Introduction and Overview[1]

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Early attempts to innovate in the rural financial markets (RFMs) were motivated by the urgent need to curb the role and operations of the moneylender. In the 1950s, it was envisaged that the state should 'provide a positive institutional alternative to the moneylender himself, something which will compete with him, remove him from the forefront and *put him in his place*' (RBI 1954, emphasis added). For the next 30 years the state provided massive doses of credit to the agricultural sector (where the bulk of the poor are located) on concessional terms, often negative in real terms, through either cooperatives or state-run banks. It had limited success. Apart from its contribution to rural non-farm growth in India, specifically targeted agricultural credit was of doubtful benefit (Binswanger and Khandker 1992). By and large, the moneylender stayed where he was, but in 'several guises' (Bell 1993), and the state-subsidised credit hardly ever reached the poor, generated economic rents and inefficiencies, and was financially unsustainable.

There is now widespread consensus that problems in state intervention in RFMs arose as much from interest-rate ceilings as from distorted incentives and weak governance structures of the public-sector financial institutions. The 'new synthesis of the 1990s' (Lipton 1998) recognises that interest rates should not be so 'distorted' by public action that they cease to correctly reflect costs and risks of lending (Chowdhury 1992; Rahman 1992; Aleem 1993). However, lending to the poor is expensive, and costs can be high, especially for formal lenders, if the cost of information on the borrower's ability and willingness to repay is not easily available. Informational problems may lead to market failure, and, in the absence of a collateral, the poor may be unable to borrow at all. Thus, the cost of credit market failure is likely to be highest for the poorest, who are least able to self-insure and self-finance.

Over the last two decades, Grameen Bank and other microfinance institutions (MFIs)[2] have

[1] Useful comments from Michael Lipton, Arjan de Haan, Imran Matin and Shahin Yaqub are gratefully acknowledged. The usual disclaimers apply.

[2] Micro-finance institution is used as a collective term for Grameen Bank (which is now a full-fledged bank) and non-governmental organisations (NGOs) that provide financial services to their members.

devised innovative credit programmes to address market failure and deliver credit to the poor. MFIs use peer monitoring and the joint liability structure to overcome the screening, monitoring and enforcement problems commonly encountered by formal lending institutions. They deliver small loans to poor borrowers, often women organised into small groups, providing more accessible deposit facilities and with much greater attention to risk management. Targeted micro-credit programmes have a strong antipoverty focus as they aim to increase incomes and smooth consumption. Enthusiastic and large-scale support for these innovations from multilateral and bilateral donors has ensured a rapid growth of the MFIs across the world[3] and they have now emerged as antipoverty instruments in many low-income countries' (Khandker).

This IDS Bulletin examines three key themes in current research on micro-credit: *impact*, *targeting* and *sustainability*. Much of the recent debate revolves around these themes and any future development of the 'micro-credit lending technology' will have to address the issues relating to impact, targeting and sustainability of the programme.

But before that two clarifications are due. First, the terms micro-credit, microfinance and micro-enterprise credit are used interchangeably in much of the literature.[4] However, micro-credit refers to small loans, whereas microfinance is appropriate where NGOs and MFIs supplement the loans with other financial services (savings, insurance, etc.). On the other hand, the major limitation of the term 'micro-enterprise credit' is that it seems to ignore loan fungibility by assuming that all credit reaching a household corresponds to an equivalent rise in investment in micro-enterprises.[5] Even though the MFIs discussed may also provide financial services, the discussion in this volume is focused on issues surrounding provision of credit to small borrowers. Second, while attempts have been made to maintain regional neutrality, critical readers may discern a 'Bangladesh-bias' in the selection of papers. To some degree that is inevitable since 'Bangladesh probably offers the best-documented and most varied efforts to reach the poor through financial mechanisms' (Von Pischke *et al.* 1997).

1 Measuring Impact

Impact assessments are usually promoted by donors keen to assess whether support of micro-credit programmes is 'good value for money'. For this it is necessary to 'prove impact' on the intended beneficiaries. This is not always easy. An immediate question is impact on what? Impact may be measured on income, wealth, food security, child nutrition, quality of life or gender relations (Copestake 1995). Johnson argues that the tools of impact assessment have so far neglected an assessment of effects which go beyond users, or the institutions which serve them, to the nature and functioning of financial markets. This may be because micro-credit programmes are currently promoted as a strategy for both poverty alleviation and women's empowerment (RESULTS 1997). This section reviews the impact of these programmes on poverty and on women's empowerment.

