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A dialogue on the future of microfinance and international development

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Jonathan Morduch (NYU)

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Abstract

This dialogue contributes to the 50th anniversary and 200th issue of *Mondes en développement* (*Developing Worlds*), the French and Belgian journal founded in 1973 by François Perroux of the Collège de France. To mark the anniversary, we discuss what has been learned about microfinance, which, as a modern movement, is also roughly 50 years old. We discuss issues including the early history of microfinance and how it arose from new views on poverty in the 1970s coupled with fall-0ut from the global debt crisis of the 1980s; the role of rhetoric within the microfinance sector; debates over subsidy; changing views of group lending; gender and finance; and whether everyone wants to be an entrepreneur.

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An anniversary is often a way to look backward and refer to what has been achieved. But it can also be a good time for developing a vision of what the future could/should be. This is the perspective we chose for this dialogue. Building on what the past has taught us, Jonathan Morduch, one of the most respected academics in the field of microfinance and financial inclusion, gives us his perception of what the future of this field could be and how it could contribute to make a better world.

Looking backward…

Marc Labie : *Mondes en Développement* is, roughly speaking, 50 years old. Before we begin discussing microfinance, let's step back. Which elements during the past five decades of international development are most important for understanding microfinance?

Jonathan Morduch: First, *bon anniversaire* to *Mondes en Développement!* The 50 years and 200 issues of the journal are a great accomplishment. Congratulations. Those 200 issues also open a window through which to see shifting debates and understandings—both for microfinance and for international development.

François Perroux's Issue number 1, which launched in 1973, is striking. Looking back, 1973 was a pivotal year for international development – and it was important too for microfinance. Issue number 1 was arranged around the theme of "unequal development," and two essays were contributed by Gunnar Myrdal, the Swedish economist and 1974 Nobel laureate. His first essay was on a "more realistic" theory of development, and his second was on "the world poverty problem." Both pushed against post-war notions of "modernization" and the idea that development equals GDP growth and industrialization.

What was so striking about 1973—and what we can see much more clearly today—is that the kinds of criticisms made by Perroux, Myrdal, and others were in fact entering the mainstream at that very moment. Most famously, in September 1973 Robert McNamara, who was then the President of the World Bank, gave a well-known speech to the joint World Bank-IMF meetings in Nairobi, Kenya. That speech marked a tectonic shift in World Bank policy, bringing commitments to focus on absolute poverty (especially rural poverty), gender, nutrition, health, and basic education. The shift also brought a focus on working with NGOs and the private sector, not just governments. Until then, the World Bank had championed GDP growth and large capital projects, but McNamara's 1973 speech took up the fight against "unequal development" and made poverty reduction the new mandate for the World Bank. In its rhetoric, at least, the hegemon gobbled up its critics.

What does this have to do with microfinance? This shift to microeconomic priorities (poverty, gender, nutrition, etc.) repudiated the idea that development was mainly a macro (GDP) problem. And that provided the opening for microfinance. Muhammad Yunus's first experiments in Bangladesh started several years later, around 1976, and Yunus came to describe microfinance as, first and foremost, a way to reduce rural poverty, even in the absence of macro growth. Eventually microfinance came to be seen as a way to serve women, to help raise the living standards of struggling families, and to do so through a non-governmental movement. Everything in microfinance was in line with this new micro-focused development thought from 1973.

ML: So, like *Mondes en Développement*, microfinance, in its « modern » form, is also roughly 50 years old. Are there other ways that microfinance and broader development thinking intertwined?

JM: Another global upheaval also had roots in 1973. This one did great damage. This is the global debt crisis, and it was also a vital context for microfinance. 1973 was the year of the Yom Kippur War, when Israel's neighbors launched a surprise attack. In defeat, the oil-rich countries created OPEC, the cartel that artificially limits the global oil supply. By early 1974 the price of oil had nearly quadrupled. The price increase devastated low-income economies that depended on foreign oil for development plans. The loans owed to global banks could no longer be repaid, and they were renegotiated on tough terms. The IMF and other lenders imposed austerity measures that led to large cuts in social spending around the world. Criticisms of the IMF filled the pages of *Mondes en Développement* as well.

