Is Microfinance the Panacea for Development? Lessons from the Developing World
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Abstract

In the contemporary world economy characterised by in-egalitarian tendencies, this paper tries to critically look at the transformations in the sphere of development finance. It tries to develop a critique against the nature of deregulation in the microfinance sector. It argues that there could be no substitute for state intervention in the macro economy towards the provision of public goods like education and health. At best, microfinance could play a supplementary role, and never the role of a substitute.

Keywords: Microfinance, Development, Deregulation.

1.0 Introduction

It is in the context of United Nations, vide its resolution 53/197 declaring 2005 as the International Year of Microcredit, that an official and developmental consensus started emerging around microfinance. Through this resolution, it decided to give impetus to microcredit programmes in the world, and to underline the relevance of microcredit in the process of eradicating poverty. It was suggested that the targets under million development goals (henceforth MDGs) could be achieved, in case the credit requirements of the financially inaccessible sections were addressed to. In the contemporary world economy characterised by in-egalitarian tendencies, which require policies focussing on redistributive justice, this paper tries to critically look at the transformations in the sphere of development finance.

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It tries to develop a critique against the nature of deregulation in the microfinance sector, and tries to place the fact that there could be no substitute for state intervention in the macro economy towards the provision of public goods like education and health (Dreze and Sen, 2002). At best, microfinance could play a supplementary role, and never the role of a substitute.

At the international level, with widening inequalities, when the world leadership has found it urgent to meet MDGs, the fund contribution in this regard is found to be wanting. Along with the declining share of official development finance (ODA henceforth) as a proportion of the GNI of the developed countries, the international market for development funds is proliferating with many private players, guided by profit motive, routing most of the funds to the private sector through social investment funds and microfinance institutions) in the developing world. Given the whole host of externalities associated with the provision of public goods, in case consolidated efforts are not made to regulate the flow of finance and bring the government back in, the declared goals would not be achieved.

1.1 Plan of the paper

The paper is structured into five sections. Section II sheds light on the literature relating to the deregulation in the financial sector, for it is in its backdrop that further deregulation has been initiated with respect to development finance, particularly microfinance. Section III focuses on the impact of international financial system on development finance. In the next section, attention is drawn to the relative decline in the share of ODA from the developed countries as against the increased private participation of donors and recipients guided by market-led principles through agencies in the private sector. The next section deals with the diverse perspectives with respect to microfinance sector. The issues relating to certain tendencies which are showing up in the course of the microfinance sector tapping international funds is dealt with in section three, shedding light on the Compartamos case. It concludes suggesting that the world of deregulated finance would do more harm than good for the long-term development of economies. If the outreach to the larger population is needed, the delivery of social goods is best done through the agency of the state through proper monitoring at various levels through public participation. However, one
needs to factor in state failures in this regard. Meaningful programmes of state intervention need to be designed after a careful analysis of success stories in different contexts. Let us remind ourselves if market fails, state need not succeed.

2.0 Financial Liberalisation and its Critics – An Overview

The rationale for financial liberalisation can be traced to the McKinnon Shaw hypothesis, which structures its argument on the basis of efficient market hypothesis. Permitting the diverse set of financial intermediaries and instruments help the countries to mature, this could be made possible only by the free interplay of market forces. The hypothesis, therefore argues that the governments, which would insist on financial architecture of their own choice, i.e., financial repression, are likely to stray from sound banking practices, which would thus come in the way of economic modernisation.

It is argued in the McKinnon-Shaw hypothesis that the governments would themselves be setting a lower interest rate, which is independent of the rest of the world. Local residents are prevented from saving in other financial markets or instruments, financial innovation is discouraged and the access to funds for the government is made at a relatively lower rate of interest compared to the rate of interest on private sector credit. This, it is argued, would result in the private sector being starved of funds, the governments resorting to a larger borrowing and fiscal extravaganza. Given the large gap between the demand for private sector credit and the supply of the same, it is argued that the system would resort to a sort of cronyism. Investment in the short run therefore gets jeopardised, with long run consequences to growth (McKinnon, 1973; Shaw, 1973).