On poverty

The impact of micro-credit programmes on poverty is notoriously difficult to measure. Targeting credit to the poor is one of many instruments for poverty reduction. Broad-based economic growth policies, food-for-work, and targeted wage employment schemes are non-credit instruments that also help reduce poverty. Is the marginal impact on poverty from the supply of micro-credit higher, therefore, than it would be if some or all resource inputs were transferred from micro-credit to the best alternative instrument for poverty reduction? Additionally:

1. Money is fungible and it is difficult to isolate

[3] According to World Bank (1996), there are more than 900 active micro-finance programmes in 101 different countries. Based on a survey conducted in September 1995 which included 206 programmes from 900 institutions, total lending is nearly $7 billion and with deposit mobilisation of over $19 billion.

[4] Three new terms have recently seeped into the terminology: 'credit' (which is the equivalent of 'micro-credit'), 'credit plus' (which refers to credit plus assistance by the MFI on the technology side, e.g. marketing, to help the enterprise), and 'credit plus plus' (which is credit linked to social development activities such as conscientisation and awareness-building practised by BRAC and Proshika for example) – Greeley (personal comm.).

[5] Ito (1998) has discussed the conceptual confusion surrounding the use of the terms 'micro-credit' and 'micro-enterprise credit'.

credit impact. Do participants have more stable and higher incomes than before? Than non-participants? It is possible to compare the income of control groups of non-participants and participants. But, as Khandker points out in his paper, it is difficult to estimate whether the increased income is due to programme participation, or would have occurred in any case.

2. The definition of 'poverty', how it might be measured and who constitute the 'poor' are fiercely contested issues. Is poverty largely about increasing incomes and consumption or is it about a much broader set of needs that encourage well-being? (Hulme and Mosley 1996). In spite of its many advantages, it is widely acknowledged that 'income is an inadequate measurement of welfare' (Greeley 1994). The broader view of well-being recognises that additional credit to a poor household may increase its capacity to bear risks and reduce the cost of insurance. This may then enable households to invest in new, more risky, but profitable, enterprises and asset portfolios, including the build-up of human capital through education, for example (Zeller *et al.* 1997). Alternatively, consumption smoothing through improved credit access may increase well-being while having little impact on a household's mean income (Zeller *et al.* 1997; Sinha and Matin).[6] Similarly, indirect impacts on nutritional levels, or on women participants' bargaining power or empowerment as indicated by their mobility or increased contraceptive use (Schuler *et al.* 1997) all contribute to well-being.

Given their goal of poverty reduction through income and employment generation, it is surprising that only a few studies (Hossain 1988; Rashid and Townsend 1994; Pitt and Khandker 1996; McKernan 1996) have systematically evaluated the impact of targeted credit schemes on productivity, incomes or living standards of borrowers. Repayment rates, the scale of operation and growing levels of institutional sustainability have been used as proxy indicators of the success of the schemes. A growing body of literature (Sebstad and Chen 1996 for example) casts doubt on the reliability of these indicators as a measure of impact. While improved access to credit frequently reduces short-term hardship and enhances income, there is little evidence of an on-going process of accumulation based on improved productivity and capacity (Dawson 1997). Khandker emphasises the importance of panel data to assess whether short-term impacts can be sustained over time, and to understand how participant behaviour may change with length of programme participation.

There is also a distributional issue in assessing poverty impact since it is likely that, because of programme externalities, benefits to the poor are generated at the expense of others. That is, do the programmes which make those who get credit better off, make others worse off? Clearly, much more nuanced research is required to address these questions.

