusive for most institutions, and we describe why good banking practices matter—and how subsidies can be deployed strategically to move microfinance forward.

Unlike most discussions of microfinance oriented toward practitioners, we do not begin by describing new microfinance institutions.⁴ We will have much to say about recent innovations later, but our approach begins instead with the nature of poverty and the markets and institutions that currently serve poor households. By beginning with households, communities, and markets, we develop analytical tools and insights that can then be used to think about the new insti-

tutions, as well as to think about directions that go beyond current approaches.

1.2 Why Doesn't Capital Naturally Flow to the Poor?

From the viewpoint of basic economics, the need for microfinance is somewhat surprising. One of the first lessons in introductory economics is the principle of diminishing marginal returns to capital, which says that enterprises with relatively little capital should be able to earn higher returns on their investments than enterprises with a great deal of capital. Poorer enterprises should thus be able to pay banks higher interest rates than richer enterprises. Money should flow from rich depositors to poor entrepreneurs.

The "diminishing returns principle" is derived from the assumed concavity of production functions, as illustrated in figure 1.1. Concavity is a product of the very plausible assumption that when an enterprise invests more (i.e., uses more capital), it should expect to produce more output, but each additional unit of capital will bring smaller and smaller incremental ("marginal") gains. When a tailor buys his first \$100 sewing machine, production can rise quickly relative to output

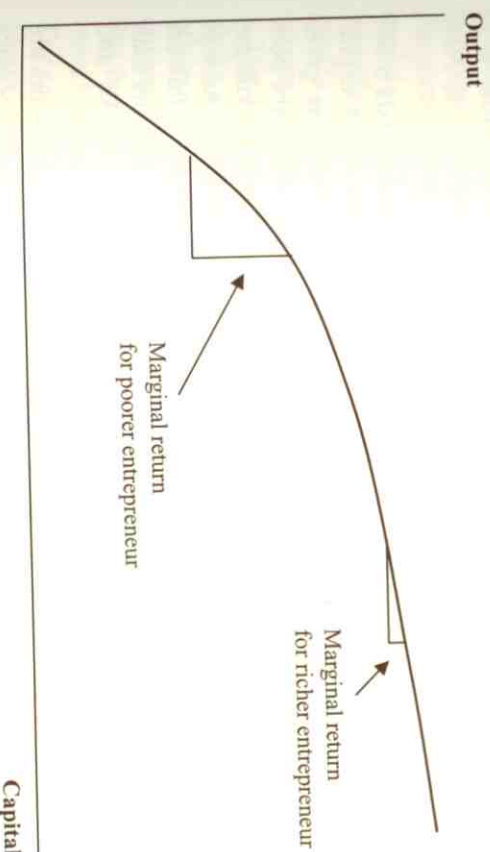


Figure 1.1 Marginal returns to capital with a concave production function. The poorer entrepreneur has a greater return on his next unit of capital and is willing to pay higher interest rates than the richer entrepreneur.

possible when using only a needle and thread. The next \$100 investment, say for a set of electric scissors, will also bring gains, but the incremental increase is not likely to be as great as that generated by the sewing machine. After all, if buying the scissors added more to output than the sewing machine, the wise tailor would have bought the scissors first. The size of the incremental gains matter since the marginal return to capital determines the borrowers' ability to pay.⁵ As figure 1.1 shows, concavity implies that the poor entrepreneur has a higher marginal return to capital (and thus a higher ability to repay lenders) than a richer entrepreneur.

