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Gandhi v. Gauss

The jarring dissonance between Gandhi's soaring plea and Hayek's quotidian observation that begins Emily Chamlee-Wright's discussion of the "extended order" has to be balanced in practice. If the last 20 percent of any march to perfection consumes 80 percent of the energy and knowledge required, surely the last single obstacle to be overcome demands an inordinate proportion of application. Depending on costs and benefits, some stopping point short of 100 percent is acceptable. Reasonable limits may be approached differently in the social world than in the physical world.

Because uncertainty is inherent in human action, a rational society finds diverse ways of dealing with "the least of these." Heroic intervention is possible and sometimes laudable, but transforming the overall human condition is inevitably a slow process. Stunning results over centuries are possible and increasingly realizable in the modern, liberal era, but the process is not widely understood, requires patience, and is fraught with unintended effects (Powelson 1994).

Large-scale interventions from on high tend to centralize power, easily slow reform, and create new problems that may dwarf those they were intended to cure. However, modest, decentralized, and competing efforts that require a commitment by the intended "beneficiaries" often do better or fail in less harmful ways. In such cases, transformation—opening up entirely new possibilities and establishing new boundaries—is likely.

As elaborated by Heather Wood Ion, microfinance is a vehicle for transformation. The most transcendent form of innovation in finance occurs when new ways of managing risk are discovered. The answer to the basic question in credit markets—"What do you think you are lending against?"—is recast through innovation (Von Pischke 1991). How else could Grameen Bank monetize the promises of poor women who had never held coins or banknotes in their hands? By rendering traditional forms of collateral no longer necessary, peer group discipline created the basis for a new market (Bornstein 1996).

The Context: A Messy Road Map

An introduction to microfinance can sketch the context for transformation through journeys into the extended order. As might be expected of a dynamic, widely dispersed activity with a range of objectives, only generalizations are possible. For example, the range of microfinance institutions' practices includes the ritualistic washing of feet, concern for household health, and hi-tech ATMs and point-of-sale transaction processing. It all began in the early 1980s with Grameen Bank in Bangladesh as a social movement centered on group credit, and with Bank Rakyat Indonesia's "village units" making individual loans on a commercial basis and collecting deposits on an incredibly large scale (Robinson 2002).

Broadly generalizing, the structure of the microfinance industry consists of two types of institutions, nonprofit NGOs and for-profit, commercial, microfinance institutions. The former are associated with group lending and modest amounts, the latter with individual lending and somewhat larger amounts. Many microfinance NGOs are changing their corporate form, becoming licensed commercial entities in order to attract deposits, increase their access to capital, and be regulated by the state as an admission ticket to broader financial markets and for better governance. NGOs often serve primarily women, tend to be concerned about social impact, and may be "maximalists," providing social services, training, and other interventions to promote the welfare of their clients. Commercial providers are often "minimalists" that provide only financial services, which simplifies and clarifies governance. Minimalists may not be concerned with impact, assuming that their clients are rational, and may be indifferent to the gender of their clients.

There may be more than ten thousand microfinance institutions worldwide. One hundred appear to be profitable, and another hundred may become profitable; these entities have a disproportionately large market share ("MicroBanking Bulletin"). Cooperatives are active in microfinance and generally conform to cooperative principles—traditional or modern—in outreach and governance.

The most popular use of microfinance is for trade, helping retailers buy more inventory to expand their businesses. Services, such as all sorts of repairs, catering, and similar enterprises are often in second place. Agriculture and manufacturing usually account for small fractions of microloans issued.

Microfinance clients are seldom the very poor or destitute—the bottom quintile of the poor—as they usually face problems that loans do not ameliorate. The working poor are those most likely to benefit from microfinance (Rutherford 2000).

How micro is micro? Donors define limits for their own purposes; lenders' definitions vary from country to country. The upper limit for micro may be $10,000 in Eastern Europe and $250 in a destitute African country.

Microfinance interest rates are "high." Annual rates greater than 50 percent are not unusual, and few commercial microfinance institutions charge less than 20 percent. These rates largely reflect the transaction costs of making tiny loans: costs of capital are usually low, even zero for grant-based lenders, and risks are generally small. These rates are attractive to borrowers because their range of choice is limited and because their total costs, consisting of transaction costs and interest charges, are lowered. Microentrepreneurs jump at this money because it is cheaper and more dependable than informal sources. Local financial markets are often dreadfully inefficient, and banks are not generally interested in this business, except possibly as consumer finance.

One major microfinance institution views a competitive microfinance market as a means of making financial markets more efficient generally (Schmidt and Zeitinger 1996). This institution targets those who have never before had access to formal credit and caters to small businesses, which create jobs for the poor. Countries with efficient financial markets fare better than those without them, other factors being equal, and more efficient financial markets benefit the poor disproportionately because of spread effects (Beck et al. 2004).

Donor agencies create sources of information, promote standardization of terms and definitions, and support "best practices." Entities associated with the World Bank include CGAP (Consultative Group to Assist the Poor) and The MIX (Microfinance Information eXchange). Several specialized microfinance rating agencies are in business, and some large microfinance institutions have been rated by one of the big three: Moody's, Standard and Poor's, and Fitch.

Impact evaluation is important to donors, and methodological problems common to social science are inherent in this quest (Dunn 2004). It is not absolutely clear from a scientific perspective whether microfinance generally fosters "development," but circumstantial evidence on the ground suggests that microfinance is a vehicle for transformation, in exactly the terms and logic specified by Ion.

