

How Brazil Has Learned Bangladesh's Microcredit Lesson

Contributed by Michael Glenwick
Tuesday, 01 January 2008

When Muhammad Yunus, the economist who founded the influential Grameen Bank (which dispenses small loans to poor people in Bangladesh), won the 2006 Nobel Peace Prize for his pioneering work in aiding the poor in his home country, many around the world hoped microcredit would become the next big tool to fight global poverty.

Microcredit is the process by which a "bank" dispenses small loans to poor people who do not have the financial resources to secure a loan under normal circumstances. The practice has become so popular that there are many observers who believe that, if institutions like the Grameen Bank are replicated on a large scale, it will be possible to eliminate poverty around the world.

Although Yunus' bank focuses solely on impoverished Bangladeshis, similar financial institutions have been established all over the developing world and in Latin America in particular. In fact, the well-known Acción International, which started providing loans in 1973, has roots that lie thousands of miles from Bangladesh, in Brazil.

As Acción's work spread, demands for small loans rose, demonstrating that a need was being filled; many Latin Americans had lost faith in their countries' authorities to provide for their well-being, and have now turned to private financial institutions to fill a gaping void.

Band-aid or Solid Rock?

To some on the left, at least, microcredit appeared to be serving as a band-aid for some Latin Americans. It was a palliative, they insisted, for what should be a main purpose of government - ensuring that the state guarantees the fundamentals of a good society. They insisted on avoiding the practice of shopping out such services to financial intermediaries, no matter how well-meaning they might be.

But how much can a few band-aids do? Can microcredit only stop the bleeding for so long and for a limited number of people, while the majority continue to starve with government providing no relief? Is microcredit a feasible solution for the future? Or is it just a convenient excuse for many indifferent Latin American governments - especially those on the conservative side - to neglect their citizens?

In any event, focusing on both the pros and cons of microcredit on a hemispheric scale, one can perhaps get a better understanding of its potential (or lack thereof) for liberating a large number of Latin Americans from the thrall of poverty.

A Brief History

How one defines microcredit may lead to different interpretations of its origin. Some people even view the Marshall Plan as the beginnings of microcredit, even though the loans given to European countries following World War II were significantly larger than anything done under the banner of microcredit. Nevertheless, the Marshall Plan was the first time in history where major loans were systematically distributed to war-torn countries and their suffering citizenry.

It can be said that there was only a rudimentary guarantee of payment on these loans, and the system was mainly based on trust; this is somewhat similar to the Grameen Bank, in which Yunus works on a much smaller scale with Bangladeshis (largely women) in the hope that they will repay the loan with interest. There is no guarantee of repayment on a Grameen loan, but Yunus has based the bank on faith that most of the loans would be repaid.

It took a bit of time after the Marshall Plan for similar - yet scaled-down - loan programs with a specific focus on poverty alleviation to emerge. Microcredit institutions started popping up in the late 1960s and early 1970s, epitomized by Samuel Greene's Penny Foundation in Guatemala and Acción in Brazil.

Acción, which started out doing humanitarian work in Latin America, realized that, generally speaking, there was a big credit gap in Latin America and an even greater shortfall in the deliverance of social services to a nation's impoverished population.

The often corrupt governments, some nonfunctional, some mean-spirited, and some a bit of both - were not fulfilling their basic obligation to their citizens. Poverty rates were astronomical, and as a result, many poor Latin Americans were eager to do anything to dig themselves out of the poverty trap.

Groups like Acción provided that help, but it must be stressed that in many senses, they were playing a role that the various countries' governments were failing to fulfill. By the 1980s, during the high tide of military rule, with army death-squads squashing human rights, Acción was working in 16 Latin American countries and providing loans to thousands of people.

By 2000, Acción had become huge, with resources in the tens of millions of dollars, and other organizations had followed its path, all with a similar (and, it should be noted, well-intentioned) goal: to aid poor Latin Americans in their quest to escape poverty by helping them start their own small businesses, which they otherwise would have been unable to do.

At the same time it should be said that microcreditors were masking a much more serious problem in Latin America and in other parts of the world, namely that elected governments were not meeting the demands of the people who needed their help the most.

Small Is Not Necessarily Beautiful

Whether they were amenable to what was happening or not, to a small extent, the vender selling cigarettes on the corner of an urban center - an example of Hernando De Soto's informal economy and the small business women who benefit from a five hundred dollar loan at a 20 percent interest rate, are diverting pressure from the government for not carrying out functions that should be borne by the state.