On a larger scale, if this basic tool of introductory economics is correct, global investors have got it all wrong. Instead of investing more money in New York, London, and Tokyo, wise investors should direct their funds toward India, Kenya, Bolivia, and other low-income countries where capital is relatively scarce. Money should move from North to South, not out of altruism but in pursuit of profit. The Nobel-winning economist Robert Lucas Jr. has measured the extent of the expected difference in returns across countries (assuming that marginal returns to capital depend just on the amount of capital relative to other productive inputs). Based on his estimates of marginal returns to capital, Lucas (1990) finds that borrowers in India should be willing to pay fifty-eight times as much for capital as borrowers in the United States. Money should thus flow from New York to New Delhi.⁶

The logic can be pushed even further. Not only should funds move from the United States to India, but also, by the same argument, capital should naturally flow from rich to poor borrowers *within* any given country. Money should flow from Wall Street to Harlem and to the poor mountain communities of Appalachia, from New Delhi to villages throughout India. The principle of diminishing marginal returns says that a simple cobbler working on the streets or a woman selling flowers in a market stall should be able to offer investors higher returns than General Motors or IBM or the Tata Group can—and banks and investors should respond accordingly.

Lucas's ultimate aim is to point to a puzzle: Given that investors are basically prudent and self-interested, how has introductory economics got it wrong? Why are investments in fact far more likely to flow from poor to rich countries, and not in the other direction? Why do large corporations have a far easier time obtaining financing from banks than self-employed cobblers and flower sellers?

The first place to start in sorting out the puzzle is with risk. Investing in Kenya, India, or Bolivia is for many a far riskier prospect than investing in U.S. or European equities, especially for global investors without the time and resources to keep up-to-date on shifting local conditions. The same is true of lending to cobblers and flower sellers versus lending to large, regulated corporations. But why can't cobblers and flower sellers in the hinterlands offer such high returns to investors that their risk is well compensated for?

One school argues that poor borrowers can pay high interest rates in principle but that government-imposed interest rate restrictions prevent banks from charging the interest rates required to draw capital from North to South and from cities to villages.⁷ If this is so, the challenge for microfinance is wholly political. Advocates must only convince governments to remove usury laws and other restrictions on banks, then sit back and watch the banks flood into poor regions. That is easier said than done of course, especially since usury laws (i.e., laws that put upper limits on the interest rates that lenders can charge) have long histories and strong constituencies.

Reality is both more complicated and more interesting. Even if usury laws could be removed, providing banks with added freedom to serve the poor and cover costs is not the only answer. Indeed, as we show in chapter 2, raising interest rates can undermine institutions by weakening incentives for borrowers. Once (lack of) information is brought into the picture (together with the lack of collateral), we can more fully explain why lenders have such a hard time serving the poor, even households with seemingly high returns. The important factors are the bank's incomplete information about poor borrowers and the poor borrowers' lack of collateral to offer as security to banks.

The first problem—adverse selection—occurs when banks cannot easily determine which customers are likely to be more risky than others. Banks would like to charge riskier customers more than safer customers in order to compensate for the added probability of default. But the bank does not know who is who, and raising average interest rates for everyone often drives safer customers out of the credit market. The second problem, moral hazard, arises because banks are unable to ensure that customers are making the full effort required for their investment projects to be successful. Moral hazard also arises when customers try to abscond with the bank's money. Both problems are made worse by the difficulty of enforcing contracts in regions with weak judicial systems.

These problems could potentially be eliminated if banks had cheap ways to gather and evaluate information on their clients and to enforce contracts. But banks typically face relatively high transactions costs when working in poor communities since handling many small transactions is far more expensive than servicing one large transaction for a richer borrower. Another potential solution would be available if borrowers had marketable assets to offer as collateral. If that were so, banks could lend without risk, knowing that problem loans were covered by assets. But the starting point for microfinance is that new ways of delivering loans are needed precisely because borrowers are too poor to have much in the way of marketable assets. In this sense, for generations poverty has reproduced poverty—and microfinance is seen as a way to break the vicious circle by reducing transactions costs and overcoming information problems.⁸

1.3 Good Intentions Gone Awry: The Failures of State-Owned Development Banks

The lack of banks does not mean that poor individuals are unable to borrow. They do—but from informal sources such as moneylenders, neighbors, relatives, and local traders. Such lenders often have the rich information (and effective means of enforcing contracts) that banks lack. Their resources, however, are limited. Microfinance presents itself as the latest solution to the age-old challenge of finding a way to combine the banks' resources with the local informational and cost advantages of neighbors and moneylenders. Like traditional banks, microfinance institutions can bring in resources from outside the community. Microfinance is not the first attempt to do this, but it is by far the most successful.

