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Microfinance and Financial Development

Michael S. Barr*

*University of Michigan Law School, msbarr@umich.edu

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MICROFINANCE AND FINANCIAL DEVELOPMENT

*Michael S. Barr**

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I. INTRODUCTION

Close to three billion people—half of the world's population—live on less than two dollars a day.[1] Within these poor communities, one child in five will not live to see his or her fifth birthday.[2] To boost international development, the United Nations (UN) announced the Millennium Development Goals, aimed at eradicating poverty by 2015.[3] A number of countries responded at the International Conference for Financing International Development in Monterrey, Mexico, by creating action plans to begin to implement the Millennium Development Goals.[4] Yet the Millennium Development Goals will prove difficult to achieve.

International institutions, developed nations, and the developing world are approaching these development goals from many different perspectives. Much of the development community's energy and efforts seem to be focused on cultivating long-term donors and securing foreign

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1. SHAOHUA CHEN & MARTIN RAVALLION, HOW HAVE THE WORLD'S POOREST FARED SINCE THE 1980s?, *at* 17 (World Bank Policy Research Working Paper No. 3341, 2004), *available at* http://econ.worldbank.org/files/36297_wps3341.pdf.
2. *Id*.
3. G.A. Res. 2, UNGAOR, 55th Sess., U.N. Doc. A/RES/55/2 (2000).
4. *See Report of the International Conference on Financing for Development*, U.N. Doc. A/CONF.198/11, U.N. Sales No. E.02.II.A.7 (2002).

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aid.[5] The United States is focusing development assistance to countries that it views as having sound policies, through its Millennium Challenge Accounts.[6] Additionally, many organizations are increasingly focused on international trade as a means to increase development.[7] Indeed, the Doha round of World Trade Organization (WTO) negotiations explicitly addressed the role of trade in development,[8] and high-level working groups are focusing on the importance of real development for trade.[9]

Others focus on the critical importance of international capital flows,[10] which swamp official governmental assistance.[11] Currently, much attention is given to the development of efficient capital markets, emphasizing corporate governance, disclosure, and shareholder rights.[12] In the banking sector, negotiations over the financial services agreement in the WTO have opened the banking sectors of many developing countries to foreign involvement, which in some instances is helping to deepen banking markets and strengthen banking institutions.[13] The Basel Committee on Banking Supervision[14] has focused on developing supervisory capacity and the best practices in bank regulation to match this financial deepening, building on the Basel Committee's success in promulgating the original Basel Capital Standards and its ongoing work on a new capi-

5. *See generally* The Development Gateway, *available at* http://topics.developmentgateway.org/alltopics/ for a list of topics commonly focused on by these development initiatives.

6. *See* Sarah Lucas & Steven Radelet, *An MCA Scorecard: Who Qualified, Who Did Not, and the MCC Board's Use of Discretion* (2004), *available at* http://www.cgdev.org/.

7. See, for example, the U.N. Conference on Trade and Development website for resources devoted to furthering development through trade at http://www.unctad.org/Templates/StartPage.asp?intItemID=2068.

8. *See* WTO, *Announcement of the Doha Round*, WTO Doc. WT/MIN(01)/DEC/1 (2001), *available at* http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm.

9. *See* Robert Rubin et al., *Sharing the Benefits of Trade*, FIN. TIMES, May 19, 2003, at 17.

10. *See, e.g.*, IMF Research Dep't Staff, Capital Flow Sustainability and Speculative Currency Attacks, FIN. & DEV. 34(4) (1997).

11. *See* IMF, World Economic Indicators (2004), *available at* http://www.imf.org/external/pubs/ft/weo/2004/02/data/1_3.pdf [hereinafter World Economic Indicators]; UNDP, *Flows of Aid, Private Capital, and Debt*, HUMAN DEVELOPMENT REPORT 201, table 18 (2004), *available at* http://hdr.undp.org/reports/global/2004/pdf/hdr04_HDI.pdf [hereinafter Aid, Private Capital, and Debt].

12. *See, e.g.,* Laura Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, AM. L. & ECON. REV. (forthcoming 2005).

13. *See* IMF Independent Evaluation Office, The *IMF and Recent Capital Account Crises: Indonesia, Korea and Brazil* (2003), *available at* http://www.imf.org/external/np/ieo/2003/cac/pdf/all.pdf. *But see* Joseph Stiglitz, *The Role of the State in Financial Markets*, *in* ANNUAL WORLD BANK CONFERENCE ON DEV. & ECON. 19 (1994) (arguing that liberalization can often lead to financial crisis).

14. For information on the Basel Committee, see the official website at http://www.bis.org/bcbs/.

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tal accord.[15] At the same time, many developing countries have focused on lifting internal restrictions on credit, such as directed lending and interest rate caps, which had blocked the growth of retail and consumer finance.[16]

Domestic financial reforms have the potential to play a role in poverty alleviation by deepening financial markets and institutions that may contribute to economic growth, which can, in turn, sometimes help poverty alleviation.[17] But the link between financial reform and poverty alleviation is not a straightforward one. Jalilian and Kirkpatrick argue that "[t]he refocusing of the goals of development strategy from an exclusive concern with economic growth to growth with poverty reduction has increased interest in the contribution that financial development can make to poverty reduction in developing countries."[18] What that contribution might be is a matter for some debate.

In that regard, microfinance is a form of financial development that has as its primary aim poverty alleviation. Microcredit, lending small sums to poor or near-poor households, achieved prominence in the 1980s, thanks to innovative programs such as the Grameen Bank, launched by Mohammed Yunus,[19] and enthusiastic support from government officials, including President Clinton.[20] The UN has designated 2005 as the International Year of Microcredit. The UN has stated that

15. To some extent, the experience of countries adopting the Basel Accords goes against the "institutionalist" and new institutional economics lessons about the difficulty of importing foreign standards. The Accords have been widely adopted and, although regulatory capacity differs markedly across countries, the Accords seem to have succeeded in preventing a regulatory race to the bottom of capital standards. Moreover, the fact that the standards are external gives backing to forces within developing countries seeking greater transparency and more effective supervision. Regional groups of bank regulators in the developing world have also formed alliances around the Accords to improve their supervisory capacity. *See, e.g.*, CHARLES GOODHART ET AL., FINANCIAL REGULATION: WHY, HOW, AND WHERE NOW? (1998).

16. CGAP, INTEREST RATE CEILINGS AND MICROFINANCE: THE STORY SO FAR (Occasional Paper no. 9, 2004), *available at* www.cgap.org/docs/OccasionalPaper_9.pdf; Jacob Yaron & McDonald Benjamin, *Developing Rural Financial Markets*, 34 (4) FIN. & DEV. 40 (1997), *available at* http://www.imf.org/external/pubs/ft/fandd/1997/12/pdf/yaron.pdf.

17. For variations on this theory, see Thorsten Beck et al., *Finance and the Sources of Growth*, 58 J. FIN. ECON. 261 (2000); Solomon Tadesse, *Financial Architecture and Economic Performance: International Evidence*, 11 J. FIN. INTERMEDIATION 429 (2002); Thierry Tressel, *Dual Financial Systems and Inequalities in Economic Development*, 8 J. ECON. GROWTH 223 (2003); HOSSEIN JALILIAN & COLIN KIRKPATRICK, FINANCIAL DEVELOPMENT AND POVERTY REDUCTION IN DEVELOPING COUNTRIES (Fin. and Dev. Research Programme Working Paper No. 30, 2001).

18. JALILIAN & KIRKPATRICK, *supra* note 17, at 5.

19. *See* http://www.grameen-info.org for more information about the Grameen Bank.

20. *See*, *e.g.*, President Bill Clinton, Address at the University of California, Berkeley (Jan. 29, 2002), *transcript available at* http://www.berkeley.edu/news/features/2002/clinton/clinton-transcript.html. For a good discussion of the rise of microcredit, see Jonathan Morduch, *The Microfinance Promise*, 37 J. ECON. LIT. 1569 (1999).