With the era of financial repression coming to an end, the financial markets in these countries would be able to offer higher rates of return. Not just that the foreign savings would flow into the country, but even domestic savings would be on the rise, resulting in the interest rate in the country not necessarily increasing ex post, and even falling at that. In this course, not just the parties in the private sector, but also the government would be able to take recourse to the abundant availability of credit. Thus McKinnon-Shaw hypothesis gave ideological credence to the episodes of financial liberalisation in the entire of the South.
It is assumed by the hypothesis that access to credit would be on the upside with the financial market liberalisation, with the entry of sophisticated financial firms, providing efficiency of financial services. The financial services would accrue to the higher segment of the society for whom concerns with financial exclusion was never a consideration. The extent to which the new financial firms in the country would be bothered to reach out to the hinterlands is anybody's guess. Catering to the urban markets in and high-income groups, the foreign firms would find their entry into the new markets beneficial just for themselves.

The negative externalities, which would accrue to the country at large due to the entry and retreat of the funds under the era of financial liberalisation, would manifest in the form of volatility not just in the exchange rates, but in incomes and therefore would have a negative impact on the livelihoods of huge populations. That said, it would only be appropriate to take note of the series of exchange rate crashes, which has happened in the course of the nineties to the current decade, ranging from Mexico to East Asia, and Brazil and Argentina. The eruption of the sub-prime crisis in the developed United States exposes us to the fact as to how risks in the developed countries has been successfully diversified to the developing world in the name of the internationalisation of financial markets (Murthy and Deb, 2012).

The neoclassical prediction which the McKinnon-Shaw hypothesis makes is as ahistoric as is the basic analytical framework of neoclassical economics. The access to cheaper sources of funds, under the various restrictions inherent under financial repression has also resulted in the governments in different developing countries like India and China being able to cater to the creation of diverse public goods, without which businesses or enterprises to begin with would have been an impossibility. Given the externalities and public good nature associated with government expenditure, to expect the private entrepreneurs to undertake investment discounting for the social return, in the course of the supply of loanable funds increasing is ill-founded logic. In fact, given the large risks and uncertainties associated with economic activities in developing world, the era of financial repression with restriction on interest rates made perfect sense. The qualitative credit controls, which were imposed by the system on different streams of activity, were able to discriminate on the basis of the alternative rates of interest charged. In fact, finding fault with the period of financial repression in
the developing economies and taking them to task would be like finding fault with the whole gamut of exercises in the rubric of development planning.

The edifice of the traditional macroeconomic theories relating to credit came under scathing attack from the paper on credit rationing by Stiglitz and Weiss (1981), which drew attention to the notion of asymmetric information prevalent in the credit markets. In the course of the crisis, which erupted in the eighties in the international capital markets, these arguments based on asymmetric information presumed significance. Elsewhere Stiglitz had attributed part of the success in East Asia to the ability of government led arrangements to resolve the asymmetric information related incentive problems. Higher delinquency rates would set in if the interest rates are determined by the free interplay of demand and supply, the government role in this regard is noteworthy, not just in determining the rate of interest charged, but also in directing the sectors to which credit is allocated, due to long-term growth objectives with which it would be working with. Rather than viewing credit rationing as a logical outcome of economic environment characterised by imperfect information, arguing that attracting funds from abroad to tide over the issue would lead the economy to be exposed to further risks and uncertainties associated with the international capital markets.