The success of microfinance depends in part on studiously avoiding the mistakes of the past. As low-income countries attempted to develop their agricultural sectors after World War II, rural finance emerged as a large concern then too. Large state agricultural banks were given the responsibility for allocating funds, with the hope that providing subsidized credit would induce farmers to irrigate, apply fertilizers, and adopt new crop varieties and technologies (e.g., Reserve Bank of India 1954). The hope was to increase land productivity, increase labor demand, and thereby to increase agricultural wages.

Heavy subsidies were also deployed to compensate the banks for entering into markets where they feared taking huge losses due to high

transactions costs and inherent risks. The subsidies were also used to keep interest rates low for poor borrowers. In the Philippines, for example, interest rates charged to borrowers were capped at 16 percent before a reform in 1981, while inflation rates were around 20 percent annually (David 1984). The negative real interest rates created excess demand for loans, adding pressure to allocate loans to politically favored residents, rather than to target groups. Meanwhile, the interest rates offered to rural depositors were only about 6 percent per year, so inflation eroded the purchasing power of savings at a rate of about 14 percent per year. The policies, not surprisingly, turned out disastrously. David (1984, 222) concludes that in the Philippines "credit subsidies through low interest rates worsen income distribution because only a few, typically well-off farmers, receive the bulk of the cheap credit. When interest rates are not allowed to reflect costs of financial intermediation, wealth and political power replace profitability as the basis of allocating credit." Rather than delivering access, the policies have been blamed for creating financial repression (McKinnon 1973).⁹

India's Integrated Rural Development Program (IRDP) is, to many, a too perfect example of inefficient subsidized credit. The program allocated credit according to "social targets" that in principle pushed 30 percent of loans toward socially excluded groups (as signified by being a member of a "scheduled" tribe or caste) and 30 percent toward women. Achieving social goals became as important as achieving efficiency. Under the system, capital was allocated according to a series of nested planning exercises, with village plans aggregating to block plans aggregating to district plans aggregating to state plans. Subsidies between 1979 and 1989, a period of rapid IRDP growth, amounted to \$6 billion (roughly 25 percent to 50 percent of loan volume made to weak sectors). Those resources did not generate good institutional performance. According to Pulley (1989), IRDP repayment rates fell below 60 percent, and just 11 percent of borrowers took out a second loan after the first (which is particularly striking given the importance accorded to repeat lending by microfinance practitioners). In 2000, the IRDP loan recovery rate fell to just 31 percent (Meyer 2002).¹⁰ As institutional performance dramatically weakened, the IRDP failed to be a reliable and meaningful source of services for the poor.

In the late 1970s and early 1980s, the Rural Finance Program at Ohio State University launched a devastating critique of government-led development banks like the IRDP and the Philippine programs.¹¹ Its

starting point was that credit is not like fertilizer or seeds. Instead, the critics argued, credit should be thought of as a fungible tool of financial intermediation (with many uses) and not as a specific input into particular production processes. Thus one problem, according to the critics, came from mistakenly believing that credit could be "directed" to particular ends favored by policymakers (e.g., expanding the use of high-yielding crop varieties). And that, coupled with cheap credit policies, created havoc in rural financial markets and ultimately undermined attempts to reduce poverty (Adams, Graham, and Pischke 1984). The story hinges on a failure to adequately account for the incentive effects and politics associated with subsidies. Subsidizing banks, it was argued, made those banks flabby by creating monopolies and removing market tests.