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microcredit programs have tripled within the past five years, and that nearly twenty-seven million people, mostly women, had become borrowers by 2001.[21] More than $1 billion in microcredit loans are outstanding today, and repayment rates are in excess of ninety-five percent.[22] Microfinance encompasses not only these microcredit programs, but also the full range of financial products that permit poor households to protect against economic risks—through access to credit, savings, insurance, and transactional services.[23]

Although financial development can assist with poverty alleviation, and microfinance is a form of financial development that has as its aim poverty alleviation, most policymakers and scholars conduct separate conversations about financial development and microfinance. This Article attempts to bridge that gap. The Article argues that microfinance can play an important role in financial development, and that by focusing on microfinance, development policy can strengthen the links between financial development, economic growth, and poverty alleviation. Rather than focusing exclusively on microfinance as an anti-poverty strategy, microfinance should be seen as an integral component of a developing country's broader financial development strategy. By demarginalizing microfinance programs serving the poor, our international financial institutions, donor nations, and developing countries may be able to more quickly reach the Millennium Development Goals.

Parts II and III lay the basic groundwork for the argument. Part II briefly analyzes existing theoretical and empirical literature on the connection between financial development, economic growth, and poverty alleviation. Part III explains microfinance. Part IV argues that microfinance should be seen as part of a broader financial development strategy, not simply as a marginal program to serve the poor. My argument here is largely theoretical, even aspirational. Part IV also sketches some legal and policy implications of this approach, although full development of these policies is beyond the scope of this brief Article. Part V concludes.

21. United Nations, Press Release GA/EF/3039, Under-Secretary-General Lauds Effectiveness of Microcredit as Second Committee Takes Up Implementation of Decade for Eradication of Poverty (Sept. 10, 2003).

22. For comprehensive microfinance information, see The Microfinance Information Exchange Market, *Who Are the Clients of Microfinance?*, *at* http://www.mixmarket.org/en/who_are_microfinance_clients.asp.

23. *See generally* The Consultative Group to Assist the Poor (CGAP), *About Microfinance*, *at* http://www.cgap.org/about/faq01.html.

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II. FINANCIAL DEVELOPMENT AND GROWTH

Economic theory suggests that financial development can contribute to economic growth, and growth can contribute to poverty alleviation, although there is wide disagreement about whether and under what circumstances this occurs. It has long been observed that financial development accompanies economic growth, but the proposition that financial development promotes economic growth has been debated in the theoretical literature and has been questioned on empirical grounds. Schumpeter argued that banks are key to economic development because they channel society's savings to entrepreneurs who innovate.[24] Financial intermediaries have economies of scale in information gathering, assessment, and monitoring; in mobilizing savings for investment; and in spreading and managing risk. Financial development can thus in theory improve a society's allocation of resources.[25] External finance complements internal corporate funding and permits firms to grow in size; larger firms, in turn, contribute to financial development, as their assets become collateral for loans, and their stocks and bonds become instruments for investment.

While not uncontested, empirical evidence linking economic growth with the development of strong financial architecture is promising.[26] An assessment of the last few decades of comparative research shows that "higher levels of financial development are significantly and robustly correlated with faster current and future rates of economic growth, physical capital accumulation and economic efficiency improvements . . . . [F]inance does not only follow growth: finance seems importantly to lead to economic growth."[27]

In addition to determining whether financial development promotes growth, research has attempted to determine how and under what circumstances financial development leads to growth. Some scholars focus on comparing the circumstances best suited for capital market-led

24. *See*, J.A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT 74 (1955). *See also* R.W. GOLDSMITH, FINANCIAL STRUCTURE AND DEVELOPMENT (1969); R.I. MCKINNON, MONEY AND CAPITAL IN ECONOMIC DEVELOPMENT (1973); J.G. Gurley & E.S. Shaw, *Financial Aspects of Economic Development*, 45 AM. ECON. REV. 515 (1955).

25. *See generally* FRANKLIN ALLEN & DOUGLAS GALE, COMPARING FINANCIAL SYSTEMS (2000).

26. *See* FELIX ESCHENBACH, FINANCE AND GROWTH: A SURVEY OF THE THEORETICAL AND EMPIRICAL LITERATURE (Tinbergen Institute Discussion Paper No. TI 2004-039/2, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530123. *See also* ROSS LEVINE, FINANCE AND GROWTH: THEORY AND EVIDENCE 79 (National Bureau of Economic Research Working Paper No. 10766, 2004) ("financial development exerts a first-order impact on economic growth"), *available at* http://www.nber.org/papers/w10766.

27. Robert G. King & Ross Levine, *Finance and Growth: Schumpter Might Be Right*, 108 Q. J. ECON. 717, 717-18, 730 (1993). *See also* Tressel, *supra* note 17.

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growth, versus those situations more appropriately led by the banking sector.[28] The determining circumstances seem to be based on the strength of the country's legal and financial institutions, with bank specialization in monitoring being more important in countries with weak contractual enforcement, and stronger legal institutions required for market-led economies that rely on the efficient transmission of information to reach large scale.[29] Others argue that both sectors are necessary for growth and are mutually reinforcing, providing different functions to the economy, and to each other.[30]

Moving from the link between financial development and economic growth to the link between financial development and poverty alleviation is more challenging. Higher levels of growth through financial development can sometimes lead to poverty alleviation.[31] Credit constraints from low-functioning financial systems and weak legal systems affect the poor more deeply than the wealthy, who can rely on relationships and ample assets in the face of information-poor and legally weak markets.[32] Financial development could contribute to poverty alleviation directly, by easing credit constraints on the poor, and indirectly, by fostering eco-

28. *See* Tadesse, *supra* note 17.

29. *Id.* at 429–33. *See also* Arnoud W. Boot & Anjan Thakor, *Financial System Architecture*, 10 REV. FIN. STUD. 693 (1997) (arguing that bank-based systems dominate the financial system at early stages of development, while market-based systems dominate when information is more widespread).

30. *See* Levine, *supra* note 27, at 79; GOODHART ET AL., *supra* note 15 (arguing that thick capital markets reinforce banking institutions because such markets contribute to externally raised bank capital, lessen the likelihood of regulatory capture, and provide a market for defaulted collateral that improves incentives for collection); ROSS LEVINE, BANK-BASED OR MARKET-BASED FINANCIAL SYSTEMS: WHICH IS BETTER? (William Davidson Working Paper Series No. 442, 2002) (arguing that empirical evidence does not support either a bank-based or market-based view of development but that strong legal institutions support financial development).

31. *See generally* THORSTEN BECK ET AL., FINANCE, INEQUALITY AND POVERTY: CROSS-COUNTRY EVIDENCE (National Bureau of Economic Research Working Paper No. 10979, 2004), *available at* http://legacy.csom.umn.edu/WWWPages/FACULTY/RLevine/POVERTY.pdf.

32. *See* Phillippe Aghion & Patrick Bolton, *A Theory of Trickle-Down Growth and Development*, 64 REV. OF ECON. STUD. 151 (1997); Abhijit Banerjee & Andrew Newman, *Occupational Choice and the Process of Development*, 101 J. POL. ECON. 274 (1993); Oded Galor & Joseph Zeira, *Income Distribution and Macroeconomics*, 60 REV. OF ECON. STUD. 35 (1993). *See also* STEPHEN HABER ET AL., THE POLITICS OF PROPERTY RIGHTS: POLITICAL INSTABILITY, CREDIBLE COMMITMENTS, AND ECONOMIC GROWTH IN MEXICO, 1876-1929 (2003); RAGHURAM RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS: UNLEASHING THE POWER OF FINANCIAL MARKETS TO CREATE WEALTH AND SPREAD OPPORTUNITY (2003); Randall Morck et al., *Corporate Governance, Economic Entrenchment and Growth*, J. ECON. LIT. (forthcoming 2005).

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nomic growth that benefits the poor. Cross-country comparisons suggest that financial development does reduce income inequality.[33]

There are lots of cases, however, where financial development does not lead to poverty alleviation.[34] Inequality within domestic economies can be eased through expanding access to the financial system,[35] but so too can inequalities be perpetuated or worsened through unequal access to a growing financial sector.[36] Economic growth can leave many low-income households behind.

Furthermore, financial development without an appropriate focus on governance—including regulation and supervision of the financial sector, as well as broader measures of transparent, honest governance—can contribute to financial crises that harm the poor the most.[37] For example, the financial crises in both Thailand and Indonesia caused economic dislocations that wreaked havoc on poor households in those countries.[38] Furthermore, weak legal institutions that do not protect and enforce creditor and investor rights inhibit financial development.[39] Moreover, weak enforcement can make it difficult for financial institutions to collect against collateral. When that occurs, relationship lending dominates

33. Beck, *supra* note 17; GEORGE CLARKE ET AL., FINANCE AND INCOME INEQUALITY: TEST OF ALTERNATIVE THEORIES (World Bank Policy Research Working Paper No. 2984, 2003).