This macro context, which was reinforced by the *laissez-faire* leanings of Reagan and Thatcher in the 1980s, also framed microfinance. To simplify (perhaps too much): the "micro" commitments to reducing poverty and inequality from 1973 clashed sharply with the "macro" and financial imperatives that resulted from the debt crisis. They clashed too with the Reagan-Thatcher free-market ideology and the economics of austerity.

Yet what is most remarkable about microfinance is that it thrived amidst this conflict! Or, more precisely, it thrived *because* of the conflict.

Yunus and the early pioneers promised to reduce rural poverty while operating business-like nonprofit banks. The entrepreneurial spirit of poor people would be unleashed, allowing them to escape poverty through their own hard work and ingenuity. At the same time, the pioneers argued that their new intervention did not require large government outlays beyond start-up capital.

This was the genesis of the original "win-win" formulation for microfinance. Microfinance promised to deliver poverty reduction by supporting entrepreneurship (a big "win") that worked without needing continual government subsidy (another big "win" in a time of austerity)! It had great success as a marketing strategy, and it was tailor-made for its moment in the late 20th century.

But, in retrospect, we can also see that important claims about microfinance were misleading or simply wrong. The theory and data on which they rested were flimsy. And yet – here is another surprise – microfinance flourished nevertheless. To understand why, we need a different narrative. That narrative highlights the importance of instability and illiquidity in people's lives, and the role that microfinance plays in managing that instability and providing liquidity.

ML: So, during these roughly five decades of microfinance, it seems that we can identify three periods: the first decade (the 70's) when most observers were skeptical of the ability to provide financial services to financially excluded people, and when attempts by state-owned banks were heavily criticized for being inefficient and overly-politicized; followed by three decades (80's, 90's and 2000's) of overpraised expectations for microfinance; and, lastly, the last ten years during which criticism has clearly dominated the field. What lesson do you draw from these 50 years?

JM: When we look back to that middle period—the heyday of microfinance leading up to the 2006 Nobel Prize to Grameen Bank and Yunus—we can see that reality was much more complicated than was advertized, and not all claims were true. It is not true that every villager wants to be, or can be, an entrepreneur. It is not true that borrowing, on average, leads to transformational gains in income. Those fundamental parts of the microfinance narrative have to be set aside. But the criticisms of the past decade have also been over-stated.

My sense of optimism comes from seeing the unraveling of the original microfinance narrative, and seeing it replaced by more accurate understandings of the financial lives of poor families. This was a motivation for the work behind *Portfolios of the Poor*.[1] The book documents people's financial lives by following their strategies and daily lives, not by looking through the lens of microfinance.

The financial diaries revealed that most people want and need credit in order to manage a wide range of household expenses, from keeping food on the table to paying for healthcare to making household repairs. Funds for business are often needed, but they are just one financial need among many.

Experts and policymakers think about poverty as fundamentally a problem of low incomes. This is, of course, a big part of poverty. How could one argue otherwise? But poverty is also very much a spending problem, as households struggle to get hold of the right money at the right time for important needs. The challenge of illiquidity is hidden in the large surveys used to analyze inequalities, but the financial diaries make it clear, family after family.

A few months ago, I was described as a "former microfinance sympathizer" in a magazine, but that gets it wrong. I still very much believe in the value of the financial access that microfinance can bring. Recent criticism of microfinance, based on results from randomized experiments, places too much weight on weak results on households' business profit and impacts on household income. In practice, most households use microfinance as a source of general liquidity, to facilitate lumpy spending and smooth consumption. We need to take seriously the value of that capability.

ML: Words that dominate a field indeed often tell us something about the way this field is evolving over time in terms of priorities and values. In the present case, the industry clearly moved from "microcredit," to "microfinance" to "financial inclusion" nowadays. Do you think that this change of terms truly is meaningful both conceptually and in the practices of microfinance organizations? What does it say for the future? And in your opinion, what will be the next (buzz)word in our field?