On empowerment

It is argued that credit programmes empower women by strengthening their economic roles, increasing their ability to contribute to the family's income, helping them establish their identity outside of the family, and giving them experience and self-confidence in the public sphere. For Bangladesh, Hashemi *et al.* (1996) show that participation in Grameen Bank and BRAC is positively associated with a woman's level of empowerment, defined as a function of her relative physical mobility, economic security, ability to make various purchases on her own, involvement in major household decisions, relative freedom from domination within the family, political and legal awareness, and participation in public protests and political campaigning. The study concluded that involvement in credit programmes does empower rural women. Critics (notably Ackerley 1995; Montgomery *et al.* 1996; Goetz and Sengupta 1996) argue that the patriarchal social structure in most developing countries precludes women's empowerment through provision of credit and, under some circumstances, may even worsen their situations. Often, women's incomes are controlled by men. All the same, lending to women still enhances household welfare (Pitt and Khandker 1996), and the issue of impact of targeted credit on women's empowerment is far from resolved.

[6] That is, if a household is in an average year just above the poverty line, and credit reduces fluctuations while not affecting mean income, then the percentage of time that the household is in poverty falls – and so do incidence, intensity and severity of poverty.

The real issue is not so much that many women hand over their loans to men, but the broader one of finding new and productive economic roles for women so that more women can use their loans themselves (ADB 1997). Unless progress is made on this front, 'a simple emphasis on disbursing loans to women is likely to encourage tokenism and the reinforcement of gender roles' (Hulme and Mosley 1996).

Osmani uses the concept of 'breakdown position' to assess the impact of minimalist credit on women's relative well-being within the household. Based on Sen's idea about 'cooperative conflict' and the 'fall-back position', breakdown position represents the welfare of individuals in the event of a breakdown of co-operation. It reflects the strength, or vulnerability, of a person in the bargaining process.[7] The stronger a woman's 'breakdown position', the stronger her bargaining power and hence the better her welfare outcome. The article argues that the relative well-being of women depends on their respective bargaining power, which in turn is a function of their 'breakdown position', perceived contribution to the household, and perceived self-interest.

Osmani's results show that women's access to credit has improved their breakdown position,[8] but seems to have had little or insignificant impact on women's perceived contribution and perceived self-interest. Osmani cites two reasons for this partial improvement in women's well-being:

1. Women's limited ability, arising from a lack of mobility, skills and economic opportunities, to independently manage large credit volumes, leads to increased dependence upon their husbands. This suggests that women's independence and control over loans decrease as loans get bigger. Thus, loan size needs to be factored in while assessing impact on women's empowerment. But small loans, if specific to women, do less to raise their 'value to men' than do big loans. So maybe empowerment is not the right thing to be looking for: poverty reduction and shifts in women's rate of market engagement could be enough.

2. Exposure to income-earning activities in a single generation cannot perhaps wipe out centuries of cultural conditioning. This is absolutely critical in interpreting results of studies that rush to claim a definite positive impact of credit access on women's empowerment. The results need to be tempered by an understanding that indeed it is too ambitious to expect centuries of social and cultural oppression and male domination to be overcome by a few years of participation in a group activity and exposure to income-earning opportunities. After all, the 'Grameen Bank ... lends to some women who have never before even held money in their hands' (Von Pischke *et al.* 1997). Clearly, directing credit to poor rural women alone may be unable to lead to empowerment, unless several requirements are met jointly ('Principle of Joint Requirements' – Lipton 1998). Women need credit. But women's improved access to credit will have to be accompanied by a number of additional measures, such as non-formal education, skill upgradation, and social and political consciousness-raising to challenge the patriarchal social structure, if credit access is to facilitate women's empowerment. The playing field is only now beginning to be levelled, it will take more time and sustained effort before the scores are also level.

But there is also a methodological issue: how well can existing methods measure empowerment?

Mayoux is critical of the conventional methodologies often used to assess the various complexities of 'empowerment', which is a tricky concept: difficult to define, identify or measure. It is unlikely that existing quantitative methods can realistically assess the impact on empowerment. Hashemi *et al.* (1996) have used eight indicators to measure empowerment, but it is not evident whether they tally with women's own perceptions of empowerment.[9] For

[7] If the breakdown of negotiations would have disastrous consequences for a person, he/she would be eager to accommodate the other person's interest in order to save the negotiation from breaking down. This would ensure that the other person would gain an upper hand at his/her expense, when the final outcome is settled.