34. *See generally* Jeremy Greenwood & Boyan Jovanovic, *Financial Development, Growth, and the Distribution of Income*, 98 J. POL. ECON. 1076 (1990) (arguing as a theoretical matter that financial development contributes to income inequality at early stages of development because the wealthy can reap better returns on their savings). *See also* Martodinoto Mubyarto, *Poverty in Indonesia Before and After the Crisis*, *in* POVERTY REDUCTION: WHAT'S NEW AND WHAT'S DIFFERENT (Asian Development Bank ed., 2001), *available at* http://www.adb.org/Documents/Conference/Poverty_Reduction/Chap4.pdf.

35. *See generally* Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121 (2004); Michael S. Barr, *Credit Where It Counts*, 80 N.Y.U. L. REV. 101 (2005). *See also* THORSTEN BECK & MICHAEL FUCHS, STRUCTURAL ISSUES IN THE KENYAN FINANCIAL SYSTEM: IMPROVING COMPETITION AND ACCESS (World Bank Policy Research Working Paper No. 3363, 2004), *available at* http://econ.worldbank.org/files/37048_wps3363.pdf.

36. *See* Stephen Haber, *Industrial Concentration and the Capital Markets: A Comparative Study of Brazil, Mexico, and the United States, 1830-1930*, 51 J. ECON. HIST. 559 (1991); Stephen Haber, *Mexico's Experiment with Bank Privatization and Liberalization, 1991-2003*, J. BANKING & FIN. (forthcoming 2005), *available at* http://www.stanford.edu/~haber/papers.html.

37. *See* JALILIAN & KIRKPATRICK, *supra* note 17, at 4.

38. Microfinance institutions and their borrowers seem to have fared better than others. *See* Hassan Zaman, *Microfinance in Bangladesh: Growth, Achievements, and Lessons, in Scaling Up Poverty Reduction: Case Studies in Microfinance* 47, CGAP CONFERENCE REPORT (May 2004) [hereinafter Scaling Up Poverty Reduction], *available at* http://www.cgap.org/docs/CaseStudy_scalingup.pdf.

39. *See*, *e.g.*, Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FINANCE 1131 (1997); Thorsten Beck et al., *Law and Finance: Why Does Legal Origin Matter?*, 31 J. COMP. ECON. 653 (2003).

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and intermediaries do not look to a broader potential base of borrowers. Under such circumstances, banks lend to favored customers, but not to the broader public.[40] Financial development can also stall out because of "financial repression,"[41] which encompasses problems endemic to some developing countries, such as crony capitalism and pervasive interest rate controls that limit the supply of finance.

Financial development can also occur more slowly because of low demand. For instance, there may be too few people who possess collateral and assets that would enable them to borrow,[42] potential borrowers may own assets that are not readily transferable to bank collateral, or households may lack credit histories and bank accounts to demonstrate creditworthiness.[43] That is, poverty itself diminishes the possibilities for financial development. As Stiglitz posits, "[m]arket failure is a fundamental cause of poverty, and financial market failures, particularly asymmetric information and high, fixed costs of small scale lending limit the access of the poor to formal finance."[44]

If financial development can lead to poverty alleviation under some circumstances, then there ought to be greater attention paid to the question of what those circumstances are. The contribution of this Article is simply to suggest that focusing on microfinance might be an important lens through which to begin to answer at least a part of that question. To explain why, I first lay out some basics of microfinance, and then I explain what I mean by focusing on microfinance. I then analyze how microfinance can contribute broadly to financial development.

III. MICROFINANCE

Microfinance is a form of financial development that is primarily focused on alleviating poverty through providing financial services to the poor. Most people think of microfinance, if at all, as being about microcredit, lending small amounts of money to the poor. Microfinance is that, but it is also broader, including insurance, transactional services, and importantly, savings. There is now a reasonably large body of literature explaining why and under what conditions microfinance works.[45] Recent

40. *See*, *e.g.*, GOODHART ET AL., *supra* note 15.

41. *See* RONALD MACKINNON, MONEY AND CAPITAL IN ECONOMIC DEVELOPMENT (1973).

42. *See* HERNANDO DESOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE (2000).

43. Barr, *supra* note 35, at 158.

44. Stiglitz, *supra* note 13, at 19-52.

45. *See* CGAP's extensive microcredit library at http://www.cgap.org and The Microfinance Gateway's resources at http://www.microfinancegateway.org.

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debates focus on whether microfinance can be self-sustaining by charging higher interest rates and becoming more efficient,[46] or whether it can and should reach deeper into the ranks of the poor.[47]

The financial services commonly available to the poor in developing countries "often have serious limitations in terms of cost, risk, and convenience."[48] Microfinance institutions play a complementary role to the banking system by extending credit to borrowers whom banks view as too costly or too risky to reach. Lacking collateral, and often living far from banks, poor households often turn to expensive informal moneylenders when confronted with urgent credit needs. Repayment of these moneylenders may leave some families worse off.[49] Microfinance institutions attempt to compete with moneylenders by offering credit to a broader range of households on more favorable terms.

Microcredit institutions use a variety of strategies, which have been reported on in detail elsewhere, to reduce their own risks: superior information about borrowers to reduce risks given low or nonexistent collateral; peer lending circles to serve as pre-screening devices to reduce information asymmetry; joint liability contracts among borrowers to enforce payment despite weak legal institutions; short-term loan contracts with regular repayments to substitute for information; loan ladders that permit successful borrowers to take out increasingly larger loans as incentives for repayment; social networks and shaming to increase repayment rates; and a variety of other substitutes for information, collateral, and legal enforcement to extend credit to low-income borrowers without collateral assets.[50]

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46. *See*, *e.g.*, Morduch, *supra* note 20.

47. *See*, *e.g.*, MicroCredit Summit, *at* http://www.microcreditsummit.org/.

48. CGAP, About Microfinance, *at* http://www.cgap.org/about/microfinance.html.

49. *Id*.

50. *See* Michael Fiebig et al., Savings in the Context of Microfinance—State of Knowledge, CGAP Working Group on Savings Mobilization Document (1999), *available at* http://www.cgap.org/assets/images/savings.pdf; Rafael Gomez & Eric Santor, *Membership Has Its Privileges: The Effect of Social Capital and Neighborhood Character on Earnings of Microfinance Borrowers*, 34 CANADIAN J. ECON. 943 (2001); Sanjay Jain & Ghazal Mansuri, *A Little at a Time: The Use of Regularly Scheduled Repayments in Microfinance Programs*, 72 J. DEV. ECON. 253 (2003); Ana Marr, *Studying Group Dynamics: An Alternative Analytical Framework for the Study of Microfinance Impacts on Poverty Reduction*, 14 J. INT'L DEV. 511 (2002); Linda Mayoux, *Tackling the Downside: Social Capital, Women's Empowerment and Microfinance in Cameroon*, 32 DEV. & CHANGE 435 (2001); Angelyn Zephyr, *Money is Not Enough: Social Capital and Microcredit*, 13 ISSUES IN POL. ECON. (2004); Alain de Janvry et al., *Up the Lending Ladder: Extending Financial Services for the Rural Poor Through Credit-Reporting Bureaus* (2003), *available at* http://www.basis.wisc.edu/live/basbrief16.pdf; Craig McIntosh & Bruce Wydick, *Competition and Microfinance* (2004), *available at* http://www-irps.ucsd.edu/academics/McIntosh%20CompetitionMicrofinance.pdf. *But see* Malgosia Madajewicz, *Is the Popularity of Group Loan Deserved? The Impact of Microcredit on Poverty*, *in* CREDIT MARKETS FOR THE POOR (Patrick Bolton & Howard Rosenthal eds., forthcoming

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Microfinance institutions have developed a strong track record over the last thirty years in alleviating poverty and advancing the economic needs of low-income households.[51] Microfinance programs have been found to increase and diversify household income, promote household savings, and permit "consumption smoothing" in the face of volatility of income.[52] Studies have also found that microfinance clients have better educational and health outcomes.[53] Others have found that microfinance can, under some circumstances, empower women in their households as well as in society more generally.[54] There are, of course, problems with particular microfinance organizations such as default rates that, in some instances, are too high, and there is a general need for greater transparency regarding loan performance and other measures, which industry leaders are beginning to address.[55] My focus is elsewhere, however; I want to look at how microfinance can contribute more broadly to financial development.

