The Developing World's Tragic Engagement with Microcredit

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MILFORD BATEMAN, OCT 20 2014

About thirty years ago, the international development community was abuzz with excitement. After many years of desperately searching, it appeared that a solution to poverty had finally been found in the shape of *microcredit*. As originally conceived, microcredit is the provision of tiny loans – 'microloans' – which allow for the establishment of a range of income-generating activities, thereby supposedly facilitating an individual or household escape from poverty. As is well known, the modern microcredit movement is most famously associated with Bangladesh, thanks to Dr Muhammad Yunus and the Grameen Bank that he founded in 1983. The assumed success in Bangladesh greatly helped to expand the microcredit movement almost everywhere. By the mid-2000s, the excitement surrounding microcredit reached a crescendo, with one leading microcredit advocate, Bernd Balkenhol (2006), calling it "*the* strategy for poverty reduction par excellence" (emphasis in the original). Almost the entire international development community – if not the entire world – now appeared to concur with Yunus that the microcredit model represented nothing less than the economic and social salvation of humankind and that, as Yunus himself famously once said, it would "eradicate poverty in a generation".

However, the sour reality that the world is now facing up to thirty years later is that Muhammad Yunus was completely wrong. Not unlike in the case of an earlier intervention widely believed capable of resolving poverty, exploitation, and under-development – central planning – practise has shown that the microcredit model has been a catastrophe in precisely those developing countries, regions, and localities in which it has achieved critical mass. So what went wrong? Let me point to just a few of the very many fundamental flaws in the microcredit model.

Why Microcredit Does Not Work

Perhaps the most devastating fact we have to comprehend, first of all, is that the modern microcredit movement was actually founded upon a very fundamental misunderstanding, one that must really be very firmly laid at the feet of Dr Muhammad Yunus himself (Bateman, 2014). In seeking a resolution to the huge poverty he found all around him in 1970s Bangladesh, Yunus came across something called 'microcredit'. After making a few changes to the basic model, Yunus began to promote his own microcredit model to the international development community, arguing that it was effectively a 'magic bullet' (Hulme, 2008: 6). Importantly, Yunus's claims were based on the far-reaching assumption that the poor, and especially women in poverty, could very easily establish and operate an informal microenterprise selling simple items and services to other poor individuals in the same village. This held even in the very poorest communities, where the poor (by definition) struggle to afford the very simple items and services that might ensure their basic survival. So long as the poor were capable of actually producing something, there should, according to Yunus, be no problem whatsoever in actually selling it. As Yunus later famously stated, a "Grameen-type credit program opens up the door for limitless self-employment, and it can effectively do it in a pocket of poverty amidst prosperity, or in a massive poverty situation" (Yunus, 1989: 156).

Unfortunately, Yunus erred big-time. By wrongly assuming that "(local) supply creates its own (local) demand", Yunus fell victim to a long-disproved fallacy in economic history known as *Says Law*. As the late Alice Amsden brilliantly explained, the core problem in developing countries today is *not* the supply of the simple items that the poor require to survive, but the sheer lack of local demand (or purchasing power) required to absorb it. After all, even in the very poorest communities there are generally always enough retail stores, street food outlets, basket-makers, bakeries, and so on, but the poor do *not* always have sufficient income to regularly access such important items in order to survive. Amsden argued that the entire history of development shows that simply improving things on the supply-side of the local economy – through training, providing more microcredit, etc. – achieves almost nothing for the poor if the demand side is not also fundamentally dealt with.

This 'demand constraint' issue therefore brings us to the first drawback to the microcredit model, in the form of 'displacement'. Displacement occurs when the employment and additional income associated with a microcredit-induced increase in the number of *new* microenterprises, or an increase in the output of an *existing* microenterprise, is compensated for by a decrease in the level of employment and income in *existing* microenterprises not supported by microcredit. New jobs and incomes registered in one microcredit-supported microenterprise are thus often cancelled out, sometimes completely, by the decline in jobs and incomes in local competitors. A second drawback here is what we call 'exit', which is the process whereby both new and existing microenterprises are forced to close, thanks to the additional supply of informal microenterprises operating in the same sector. Here we have to pay heed to the words of an internationally respected authority on small business policy, David Storey, who pointed out that "the single most important fact to be borne in mind when implementing measures for smaller firms is the high death rate of such businesses" (Storey, 1993: 2). Indeed, what we find in practise in developing countries is that, for the vast majority of those accessing a microloan in order to invest in some income-generating project, *the typical outcome is failure*. Failure then leads to personal over-indebtedness, loss of family assets and income flows, humiliation, despair, and, in many cases, irretrievable poverty.

Displacement and exit together account for why we generally find no or very little *net* increase in employment and average incomes associated with the microcredit model. This then also helps to explain why, as even long-standing supporters of microcredit have now come around to accepting, there is simply no empirical evidence to show that microcredit has had a positive impact on poverty. In general, microcredit boosts the rate of informal microenterprise entry, which is then followed by an equally high rate of exit, creating nothing more than an unproductive and wasteful process known as 'churn' or 'turbulence' (Nightingale & Coad, 2014).