[8] Breakdown position is measured by three indicators: (i) land owned by the wife in her own name, (ii) the wife's non-land assets, and (iii) whether the wife thinks she can support herself if left alone.

[9] This is akin to Jodha's (1988) finding that households in Rajasthan who became income-poorer during 1963/6–1982/4 regarded themselves as being better off in terms of their *self-defined* criteria of the quality of their lives.

example, women may score well on most or all of the eight indicators but still not 'feel' empowered. Further, Hashemi's study completely ignores the life-cycle effect by which older women[10] often have fewer restrictions on mobility, greater economic security, freedom to make purchases, freedom from domination within the family, greater contribution to major household decisions, and greater all-round awareness. This suggests that women's empowerment would occur in any case and, at least for older women and female heads of households, cannot necessarily be attributed to targeted credit programmes.

At the same time, a review of recent evaluations into the effectiveness of credit programmes in addressing women's empowerment produces conflicting results. According to Kabeer (1998), the conflict arises because the evaluations are based on differing models of power in the context of gender relations, and none of them examine impact from the perspectives of poor, rural women themselves.

Mayoux extends these arguments and proposes the use of a participatory learning approach (PLA) for integrating women's concerns into any assessment of impact on women's empowerment. PLA begins by examining women's own priorities and strategies rather than using an externally-imposed set of indicators. This itself would contribute to empowerment. First, programme staff would be given a more representative and reliable exposure to the priorities and problems of programme participants. Second, it would develop networks and a forum for discussion between women themselves on issues relevant to their interests and integrated into programme decision making. In spite of some costs, the approach would be an important contribution to long-term programme sustainability and wider institutional development.

2 Targeting

Micro-credit programmes maintain their poverty-focus by using an exogenous eligibility criterion to screen out non-poor groups. Usually a land-based criterion is selected since land ownership is often correlated with wealth in rural areas. Zaman questions the use of a land-based targeting criterion, especially since it may include the non-poor (such as teachers, shopkeepers) who are land poor (the inclusion error), and/or exclude the landed poor (the exclusion error). All the same, it is widely agreed[11] that landlessness is a fair approximation for poverty in Bangladesh. Successful targeting is assumed to be a proxy for the programme's success. But Besley (1997) contends that inclusion of the non-poor may be necessary to a limited degree to prevent them from capturing benefits meant for the poor. Analysing data from BRAC's Rural Development Programme, Zaman extends Besley's argument to assert that an inflexible implementation of the targeting criterion to exclude the non-poor can be detrimental to the poor. At the same time, target households may themselves be keen to include, in their group, one or two non-target group members for help to ensure on-time loan repayments.

Given the targeting indicator chosen by the programme, why does mis-targeting occur? Is it purely exogenous or a consequence of MFI policy? Has it increased over time? Matin answers these questions by relating the cause of mis-targeting among Grameen Bank borrowers to rapid increases in loan size (also called credit deepening) since the introduction of seasonal loans in 1992. These loans can be held in addition to the general loan and have led to a sudden jump in the average loan size per borrower. Thus, recent members (those who joined after 1992) own significantly more land than pre-1992 members. While they may still be poor or the 'vulnerable non-poor' (Zaman's argument), larger landownership indicates that these households are likely to divert a smaller proportion of the MFI loan to smooth consumption (and repay loans) and use the bulk of it for investment in economic activities. Sinha and Matin establish that non-target group households in Madhupur (Bangladesh) use 33 and 30 per cent of the MFI loan respectively for consumption (and debt-servicing), and investment in agriculture and business enterprises. The comparative figures for target-group households, on the other hand, are 63 and 20 per cent.

[10] As do female heads of households.

[11] See Ravallion and Sen (1994) on scope and limits of land-based targeting in Bangladesh.