2005) (arguing that collateralized loans would benefit the better-off among credit-constrained borrowers as compared to peer-monitored loans).

51. *See generally* Morduch, *supra* note 20; ELIZABETH LITTLEFIELD ET AL., IS MICROFINANCE AN EFFECTIVE STRATEGY TO REACH THE MILLENNIUM DEVELOPMENT GOALS? (CGAP Focus Note 23, 2003), *at* http://www.cgap.org/docs/FocusNote_24.html.

52. LITTLEFIELD ET AL., *supra* note 51, at para. 11 (citing BARBARA MKNELLY & CHRISTOPHER DUNFORD, IMPACT OF CREDIT WITH EDUCATION ON MOTHERS AND THEIR YOUNG CHILDREN'S NUTRITION: CRECER CREDIT WITH EDUCATION PROGRAM IN BOLIVIA (Freedom from Hunger Research Paper No. 5, 1999)). *See also* M. HOSSAIN, CREDIT FOR THE ALLEVIATION OF RURAL POVERTY: THE GRAMEEN BANK IN BANGLADESH (1988); SHAHIDUR KHANDKER, FIGHTING POVERTY WITH MICROCREDIT: EXPERIENCE IN BANGLADESH (1998); MICROFINANCE AND POVERTY ALLEVIATION: CASE STUDIES FROM ASIA AND THE PACIFIC (Joe Remenyi & Benjamin Quinones, Jr. eds., 2000); ANTON SIMANOWITZ, APPRAISING THE POVERTY OUTREACH OF MICROFINANCE: A REVIEW OF THE CGAP POVERTY ASSESSMENT TOOL (PAT) (Imp-Act Programme Occasional Paper No. 1, 2002); HASSAN ZAMAN, ASSESSING THE POVERTY AND VULNERABILITY IMPACT OF MICRO-CREDIT IN BANGLADESH: A CASE STUDY OF BRAC (World Bank Policy Research Working Paper No. 2145, 2000); CAROLYN BARNES, MICROFINANCE PROGRAM CLIENTS AND IMPACT: AN ASSESSMENT OF ZAMBUKO TRUST, ZIMBABWE, (USAID-AIMS Paper 2001); S. Mustafa et al., Beacon of Hope: An Impact Assessment of BRAC's Rural Development Programme, BRAC Research and Evaluation Division Document (1996).

53. LITTLEFIELD ET AL., *supra* note 51, at para. 3 (citing A. Mushtaque et al., *Do Poverty Alleviation Programmes Reduce Inequities in Health? Lessons from Bangladesh*, *in* POVERTY, INEQUALITY AND HEALTH, AN INTERNATIONAL PERSPECTIVE (David Leon & Gill Walt eds., 2000)).

54. LITTLEFIELD ET AL., *supra* note 51, at para. 19 (citing Susy Cheston & Lisa Kuhn Fraioli, *Empowering Women through Microfinance*, *in* PATHWAYS OUT OF POVERTY: INNOVATIONS IN MICROFINANCE FOR THE POOREST FAMILIES (Sam Daley-Harris ed., 2002)).

55. *See generally* Robert Peck Christen, *In Search of Credibility: Transparency and the Microfinance Industry*, THE MICROBANKING BULLETIN No. 5 (2001), *available at* http://www.mixmbb.org/en/mbb_issues/07/mbb7_article2.pdf.

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IV. MICROFINANCE AND FINANCIAL DEVELOPMENT

To what extent can a focus on microfinance make it more likely that financial development leads to poverty alleviation? What do I mean by focusing on microfinance? I do not mean simply focusing on microfinance institutions and learning about their techniques for risk mitigation, although these topics are quite interesting in their own right. I do not mean simply focusing on microfinance borrowers—that is, the unique nature and needs of the poor and near poor, their assets, and their human capital, although I also think this topic is quite important. What I do mean is thinking about financial development as a whole from the vantage point of facilitating a microfinance system.

This is somewhat odd. In designing policies and institutions for the core financial institutions in society, how could it help for us to think about the marginal, the fringe, the poor? After all, microfinance currently is quite small in comparison to: (a) the problem of economic development and poverty alleviation;[56] (b) private capital flows to the developing world;[57] and (c) government and donor contributions.[58] Moreover, the poor are often marginalized within their own societies and are rarely thought of as important for a country's macroeconomic development. In addition, reforming weak legal institutions and advancing good governance are critical for development and ought to be undertaken directly when possible.

Nevertheless, viewing financial development through the lens of microfinance might help for four reasons, which I explore in more detail in the sections that follow: First, financially self-sustainable microfinance programs can contribute directly, and at scale, to poverty alleviation, and promote market deepening that in turn advances financial development. Second, microfinance may be a useful strategy to consider in countries with bad governance where other development strategies face significant barriers. Third, microfinance can help financial markets in developing countries to mature, while playing more limited, but useful, roles in poverty alleviation in both financially undeveloped and financially developed countries. Fourth, microfinance can help to break down opposition to, and build support for, domestic financial reforms.

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56. *See supra* note 1 (stating that more than three billion people live on less than $2 per day).

57. The IMF's World Economic Indicators show that more than $120.4 billion in private capital flowed to the developing world in 2003. *See* World Economic Indicators, *supra* note 11.

58. Developing countries received over $55 billion in official development assistance in 2002. *See* Aid, Private Capital and Debt, *supra* note 11.

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A. *Sustainable Microfinance*

Microfinance institutions themselves might increasingly reach financial self-sustainability and attract private capital flows to their mission of poverty alleviation. Private financial flows are attractive for obvious reasons. Private flows instead of government flows mean donor governments are spending less on development aid (or less for this purpose), and microfinance institutions would not need to rely on fickle donors. Private capital flows dwarf development assistance, and steering some of these flows to the service of microfinance for the poor could make a real difference for millions of households. Moreover, relying on private flows of finance will put pressure on microfinance institutions to provide greater transparency and to become more efficient in their operations, which, in turn, would be beneficial to donors, the institutions, and borrowers.

Microfinance institutions have demonstrated that it is possible to serve poor clients, operate in a financially sound manner, and reach scale. The Microfinance Exchange, which tracks performance for about 150 microfinance institutions, has found that about forty percent of the institutions it tracks are financially self-sufficient, and many others are nearly so.[59] Financial self-sustainability does not seem to be confined to a particular lending strategy, region, or poverty status of the borrower base. For example, the Association for Social Advancement, BRAC (formerly known as the Bangladesh Rural Advancement Committee), the Grameen Bank, and Proshika together provide credit to 11.5 million households in Bangladesh.[60] A number of microfinance institutions in Latin America are growing rapidly, and operating successfully. For example, CrediAmigo, a microfinance program operated by Banco do Nordeste in Brazil, has provided 300,000 poor households with access to microfinance in the last five years.[61] In Kenya, the Equity Building Society has grown to 250,000 depositors over the last decade.[62] Bank Rakyat

59. *See* MICROBANKING BULLETIN, *Focus on Standardization*, No. 8 (Nov. 2002); MICROBANKING BULLETIN, *Focus on Savings*, No. 9 (July 2003), *both available at* http://www.mixmbb.org/en/index.html. The microfinance institutions that the Microbanking Bulletin tracks, however, are not likely to be representative of the industry as a whole. These institutions are likely to be among the better performers. One cannot argue from this data that the industry as a whole is moving towards financial self-sustainability, but rather that a significant part of the best institutions are doing so.

60. Zaman, *supra* note 38, at 49.

61. Robert Peck Christen, *Struggling Through the "Growth versus Best Practice" Tradeoff: The CrediAmigo Program of the Banco de Nordeste, Brazil*, *in* SCALING UP POVERTY REDUCTION: CASE STUDIES IN MICROFINANCE, *supra* note 38, at 1.

62. Tamara Cook, *Equity Building Society: A Domestic Financial Institution Scales up Microfinance*, *in* SCALING UP POVERTY REDUCTION: CASE STUDIES IN MICROFINANCE, *supra* note 38, at 15.