3.0 International Monetary System and Development Finance

The Post Keynesians and the structuralists to the collapse of the Brettonwoods system characterized by the fixed exchange rates attribute the increasing uncertainties and risks, associated with the international monetary system. Davidson (2000) argues that unless a proper re-engineering of the international financial system is undertaken with a well-defined global lender of last resort, in the place of the Brettonwoods system which collapsed in the seventies, the

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1 In yet another paper, Greenwald and Stiglitz (1986) had come severely against the prognostications of efficient market hypothesis. ‘...’ one of the advantages of such opening up ..........is presumably that it creates credit institutions which can make use of foreign expertise to provide credit more efficiently and effectively ... (but) foreign lending and domestic lending are not perfect substitutes, since the two sets of institutions have different information bases, and are therefore likely to lend to different kinds of firms. It is possible that even if overall lending increased, domestic firms could be worse off.
uncertainties in the international financial markets are likely to continue or worsen. In such an international economic environment, to expose the developing countries would be tantamount to exposing them to the caprices of the speculators. Unless the turmoil in the international capital markets, which exposes the countries to speculative attacks, explained by neither the first or second models of balance of payments crises (Krugman, 1979; Obstfeld, 1986), the utility of the international capital markets to the developing countries as a source of development finance is disputable.

In an investigation conducted, Feldstein and Horoika (1980) has drawn attention to the high correlation between investment ratios and savings ratios across countries, clearly underlying the importance of domestic savings as a source of capital accumulation, with the foreign savings only being able only to supplement the same. Of late, in the heydays of financial globalization, replete with the risky financial instruments which have been packaged and repackaged, and floated in the international capital markets, the developed countries, particularly United States, have been able to get rid of the risks and uncertainties associated with their banking system, thus worsening the condition of the financial systems elsewhere. The asymmetries in the international financial system have enabled the leader country in the world economy to gobble up to 60% of the current account surpluses of the different countries towards financing its current account deficit. It is paradoxical to note that the savings to finance the same accrues from the developing countries characterized by extremely poor levels of per capita income.

In other words, the inability of the developing world to access the international capital market, with an exception of a few, being a hard truth, it would only be appropriate that the economic policy makers should open their eyes towards putting sand in the wheels of finance, (Eichengreen, Tobin, & Wyplosz, 1995) so as to reduce the volatility in the international capital markets. In this regard, the concerns with regard to the development finance presume all the more importance, for the same has to do with improving the parameters of health, education and life expectancy and therefore to are consequential in determining the human development indicator outcomes of the world economy.

It has already been mentioned that, contrary to the Chenery-Strout model of financing current account deficits of the less developed world with capital
inflows from abroad (Chenery, and Strout, 1966), the contemporary world economy is witness to the current account deficits of different countries like United States being financed with the surpluses from the Asian countries, which have far lower per capita incomes compared to the developed world. In such a conjuncture in the world economy, the question of development finance presumes all the more importance.

4.0 The New International Marketplace of Development Finance - The Dwindling Share of ODA

This brings us to the crucial issue of the dwindling nature of the ODA commitments and disbursements in a world, which in the course of globalization is characterized by distributive injustice. Worst of all, this space is being occupied or substituted by private sector-led development finance. The decline in the official development assistance to the developing world in the course of the years has compelled the world polity, first in the course of the 1970s to think in terms of the New International Economic Order, requiring the developed world to pay up 0.7% of its GDP. In fact, there were large deliberations on the importance of taxing brain drain to the developed world, and using the proceeds to set up global public goods. In fact, like any usual international discussions on development, the same was a non-starter.

Deliberations which were held in the context of the Millennium Conference, found the world leadership formulating targets to be achieved in the course of a time span, MDGs, the financing of which had to be undertaken by countries in the developed world contributing 1% of their GDP. This was further ratified as the Monterrey Consensus. Apart from a few Scandinavian countries, which have contributed more than their share, many are yet to pay up their prescribed contributions. Till before the sub-prime crisis, the cross-border investment in microfinance had tripled to reach a level of US $1.4 billion in 2006, reveals CGAP sources. The UN Conference at Monterrey recognized that a substantial increase in foreign aid and other resources is required to facilitate the achievements of MDGs in the developing world. In this context the developed countries were urged to make contributions to the tone of 0.7% of their GDP. Further there was international consensus on increasing the ODA allocated to
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sub-Saharan Africa by 25 bn $ year by 2010. But nonetheless the donors have not made much progress with respect to their commitments. ODA net of debt relief declined form 0.26% of the GNI of DAC to 0.25% in 2006. Though higher than the 2001 level of 0.21%, it is far below 0.33% of the early nineties, and far short of the proposed UN target.  