JM: Microfinance is a rich text for students of rhetoric. In practice, each shift in wording has brought a shift away from concerns with poverty and social justice toward finance for less poor populations.

Muhammad Yunus was upset when people initially abandoned the term "microcredit" in favor of "microfinance," even though microfinance better captured the breadth of activity and innovation in the sector. Yunus accurately perceived that,

[1] Daryl Collins, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven. 2009. *Portfolios of the Poor: How the World's Poor Live on $2 a Day*. Princeton, NJ: Princeton University Press.

in practice, rejecting "microcredit" was part of a broader rejection of his particular pro-poor worldview—and not just a reflection of the emerging importance of saving and insurance.

That continues now with the buzz around "financial health" and the move away from "microfinance," "financial access," and even "financial inclusion." "Financial health" is a useful phrase since it shifts concern from providing financial inputs to securing financial outcomes. As a terminological evolution, "financial health" can be defended with compelling, neutral logic. But the reality is that, in practice, the shift in wording again dilutes the focus on the historical exclusion of and discrimination against the most disadvantaged communities.

Discussing key impact issues…

ML: An aspect that contributed originally a lot to the attention devoted to microfinance was the role it was supposed to play in the empowerment of women. Microfinance was supposed to help women who were themselves supposed to be not only poorer but also more socially and financially responsible than men. Besides, many microfinance organizations were created by women (let's remember for instance the founders of FIE in Bolivia, of SEWA in India or those of the Women World Banking network worldwide). 50 years later, doubts have emerged on the social performance of microfinance and many organizations originally created by women are now run by men. Do you think that microfinance has a contribution to provide to a world where women and men would be treated in a more equal way? And if so, how?

JM: One of the ironies of microfinance is that it aims for the empowerment of women, yet microfinance also succeeds in part because female customers are often disempowered, with limited options for access to capital. Thus, poor women, especially, have strong incentives to repay loans at all cost, helping to maintain high loan repayment rates; in that sense the disempowerment of women has contributed to the viability of microfinance.

This irony does not mean that microfinance is unhelpful to women, but it points to complexities in understanding gender in microfinance. Recent work by researchers affiliated with CERMi shows, for example, that microfinance lending in India can reinforce gendered burdens to manage household budgets, rather than undoing those roles.[2]

[2] Isabelle Guérin, Christophe Nordman, and Elena Reboul. 2020. "The Gender of Debt and Credit: Insights from Rural Tamil Nadu." IZA DP No. 13891. Bonn, IZA – Institute of Labor Economics, November.

As SEWA's Ela Bhatt demonstrated, having a gender lens is not just about the genders and commitments of the top leadership but also about the structure of incentives and the genders and commitments of loan officers and other employees.[3] Creating fairer labor markets—access to good jobs at good wages—is likely more important for most women, but creating fairer capital markets remains critical too.

ML: Many international institutions and local governments would like microfinance organizations to support the development of rural and agricultural communities which are often much poorer than urban areas. But microfinance works particularly well for income generating activities that combine high return and short-term cash flow cycle, which are not the prime characteristics of agriculture. Isn't there a contradiction there? And what could microfinance and financial inclusion do in the future for poor rural areas?

JM: Is it a contradiction? I never saw it that way, but it is an interesting strategic question. Yunus took a step that was not at all obvious but which turned out to be pivotal for the success of microfinance. That step was to focus on rural communities, but *not* on agriculture. Yunus knew that agriculture is risky because revenues depend on seasonal fluctuations of weather and prices. Public banks had for decades failed to manage the risks. Farmers are also a powerful political bloc, which creates its own challenges. So, from the start, microfinance instead focused on other kinds of rural activities, like small-scale manufacturing, small shops, and other businesses, which are less seasonal and less sensitive politically. The early pioneers showed that this strategy could work – and that it was a better way to reach women as well.

My sense is that the success of microfinance comes from tackling narrow problems, not from trying (and perhaps failing) to tackle larger problems like transforming agriculture. In the same way, the earliest microfinance pioneers did not try to add technical training or marketing services alongside capital. From the perspective of economic development, that's a surprising choice. But, from the perspective of trying to deliver capital services in risky environments, the narrow strategy was very deliberate in hyper-focusing on streamlining costs and processes.