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Indonesia (BRI) serves over three million poor borrowers with $1.7 billion in loans and provides bank accounts to some thirty million low-income households, who have saved an aggregate of $3.1 billion.[63] Moreover, microfinance programs are increasingly being linked to remittances from abroad as a development strategy. Given the large size of these flows, which account for a significant part of gross domestic product in some developing countries,[64] remittances may become an important source of capital for microfinance institutions.

While there has been enormous progress in this regard, reaching financial self-sustainability and scale has proved elusive for many microfinance institutions, and even those that are now self-sustaining have required significant donor support.[65] This is not surprising, because even with high repayment rates, the transaction costs in lending small amounts to lots of poor borrowers are high. Moreover, even if self-sufficiency can be realized, private flows can have downsides too—they flow out, as well as in, as the Asian crisis and its aftermath demonstrated. Indeed, data from Indonesia suggest that the microfinance institutions did well there while other financial firms failed in part because short-term loans with tight repayment schedules did not leave them highly exposed, in part because of borrower repayment discipline driven by the need to borrow in the future, and in part because their sources of funds were not as liquid, and external, as other firms.[66] Still, the drive towards financial self-sustainability can help to improve the efficiency, discipline, and transparency of microfinance institutions, all to the good, even if the industry as a whole does not reach financial self-sufficiency and always requires donor funding. Financial self-sustainability is the best case scenario. How does microfinance matter in the worst case scenario?

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63. Klaus Maurer, *Bank Rakyat Indonesia: Twenty Years of Large-Scale Microfinance*, *in* SCALING UP POVERTY REDUCTION: CASE STUDIES IN MICROFINANCE, *supra* note 38, at 95.

64. *See*, *e.g.*, Barr, *supra* note 35, at 195–98 (citing the Mexican example); MANUEL OROZCO, THE REMITTANCE MARKETPLACE: PRICES, POLICY AND FINANCIAL INSTITUTIONS (Pew Hispanic Center Report 2004), *available at* http://pewhispanic.org/files/reports/28.pdf; Scott Robinson, Remittances, Microfinance and Community Informatics: Development and Governance Issues (2004), *available at* http://www.fdc.org.au/files/RobinsonpaperREMIT.pdf; ROBERT SURO ET AL., BILLIONS IN MOTION: LATINO IMMIGRANTS, REMITTANCES AND BANKING (Pew Hispanic Center & Multicultural Investment Fund Report 2002) (stating that 14.6% of the El Salvadorian gross domestic product and 15% of the Haitian gross domestic product is derived from remittances), *available at* http://pewhispanic.org/files/reports/13.pdf.

65. There is also some ambiguity in defining financially self-sustaining programs. *See*, *e.g.*, Morduch, *supra* note 20; Terry Buss, *Microenterprise in International Perspective: An Overview of the Issues*, 1 INT'L J. ECON. DEV. 1 (1999), *available at* http://www.spaef.com/sample.pdf; JOAN PARKER & DOUG PEARCE, LINKING MICROFINANCE AND SAFETY NET PROGRAMS TO INCLUDE THE POOREST (CGAP Focus Note 20, 2001), *available at* www.cgap.org/docs/FocusNote_20.html.

66. *See*, *e.g.*, Maurer, *supra* note 63, at 97–98.

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B. *Microfinance as a Strategy in the Face of Poor Governance*

Microfinance institutions might grow up in the cracks between the cement blocks of bad government. Microfinance institutions would help alleviate poverty and, over time, grow domestic credit demand slowly despite weak formal institutions, legal and otherwise. Microfinance institutions can thrive in weak legal and other formal institutional environments because they largely do not have to rely on such formal institutions to operate.[67] Many of the risk-mitigation techniques developed by microfinance institutions, such as peer lending, are functional substitutes for legal-institution-intensive forms of creditor protection, such as enforcement on collateral. Microfinance is a form of financial development that, at least in its initial stages, can thrive without relying heavily on government regulation or support, or strong legal institutions that permit the poor to borrow against their assets or creditors to collect.[68]

In that regard, microfinance might be an important financial development strategy in the face of weak, incompetent, or corrupt governance, and in post-conflict reconstruction efforts.[69] Bad governance can hinder microfinance's growth,[70] and good governmental policies certainly can and should be used to advance microfinance. Macroeconomic instability can wreak havoc with microfinance programs, and corruption can harm institutions seeking government licenses to operate.[71] Some licensing

67. *See*, *e.g.*, Robert C. Vogel, *Other People's Money: Regulatory Issues Facing Microfinance Programs*, *in* STRATEGIC ISSUES IN MICROFINANCE 210 (Mwangi S. Kemenyi et al., eds., 1998).

68. *See* DESOTO, *supra* note 42 (arguing that high transaction costs and the absence of legal rules permitting legal recognition of the assets of the poor as collateral inhibit the expansion of access to credit).

69. *See* Christen, *supra* note 61. Post-conflict reconstruction efforts using microfinance are likely to be quite difficult and failure rates might be higher than in other circumstances; nonetheless, it is worth exploring the role that microfinance can play in such scenarios. TAMSIN WILSON, MICROFINANCE DURING AND AFTER ARMED CONFLICT: LESSONS FROM ANGOLA, CAMBODIA, MOZAMBIQUE AND RWANDA (Concern Worldwide & Springfield Centre for Business in Development Document, 2002), *available at* http://www.postconflictmicrofinance.org/PCM%20Synthesis%20Report.pdf; MICROFINANCE BEST PRACTICES PROJECT, MICROFINANCE FOLLOWING CONFLICT: INTRODUCTION TO TECHNICAL BRIEFS (MBP Microfinance Following Conflict Brief No. 1, 2001)(on file with MICH. J. INT'L L.); KAREN DOYLE, MICROFINANCE IN THE WAKE OF CONFLICT: CHALLENGES AND OPPORTUNITIES (Microenterprise Best Practices Working Paper, 1998). *But see* MICROCREDIT: ONE OF MANY INTERVENTION STRATEGIES (CGAP Donor Brief No. 2, 2002), *available at* http://www.cgap.org/docs/DonorBrief_02.pdf (arguing that post-conflice reconstruction is too risky to deploy microfinance successfully).

70. *See*, *e.g.*, Zaman, *supra* note 38 (explaining the importance of sound macroeconomic policies to the growth of Grameen Bank in Bangladesh); Maurer, *supra* note 63 (explaining the importance of interest rate deregulation and macroeconomic stability to the growth of BRI in Indonesia).

71. *See* Scaling Up Poverty Reduction, *supra* note 38 (discussing importance of macroeconomic stability); Jeffery R. Franks, *Microeconomic Stabilization and the*

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restrictions that prevent nonprofit nongovernmental organizations from providing credit can undoubtedly block the growth of microfinance, and interest rate and other controls can make microfinance unprofitable, and unsustainable, for both specialized institutions as well as mainstream banks. I am distinctly not arguing in favor of the proposition that governmental policies should be ignored.

If we have learned anything in the last generation about the role of law in development, however, it is that strengthening society's institutions is not simply a matter of writing better laws.[72] The reform of legal institutions is a long-term strategy. Thus, the possibility for microfinance to exist even in bad policy and governance environments might suggest a strategy for donors dealing with such countries,[73] instead of either pumping aid dollars through ineffective, corrupt, or repressive regimes, or refusing to help the poor in those countries.

Microfinance institutions can play an important role in development in circumstances where other sectors of the economy are repressed. Microfinance institutions can help to improve the ability of the poor to build assets, increase price competition and drive down interest rates, and lay the groundwork for banking sector development should legal institutions take root. In developing countries with weak governance, the emphasis on financial development may be more successful by focusing, at least initially, on a strategy of financial growth that relies on microfinance institutions.

This is admittedly a risky strategy, particularly for microfinance advocates. Microfinance institutions operating in bad legal and policy environments are likely to fare much worse than their counterparts elsewhere, and high failure rates may not only harm local development but also drag down the reputation of microfinance generally and thus harm efforts in other countries that are lower risk. Still, the risk may be worth exploring in countries where other options are limited.