Thus, critics of the subsidized state banks argue that poor households would often have been better off *without* the subsidies. This is in part because, first, subsidized banks pushed out informal credit suppliers on which the poor rely. Second, the market rate of interest is a rationing mechanism—those who are willing to pay for credit are only those with projects that are most worthy. But with subsidies driving interest rates well below market rates of interest, the rationing mechanism broke down. Credit was no longer allocated to the most productive recipients, but instead was often allocated on the basis of politics or social concerns. Good projects thus went unfunded. Third, bankers' incentives to collect savings deposits were diminished by the steady flow of capital from the government, so poor households were left with relatively unattractive and inefficient ways to save. Fourth, the fact that the banks were state banks led to pressure to forgive loans just before elections, to privilege the powerful with access to cheap funds meant for the poor, and to remove incentives for management to build tight, efficient institutions. Braverman and Guasch (1986) conclude that government credit programs in Africa, the Middle East, Latin America, South Asia, and Southeast Asia have, "with a few exceptions," ended up with default rates between 40 percent to 95 percent. And at such rates, borrowers can be excused for seeing the credit programs as providing grants rather than loans. The misallocation of resources happened so regularly that Gonzalez-Vega (1984) dubs it the "iron law of interest rate restrictions."

Critics hold that these kinds of subsidies undermined the poor, although the evidence from India at least provides a more nuanced picture. New empirical work by Burgess and Pande (2002), for

example, shows net positive average impacts on the poor in India.¹² Similarly, Binswanger and Khandker (1995) find that between 1972–1973 and 1980–1981 the state banks in India increased nonfarm growth, employment, and rural wages. Still, the Indian programs have been clearly inefficient, and a great deal of money that was originally targeted to the poor ended up being wasted or going into the wrong hands. As a result, Binswanger and Khandker find only modest impacts on agricultural output and none on agricultural employment, and they conclude that the costs of the government programs were so high that they nearly swamped the economic benefits. More than any positive historical precedent, it is the repudiation of these negative legacies that has driven the microfinance movement to look to the private sector for inspiration.

1.4 The Grameen Bank and the Beginnings of Microfinance

The roots of microfinance can be found in many places, but the best-known story is that of Muhammad Yunus and the founding of Bangladesh's Grameen Bank. We briefly tell the story now and return to Grameen's experience in later chapters.¹³

In the middle of the 1970s, Bangladesh was starting down the long road to build a new nation. The challenges were great: Independence from Pakistan had been won in December 1971 after a fierce war, and two years later widespread flooding brought on a famine that killed tens of thousands (Sen 1981). Government surveys found over 80 percent of the population living in poverty in 1973–1974 (Bangladesh Bureau of Statistics 1992).

Muhammad Yunus, an economist trained at Vanderbilt University, was teaching at Chittagong University in southeast Bangladesh. The famine, though, brought him disillusionment with his career as an economics professor. In 1976, Yunus started a series of experiments lending to poor households in the nearby village of Jobra. Even the little money he could lend from his own pocket was enough for villagers to run simple business activities like rice husking and bamboo weaving. Yunus found that borrowers were not only profiting greatly by access to the loans but that they were also repaying reliably, even though the villagers could offer no collateral. Realizing that he could only go so far with his own resources, in 1976 Yunus convinced the Bangladesh Bank, the central bank of Bangladesh, to help him set up a special branch that catered to the poor of Jobra. That soon spawned another

trial project, this time in Tangail in North-Central Bangladesh. Assured that the successes were not flukes or region-specific, Grameen went nation-wide. One innovation that allowed Grameen to grow explosively was group lending, a mechanism that essentially allows the poor borrowers to act as guarantors for each other. With group lending in place, the bank could quickly grow village by village as funding permitted. And funding—supplied in the early years by the International Fund for Agriculture and Development, the Ford Foundation, and the governments of Bangladesh, Sweden, Norway, and the Netherlands—permitted rapid growth indeed. As figure 1.2 shows, the bank grew by 40 percent per year at its peak. By 1991 the Grameen bank had over one million members in Bangladesh, and by 2002 the number had swollen to 2.4 million. Today, replications exist in thirty countries, from East Timor to Bosnia.¹⁴ Group lending programs also operate in thirty of the fifty states in the United States.¹⁵