Attempts are underway to deploy funds on the basis of the Index of Economic Freedom of various countries, which in fact has no link to the nature of human development or growth performance of different countries. In fact, devolving funds under ODA to private players in the developing world, particularly to ones under the NGO framework, has been a growing tendency over the years, which tries to undermine the democratic space of decision-making.

The utilization of funds in such a way that it is prejudiced about role to be played by the government (minimalist state doctrine) as a route of social delivery mechanism is in fact a contradiction of sorts. It has been appreciated worldwide that the indubitable improvements in the living standards of people in China, which has pulled millions above the poverty line, has much to do with the public funding of education and health. The increased accessibility of public goods like health and education due to government initiatives is considered to be the most pertinent factor facilitating better achievements on the human development front in different regions like Costa Rica, Kerala state of India and Sri Lanka.

At the same time, while the ODA commitments are not forthcoming, there has been a phenomenal increase in the funding happening in the microfinance space for development aid. The Microfinance Information Exchange gives details relating to the same. The securitization deals and CDO instruments, which were thought to be vehicles of corporate finance, have now made their entry even to microfinance space. US investment in foreign microfinance is $4 billion (2006)

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2 The data in this regard provided by Global Development Finance 2007, World Bank.
3 The Index of Economic Freedom was conceptualized by New American Foundation, which calculated the same on the basis of the easiness of doing business in various countries. It is of course dubious to believe that the free market economies have delivered better in the field of development.
4 Mention about the development achievements is present in most of the volumes of Human Development Report. A comprehensive survey of literature on the development experience of Kerala by V K Ramachandran is available in Dreze and Sen (1997), Indian Development: Selected Regional Perspectives. OUP.
as against $1.6bn (2003). Vehicles like collateralized debt obligations CDOs and securitization is resorted to access these sources of finance. The Blue Orchard deal worth $40 million linked 90 investors with nine MFIs in the entire of the world. 180 million $ worth of receivables for a period of six years of BRAC (a MFI NGO based in Bangladesh which delivers credit to the poor) was securitized by a deal. The international development organizations have also been routing a chunk of their finance through NGO-MFIs, rationalizing the same under the guise of government failure in the developing world, not to speak of the private equity investors and pension funds. Major contributions done by Warren Buffet to the Melinda and Bill Gates Foundation is a case of large private donor investment. In fact the disbursements of the Gates Foundation would far overshadow the contributions done by number of G-8 countries.

5.0 Microfinance, Development Finance and Developing Countries

More than the liberalisation of financial markets, it is the reform in the development finance sector, ever since the nineties, which would be discussed in this section. With the pursuit of Washington Consensus based polices, different countries in the developing world were witness to deflationary tendencies. Despite the favourable performance in the world economy, many could not catch up with improved rates of growth. The deterioration in the terms of trade of the commodities resulted in the situation worsening in some of the countries. The fiscal contraction and monetary tightening which were initiated on the basis of global guidelines, found the social banking priorities in the pre-reform period on the decline. To make up for the retreat of banking for their traditional social functions, was the gamut of legislations, which favoured the growth of microfinance in the private sector.