Microentrepreneur, 2 J. MICROFINANCE 69 (2000); Robert Peck Christen, *In Search of Credibility: Transparency and the Microfinance Industry*, MICROBANKING BULLETIN No. 5 (2001), *available at* http://www.mixmbb.org/en/mbb_issues/07/mbb7_article2.pdf; Nimal Fernando, *Do Governments in Asia Have a Role in Development of Sustainable Microfinance Services?* (2004), *at* http://www.adb.org/Documents/Slideshows/Microfinance/Fernando_paper.pdf.

72. *See*, *e.g.*, KATHARINA PISTOR ET AL., LAW AND FINANCE IN TRANSITIONAL ECONOMIES (European Bank for Reconstruction and Development Working Paper No. 48, 2000).

73. *See*, *e.g.*, TOMÁS MILLER SANABRIA, MICROFINANCE: LESSONS LEARNED IN LATIN AMERICA (Inter-American Development Bank Document 2000), *available at* http://www.iadb.org/mif/v2/files/microeng.pdf.

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C. *Microfinance to Help Develop the Banking Sector*

Microfinance institutions can also be an important part of a strategy to strengthen the banking system and promote financial development more broadly. Tressel's study of formal and informal methods of credit in developing countries suggests that formal institutions such as banks "develop successfully only if a sufficiently large demand for bank loans materializes."[74] While most studies focus primarily on supply,[75] Tressel shows why demand matters too.[76] Particularly in countries with weak legal infrastructure and concentrated asset-holding, financial institutions are unable to reach broadly to lend throughout the society. Banks focus on relationship lending with political and economic elites. By contrast, as asset-holding broadens information is more widely dispersed, strong legal institutions develop, and banks are able to lend more broadly. Banks can mobilize savings at a scale not possible for small, informal institutions. Thus, banks can "reduce the fragmentation of capital markets in developing countries."[77]

Microfinance institutions may play an important role in "priming the pump" for bank development. Rotating savings and credit associations, curb markets, and moneylenders are often considered transitive, but "their informational advantages are now widely acknowledged."[78] Because of their proximity to their borrowers, these organizations have the ability to gain intimate first-hand knowledge of their clients, and can impose social sanctions to increase enforcement rates.[79] Because informal lenders are in practice often restricted by geography, population, or time, however, they are generally unable to raise large amounts of capital, thereby limiting the amount of financial growth that can occur.[80]

Microfinance institutions can position themselves as intermediaries between the formal and informal sectors. They may be better able to monitor local markets. Microfinance institutions "complement the banking system in the first stages of development when collateral is scarce,"

74. Tressel, *supra* note 17, at 225.

75. *See*, *e.g.*, Valerie Bencivenga & Bruce Smith, *Financial Intermediation and Endogenous Growth*, 58 REV. ECON. STUD. 195 (1991); Jeremy Greenwood & Boyan Jovanovic, *Financial Development, Growth and the Distribution of Income*, 98 J. POL. ECON. 1076 (1990); Robert King & Ross Levine, *Finance, Entrepreneurship and Growth: Theory and Evidence*, 32 J. MONETARY ECON. 513 (1993); Marco Pagano, *Financial Markets and Growth: An Overview*, 37 EUR. ECON. REV. 613 (1993).

76. Tressel, *supra* note 17, at 225.

77. *Id*. at 231.

78. *Id*. at 225.

79. Timonthy Besley, *Savings, Credit and Insurance*, *in* HANDBOOK OF DEVELOPMENT ECONOMICS (Jere Behrman & T.N. Srinivasan eds., 1995).

80. *See*, *e.g.*, Giang Ho, Rural Credit Markets in Vietnam: Theory and Practice (2004) (unpublished Honors Thesis, Macalester College), *available at* http://aede.ag.ohio-state.edu/essay/.

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even though banks need to reach further into the market dominated by the informal sector in order to finish the development process.[81] As Tressel notes, "[l]ocal institutions have an important role to play in the early stages of industrialization because of their ability to exploit local-informal-information; when the average size of firms increases, modern banks that collect savings on a large scale emerge and progressively dominate the financial sector."[82]

The potential for microfinance to contribute to financial development is likely to vary based on the types of institutions and policies in place in individual countries, as well as their levels of development. To this end, a typology will be useful in assessing what role microfinance institutions can play in financial development in a given country.

Generally, financially *developed* countries have strong legal and regulatory enforcement infrastructures. Their capital markets work efficiently. Financial institutions serve broad sectors of society, even if segments of the population are unable to access the financial sector due to market failures, discrimination, or other societal problems. Microfinance can best be used in these countries to help to correct these market failures by expanding access to credit for small firms unable to access bank credit because they are small, new, asset-poor, and opaque. Given the high costs of operating in regulated, advanced economies, coupled with the likelihood that the customer bases of microfinance institutions in the developed world are likely to need other, nonfinancial interventions (such as job training, child care, or social services, which many microfinance institutions feel compelled to provide), it will be quite difficult for most microfinance institutions to operate on a financially self-sustainable basis. Donor or governmental funding is likely to remain quite important. The regulation of financial institutions can and should be tailored to make it possible for both mainstream and specialized institutions to engage in microlending. For example, regulators should pay greater attention to nontraditional forms of collateral and documentation in evaluating the safety and soundness of bank lending. A range of incentives could also be deployed to encourage mainstream banks to engage in providing microfinancial services.[83]

In financially *un*developed countries, microcredit can serve to reduce prevailing high interest rates in the informal sector through bringing increased levels of competition. The financial sector is likely to be fragmented, however, and microcredit is unlikely to serve a broader economic function unless microfinance institutions are able to attract

81. Tressel, *supra* note 17, at 226.
82. *Id*. at 227.
83. *See*, *e.g.*, Barr, *supra* note 35, *passim*.

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significant levels of outside financial support. Until the banking sector begins to develop, microcredit in this context is primarily a means of smoothing consumption, spreading risk, improving incomes, and creating the possibility for saving at a lower cost of credit than in the informal sector. These efforts are important components of poverty alleviation in their own right. Because many financially undeveloped countries lack meaningful regulatory and supervisory infrastructures, microfinancial "regulation"—in the form of donor oversight—would initially be the province of foreign governments, multilateral development banks, and nongovernmental organizations.[84]

Financially *developing* countries, the middle type, present the most interesting case for the role of microfinance in financial development, and are the focus of the remainder of this section. These developing countries vary greatly, but are characterized as having somewhat functional banking systems. These countries may possess rudimentary securities markets, although the quality and reliability of these exchanges is likely to vary greatly. Furthermore, developing countries are likely to have some capacity for supervising and enforcing some types of regulation. Banks in these countries offer investors liquidity in thin markets and extend loans largely to their established customers who maintain balances at the banks. New or small customers have difficulty getting bank credit.[85] Information about the risks of extending credit beyond these groups is not as available as it is in developed economies.[86]

Microfinance institutions in these financially developing nations can play important roles in the banking sector. First, by helping to increase the income and asset base of the poor, they may increase demand for bank loans.[87] Once poor individuals' income bases increase, they will be more frequently able to qualify for loans. Strong microfinancial sectors in these countries could help banks to "finish" the financial market—to get the market to a point where it is adequately serving all segments of society. Microfinance institutions could help banks to reach previously marginalized sectors; however, nondepository microcredit institutions on their own are unlikely to be able to overcome market fragmentation, given their inability to mobilize savings at scale, or attract large enough amounts of capital.

Second, microfinance institutions can help develop and prove financial techniques for reaching the poor at lower cost and lower risk. While

84. *See*, *e.g.*, CGAP, *at* http://www.cgap.org; Transparency International, *available at* http://www.transparency.org.

85. GOODHART et al., *supra* note 15.

86. *See* CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY (Margaret J. Miller ed., 2003).

87. *See* Tressel, *supra* note 17, at 244.

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some techniques are quite labor intensive and not easily transferable to the banking sector as a whole, other techniques can be used by the financial sector to reach more broadly into the market, which will help accelerate the pace of development in the banking sector. For example, the development of credit histories for microfinance customers can be employed by banks to reduce the risk of lending to these households. Many microcredit institutions are themselves banks or other regulated financial institutions, and they have managed to employ a wide range of risk-mitigation techniques to serve the poor even within their regulatory structures. Grameen Bank in Bangladesh and BRI in Indonesia are the classic examples of microfinance-focused banks, but there are countless others. Over time, microfinance institutions employing these techniques can grow in scale. Moreover, at the same time, mainstream banks can move "down market" to serve lower-income households with microfinance products, as has increasingly occurred in a number of Latin American countries. That is, innovative risk-mitigation techniques to serve the poor are not incompatible with regulated financial institutions, as evidenced by the commercialization of microfinance from above and below.