Is it more valuable to try to do one narrow thing reliably and efficiently? Or is it better to attempt to meet a wider set of needs against the odds? Early in my career I would have definitely said the latter, but now I appreciate the former. I hope that's not a sign of waning idealism.

What more can microfinance do for poor rural areas? For one, I think it can provide finance to a broader range of workers, who may or may not run businesses. And it

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[3] Anaïs Périlleux and Ariane Szafarz. 2015. "Women Leaders and Social Performance: Evidence from Financial Cooperatives in Senegal." *World Development* 74 : 437-452.

could do more to connect urban migrants back to their extended families in rural areas.[4]

Discussing methodologies….

ML: Historically, microfinance was often associated with group lending as this technique was supposed to be not only a good screening and enforcing mechanism but also an innovative way to provide collateral for a loan. Nowadays, group lending is still present of course, but it receives much less attention as many individual loans programs have proven to be as efficient if not more. In your opinion, what is still to be expected from group lending in microfinance?,

JM: Group lending was the essence of microfinance, it was the beautiful idea behind everything. At least we thought so at first. The fact that microfinance can work without group lending says a lot about the overlapping (and often unheralded) mechanisms that actually drive microfinance. We now see the key roles played by dynamic incentives, alternative forms of collateral, and the installment structure of repayment schedules.

We have to remember that joint liability is, in large part, a way to punish people. To get loans repaid, lenders needed a way to punish defaulters who could not be punished in the usual way (by seizing their collateral). The problem is that joint liability pushed too much risk and responsibility onto customers, which could make the contracts both unfair and impossible to enforce. The contract was too blunt, and over time, especially as borrowers' needs changed at different rates, the mechanism became less and less tenable.

A conversation with Muhammad Yunus helped me see a positive side. He resisted my interpretation of group lending only as joint liability. He argued for seeing the group element socially, pointing out that group lending was valued for providing positive support and collective unity among customers. That seems particularly true for new borrowers, but experience shows that group meetings take valuable time from customers, and over time group meetings are fading. Group lending has also faded as microfinance has shifted away from a sharp focus on poorer communities.[5]

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[4] One idea on finance and rural-urban connectivity is in Jean Lee, Jonathan Morduch, Saravana Ravindran, Abu Shonchoy, and Hassan Zaman. "Poverty and migration in the digital age: Experimental evidence on mobile banking in Bangladesh." *American Economic Journal: Applied Economics*, January 2021.

[5] Looking back, group lending became an ongoing focus of my research. Dean Karlan and I describe the empirical literature as of about a decade ago in "Access to Finance" (In Dani Rodrik and Mark Rosenzweig, eds., *Handbook of Development Economics*, Volume 5. Amsterdam: Elsevier, 2009: 4704 – 4784). Beatriz Armendáriz and I described the overlapping contract mechanisms in

ML: Another major topic that received key attention is the role of subsidies in microfinance. Some have argued for getting rid of them as much as possible. Others defend the idea that they are absolutely necessary if we want microfinance to also pursue true social goals. And indeed, it has been shown at multiple occasions that it is feasible to work without any subsidy for a microfinance organization that is focusing on the provision of working capital loans to poor (but not the poorest) microentrepreneurs involved in activities characterized by a quick cash flow cycle in a densely populated area. But it has also be shown that in many cases, some of these characteristics are not present. In order to face this debate, you came up with the concept of *smart subsidies*. Could you remind us for this anniversary issue what you meant by that as it is clearly useful in microfinance but also in other fields of international development?

JM: Microfinance was for a long time dominated by an ideology which was very much against subsidy. Even some of the large donors, who were the main providers of subsidy, took anti-subsidy views. They argued that subsidy would undermine markets and hurt poor communities. But empirical research did not support the ideology. Practical experience did not support it. Modern economic theory did not support it—in fact, the economics of information showed that subsidy can be necessary to achieve economic efficiency in the presence of moral hazard.