Microfinance as the Frontier of Finance

The broad concept of the extended order fits nicely with the more limited scope of the microfinance revolution. The latter invades the former because microentrepreneurs—the customers of microfinance institutions—have a range of choices in how they use their loans. They may enlarge their own businesses, and some may conclude that they are in the wrong business and migrate to more remunerative opportunities.

Transformation occurs as microentrepreneurs explore the extended order. For many, their loan contracts are the first voluntary formal transactions they have undertaken, where they are willing to be held accountable to a formal institution and its procedures, where their businesses have an address, where they can exercise property rights as business owners, where they are treated as clients on an equal footing with others of similar status, and where incentives for good performance in the extended order are alive (Gonzalez-Vega 2005).

Their understanding of an extended order is nicely portrayed by one dimension of their behavior—loan repayment rates. In well-run, commercially oriented microfinance institutions that use individual lending, it is possible to achieve rates of 99 percent in southeastern Europe, 98 percent in Latin America, and 97 percent in Africa, relatively consistently (for example, see www.procredit-holding.com).

Repayment rates plus arrears rates equal 100 percent. The arrears rate commonly used in microfinance (but not by Grameen Bank—a fading star) is based on the *full outstanding amount* of any loan on which any amount that has fallen due remains unpaid for thirty days. These loans are then calculated as a percentage of the total loan portfolio. For example, $1 that is thirty-one days overdue on a loan balance of $1000 would cause the entire $1000 to be classified as being in arrears. Many microloans are installment loans, which produce information throughout the period to final maturity. These two features—installment loans and using the full loan amount outstanding to quantify arrears—constitute a rigorous test.

These arrears rates are below those of North American credit card portfolios. And when crises occur in poor countries, microloan portfolios tend to fare considerably better than those of mainstream commercial banks in both duration and intensity. Penetration into the extended order is increasingly alive, well, and positively and productively seductive for more and more millions of entrepreneurial poor people.

Commercial Practice Will Grow Faster Than Charitable Endeavors

Chamlee-Wright asks which way forward, and evidence suggests that the best way is increasingly commercial: commercial funds—the world's capital markets—are enormous and dynamic (Goodman 2006; Pouliot 2006), whereas donor funding is limited and constrained (Ivatury and Abrams 2006). As Chamlee-Wright suggests, an increasingly productive symbiosis consists of donor grants to establish microfinance institutions, donor loans to provide start-up assistance, and "patient" donor investment in the stock of commercial microfinance institutions. As commercial scale is reached, private capital and deposits take over. Donor loans are repaid, usually within five or ten years. Donor stock will be retired more slowly. This arrangement accelerates access: limited state funds leverage enormous volumes of private capital (Brugger 2006). Private money is increasingly available in the form of private equity/venture capital. Commercial microfinance debt and equity are included in pension fund portfolios, and within a decade retail investors are likely to be attracted to microfinance (de Sousa-Shields 2006; Pouliot 2006).

Microfinance institutions that offer savings facilities tend to attract more funds than they can lend, especially in poor countries where there are few safe places to save. In addition, the number of clients who are savers only is usually larger than the subset that only borrow or who have both savings accounts and loan accounts (Robinson 2002). This suggests that these institutions are achieving large gains in trust, longer time horizons, and changes in cautionary behavior and in creative capacity—all of which are attributes of the extended order and of transformation.

The core of the commercial formula is secure. Micro will become increasingly mainstream, moving money into the bottom end of the market through increased experience, efficiency, and new ways of viewing risk, such as by credit scoring. Continued probing of the frontiers of finance, supported partly by donors, is producing a current that is increasingly navigable.

Official donors and others in a charitable mood or mode will continue to be active in trying to help "the least of these." Social mission advocates, using grants, will continue to achieve political victories for their own programs and organizations, as in the case of the microfinance institutions serving the $1 per day clients that by law consume half of USAID's microfinance funding. This should ensure that microfinance does not succumb to "mission drift" away from programs that serve the very poor, such as the one in Nepal described by Ion.

Donors in particular are becoming impatient with approaches that build one microfinance institution at a time. Why has it not been possible to achieve massive breakthroughs, especially in large countries with large retail financial institutions? What new types of services could attract the majority of poor people to the microfinance revolution? Possibilities include "connectivity" that reduces sellers' transaction costs through shared electronic infrastructure, "plastic" cards that provide low-cost access for the poor, and "proxy" applications of credit scoring that use large databases rather than detailed credit analysis to determine loan size and repayment probabilities (Schreiner, forthcoming).

Outlook

Experience with the extended order gained through microfinance is likely to promote better definition of property rights, stronger basic civil rights, and better lives for very large numbers of people. While the early promotion of microfinance exhibited breathless enthusiasm and a low regard for commercial performance at the level of individual microfinance institutions, a commercial approach to microfinance is now commonly viewed as a commitment to sustainability. But some nonprofit NGOs that require continued injections of subsidy will also survive as effective providers of microfinance at the very small end of the market (Von Pischke 2002).

Hayek's extended order characterizes all facets of the spectacular growth of microfinance. Poor borrowers find greater opportunities and become comfortable in a greater variety of roles and situations. Their action changes the extended order, as does that of the microfinance institutions that serve them. Donors, investors, and regulators are also part of this universe. Transformation continues with the constant quantitative soundings that are the daily routine of finance (Pattillo 2006).

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