Social banking was a policy concern in the developing world, due to the pre-occupation of the developing country governments addressing the issues of

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5. One of the most impressive aspects of the transaction is the way that it deals with the sheer complexity of a dynamic pool that will contain about 3.3 million short tenor loans for which the average outstanding is around $95. Citigroup, Netherlands Financing Company brought one-third each whereas the rest was bought by Citigroup Bangladesh and two local Bangladeshi banks. (For further details, see International Financing Review Asia)
asymmetric information, adverse selection, moral hazard and social exclusion in the financial markets. The lack of endowments which could be used as a collateral, the ecological fragility associated with the different regions, the weather dependence on the outcome of economic activities as well as the volatility of the incomes of the individuals make various activities undertaken by the agents in the developing world to be more risk prone in nature. This also results in the interest rates charged in the underdeveloped credit markets being far higher in comparison with the ones prevalent in the organised domestic credit market, not to speak of the international capital market.

Taking stock of the market failure prevalent in these countries, efforts were on to enhance the accessibility of credit to regions and disadvantaged sections. In the course of the years of developmental planning from the fifties to the eighties, the avowed objective of upscaling the credit has resulted in a series of programmes, direct and indirect, ranging from land redistribution, the directed credit programmes, priority sector lending, large scale employment programmes (to match up for the incompatibility of growth and employment), and in certain countries event to the nationalisation of the banking system towards serving the interests of the poor. Policies towards the creation of public goods were dovetailed in such a manner that the employment aspect was also addressed. Many of the programmes like that of land distribution could not be implemented to the desired extent, due to the lack of the political will for the regimes concerned and certain others in the course of the implementation were confronted by serious design errors.

It has been the dictum of the free market economy that one should incentivise the agents in the economy to deliver a superior outcome than the existent one. With regards to not just goods, as, in the recent past, even with respect to services as well as with respect to social welfare, this is the new route suggested. When it comes to financial markets, the removal of restrictions on the interest rates, is suggested as the way to attract funds to the sector, so that the risks taken by the benevolent social investors or angel-capitalists would pay off in the form of higher return, and the agents in the system would benefit, by way of increased access to funds.

Whatever was forbidden and illegal to be done by the traditional moneylenders, due to the social conscientiousness, which has been engendered
through the struggles waged against usurious practices, now finds respectability and are provided legitimacy. Indeed throughout the world, including India, the emergence of the co-operatives and such lending institutions first came in the backdrop of the unavailability of the same in the institutional scene in the earlier years\textsuperscript{6}. The stagnation of the real wages of the agricultural labour, coupled with the usurious rates, which were charged by the moneylenders, provided fodder to the nationalist upsurge in India against the colonial order\textsuperscript{7}. In this perspective, how it could be that in the context of non-repayments in the institutional sector, they could even think in terms of coercive practices of extraction. The celebrated success in the microfinance sector, by higher repayment rates, in certain cases, could be the outcome of the vertical relationships between the microfinance operators and the beneficiaries. In many cases, it is the erstwhile moneylender, now has re-entered in the garb of a microfinance operator, thanks to the new legislation, which have given legal sanctity and constitutionality to their erstwhile duties\textsuperscript{8}. No wonder, that when the world celebrates the success of microfinance as a tool of delivery mechanism, ground level opposition to seething high interest rates charged by the sector is making a big comeback.

It is more or less in terms of the McKinnon-Shaw hypothesis, which calls for an end to financial repression, that the argument in made to liberalize interest rates in the microfinance sector. This, it is argued, would attract funds to the sector, and in the long run, reduce interest rates prevalent in the sector. The high interest rates charged by the microfinance sector have attracted the attention of policymakers worldwide. The interest rate ceilings in different developing and transitional economies have been removed indeed to provide for the growth of the microfinance sector, giving due credit to these neoclassical predictions of their ability to cater to the interests of development (Helms and Reille, 2004).

\textsuperscript{6}In the Indian case, it should be remembered that these credit institutions were outcomes of the struggles waged by the small farmers and peasants against the moneylenders in the course of the commercialisation of agriculture in the course of the nineteenth century. It should also be noted that the favourable terms of trade of agriculture notwithstanding, in the course of the previous century, not all in the countryside benefited alike.