In following this line of reasoning, Acción and other groups were doing the government's work in their objective to deliver economic betterment services to citizens. Nevertheless, as the 21st century began, an answer to the relevance and necessity of microcredit (and the parallel issues having to deal with the role of the state in Latin America) was needed.

The question does remain over whether the inherent conservative libertarian anti-government thrust that imbues some microcredit operations gives a distinct quasi-political spin to this kind of model of poverty-abatement.

Pro Arguments

A closer look at two microcredit organizations that work in Latin America - Acción and FINCA International - and the success that the two of them have had in alleviating poverty in specific pockets of Latin America and the Caribbean is vital when trying to understand why microcredit has had such a strong impact on the region.

Like Acción, FINCA (which stands for Foundation for International Community Assistance) has had more than three decades of experience working with the poverty-stricken in Latin America. They both focus on raising the status of women and making a special effort to distribute loans to women, who have long been neglected on the credit front in societies of underdeveloped countries.

In a sense, the relatively small loans that groups like FINCA and Acción have distributed in Latin America were a welcomed replacement of the role of the original "loan shark," the infamous companies and individuals who provide loans to poor people with usuriously high interest rates.

A recent New York Times story reported that loan sharks often charge individuals as much as 10 percent to 20 percent interest rate per day, which, unless that individual is fortunate enough to hit the jackpot the same day, is all but impossible to ever repay.

Due to such heartless high interest rates, many of those who are already in the debt trap could find themselves there for a lifetime. Eventually, they cannot take out new loans because they no longer have any collateral that would allow even the loan sharks to lend with any prospects of making a profit.

As just one example of the way in which enterprises in various countries are resorting to microcredit, in Medellín, Colombia, Mayor Sergio Fajardo has turned to a variety of private companies to support microlending projects designed to help meet the demand for an increase in the number of small businesses.

Although the effects of Fajardo's initiative will be hard to gauge for quite a while, early signs indicate that microcredit might be doing some good for at least a fair number of Medellínenses (as the residents of Medellín are called). Meanwhile, in Ecuador, FINCA's village banks have become deposit-taking institutions (MDIs), helping to boost savings rates in the areas in which they operate.

From 1996 to 2006,

Acción went from distributing 276,000 loans to 2,375,000, and the average loan has risen from \$581 to \$829. Almost all of the loans have been repaid in full, strengthening the microcredit cycle in Latin America and contributing toward its increased popularity today. As things now stand, ever more clients are resorting to the use of microcredit in order to dig themselves out of poverty. Instead of becoming one of many solutions, it seemingly has become the only practical solution in countries whose governments have found it necessary to resort to outside help to boost their own inadequate treatment of the poor.

Cons

But does the fact that more of the poor are turning to microcredit sources serve as an indicator of its virtues, or does it, instead, demonstrate the lack of available public alternatives and increased government outsourcing of possible solutions to problems affecting issues of societal equity? Equally important is the question of whether the microcredit institutions, which have been able to work on a micro level, have proven their ability to effectively dig the majority of their clients out of poverty on a macro level?

According to the Economic Commission for Latin America and the Caribbean, almost two out of every five Latin Americans are living in poverty today, and there is significant doubt as to whether microcredit can create sufficient change on a macro level to reduce the current 38 percent poverty rate. As certain governments (see the aforementioned example of Medellín) encourage the use of microcredit as the best way for Latin Americans to escape poverty, there is a real chance that one of the state's most important roles - to care for the welfare of its people - will be ignored or under-served.

Furthermore, there is no specific evidence that the microcredit system is, in fact, the best possible way to lift the Latin American masses out of poverty; it might very well be the best model for a small village, where a microcredit institution works with a manageable cohort of the population to achieve a limited number of specific goals. But when there are hundreds of thousands (if not millions) of the impoverished living in a large town or city, one has to wonder if a much larger financial pool should be created or sustained for such amelioration.

Loan Terms

Furthermore, it should be noted that the terms associated with the loans granted to Latin American recipients are not as favorable as many of the microcreditors would have them be. Over the course of a single year, a loan from Acción can carry as much as a 20 percent interest rate, clearly very high, even though it might be relatively low when compared to the alternative available sources.

Other institutions can charge as much as 4 percent interest a month, which can become as much as 50 percent after 12 months. A 20 percent interest rate on a loan given to someone who might barely be making a few dollars a day can often be a burdensome task to pay back; at the same time, however, it should certainly be noted that loan sharks in the past have charged interest rates that were many times higher than Acción's.