Yet many microfinance experts held firm to anti-subsidy positions.[6] It is easy to see why the anti-subsidy idea was appealing. Subsidized state banks had a terrible record of inefficiency and misallocation. Repeating those mistakes would have been a disaster. Also, microfinance institutions require capital, and the supply is limited. So, yes, sometimes the choice is unsubsidized microfinance versus no microfinance at all.

A problem with the donors' anti-subsidy stance was that, in practice, microfinance institutions were happily accepting the subsidy. The donors were then stuck without useful guidance for institutions on how to best use it. That led Frank DiGiovanni of the Ford Foundation to ask me to write on the idea of smart subsidy. The insights were not novel, but some ideas were new for microfinance. The approach involves embracing subsidy to as a way to expand access in poor communities and to crowd-

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"Microfinance Beyond Group Lending" (*The Economics of Transition* 8 (2), 2000: 401 – 420). Robert Cull, Asli Demirgüç-Kunt, and I show that group lending is more likely to be used by lenders focusing on poor customers ("Financial Performance and Outreach: A Global Analysis of Leading Microbanks." *Economic Journal*, Vol. 117, Issue 517, 2007: F107-F133). Xavier Gine, Pamela Jakiela, Dean Karlan, and I designed lab experiments in Peru to show how risk is shifted onto borrowers in "Microfinance Games." (*American Economic Journal: Applied Economics* 2(3), 2010: 60-95).

[6] This became the basis of my paper on the "the microfinance schism" (*World Development* 28 (4), April 2000 : 617 – 629), and continuing work with Jonathan Conning.

in capital. Subsidized capital, for example, can absorb risk that commercial capital cannot. At the same time, "smart subsidy" avoids distorting markets by creating credible exit strategies and using social performance targets.[7]

Looking back, the most important contribution was to show that it was possible to have a serious conversation about subsidy. Today, subsidy has been re-branded as "impact investing," and no one worries about it in the same way.

ML: The microfinance organizations that have been successful have often relied on simple standardized procedures to serve financially excluded people. But today, becoming more flexible in the way to fulfill the needs of customers appears ever more essential. Is it an impossible dilemma or do you consider that it is a challenge that can and will be met in the future?

JM: Most poor people live with instability. And when you live with instability, you require flexibility. At the same time, behavioral economists have shown that flexibility can weaken resolve, and they argue for rigid rules and "commitment saving devices."

So, there's an inevitable clash. You cannot easily marry instability with rigid rules.

You have a very nice paper on this with Carolina Laureti and Ariane Szafarz, and I know that you have thought a great deal about the dilemma.[8] I very much appreciate your work here, and you describe promising examples. Stuart Rutherford built flexibility into the DNA of the MFI Safe*Save* in Bangladesh. One recent paper documents the positive impact of a rule that allows borrowers two loan repayment installments that they may skip with no questions asked.[9] The contract is standardized, but also flexible. On the other hand, recent work shows a case where

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[7] In one way or another, the issue of subsidy has been a recurring theme in my research, starting with "The Role of Subsidies in Microfinance: Evidence from The Grameen Bank" (*Journal of Development Economics* 60, October 1999, 229 – 248). Also : "Financial Performance and Outreach: A Global Analysis of Leading Microbanks" (with Robert Cull and Asli Demirgüç-Kunt in the *Economic Journal*, February 2007, Vol. 117, Issue 517: F107-F133) ; "Microfinance Meets the Market" (with Robert Cull and Asli Demirgüç-Kunt, February 2009. *Journal of Economic Perspectives* 23(1), Winter: 167-192) ; "The Microfinance Business Model: Modest Profit and Enduring Subsidy" (with Robert Cull and Asli Demirgüç-Kunt, June 2018. *World Bank Economic Review* 32 (2), June: 221–244); "Do interest rates matter? Credit demand in the Dhaka Slums" (with Rajeev Dehejia and Heather Montgomery, *Journal of Development Economics* 47 (2), March 2012: 437 – 499).

[8] Marc Labie, Carolina Laureti, and Ariane Szafarz. 2017. "Discipline and flexibility: a behavioural perspective on microfinance product design." *Oxford Development Studies*, vol. 45, issue 3, 321-337.