One other important indication of the failure of microcredit to note here is that in many developing countries, the poor no longer choose to access microcredit in order to invest in an income-generating microenterprise, most of which either struggle to generate an income or fail, but increasingly use microcredit simply to fund the purchase of everyday consumption goods. The hope is perhaps to repay the microloan at sometime in the future, but in practise we find the poor increasingly taking out multiple microloans simply in order to cover repayments due on previous microloans (this is known as 'loan bicycling'). As a result, individual over-indebtedness in a growing number of developing countries has begun to reach quite staggering levels.

The next fundamental problem we find with microcredit is related to the presumed role of micro-entrepreneurs in development. It is often said that microcredit plays its greatest role in supporting the entry and proliferation of micro-entrepreneurs in locations where they are supposedly very desperately needed. Africa is most often given as the obvious example of a region having been seriously held back by a shortage of entrepreneurs, a problem that the international development community is desperately trying to resolve today through its support for many more microcredit programs. This argument is almost entirely false. As noted development economist Ha-Joon Chang points out, Africa already has more individual entrepreneurs than perhaps any other location on the planet, and many more are being created all the time thanks to rafts of new microcredit programs and Africa's commercial banks shifting into microcredit operations. Yet it is very much because of this fact that Africa largely remains trapped in poverty and under-development today. This is because the resulting microcredit-induced over-supply of tiny 'buy cheap, sell dear' trading operations in Africa, and the resulting intense competition and low market prices, has very effectively precluded the emergence of a more productive, industry-based, and growth-oriented local economic structure. Because most informal sellers can only ever expect to sell a tiny volume of goods and services in the face of so much informal competition, they cannot hope to amass the capital, market share, vertical and horizontal linkages, and/or technical expertise needed to consolidate, diversify, and sustainably expand their operations. The microcredit-induced expansion of the informal microenterprise sector is thus not one of the solutions to Africa's endemic poverty, low productivity ,and general under-development, *but one of the principle causes* (see also

Bateman & Chang, 2012; Chang, 2010, 'Thing 15').

Stalling Development in Africa and Latin America

One specific African example quite dramatically illustrates the depth of the problem here (Bateman, *forthcoming*). The programmed expansion of the microcredit sector, and so also the expansion of the informal microenterprise sector, was one of the principle responses by the first ANC government in post-apartheid South Africa in dealing with the historic legacy of poverty and unemployment in the black South African community. However, the deployment of microcredit precipitated a major disaster for the country. A microcredit-supported rise in the supply of informal microenterprises in the black townships and rural areas, along with little additional effective demand on account of an austerity policy, helped to bring about a quite dramatic *fall* in average incomes in the informal economy – around 11% per year in real terms from 1997-2003 (Kingdon & Knight, 2005). What happened was that the few jobs created by the expansion of the informal sector were more than offset by the fall in average informal sector incomes taking place right across the local community. Poverty inevitably increased as a result. Even worse, long-struggling black South African micro-entrepreneurs effectively 'paid' for the modest expansion in employment in new informal microenterprises through the resulting reduction in their own turnover, and so also the reduction in their own profits and wages. This was hardly an equitable solution to the problem of unemployment and poverty in black South African communities. The microcredit movement thus did nothing more than plunge large numbers of black South African's into deeper over-indebtedness, poverty, and insecurity than ever before, while the South African economy as a whole had to face up to a major sub-prime-style financial crisis.

Consider also the situation in Latin America. Here, an increasing number of dedicated microcredit institutions and 'downscaling' commercial banks have also programmatically channelled that continent's scarce financial resources (savings and remittances) into ultra-low productivity informal microenterprises and self-employment ventures, as well as into consumer loans, while ignoring virtually all other higher-productivity uses, such as formal technology-based SMEs (small and medium enterprises). The inevitable result was that the financial sector, and its important turn to microcredit, can be charged with progressively *destroying* Latin America's economic base (Bateman, 2013a). As in Africa, creating many more individual micro-entrepreneurs did not resolve the problem of poverty and under-development in Latin America, *so much as seriously exacerbate it*. Importantly, this negative assessment was also reached by the mainstream Inter-American Development Bank (IDB), which bravely reported in 2010 that the programmed proliferation of informal microenterprises and self-employment ventures was the principle *cause* of that continent's twenty year (1980-2000) descent into deeper poverty, inequality, and economic weakness (IDB 2010). The IDB's conclusion (page 6) was stunning – "the overwhelming presence of small companies and self-employed workers (in Latin America) is a sign of *failure*, not of *success*" (my emphasis).

Mexico is one of the countries in Latin America that usefully exemplifies the 'poverty trap' that has been created at the country and community level, thanks to the arrival of microcredit. Its financial institutions have all proved to be adept at channelling their funds into hugely unproductive, and all too often temporary, informal microenterprises and self-employment ventures – so-called '*changarros*' ('mom and pop' stores) – while leaving the bulk of potentially growth-oriented industrial SMEs without any substantive financial support. Over the last two decades, this 'crowding out' trend has undoubtedly undermined Mexico's once powerful industrial and technological base, while also creating both an ultra-low productivity economic base *and* an over-indebtedness problem that today threatens the entire financial system. This is not at all what the microcredit industry promised would transpire.