Third, mainstream banks may partner with microfinance institutions. For example, banks could use smaller nondepository microfinance institutions to help mobilize savings that can then be intermediated by regulated financial institutions. That is, microfinance institutions can collect the savings, but in the interest of protecting depositors, regulated banks would hold them in exchange for a fee or wholesale deposit in the microfinance institution, and invest the retail savings in the diversified range of assets available to larger institutions.[88] Banks could also partner with microfinance institutions in offering a broader range of financial products to the microfinance institutions' clientele, with fee-sharing and risk-sharing arrangements designed to take advantage of each type of institution's comparative expertise and institutional strength.

Additionally, given high levels of concentration and volatility, microfinance institutions may wish to consider mechanisms to pool and diversify their risks. Different mechanisms could be developed based on the extent of information available in the market,[89] as well as an assessment of comparative institutional strength. As one example, donors might establish risk funds into which they match payments from financial institutions. Initial losses would come out of the microfinance

88. *See*, *e.g.*, Madeline Hirschland, *Serving Small Depositors: Overcoming the Obstacles, Recognizing the Tradeoffs,* THE MICROBANKING BULLETIN No. 9, *supra* note 59 (noting pilot project for savings mobilization in Bolivia).

89. Daron Acemoglu & Fabrizio Zilibotti, *Information Accumulation in Development*, 107 J. POL. ECON. 539 (1999).

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institution's portion of the risk pool, but donor funds would serve as a backstop. These bolstered reserves would stand against microfinance losses, while the structure of the shared match would preserve appropriate incentives. Microfinance borrowers could be required to pay a portion of the microfinance institution's contribution to the loan loss reserve.[90] The presence of the loan loss reserves may reduce capital market concerns about microfinance volatility and thus draw more funding into microfinance, while overall low loss rates experienced thus far should keep actual loan-loss fund distributions to a relatively low level.

Existing mainstream banking organizations can also reach into microfinance. Donors and governments may assist banks in furthering their reach through carefully designed, targeted subsidies to banks, as has been successfully implemented in Chile. As Tressel argues, "subsidized bank loans for the poor may have an indirect impact on the cost of capital in the informal sector by increasing price competition for the borrowers who are credit rationed on the margin. Such a policy would unambiguously speed up the penetration of modern banks in poor areas."[91] Moreover, microfinance institutions "may have an indirect positive effect by reducing the market power of informal lenders even if their size is limited and they need to rely on subsidies."[92] Microfinance institutions can help to drive down interest rates, which benefits poor borrowers in the short term and helps them to accumulate assets.[93] Lastly, the redistribution of wealth to the poor that bank-subsidized loans entail can improve credit market efficiency by increasing their assets, which could help to break down financial fragmentation and hasten the development of a full-fledged banking sector that permits firms to raise capital on a scale needed for growth.[94]

Thus, over time, microfinance institutions can contribute to a more robust financial system. Initially, microfinance institutions may serve a relatively small portion of the poor in a financially developing society. Given low levels of bank penetration, however, their potential customer base is potentially large in these societies. If the microfinance institutions can attract sufficient capital and operate in a financially sound manner, they have the potential to become quite significant players in providing financial services and credit. As these institutions grow, some of them become better able to serve broader functions of financial inter-

90. This is done by capital access programs in the United States. *See*, *e.g.*, U.S. Dep't of the Treasury, Capital Access Programs: A Summary of Nationwide Performance (2001), *available at* http://www.treas.gov/press/releases/docs/cap01.pdf.

91. Tressel, *supra* note 17, at 243.

92. *Id*.

93. *Id* at 244.

94. *Id*.

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mediation. Moreover, as the microfinance sector grows, mainstream financial institutions may be better able, and more willing, to serve a broader segment of society. These institutions may begin to partner with each other, and the various financial sectors of economy may move to a more integrated financial system.

D. *Microfinance as a Strategy to Advance Domestic Reforms*

Focusing on the needs of a growing microfinance sector may lead domestic entities, including the private sector and the government, to respond by strengthening the domestic institutions needed for broad-based financial development by both mainstream and microfinance institutions seeking to serve a broader segment of the population. Microfinance institutions may contribute to domestic demand for the better governmental and market institutions required for deeper financial development. Thus, microfinance institutions have strong potential to play a social role in these societies (indeed, this was often an impetus for their creation).[95]

Microfinance can help foster internal demand for political changes regarding financial repression, including easing interest rate controls, permitting greater foreign ownership of financial firms, and ending directed lending to cronies that hamper financial development for the financial sector as a whole. Entrenched elites who benefit from the current system have little incentive to promote these changes even though financial development would benefit the country broadly.[96] These elites have access to finance under the current system, and oppose any financial liberalization that increases competition.[97] While opening up capital markets could play a strong role in diminishing the influence of these elites or changing the incentives facing them with respect to market reforms, capital market liberalization can also serve to entrench elites,[98] or open up the economies of countries with weak governance structures to financial crises.[99] While the effects of microfinance are necessarily more limited, growing microfinance institutions might be able to play a role in serving as a counterpoint to those who oppose reform. Microfinance institutions focus on serving poor and near-poor borrowers, and this focus seems largely, but not entirely, to be able to withstand commercialization

95. *See*, *e.g.*, Zaman, supra note 38 (noting role of Grameen Bank). This social role, however, can cut against moving toward financial self-sustainability and efficiency as a business.

96. *See* Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003).

97. *Id*.

98. *Id*. at 22.

99. *See*, *e.g.*, Stiglitz, *supra* note 13.

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and larger scale.[100] As microfinance becomes larger scale, more deeply capitalized, and more commercialized in some countries, these pressures can help to bolster the constituencies needed to demand improvements in the financial market overall.[101]

Understanding the difficulties associated with supervising and regulating microfinance institutions may lead central banks (or the appropriate bank regulatory body) to rethink their supervisory approach as a whole. For example, the growth and commercialization of microfinance might put pressure on governments to remove interest rate controls and directed lending to cronies. Similarly, a focus on microfinance might force regulators to move away from rigid capital adequacy and more toward risk-based supervision of internal systems for information gathering, monitoring, and risk control. Unfortunately, many supervisors in the developing world will not have the capacity to do this well, even for mainstream banks, let alone microfinance institutions.

Microfinance can help foster demand for market innovations, such as credit information bureaus, that benefit financial deepening. As microfinance institutions grow, increased competition will result in better borrower choice among lenders, which can mean higher default rates as the bond between borrower and lender weakens.[102] Moreover, a sound credit history can play the role of "reputation collateral" for microcredit borrowers, who usually lack much by way of physical collateral.[103] Thus, there is an increasing need for credit information clearinghouses to facilitate microfinance.[104] Clearinghouses can play critical roles in financial development more broadly by reducing asymmetry of information between borrowers and lenders, and thus reducing risk. Well-developed credit information clearinghouses are essential to widespread consumer and retail lending.[105]

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100. *See*, *e.g.*, ROBERT PECK CHRISTEN, COMMERCIALIZATION AND MISSION DRIFT: THE TRANSFORMATION OF MICROFINANCE IN LATIN AMERICA (CGAP Occasional Paper No. 5, 2000); ELISABETH RHYNE & ROBERT PECK CHRISTEN, MICROFINANCE ENTERS THE MARKETPLACE (U.S. Agency for International Development Document 1999).

101. *See* JOHN COFFEE, CONVERGENCE AND ITS CRITICS: WHAT ARE THE PRECONDITIONS TO THE SEPARATION OF OWNERSHIP AND CONTROL? (Columbia Law & Economics Working Paper No. 179, 2000) (providing an example of demand-led theories of legislative change), *available at* http://www.ssrn.com/abstract=241782.

102. *See* McIntosh & Wydick, *supra* note 50 (regarding the increase of competition among microfinance institutions and the potential negative impact on default rates).

103. *See* CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY, *supra* note 86, at 2.

104. *See* Rhyne & Christen, *supra* note 100 (noting that Chile's credit bureau helped to promote bank entry into the microfinance market).

105. *See* CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY, *supra* note 86.