[9] Marianna Battaglia, Selim Gulesci, and Andreas Madestam. "Repayment Flexibility and Risk Taking: Experimental Evidence from Credit Contracts." PEDL-CEPR Working Paper 3778, 1 April, 2021.

flexibility can erode social norms. So, the last word has not been written, but the conflict that you describe runs deep.[10]

ML: Another common characteristic of successful microfinance organizations is their proximity – geographically but also culturally and socially – with their customers/beneficiaries. But this fundamental characteristic is also often one of the major sources of administrative costs that microfinance organizations must bear. Some people believe that technology could help solving this dilemma. What is your opinion?

JM: Each question that you ask reveals another way that microfinance involves conflicts and dilemmas. Maybe those conflicts and ambiguities are what has held our interest over all these years!

Traditional microfinance was always "high touch", and now people ask whether it can be "high tech" instead. Technology holds the promise of slashing costs through "low-touch" tools, and thus helping to democratize financial opportunity. Still, my sense is that technology remains most useful when layered on top of traditional engagements with customers, adding extra functionality. The cost advantages have been hard to reap since high tech is an imperfect substitute for high touch, especially when it comes to recruiting new customers, and especially in poorer communities. Technology will continue to shape the sector, but we need to proceed with open eyes. Evidence shows that tech creates biases in customer acquisition, in addition to creating well-known algorithmic biases. Of course, what is true today may not be true in five years. That's the nature of technology.[11]

ML: In banking, discipline is key, particularly in the management of loans portfolio and the protection of customers' savings. In many cases, this discipline is obtained through constraints and negative incentives (no more credit if people don't reimburse well; extra cost if they repay late; required savings to have access to services...) rather than through positive ones. Some argue that to experience a new revolution in the future, favoring positive incentives (e.g., allowing bonuses or advantages to those who comply with their commitment on time rather than punishing those that are late) should be considered a promising avenue. Yes or no?

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[10] Kristina Czura, Anett John, and Lisa Spantig. 2021. "Flexible Microcredit: Effects on Loan Repayment and Social Pressure." Working paper, May 2021.

[11] The state of play is nicely summarized by Todd A. Watkins, Paul DiLeo, Anna Kanze, and Ira Lieberman, "Fintech in Microfinance: In Search of the High-Tech High-Touch Unicorn?" Center for Financial Inclusion blog, May 11, 2017. https://www.centerforfinancialinclusion.org/fintech-in-microfinance-in-search-of-the-high-tech-high-touch-unicorn

JM: Can one choose both? You've nicely articulated a dilemma that opens possibilities. Yes to both, depending on the context—since negative incentives can still be helpful.

ML: In the early days of the industry, microfinance was developed mainly thanks to Saving and Credit Cooperatives and NGOs. Over time, Non-Banking Financial Institutions and commercial banks have clearly come to dominate the field as a result of the conversion of some major NGOs and the entry of commercial actors attracted by the potentially high profits that microfinance enables in certain circumstances. Besides, for the last few years, Fintech seem more and more willing to get involved in topics related to financial inclusion. How do you see the future on this issue? What is the future of cooperatives and NGOs in microfinance?

JM: The microfinance narrative has long wrestled with two opposing views. One is that only commercialization will permit large scale by tapping the market. The other view is that only social businesses, which include NGOs and cooperatives within microfinance, have the social focus and incentives to pursue the greatest good without existential worry about financial bottom lines.

History has shown the power of the market in quickly getting to scale, but we also see that market solutions are not necessarily pro-poor and are sometimes actively anti-poor. And history has shown the continuing power of NGOs in staying committed to social missions.

I was just reading a recent paper on the impact of large capital loans given by Akhuwat in Pakistan, for example. Akhuwat is a nonprofit which provides Islamic Finance in the form of zero-interest loans, reporting having benefited over 5 million families.[12] Cooperatives and NGOs like Akhuwat will continue to be an important source of finance, working in markets that commercial players have largely avoided so far. Even with the latest fintech innovations, I can't imagine a world where NGOs and nonprofits are not vital to serving important parts of the market.