Neoliberalised Microcredit

Yet another key problem with the microcredit model is associated with important ideologically-driven changes that were made to the microcredit model in the 1990s. With the global neoliberal political project in ascendance from 1980 onwards, thanks to the election in the UK of Margaret Thatcher and Ronald Reagan in the USA, there was a major ideologically-driven focus on developing countries reducing state subsidies to all manner of organisations. This restriction eventually extended to microcredit institutions. With advice and financial support provided by USAID and the World Bank, the microcredit model was therefore very extensively commercialised (or one might say 'neoliberalised') and turned into a for-profit business model operating according to supposedly ultra-efficient Wall

Street-style incentive structures and overseen by ‘light touch’ regulatory bodies. Egged-on by a number of high-profile market fundamentalists drawn into the microcredit sector (notably Otero & Rhyne, 1994, and Robinson, 2001), the microcredit industry became convinced that commercialised microcredit would open up the door to a ‘new world’ of massive poverty reduction and ‘bottom-up’ development. Crucially, because microcredit institutions would all be financially self-sustaining, this enormous benefit would involve no cost to the government or to the international development community. It appeared that, after all, there was such a thing as a ‘free lunch’.

However, the commercialisation of microcredit only added to the catastrophe for the poor that microcredit represents. Among other things, commercialisation directly and predictably led on to spectacularly damaging levels of Wall Street-style greed, profiteering, and corruption. Further adding to the commercialisation-driven destruction are by-now depressingly regular ‘microcredit meltdowns’ and the social and economic chaos that comes from the rise in a growing number of countries of an individual over-indebtedness scenario of simply staggering proportions. In short, commercialised microcredit effectively established the developing world’s very own ongoing version of the USA’s sub-prime lending crisis.

Ironically, or perhaps predictably, it is in the pioneering country – Bolivia – where some of worst commercialisation-driven impacts first began to surface. By 1999, the country was plunged into crisis after an extraordinary level of over-indebtedness forced many poor individuals to renege on repaying their microloans. With government and international donor support, the situation was stabilised by 2001, but an enormous amount of economic and social damage had been inflicted on the country and its people in the meantime. Moreover, with as much as 37% of Bolivia’s financial resources now intermediated through the mainly profit-driven microcredit sector (Vogel, 2012), the Bolivian government today has an almost impossible task to halt the hugely damaging de-industrialisation, informalisation, and primitivisation trajectory underway in the country.

Mexico has also experienced similar problems with commercialised microcredit, notably with regard to the country’s largest microcredit bank, Banco Compartamos. With spectacular profiteering by senior managers, shareholders, and even by some external US-based individual advisors (Sinclair, 2012), with real annual interest rates that go up to as much as 195%, and with no evidence whatsoever of it having made any positive impact on poverty in the community, Banco Compartamos is deservedly seen as one of the most damagingly exploitative microcredit institutions in the world. Bosnia warmly embraced the commercialised microcredit model, becoming by 2008 the world’s second most microcredit-penetrated country after Bangladesh. But with this development also came obscenely high salaries and bonuses, profiteering, and asset-stripping, developments that tarnished the entire experiment in the eyes of the population (Bateman, Sinković & Škare, 2012). Finally, in Bangladesh, the unrelenting drive to expand the microcredit sector, thereby to maximise the salaries and bonuses paid to senior personnel and loan officers, has led to the emergence of some very aggressive and exploitative practices (Hulme & Maitrot, 2014). In truth, the global microcredit movement is now seen as having provided nothing more than a new and, importantly, *socially validated* mechanism through which financial elites can extract significant value from the poor, a process Harvey (2014) has famously called ‘accumulation by dispossession’.

The Failure of Microcredit

The microcredit model has tragically failed. It has mainly and deliberately enriched a narrow elite working in and around the microcredit sector while wantonly destroying the main pillars of the economy and society. Developing country governments now need to urgently begin a process of establishing an enhanced set of community-based financial institutions genuinely capable of promoting sustainable pro-poor development. Financial cooperatives, credit unions, community development banks, state development banks, and social venture capital funds are just some of the options on offer that possess an impressive, but often wilfully ignored, historical track record of success in both developed and developing countries (Bateman, 2013b). It will, however, not be at all easy for developing country governments to make these changes, not least because financial elites everywhere have been hugely empowered this last thirty years or so and are willing and able to resist fundamental change that will restrict their freedom and ability to profiteer. But developing country governments must nevertheless try very hard to force through important pro-poor changes to the financial sector in what has been called, perhaps too optimistically, in retrospect, the ‘post-neoliberal era’. After so much wanton destruction caused by the global financial elite, including through its engagement with the microcredit model, developing country governments owe the global poor nothing less than this.

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