\textsuperscript{7}See for the same argument and related studies Tomlinson(1997) and Habib (2006 )

\textsuperscript{8}The Central Bank in India, RBI is trying to bring in a mechanism to license the moneylender and bring him into the system.
The neoclassical stream of reasoning argues that the interest rate ceilings hurt, rather than improve the lot of the poor. These restrictions, it is argued, is coming in the way of enhancing financial accessibility to the poor. It is further argued that for the institutions engaged in microfinance to be able to cover up for the transactions costs involved in the disbursement of small size loans, which is at times distributed without a proper collateral, it would not be possible. Juxtaposing the transactions costs involved in the dealings of bank vis-à-vis that of microfinance institutions, it is often argued that given the higher ratio of operational costs ratio in the former, unless the latter is allowed to charge a higher rate of interest, the business of microfinance in itself would turn out to be unsustainable, thus coming in the way of the delivery of microfinance services to the poor.

In the economic literature, opinion is divided between those who believe that globalisation signals the increasing irrelevance of the geographical place (O’Brien, 1992) and the others who insist on the continued significance of the local dynamics in the credit and money processes (Leyshon and Thrift, 1997). Spatial thinking on the economic geography of credit has looked into the details of the distribution of credit and banking services over space, and the research paradigms in racial and gender discrimination as well as redlining in the credit markets have been usefully deployed in the understanding of the disbursement of credit (Dymski, 2003).

The microfinance space in the developing world is a diverse space. It has number of players under its umbrella. The complex set of institutions in the development sector in India in itself would reveal the diversity of the same. The SHG-bank linkage programme nurtured by NABARD in the government sector, the MFIs promoted and nurtured by SIDBI, the working women co-operative in SEWA, the modernizing NGOs like BASIX, the ones which have benefited from international capital infusion like BANDHAN, SKS Microfinance, Share Microfin—all these belong to various forms of organizational structures. Bringing them all under one umbrella of analysis would be erroneous. Though lessons ought to be drawn from these successful cases, the extent of outreach made possible by the government-led initiatives needs special mention. The government could also try out replicating some of these models on a pilot basis in certain regions.
The good intent of the policies pursued under dirigiste regime of subsidizing the interest rate charged on the loans granted under the priority sector lending schemes of the banking system, directed though they are by the government, also draw the wrath of the liberalizers. Under the pretext that the loan recovery rate in many of the government led IRDP programmes in countries like India was around 10 to 55%, whereas the ones in MFIs in India like Share and BASIX are near to 100%, it is argued as a classic case of government failure (Mahajan and Ramola, 2003). This is used as an advantageous situation to argue out a case for the liberalisation of the microfinance sector. But is should be noted that the largest employment programme in the world, IRDP, which has its presence in all the districts, is compared against the microfinance programmes which are concentrated in a few districts of the country. This apart, these MFIs are some of the best of its kind in different other aspects.

The scope, extent and outreach of programmes run by the government should be adjusted for, when comparison is made of its relative performance vis-à-vis private initiatives in the microfinance sector. Some of the MFIs, which have made a mark of theirs in the districts of their operation, have been able to do so by virtue of their trying to harness the sort of forward and backward linkages made possible in the sector. The capacity building undertaken in some of the regions give them the role played by an agency like the state. But there are limits to the geographic area in which they can concentrate and expand their activities.

It has also to be noted that the decision with respect to the nationalization of banks in the course of the seventies, not only resulted in increasing the mobilization of savings from the interior hinterland, but had had a perceptible influence on the reduction of the clout of the informal money lender classes in the rural areas. The empirical exercise undertaken by Burgess and Pande (2005) on the favorable impact, which the nationalization of banks have had in the course of the seventies on poverty alleviation and increasing accessibility to credit.