ML: Talking about markets, one of the major changes that the microfinance industry has experienced over the last twenty years or so is the connection to capital markets, mainly through Microfinance Investment Vehicles (MIVs). Now often included in the broader field of impact investments, they have clearly played a role in establishing norms for the sector. What is your opinion on this evolution?

JM: MIVs are an efficient way to invest in the microfinance sector. They move billions of dollars and are an important part of the infrastructure. But MIVs have narrowly financial concerns. When the pandemic hit, for example, the MIVs were

[12] Faisal Bari, Kashif Malik, Muhammad Meki, Simon Quinn. 2021. "Asset-based Microfinance for Microenterprises: Evidence from Pakistan." CEPR Discussion Paper DP15768, February.

not well-placed to help struggling lenders on their own. It was Development Finance Institutions – traditional public agencies – and national governments that had to step in to assist the sector.[13]

As a conclusion…

ML: Over the last decade, the support that microfinance had received in previous years has clearly diminished. Many donors and international organizations have reoriented their priorities believing that the impact of microfinance was over-stated. But at the same time, the industry keeps growing and financially excluded customers remain numerous. Could you explain us how these elements may get together? And at the end of the day, do you think that microfinance and financial inclusion have a major role to play in development?

JM: In the end, we should see microfinance and financial inclusion as an enabler. For some customers, it enables business. For others, it enables housing and nutrition. For others, it enables transportation. And so forth. That to me, is one essence of development: the spread of reliable tools to achieve basic goals.

The impact of microfinance was over-stated. On the other hand, there is a case to be made that the possibilities for microfinance have been under-stated. The evidence shows clearly that household finance has an important role to play in development, even if the world is not full of capital-starved entrepreneurs as early pioneers asserted. Recent work, both theoretical and empirical, shows the diversity of people who need financial liquidity.[14]

ML: You are the author of "The Microfinance Promise," the most cited academic paper in the microfinance literature.[15] This paper has clearly played a major role for all those who are or were ever interested in microfinance. What can you tell us about the way this paper was born and how do you look at it nowadays?

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[13] Microfinance Investors are Boxed In - and DFIs Need to Step Up
June 4, 2020 Elisabeth Rhyne. FAI Blog.
https://www.financialaccess.org/blog/2020/6/4/microfinance-investors-are-boxed-in-and-dfis-need-to-step-up

[14] M. Shahe Emran, A. K. M. Mahbub Morshed, and Joseph E. Stiglitz. 2021. "Microfinance and missing markets." *Canadian Journal of Economics/Revue canadienne d'économique* 54(1): 34-67, February. Also: Girija Bahety and Marina Ngoma. 2021. "Microfinance, Microentrepreneurship and Misallocation." PEDL/CEPR working paper 8409, 6 December.

[15] Morduch, Jonathan. 1999. "The Microfinance Promise." *Journal of Economic Literature*, 37 (4): 1569-1614.

JM: The paper was born quite a long time ago. The paper was published in 1999, and I started working on it during a year at Stanford University in 1997-98. The paper consolidated a series of ideas and projects on microfinance that had been brewing.

Before I started writing on microfinance, I worked on issues connected to poverty and risk. I felt that the pieces were not adding up to something bigger, and few people outside of academic seemed to notice any of it.

Amidst uncertainty about how to proceed, Jeffrey Sachs encouraged me to focus more heavily on microfinance. Sachs was at Harvard then and was running the Harvard Institute for International Development (HIID). He was perhaps the world's best known economist at that point, and he thought a lot about the world beyond academia—to an extent which made him a bit of an outsider in the Harvard Economics Department. His view was that microfinance seemed interesting but that no one within economics was pulling the pieces together, so he urged me to consolidate a research agenda. It was a short conversation, but it helped me see a way forward.

A lot had been written on microfinance in the decade leading up to "The Microfinance Promise," but it was a jumble. Research was often combined with advocacy, and the most lively conversations were taking place outside of academia, or on the edges. So there was plenty of material, but it was undisciplined.