Matin's central argument is that the increase in loan size creates incentives for the principal stakeholders (non-target group households, MFIs, and target-group households) to encourage mis-targeting, explicitly or implicitly (Table 6 of Matin's paper). Reduced likelihood of default by the non-target group households (with increasing loan sizes) seems to be an important incentive for MFIs to begin to include the less poor (i.e. those just below or above the poverty line). Loan delinquency has emerged as a critical issue, since in spite of the hype, repayment rates do not hover around 98 per cent. Though there has been no systematic research, micro-studies (notably, Matin 1998) and private conversations reveal a steady increase in default rates[12] at a time when donors have begun to insist that MFIs achieve financial sustainability. Under these circumstances, what can an MFI do? Sustainability is difficult to attain through interest rates increases since the type of activities funded by most MFIs limit the return on investments. Overly high interest rates may also be perceived to increase project failures, drive out safe projects and attract risk-taking investors (Yaqub). A better alternative may be to lend larger amounts (i.e. increase the volume of money circulation) to borrowers more likely to invest in productive enterprises in order to get higher returns and therefore, less likely to default. Typically, these borrowers will be marginal farmers, possess some skills and education and have an existing income source (a shop or an enterprise).

This approach is pragmatic from another perspective. There is considerable evidence that targeted credit programmes do not benefit (i.e. reduce poverty of) the poorest of the poor. For them, 'Other targeted programmes would be required to address their specific needs' (Hashemi 1997). So shifting of the target group to the marginal farmer category (the not-so-poor or the vulnerable non-poor), may be the only way for the MFIs to achieve their twin goals of poverty reduction and financial sustainability. Thus, the 'mutually assured mis-targeting' as reported by Matin, could be an early indicator of a silent shift in emphasis of targeted credit programmes from exclusive antipoverty towards primarily financial sustainability with a bit of poverty reduction on the side.

3 Sustainability

A current central concern is to reconcile how MFIs can *continue* to lend, without recourse to subsidised funds (i.e. be sustainable), to *more* poor people (i.e. increase outreach). This concern is largely due to the high cost of MFI operations and declining subsidised funds (World Bank 1996). But declining subsidies is not exogenous. It seems to have come about as a result of:

(i) high repayment rates achieved by poor borrowers in the early years in spite of borrowing at near-market rates of interest, along with
(ii) an inability to convincingly establish that 'a dollar spent on targeted credit has a greater impact on poverty than a dollar spent on alternative policies' (van de Walle 1997).

From (i) it would be tempting to argue that since the poor manage to repay loans borrowed at near-market rates, there is little reason for them to continue to receive subsidised public funds. Instead, subsidies should move to other areas such as basic health care, primary education, food-for-work and public employment programmes. But this argument is fallacious since it is the (often modest) subsidies to reduce the administrative or transaction costs of lending, and not the subsidisation of interest rates, that increase the poor's access to 'market' credit (Gaiha 1993; Lipton 1998) for reasons explored by Stiglitz and Weiss (1981).

And as (ii) indicates, despite claims, there is little empirical evidence that increasing outreach has indeed reduced poverty. Future impact assessment studies will have to address this challenge.

Financial sustainability is regarded as a means of increasing outreach since 'sustainability today is outreach to the poor tomorrow' (Gonzalez-Vega, quoted in Von Pischke *et al.* 1997). A key finding of a recent study is that, with very few exceptions, microfinance programmes that have pursued financial sustainability have achieved far greater outreach than programmes that have provided subsidised credit and relied on continuing donor support to make up the resulting losses (Christen *et al.* 1995). This is confirmed by Seibel and Parhusip who analyse the performance of Bank Shinta Daya, a

[12] Various reasons for declining repayment rates have been analysed by von Pischke *et al.* (forthcoming).

private rural bank in Java (Indonesia). Using a combination of individual and group-lending technologies, the bank has been able to increase its outreach (through the latter), while maintaining its profitability (through the former). The authors conclude that only financially viable institutions can sustainably reach the poor in significant numbers. But it is not clear why they should do so since if sustainability is desired, and shown to be achieved by directing loans to the non-poor, this practice will be encouraged for ever.

McNamara and Morse on the other hand, present the problems faced by a Nigerian NGO – the Diocesan Development Services (DDS) – when a major donor tried to push rapidly for attaining financial sustainability. It almost threatened to derail the years of good work by the DDS as it tried to cope with the sudden change in approach by the donor. This article highlights the various problems which arise when attainment of financial sustainability becomes the centre-piece of donor strategy. Credit provision is often only one of the many activities undertaken by NGOs which are multi-purpose organisations. An over-emphasis on financial sustainability can threaten other activities (such as agricultural advice, awareness on AIDS, TB and the handicapped, and input supply) with disastrous consequences for poverty and welfare.