The decennial survey conducted by the NSSO, All India Debt and Investment Survey documents that reliance of Indian cultivators on formal debt sources increased substantially from 18 percent in 1961/62 to 63 percent in 1981/82, but this progress was reversed in the next two decades as the share of cultivators’ debt from moneylenders increased from 18 to 30 percent between 1991 and
20029. This presumes all the more relevance, particularly in the context of the retreat of social banking in the post-reform period, and is also representative of the era of financial liberalisation.

Over and above this, the rise to ascendancy of microfinance as a vehicle of poverty alleviation occurred at a time, when certain countries like India were inundated with capital inflows from abroad, particularly of short-term nature. This has resulted in a steady appreciation of the rupee vis-à-vis dollar. For the same was affecting the competitiveness of many of our export goods, the Central Bank had to resort to purchase of Treasury bonds, which were yielding extremely low rates of return. As against this, not only were the inflows fetching the foreign institutional investors far higher rates of return, but the bonds which were issued by the Central Bank in the course of sterilization of the increases supply of money was far higher. This resulted in the profitability of the Central bank being at stake. The impact of the same on the grants and transfers to development financial institutions like NABARD, manifested in the form of low increase in the credit to the agricultural sector from the formal sector, resulting in the unfavorable performance of the agricultural sector, which has serious consequences from the angle of inter-sectoral linkages in the Indian economy.

6.0 Shareholder Wealth Maximization Model Work in the Social Sector?
The Case of Compartamos and SKS

Will the benefits outweigh the costs from exposing the microfinance/rural credit sector to the vagaries or risks of the international capital markets? Will the formation of microfinance organisations on Anglo-Saxon shareholder wealth maximisation lines, augur well for the beneficiaries in the microfinance sector? The consequences of the same would be of much interest particularly so in the light of the sub-prime crisis. The case of Compartamos in Brazil (CGAP Focus Note, 2007) and SKS in India (Saxena and Deb, 2013) assume importance in this regard.

It is argued that, over periods of time, when the number of loan products and its average size increases, economies of scale would creep in, and the same

would manifest in the form of reduced interest rates. If one is to go by the experience of Compartamos, it is extremely difficult to discern as to whether there is any difference left if any between investment and social investment. No wonder, lured by the high rates of return, the hedge funds and sovereign wealth funds are finding in the microfinance sector, a profitable avenue for investment.

In the light of the contemporary trends in leaving the alleviation of poverty in itself to the market and to the institutions in the market, it would be interesting to take note of the Compartamos story, particularly so because, it was one of the early developmental organizations, which transformed itself to be a financial intermediary, and was a beneficiary of the discourse against interest rate ceilings, which was rationalized by CGAP, through its various writings and research studies.

6.1 The Case of Compartamos

Ever since its inception in 1990, until 2000, Compartamos operated as a not-for-profit, non-governmental organization. During this period, it received US$4.3 million from international development agencies and private Mexican sources, and made tiny loans to poor and lower income women. By 2000, it reached 60,000 borrowers. In order to tap commercial funds for even faster growth, it decided to set up a regulated finance company, organized as a for-profit corporation. Beginning in 2002, Compartamos was able to issue roughly $70 million in bonds on the Mexican securities exchange; most of these bonds were partially guaranteed by the International Finance Corporation (IFC). In addition, the company has raised about $65 million by borrowing from Mexican banks and commercial lenders. By the time of the issue, it was already serving more than half a million customers.

On the successful listing of the IPO, the CGAP Focus Paper observed “The spectacular success of the IPO was a milestone not only for Compartamos, but for microfinance….The transaction will probably give a significant boost to the credibility of microfinance in commercial capital markets, and accelerate the mobilization of private capital for the business of providing financial services to poor and low-income people.” (CGAP Focus Note 42, 2000). Reduction in interest rate in the wake of economies of scale, increase in the loan size, and enhanced utilization of technology in the delivery of financial services as well as
expansion in the number of borrowers did not hold true in the case of Compartamos, as per the CGAP understanding in this regard.

