Failing **by Installment**

With the financial markets broadening their international reach, there was hope that microcredit might alleviate poverty and lead to the emancipation of women in the "global South." Sadly, however, there are no indications that microfinance has had a positive effect. On the contrary, the poor have suffered more discipline, while surplus labor is extracted from them even more than before. Worse still, the microfinance sector has triggered a series of devastating crises. Our author explains why we can't use more debt to create social justice.

TEXT **PHILIP MADER**

It was around the early 1980s that the term "microcredit" was coined to describe the lending of small sums, a few hundred euros at most, often to those involved in small business in the informal sector of developing countries. 2013 marked the thirtieth anniversary of the founding of the legendary Grameen Bank, which came to the notice of a wider audience in 2006 when its founder Muhammad Yunus was awarded the Nobel Peace Prize. Thanks not least to generous public sector support, microloans are now one of the most popular and well known instruments in the field of economic cooperation and development. They increasingly constitute a financial market of their own that has caught the attention of big investors like George Soros and Bill Gates.

Microloans have aroused the interest of wealthy investors worldwide

Between 2001 and 2011, lending in this sector rose from just under 3 billion US dollars to almost 90 billion, distributed to over 200 million men and women worldwide. The microfinance sector has grown dramatically, gaining more and more people in the "global South" – as developing countries are often collectively referred to – as borrowers. Microloans, so the theory goes, help women emancipate themselves by enabling them to earn an independent income. Such loans are also said to generate momentum for local development. Of course the term microfinance refers to more than just lending – insurance and savings, for example – but the emphasis remains on loans. These are generally repaid in weekly installments over less than one year, at average interest rates of around 27 percent.

Microfinance is now a transnational industry that is ever more closely interlinked with the traditional financial markets, directing capital from donor organizations and investors to the remotest reaches of the global economy. Unfortunately, however, for all the development policy hopes riding on this flow of funds, no sustained changes are visible to date – no clear reduction in poverty. A series of broad-based studies carried out in recent years found no improvements in living conditions and only a minimal increase in business activity among the poor as a result of microfinance. These studies reveal that, while the poor work somewhat harder when in receipt of a microloan, they don't earn more.

The problems are fairly evident: Even if microloans were only ever invested in entrepreneurial proj-

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A fate is sealed: Women in India use a thumb print to sign their loan agreements.

ects, the creation of countless new mini-businesses doesn't constitute actual economic development. It simply continues and expands the bazaar-type economy that, at best, already represents a forced self-help

Multitudes of new micro-businesses don't constitute economic development

solution for those who would otherwise have no employment at all. What's more, the majority of loans aren't used to run a business, but to fund consumption: to overcome emergencies such as illnesses, and to survive day to day. It is hardly surprising that, in these cases, it is tough for the borrowers to scrape together the money for interest payments and loan installments.

On what foundation, then, did development policymakers build their hopes? Newspaper readers will be familiar with the stories of small businessmen and -women (around three quarters of borrowers are female) who, thanks to a microloan, have worked their way up, if not to the ranks of millionaires, then at least out of the bonds of hopelessness to be able to provide for their families with the income they earn as hawkers or food vendors. Such reports from countries like Nigeria and Bolivia have established microfinance in the eyes of the public as a kind of silver bullet in the fight against poverty.

Collectively, these stories form a narrative telling us that it isn't primarily business skills, education, or public services that the poor lack so much as access to capital to develop their potential. The microfinance industry and its adherents interpret poverty as a problem that is best solved transnationally with the resources of the financial markets. Many donor organizations in recent years have even gone so far as to expressly distance themselves from the goal of supporting predominantly business borrowers, preferring instead to pursue a more comprehensive program of "financial inclusion." The idea is that not just entrepreneurs, but all poor people should be able to access funds via the microfinance industry in any situation, from a sudden family illness to a daughter's dowry payment, and thus use credit to deal more effectively with the financial problems inherent in their poverty.

It's remarkable how this narrative has mobilized donors and investors to become part of the recipe for success. By investing in microfinance organizations, so the story goes, holders of capital in wealthy countries can generate small economic miracles in Africa and Asia, and even turn a profit in doing so. Microloans are meeting the recent increase in investor demand for "social investments." The idealistic – but also market fundamentalist – overtone of this narrative of aid through the financial markets is that nobody should be demeaned by the gift of alms. Microfinance merely establishes a commercial relationship that presumably benefits both sides. One party pays for the fleeting hope of escaping poverty, while the other makes a modest return. The investor or donor who enables a borrower to incur debt, so the narrative goes, actually behaves more ethically than a do-gooder whose gift of alms patronizes, pampers or demotivates the recipient.

The unequal balance of power between the lender and the borrower, however, is kept out of sight. On closer inspection, the microfinance system establishes a chain of discipline and punishment between the owners of capital (lenders or investors) and their debtors, the effects of which are becoming ever more powerful as microfinance becomes more directly integrated into the mainstream financial markets. To illustrate this chain, let us begin at the top: Most private individuals, development organizations and commercial investors today channel their commitments to microfinance through special investment funds or bonds that are frequently managed by commercial investment banks. Even charitable organizations and state-owned development banks are happy to invest in such profit-oriented microfinance investment funds because of the cost efficiency they offer and the simplification of the process of identifying suitable investment targets.