Conceptually, financial sustainability can be achieved by increasing either breadth (number of clients served with different kinds of instruments) or depth (poverty level of the clients) of outreach.[13] However, this is only partially successful.

First, increasing breadth by increasing membership can involve high transaction costs for the MFI because of increased staff time, infrastructure, processing and follow-up costs. These costs can further increase, as in Bangladesh, where there is intense MFI competition, with a large number of MFIs chasing a limited number of potential borrowers.[14] Thus, there is an upper bound on the breadth of outreach imposed by search and expansion of client membership.

Second, the potential for increasing the depth of outreach is limited. In Bangladesh for example, only about 50–55 per cent of the target-group households in a village are MFI members.[15] This maybe because the non-members rightly think that their welfare will grow faster without MFI-membership, or that their lack of access to land, physical capital, or skills needed will make it difficult for them to obtain a return above the rate of MFI interest.

These have important policy implications for the MFI which then has little option but to work towards attaining sustainability by increasing the loan portfolio of existing clients.[16] This has been discussed in the previous section. Put on a treadmill of continuously increasing loan size, poor borrowers cross-finance their MFI and informal loans.[17] But this can be unsustainable in the long term[18] if households continuously manage loan repayment with a limited ability to repay. The latter arises from the household's resource profile, economic opportunities within and around the village, or the macro-economic and policy environment. Each factor, alone or in combination, can impose limits on the marginal return to capital (Sinha and Matin). Moreover, since most loans are used primarily for non-farm activities, limitations on the expansion of the non-farm sector sets a limit on the amount of credit that can be utilized profitably. Expansion of credit alone (i.e. outreach) will not create new employment opportunities for the poor but may undermine credit viability.

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[13] This categorisation relies on Christen (1997) and Yaron *et al.* (1997).

[14] Matin (this volume) reports of more than 30 NGOs providing credit in his study area in northern Bangladesh.

[15] Of these about two-thirds are usually Grameen Bank members.

[16] Wiig (1997) refers to this process as capital deepening which arises when additional credit is made available to current borrowers from existing institutions.

[17] The target-group households (in Sinha and Matin's study) used 35 per cent of the value of the MFI loan and 45 per cent of the informal loan for debt-servicing. The figures dropped to 15 and 18 per cent respectively for non-target group households.

[18] If members borrow cheaply (say, at 20 per cent) from the MFI to repay expensive (say, at 50 per cent) informal loans, it does not automatically constitute a debt trap. However, it may become a trap if the MFIs have an incentive to overlend.

4 Emerging Challenges

Three sets of issues seem central across targeted micro-credit programmes that aim to reduce poverty in developing countries.

1) **Targeting**. It is probably meaningful to assess the various targeting instruments and their relevance to targeting the poor before addressing the issue: What percentage of MFI members are poor?
2) **Impact**. It is likely that MFI intervention may reach the poor but not benefit them. Thus, it is important to assess what effect the money is having on poverty. But impact indicators are difficult to measure. Output indicators, such as outreach, loan repayment rates or financial viability, are only second-best since they assume that a certain output achieves a certain impact. As the preceding discussion suggests, mis-targeting limits the outreach to the poor but might help the MFI attain sustainability. And, high loan repayment rates may tell us very little about whether borrowers use loans to increase their incomes. So output indicators cannot be true measures of the impact on poverty. Improving methods for examining the impact of micro-credit on poverty is an immediate challenge.
3) **Sustainability**. MFIs should aim to work towards attaining financial viability since attempts to reduce poverty will prove fragile and non-replicable when the MFIs no longer receive public funds. However, allocation of public funds for micro-credit programmes should be judged more on the basis of economic sustainability of the public investment than on financial sustainability of the MFI.[19]

Policymakers must allocate public funds among competing investments so that social returns are maximised. A recent report warns against the siphoning of scarce development assistance funds away from crucial sectors like agriculture, infrastructure, health, sanitation and education for *relatively untested* micro-credit schemes (UN 1998, emphasis added). Thus, a comparison of welfare gains from targeted micro-credit programmes with those achieved from alternative approaches is urgently required to justify the public outlay.

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