Furthermore, with the number of microcredit banks on the rise, studies have shown that cuts in public programs (such as those in public health and education) may have increased, due to less citizen pressure being put on local authorities. Certainly, the case could be made that leaving a nation's poverty battle to the microcreditors might allow governments to allocate the funds saved toward other projects for the public good, such as health care.

Equally important, it often is assumed that the recipient of a microcredit loan needs only one loan in order to get his or her small business up and running. A more likely situation is that that loan could be the first of many, and with each loan comes the possibility that that entrepreneur will be constantly in arrears, unable to start up a business and stuck in an ever-deepening financial hole.

More Aspects of the Issue

One of the biggest deficiencies the microcredit system has in Latin America is that it fails to address one of the biggest economic challenges facing the everyday poor - the need to save. In order to properly and successfully manage problems like illness, natural disasters and debt, there needs to be a functioning savings program in place, a necessity that most microcredit institutions fail to address.

This is because without proper support mechanisms in place, microcredit can only go so far; this is not a failing of microcredit but rather an indicator of its inability to solve all the fiscal problems that burden the impoverished in Latin America.

In addition, even for the good work that microcredit organizations are able to accomplish with respect to the distribution of loans, considerable amounts of start-up money, time and basic skills are necessary, as a Boston Globe op-ed piece by Rashmi Dyal-Chand points out; this may be one of the relatively few drawbacks to Acción's work.

Thus, the amount of resources that must be devoted to a microcredit transaction is relatively large, and there is some question as to whether it is worth it (relative to larger-scale welfare projects which are sometimes beyond the magnitude of the transactions under discussion).

Yunus, the man who started it all, once wrote in his book, *Banker to the Poor: Micro-Lending and the Battle Against World Poverty*, "I believe that 'government,' as we know it today, should pull out of most things except for law enforcement and justice, national defense and foreign policy, and let the private sector, a 'Grameenized private sector,' a social-consciousness-driven private sector, take over their other functions."

Understandably, this point of view is what Yunus would prefer; microcredit is his claim to fame, and the success (and magnitude) of it will determine his legacy. Nonetheless, just because Yunus and other microcredit-backers are calling for an entirely privatized system of social welfare does not necessarily mean it should be embraced with open arms (or at all).

Even among the "beneficiaries" of the Grameen Bank, 55 percent of those people who have received loans still cannot meet their most basic nutritional needs. With regard to Latin America, a "Grameenized private sector" poses a number of serious problems. Given a history in which many Central and South American state governments have neglected the economic and social needs of their citizens, the world's support for microcredit might present an opportunistic escape for local authorities.

By openly shifting responsibility for the well-being of their citizens to private financial institutions like Acción or FINCA, governments would be able to actively shy away from what has generally been perceived to be one of their most important obligations.

Although one can make a valid claim that Latin American governments have not always been properly held accountable for their citizens' well-being, we should aspire toward an improved and a somewhat more moral model of government that might, on the whole, achieve more than what a scattering of microcreditors have.

Summary

There certainly is a great deal of truth regarding the success of microcredit in Latin America. There are a significant number of people - from Mexico to Argentina - who have benefited from the small loans offered to them by microcreditors. Small businesses have sprung up that otherwise might not have been able to exist. At the same time, however, one of the reasons why the small loans were necessary in order to initiate certain economic projects was the all-too-prevalent problem of government neglect, inadequacy or inability.

In the last few decades of the 20th century, plenty of Latin American (and, for that matter, Middle Eastern, African, and Asian) governments did not sufficiently commit themselves to nurturing the lives of their citizens as one might expect. As a result, the door was opened for the progressive advent of microcredit organizations.

Those poorly run governments were more than happy to let private banks do their work. But, just because the microcredit banks were originally invited in (and have subsequently achieved various degrees of success) does not mean that the lending sector should be progressively turned over to them.

This is not to say that microfinance as a policy should be ignored or dismissed; it is a crucial piece of the puzzle aimed at ending poverty in Latin America. Yet the growth of microfinance must not be accompanied by the weakening or elimination of state programs that have a macro vision and the potential to cover more people more efficiently.

With a pivotal role in Latin America that will not end any time soon, microfinance is certainly a commendable effort, but it is not necessarily the overall cure to the problems that Latin Americans face, a fact that is critical when considering the still-parlous state of the poor in 2007.

This analysis was prepared by COHA's Research Associate Michael Glenwick. The Council on Hemispheric Affairs (COHA) - www.coha.org - is a think tank established in 1975 to discuss and promote inter-American relationship. Email: coha@coha.org.