The funds, generally based in Europe, the US or various tax havens, demand that loan defaults be kept to a minimum, and that payments be sufficiently high and regular. Microfinance institutions must therefore ensure that their funding providers regularly receive high payments, leading them to implement

strict controls and incentive systems. The typical weekly (rather than monthly) repayments required from borrowers constitute an important control mechanism in their own right, in that any slippage in discipline can be quickly identified. Additionally, as an incentive, loan officers are paid large shares of their income as performance bonuses that are linked to loan volumes and repayments, with the result that they continue to collect loans even in the face of natural disasters or epidemics.

Most microfinance company employees are men, while most borrowers are women. Even the first signs of tardiness on loan repayment often incur a penalty. For example, all the members of a borrower group may be detained at a meeting point until the one woman who is late with her payment comes up with the money – which can cost as many as 40 families their daily wages. For this reason, the groups keep a close eye on their members. Non-payment is punished by social exclusion, which is often even more serious than financial penalties. The groups can seize, so to speak, the "social capital" that poor people pledge as security for their debts. In traditional societies such as Bangladesh, the public humiliation of women is a very effective means of applying pressure. In the worst cases, group members – often urged on by the loan officer – will even resort to tearing down houses or abducting children. As people find themselves backed into a corner, the consequences range from domestic violence to fleeing the village or even suicide.

Nevertheless, active disciplining, or actual use of force, remains the exception. The players in this chain of observation and punishment are expected to keep their own proverbial houses in order so as to avoid negative consequences. The structure of the microfinance system ensures that the last links in the chain exercise self-discipline in the interest of the capital providers. Researchers in India, for example, found that borrowers reduced their spending on little luxuries such as tea or food consumed outside the home, or took out extra loans to repay their old loans. As a result, business is booming again for traditional loan sharks in regions where microfinance has a high penetration. It comes as little surprise that, in other studies, borrowers describe themselves as less satisfied with their lives than those without a loan.

Although poverty as such is not being reduced, this discipline is definitely leading to a notable siphoning off of payments from the poor population. The microfinance system effectively creates new relationships between capital and labor – relationships that are of no clear benefit to the poor, but that are demonstrably positive for the finance industry. Interest rates of over 100 percent are by no means rare among microloans, particularly among the more economically successful microfinance banks. For instance, the Mexican industry leader Compartamos Banco, which is listed on the stock exchange, charges annual interest rates of up to 195 percent. Despite the high costs involved in administering tiny, labor-intensive loans, they harbor the potential for very high profits, which debtors must pay out of their earnings.

Calculations using data on loan portfolio size and loan yield show that microfinance banks earned a total income of almost 19.6 billion US dollars in 2010.

Late payments incur immediate penalties; borrower groups react with social exclusion

In other words, microborrowers paid more in interest on their loans than the 16.6 billion the Greek government spent in the same year to service its debt. This clearly shows the "systemic relevance" of the present scale of microfinance. Despite its promise to bring development for the poor, microfinance reveals itself to be an instrument with which to "financialize" poverty. Microloans grant financial markets and market players access to the activities that people in the global South do in order to survive, even to the extent of making these activities attractive or profitable.

However, all of this – the positive narrative, the disciplinary measures and the successful siphoning off of surplus labor – remains an analysis of the norm. But the system of microfinance is not a stable monolith, as the remarkable series of crises in recent years demonstrates – Bolivia in 2000, Nicaragua, Bosnia-Herzegovina, Pakistan and Morocco in 2008, India in 2010 – each of which the microfinance industry has interpreted variously as inadver-

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tent hiccups or illegitimate political interference. Overall, however, these crises reveal that, under the weight of its success in selling debt, the sector continually pushes the limits of what its customers can sustain, and then collapses.

The case of India vividly illustrates the process: The subcontinent was considered a late-starter; with such a vast potential of new clients, the market potential appeared infinite. Particularly the southern state of Andhra Pradesh, a paragon of the structural reforms of the 1990s, was hailed by investors as the new "Mecca of microfinance." Many of the non-governmental organizations founded here around the millennium with charity money were, within a matter of a few years, privatized as profit-oriented institutions that went off in search of investment capital to finance annual growth rates of, in some cases, more than 100 percent. This growth came at the price of the constant erosion of lending standards: more and more loans were simply used to pay off existing debt, and individual employees were tasked with managing hundreds of customers. In addition, many groups of borrowers were simply "poached" from the state self-help group-lending program and provided with loans upon loans. Still, Andhra Pradesh was regarded worldwide as a model of how, despite fierce competition in the microfinance market, private investment capital could achieve the full "financial inclusion" of an entire population within just a few years.