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Banks, however, may not demand clearinghouses, or may support clearinghouses in which only banks get access to the credit data. As a theoretical matter, the private returns to banks are lower (or put another way, the private costs are higher) than the social returns to information sharing under a number of plausible scenarios.[106] Moreover, because of the closed nature of bank lending in many developing countries, where banks only lend to the elite—their depositors—and these depositors largely borrow from their bank, the incentives for banks voluntarily to share information about their borrowers is significantly diminished. As Tressel argues, relationship lending and below-market deposit rates link banks and borrowers, but new borrowers are not part of the equation.[107] In a number of developing countries, public credit bureaus were created in the 1990s only after massive economic shocks to the financial system, or conversely, only after long periods of economic stability, during which the lack of credit bureaus may have delayed more rapid growth.[108]

Moreover, good clearinghouses are hard to build. In many countries, one needs to worry about corruption, erosion of privacy, lack of complete and accurate information, and technical capacity, as well as fragmented credit information availability and restrictions on what type of institution may use the data.[109] In the United States, credit bureaus were built up as voluntary process over a very long time.[110] In developing countries, microfinance institutions might work together to broaden access to existing credit clearinghouses, so that a wider range of institutions can have access to the credit data, a wider range of borrowers are recorded in the system, and both positive and negative credit histories are recorded, rather than simply focusing on negative reporting. Where such credit information clearinghouses do not yet exist, microfinance institutions can help to develop such clearinghouses, either privately, in conjunction with the banking sector, or through the central

106. Tullio Jappelli & Marco Pagano, *Information Sharing in Credit Markets*, 43 J. FIN. 1693 (1993).

107. Tressel, *supra* note 17, at 6.

108. *See* Margaret J. Miller, *Credit Reporting Systems Around the Globe: The State of the Art in Public Credit Registries and Private Credit Reporting Firms*, *in* CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY, *supra* note 86, at 25, 34–35; ANDREW POWELL ET AL., IMPROVING CREDIT INFORMATION, BANK REGULATION AND SUPERVISION: ON THE ROLE AND DESIGN OF PUBLIC CREDIT REGISTRIES 5 (World Bank Policy Research Working Paper No. 3443, 2004), *available at* http://econ.worldbank.org/files/39968_wps3443.pdf.

109. *See generally* CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY, *supra* note 86; Rhyne & Christen, *supra* note 100, at 23 (noting that Bolivia restricts participation in the credit bureau to banks).

110. *See* Michael E. Staten & Fred H. Cate, Does the Fair Credit Reporting Act Promote Accurate Credit Reporting? (Joint Center For Housing Studies Working Paper BABC 04-14, 2004), *available at* http://www.jchs.harvard.edu/publications/finance/babc/babc_04-14.pdf.

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banks, by establishing public registries with procedures for access by a wide range of creditors.

Lastly, as microfinance institutions have grown and some of them have taken on retail deposits, questions have arisen about whether and how to regulate them. Microfinance institutions have presented challenges to developing governmental systems. Because they tend to offer different services—depending on the location in which they operate, the economics and needs of the clientele, the sophistication of their programs, and their financial success—the regulatory scheme can vary.

With regards to deposit taking, microfinance institutions are broadly categorized in two groups. Some microfinance institutions have for a long time required cash balances to be maintained by borrowers as a form of collateral, earnest money, or a demonstration of ability to repay. Other institutions have served more broadly to mobilize the savings of poor communities as an end in itself or as a source of funding for credit and other operations. As microfinance institutions increasingly look to diversify their sources of funding through retail deposit taking, there has been a concomitant rise in interest in the appropriate forms of supervision and regulation for microfinance institutions. These distinct scenarios represent challenges for governments focusing on creating fledgling regulatory regimes.

There is a burgeoning literature in this area,[111] and for purposes of this short Article, I only wish to offer a few basic observations. As an initial matter, I agree with commentators who suggest that microfinance regulation, at least in terms of prudential supervision, ought to be generally reserved for institutions that take retail deposits beyond the small deposits of earnest money that some microfinance institutions collect from their borrowers.[112] Moreover, small, rural microfinance institutions, even those that accept small levels of deposits, would be difficult to supervise effectively, and may be better off left unregulated, if the regulations cannot be tailored to be reasonably cost effective for regulators and the microfinance institutions. If regulatory costs drive such institutions to be non-viable, depositors may be forced to leave their savings in higher-risk mechanisms (e.g., buying livestock, keeping cash

111. *See*, *e.g.*, Rodrigo Chaves & Claudio Gonzalez-Vega, *Principles of Regulation and Prudential Supervision and Their Relevance for Microenterprise Finance Organizations*, *in* THE NEW WORLD OF MICROENTERPRISE FINANCE: BUILDING HEALTHY FINANCIAL INSTITUTIONS FOR THE POOR 55 (Mario Otero & Elisabeth Rhyne eds., 1994); ROBERT PECK CHRISTEN & RICHARD ROSENBERG, THE RUSH TO REGULATE: LEGAL FRAMEWORKS FOR MICROFINANCE (CGAP Occasional Paper No. 4, 2000).

112. ROBERT C. VOGEL ET AL., MICROFINANCE REGULATION AND SUPERVISION CONCEPT PAPER 3 (Microenterprise Best Practices Working Paper, 2000).

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under the mattress).[113] The volatility, geographic and sector concentration, fast growth, and low capital of many microfinance institutions may mean that regulators would need to require high capital adequacy ratios for deposit-taking microfinance institutions.[114] Because prudential regulation is hard to do well, donors, international financial institutions, and microfinance institutions ought to think about strategies that would delay the need for such regulation. For example, microfinance organizations could choose not to fund themselves directly with deposits, but to serve as deposit-takers for supervised depositories who can then lend to microfinance institutions more cheaply or pay fees in exchange for deposit funds. Donors could also encourage microfinance institutions to take on risk-mitigation measures, such as pooled loan loss funds or other devices.

The challenges of extending supervision to large numbers of often quite small microfinance institutions would be enormous, given the ineffectiveness of normal supervisory tools (for example, capital calls are more difficult given that "equity" may consist entirely of donor grants, and stop lending orders will undermine repayment in programs that rely on graduated loan ladders as an incentive for repayment).[115] Moreover, many developing countries with scarce governmental capacity will have difficulties implementing the new Basel capital standards even for the largest commercial institutions, without regard for the microfinance sector. Thus, developing nations should be cautious about extending supervision beyond large microfinance institutions that choose to take on retail deposits and commercial banking institutions that choose to take on microfinance. A number of large microfinance institutions are already regulated banks, credit unions, or other licensed entities. Many of these institutions started out as smaller, microfinance-focused organizations, while others were mainstream banks that chose to move into the microfinance sector, in whole or in part. The main challenge for regulators will be to adapt prudential supervision to take account of the particular risks,

113. *See* ROBERT PECK CHRISTEN ET AL., MICROFINANCE CONSENSUS GUIDELINES: GUIDING PRINCIPLES ON REGULATION AND SUPERVISION OF MICROFINANCE (CGAP Document 2003), *available at* http://www.cgap.org/docs/Guideline_RegSup.pdf; Elizabeth Rhyne & Maria Otero, *Financial Services for Microenterprises: Principles and Institutions*, *in* THE NEW WORLD OF MICROENTERPRISE FINANCE: BUILDING HEALTHY FINANCIAL INSTITUTIONS FOR THE POOR, *supra* note 111, at 26.

114. *See, e.g.*, Vogel, *supra* note 112, at 5.

115. *See*, *e.g.*, Christen et al., *supra* note 113; Garry Christensen, *Limits to Informal Financial Intermediation*, 21 WORLD DEV. 721 (1993).

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and risk mitigation techniques, of microfinance undertaken by both mainstream and microfinance-focused institutions.[116]

V. CONCLUSION

Microfinance is not a panacea, but it is a more promising approach than many we have had for development for some time, in its own right. I suggest that by thinking about financial development from a microfinance vantage point, we might increase the likelihood that financial development more broadly can contribute to poverty alleviation. This preliminary Article is largely aspirational, rather than empirical, and much further research is required to test out these propositions.

116. *See*, *e.g.*, Christen et al., *supra* note 113; Vogel, *supra* note 112, at 11 (arguing for a focus on better information systems and risk-based supervision of loan training, monitoring, and staff control systems.)

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