Grameen's group lending contract works very differently than a standard banking contract for small business. In a standard relationship, the borrower gives the bank collateral as security, gets a loan from the bank, invests the capital to generate a return, and finally pays the loan back with interest. If borrowers cannot repay, their collateral is seized. But Grameen clients are most often too poor to be able to offer collateral; instead, the Grameen contract takes advantage of the client's close ties within their community. To take advantage of those relationships, the loan contract involves groups of customers, not individuals acting on their own. The groups form voluntarily, and, while loans are made to individuals within groups, all members are expected to support the others when difficulties arise.

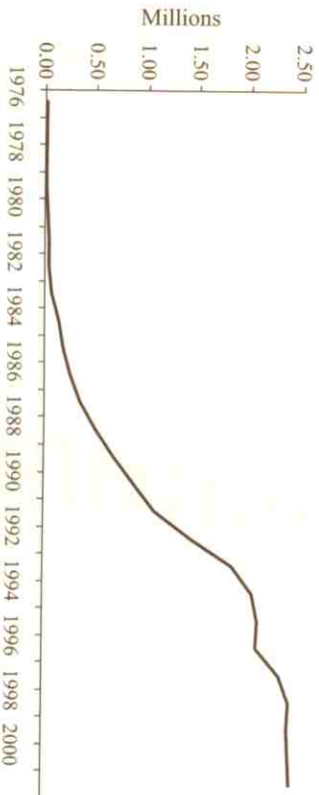


Figure 1.2

Growth in Grameen Bank membership, 1976–2001.

Source: Grameen Bank, *Annual Reports* (various years).

The groups consist of five borrowers each; loans go first to two members, then to another two, and then to the fifth group member. As long as loans are being repaid, the cycle of lending continues. But, according to the rules, if one member defaults and fellow group members do not pay off the debt, all in the group are denied subsequent loans.¹⁶ This feature gives customers important incentives to repay promptly, to monitor their neighbors, and to select responsible partners when forming groups (Fugelsang and Chandler 1993). Moreover, the five-member group is part of a “center” composed of eight groups. Repayments are made in public, that is, before the forty members of the center, in weekly installments. Group lending thus takes advantage of local information, peer support, and, if needed, peer pressure. The mechanisms rely on informal relationships between neighbors that facilitate borrowing for households lacking collateral (Besley and Coate 1995; Armendáriz de Aghion 1999a). The program thus combines the scale advantages of a standard bank with mechanisms long used in traditional modes of informal finance.

The “joint liability” condition is the most celebrated feature of the Grameen contract, and it is why microfinance is so closely associated with the idea of group lending. Economic theorists have been intrigued by Grameen’s contracts, and there has been an outpouring of research, beginning with Stiglitz (1990), on how joint liability works.¹⁷ Throughout the 1990s, however, we have witnessed a growing diversity of approaches that go well beyond group lending with joint liability. As we argue in chapter 5, although Grameen Bank’s “joint liability” contract gets much attention, there are other, often overlooked, features of the lending relationship that make the Grameen model different from the textbook bank example. In particular, Grameen creates “dynamic incentives” and generates information by starting with very small loans and gradually increasing loan size as customers demonstrate reliability. In addition, the bank uses an unusual repayment schedule: Repayments usually begin just a week after the initial loan disbursement and continue weekly after that; this makes the contract look much closer to a consumer loan than a business loan and changes the nature of the risk that the bank is taking on—and the service that it is providing. Beyond these economic mechanisms, Grameen has found that not only does having a customer base that is 95 percent female improve social impacts, but it may also reduce the financial risk for the bank, an issue to which we return in chapters 5 and 7. While traditional banks have historically lent nearly exclusively to men, women make up the

bulk of Grameen borrowers and they are often more reliable customers than their husbands (Khandker 1998).