There had been fundamental academic work for sure. By that point, Tim Besley, Abhijit Banerjee, Joseph Stiglitz, and others had written economic theories explaining group lending in microfinance. Mark Pitt and Shahidur Khandker had circulated a draft of their impact evaluation of Grameen Bank and BRAC, which Pitt presented at Harvard.

Much of the activity, though, was in applied research outside of the main economics journals. Stuart Rutherford had written his biography of ASA and had published *The Poor and their Money*, with its attention to the importance of the cadence of cash flows. Maria Otero and Elisabeth Rhyne had released *The New World of Microenterprise Finance* in 1994, taking a commercial view. David Hulme and Paul Mosley had put together the case studies in the two-volume, *Finance Against Poverty*, again with a pro-business message on impact. JD von Pischke, Dale Adams, Claudio Gonzalez-Vega, and colleagues at Ohio State were also hammering away against subsidized finance.

Academic economists did not engage much, if at all, with that work. But I read as much as I could. Over time I got to know many of the leading voices on microfinance policy, helped by the fact that much of the buzz was in Washington, DC, which was easily accessible by train. I wasn't convinced by everything, but it was helpful to see how arguments were framed and to piece together underlying assumptions.[16]

At the same time, HIID was heavily involved in microfinance at Bank Rakyat Indonesia. My graduate school friend, Don Johnston, had worked at BRI for years, and I got an inside view during a visit to Jakarta in 1996. I visited Grameen and BRAC in Bangladesh, learning from Syed Hashemi and Imran Matin, and returned to India. In China, I visited Grameen replications and was involved in household surveys. I spoke with loan officers and members of the community. All of that became part of my microfinance education.

There is a joke that economists are people who see something that works in practice and wonder if it works in theory. That was me. I lived that joke. "The Microfinance Promise" was an attempt to take the scattered observations back into the formal framework of economics. I'm sure that I missed a lot, but I also saw much that was new and interesting—and that went in different directions from accepted views. I wanted to provide a way to think about microfinance, not just to summarize the literature.

What do I think of it now? It is both too much and too little.

"The Microfinance Promise" foreshadows most of the elements of *The Economics of Microfinance*, my book with Beatriz Armendáriz. Among other contributions, Beatriz greatly improved on my attempts at mathematical theory.[17] The discussion of impact evaluations in "The Microfinance Promise" took place well before the new wave of randomized controlled trials, but the discussion in the paper still holds up well after 20 years. My sense, even then, was that the wild claims for huge impacts were at odds with the evidence, and that average impacts on headline outcomes were bound to be modest. That is a mainstream view today, but it was not then. So too is the idea that group lending is not elementally important to microfinance. There is also greater recognition of the role of subsidy today.

But much has changed in a quarter-century. Technology now drives innovation; behavioral economics has brought psychology into finance; and there is much more experimentation than before. But we remain limited, even now, by narrow understandings of people's financial lives. If I were to write "The Microfinance Promise" today, I would be tempted to keep the same title. The sector can count incredible successes, but the biggest economic and social ambitions remain as promises.

[16] "The Microfinance Schism." *World Development* 28 (4), April 2000, 617 - 629.

[17] Beatriz Armendáriz and Jonathan Morduch. 2010. *The Economics of Microfinance*. 2nd Edition. Cambridge, MA: MIT Press.

ML: Finally, I would like to quote Richard Patten, one of the old gentlemen who built that industry; he once told me in class – at a time when microfinance was still too often perceived as the magic bullet it is not - « *If microfinance is the answer, what is the question ?* ». For you, what is the question to which microfinance is the answer?

JM: I once met Richard Patten in Indonesia. He had seen so much in his career and had little patience for overly bold claims and hyperbole.[18] He was skeptical of me too – a young assistant professor without much practical experience.

Taking his question seriously, here is my try at a response, borrowing from Stuart Rutherford: Can a simple financial service be delivered reliably and help poor households spend their very scarce resources more effectively?

Microfinance is neither more nor less than that.

[18] Jay Rosengard and Richard Patten. 1991. *Progress With Profits: The Development of Rural Banking in Indonesia*. San Francisco: Institute for Contemporary Studies Press.