The growth of profit-oriented institutions comes at the price of eroding lending standards

The crash came just after the euphoria reached its peak – three months after the largest institution, SKS Microfinance, was floated on the stock market amid loud applause, and SKS founder Vikram Akula pocketed 60 million dollars for his services to the poor. Amid countless reports of violence and exploitation, early autumn of 2010 saw a wave of borrower suicides sweep Andhra Pradesh. In some cases it was the loan officers themselves who drove their customers to take their lives, so that the bank could cash in the life insurance policies sold as an obligatory add-on to the loans. The government of Andhra Pradesh abruptly issued a decree putting a stop to all microfinance business, prompting an outcry from banks and investors and an accusation that the government was intervening only to protect its state-led self-help credit system against superior competition.

Although this assessment wasn't entirely inaccurate, it clearly revealed the extent to which India's microfinance industry was focused on preserving its business model, no matter the cost. The argument the banks put forward – that many of the dead borrowers were in default on loans issued, not by them, but rather by their competitors – says more about the success of their collection techniques than about the fairness of their business model. It turned out that the majority of households in Andhra Pradesh had taken out four or more loans. The target of "financial inclusion" had been overshot by far; loans issued by microfinance banks had risen faster than any other type in the last years.

Since 2010, the microfinance business has stagnated throughout India, and has almost entirely collapsed in Andhra Pradesh. The industry is evidently struggling to understand its own demise, since it had adhered precisely to the rules of "financialized" microfinance – that is, a system that decoupled itself from benevolent donors and subordinated itself to the laws of the financial market: satisfy demand, work hard to achieve growth, attract investors, achieve efficiency, compete fiercely, make profits, become more efficient, continue to grow, and so on. But it was precisely these factors that triggered the crisis. Rather than as a victim of politics, it is perhaps better to describe the finance industry as having been brought down by its own ostensible success. The demand to which it responded was generally prompted, not by entrepreneurial opportunities, but by the opposite: the lack of opportunities and the desperation of peasant farmers, slum dwellers and the unemployed, especially in the neoliberal pioneer state of Andhra Pradesh. Much of the demand was merely to refinance existing loans. Competition and a glut of capital didn't clean up the market, but rather amplified the incentives to lend more generously, erode internal controls and ultimately drive customers into a debt trap.

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To ultimately assess microfinance, it is therefore important to consider the causes and effects of the general expansion of the financial sector ("financialization") in recent decades, and to ask where the limits lie. It is evident that financial markets and market participants are playing an ever greater role in meeting and directing social needs, from making provisions for our old age and putting a roof over our heads – think of the US mortgage bubble – to climate protection (emissions trading) and the provision of public goods. It also becomes apparent that it is precisely the supposed successes resulting from the expansion of financial markets that render us more susceptible to crises.

In the case of microfinance, the positive spin put on the emancipatory power of loans played a central role. "Financial inclusion" was expected to enable poor people to satisfy their needs more effectively, with the holders of capital helping as investors and providers of funding. The promise that poverty would be reduced with the aid of the financial markets seemed to be coming true. In reality, however, the positive effects of microloans – at least according to the current state of research – haven't materialized. Instead, the microfinance system has constructed a transnational chain of disciplinary measures that, in the interests of regular capital flows, compels poor people to tighten their belts yet another notch and hand over a sizeable share of the surplus value created by their work. But Andhra Pradesh proves that there are also limits to this system.

The unequal distribution of wealth is worsening

Overall, this analysis of microfinance reveals that the financial markets have a tendency to exacerbate the existing unequal distribution of wealth – even where the markets operate under the banner of poverty reduction. The desire to create social justice through debt has proved to be an unfulfillable promise and a poor replacement for public welfare or redistributive development policies. ◂

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Photo: Private

Philip Mader (29) is a researcher at the Max Planck Institute for the Study of Societies. He studied economics at the University of Sussex in Great Britain before completing a master's degree in development studies at the University of Cambridge. He began working toward his doctorate at the Max Planck Institute for the Study of Societies in 2008, heading for Andhra Pradesh in spring 2010 to undertake fieldwork before moving on to Harvard as a visiting scientist. He has been co-editor of the research blog "Governance Across Borders" since 2009. He completed his doctorate at the University of Cologne in 2012. Philip Mader was awarded the Otto Hahn Medal in June 2013, and in November, the Körber Foundation's German Thesis Award (1st prize) in the social sciences category.

FIRST MEETING OF CRITICS

In August 2013, Philip Mader joined forces with Journalist-in-Residence Gerhard Klas at the Max Planck Institute for the Study of Societies in Cologne to organize the first conference to bring together critical voices in the German-speaking world. Under the title "Three decades of neoliberal development policy and microfinance: Taking stock," the conference provided an opportunity for around 40 participants to assess the growth of the microfinance industry in the context of global development policy and the continuing crisis of capitalism. The development practitioners, scientists and journalists who assembled in Cologne also evaluated alternative strategies for North-South cooperation and discussed potential solutions. In essence, these included supporting local debtor organizations and (re)developing public welfare systems and helping people demand their basic rights – instead of debts. The results of the conference have been integrated into an edited book to be published in early 2014 with Campus.