Disentangling how the various mechanisms work matters, since what works in Bangladesh may work less well in Brazil or Uganda. Even in rural Bangladesh a variety of approaches are being employed. ASA, for example, started with group lending in 1991, with twenty-person groups (rather than five-person groups) and a highly standardized process. In the beginning, ASA's members took loans in the same amount as one another and thus repaid the same each week, and also saved the same amount. But ASA's program has become far more flexible, one outcome of which has been to reduce reliance on the joint liability contract. ASA's repayment rates have not suffered at all.¹⁸ In other countries different methods are used, including the use of collateral—but often on more flexible terms than a standard bank would use. In general, the use of "individual lending" (as opposed to group lending) methods is gaining ground. We unpack these mechanisms and models in chapters 4 and 5.

1.5 A Microfinance Revolution? From "Microcredit" to "Microfinance"

One of the most important departures has involved the shift from "microcredit"—which refers specifically to small loans—to "microfinance." The broader term embraces efforts to collect savings from low-income households, to provide insurance ("microinsurance"), and, in some places (BRAC in Bangladesh has pioneered here), to also help in distributing and marketing clients' output. Robinson (2001) provides a rich description of a "microfinance revolution" that is just beginning.¹⁹

While the words *microcredit* and *microfinance* are often used interchangeably, they have different resonances and are loosely attached to contrasting beliefs about the state of rural finance and the nature of poverty. The small difference in language signals, for some, a big difference in opinion.²⁰ Microcredit was coined initially to refer to institutions like the Grameen Bank that were focusing on getting loans to the very poor. The focus was explicitly on poverty reduction and social change, and the key players were NGOs. The push to "microfinance" came with recognition that households can benefit from access to financial services more broadly defined (at first the focus was mainly on savings) and not just credit for microenterprises. With the change in

language has come a change in orientation, toward "less poor" households and toward the establishment of commercially oriented, fully regulated financial entities.

The push to embrace savings is a welcome one, because it recognizes the pent-up demand for secure places to save, and in that context, the shift from microcredit to microfinance should not be contentious. Debate arises, though, with the relatively new (and wrongheaded in our belief) argument that in fact the poorest customers need savings facilities *only*—that making loans to the poorest is a bad bet.²¹ (So much for the principle of diminishing returns to capital!)

The debate drags up the legacy of the "exploitative moneylender" on one side and the legacy of the subsidized state banks on the other. In the process it also brings out tensions that run through academic work on household consumption patterns in rural areas. Those who see informal moneylenders as exploitative are sensitive to the powerlessness of poor borrowers (e.g., Bhaduri 1973, 1977). But, as Basu (1997) argues, the question then becomes: Why do the poor remain powerless? If only borrowers could tuck away a bit of money at regular intervals, eventually they would accumulate enough to get out from under the clutches of the moneylender.²² Bhaduri's response is that the very poor are so close to subsistence that saving is impossible—all extra resources need to go into consumption.²³ Loans not savings, are thus essential.

Against this is the argument that, to the contrary, even the very poor can save in quantity if only given the chance. The fact that they have not been, it is argued, is due to "mistaken" beliefs along the line of Bhaduri (1973) and the fact that subsidized state banks never made a serious effort to collect saving deposits, leading some to wrongly infer that the lack of savings is due to inability, not lack of opportunity (Adams, Graham, and von Pischke 1984). Moreover, Adams and von Pischke (1992) argue that very poor households can seldom productively use loans. Exactly counter to Bhaduri, they argue that savings facilities (and not loans) are thus critical for the poorest. Only the "less poor" should thus be the target of microlending.²⁴ The precepts that were the basis of the early microfinance movement have thus been turned on their head.

In chapter 6, we attempt to steer between these two poles of rhetoric. Our view is that the very poor can profit from having better ways to both save and borrow—although the belief, for now, rests more on inference than on direct evidence. In chapter 6, we also consider new