As per its financial history details provided by the MIX, by 1997, it had 1 mn $ of equity and 1.3 mn$ of reinvested profit. In 2000, it converted itself into a SOFOL, i.e., a for profit company, with additional investments from ACCION and IFC, bringing its total equity to 11mn $. With a compounded rate of return on equity of 50%, which was reinvested, the equity base of 11mn$ (2001) turned to 18 mn $(2002), to 30 mn $(2003), 50 mn$ (2004), 80 mn$(2005) and 125 mn $ (2006). The company took a decision to sell 32% of its share in the form of an IPO to around 6000 new shareowners. The original investment of 6 million $ made by shareholders increased to 125 million $. The amount so mobilized through the sale of shares to the six thousand new shareholders accrues directly to the original shareowners of the firm. However, the poor borrower of the firm, the interest accruals of whom was the source from which profits accrued, still continue to be charged high rates of interest.

There was a series of interchanges among microfinance practitioners with respect to the Compartamos affair. Strong exception was taken to the method of utilizing usurious and predatory interest incomes from clients towards bolstering up the profits of a firm, of which the original intent was to increase accessibility of finance to the poor. In fact, Muhammad Yunus himself remarked, “Compartamos is not microcredit, it's raking in money off poor people desperate for cash.”

6.2 The Case of SKS

Professor Yunus' acolyte, Vikram Akula, founded his own microcredit organization, Swayam Krishi Sangham, which stands for “self-help society” as a NGO in 1997. The company was incorporated as SKS Microfinance Private Limited under the Indian Companies Act, 1956 on September 22, 2003. In 2005, SKS Registered with RBI as a “for profit” Non Banking Finance Company. Akula started chasing private investment in order to achieve the massive scale required to grapple with global poverty. In October 2008, Boston-based Sandstone Capital, now SKS' largest investor, made a major investment. It joined U.S. private equity firm Sequoia Capital, on the board of directors. Akula, who had been chief executive in the company's early days, stepped down in December
2008 but continued on as chairman. The company brought in new top executives from the worlds of finance and insurance. Following a resolution of its shareholders passed on May 2, 2009, the Company was converted into a public limited company and the word “private” was deleted from its name.

On December 1, 2009, SKS began a massive sales drive. The “Incentives Galore” programme ran through February 2010, just one month before the company filed its IPO prospectus. In a month, SKS added 400,000 borrowers and 100 branches, and trained more than 1,000 new loan officers. SKS had 6.8 million borrowers in nearly 100,000 villages and had disbursed loans amounting to Rs. 15,680. SKS clearly emerged not only India’s largest micro lender but also the fastest growing microfinance company in the world. In July 2010, SKS went public. Its IPO of Rs. 1,715 crore was oversubscribed by nearly 14 times. Its stock surged more than 10 per cent on its first day. The existing shareholders made handsome profits at a share price that was four times greater than the book value!

During the later part of 2010, more than 200 poor, debt-ridden residents of Andhra Pradesh killed themselves on account of the pressure from the lenders. The state government enacted Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010 (the “AP Act”), effectively closing down all profit driven microfinance institutions operating in the state. Incidentally, the state of Andhra Pradesh accounts for nearly 40 per cent of all microfinance activity in India. On November 23, 2011 Akula resigned from the board of SKS.

Could the case of SKS be regarded as a stray incident of misdirected / poorly governed company that in its attempt to appear good to the stock market went overboard for enlisting clients and disbursing loans? Or is it that the ethos of marketization inherently fraught with these possibilities? In India, for example it is worth examining as to why more than 2/3rd of India’s microfinance industry is concentrated in the Southern region, which incidentally does not have any desperately poor state. If the objective of microfinance is poverty alleviation

10. According to Oxford Poverty and Human Development Initiative (OPHI, 2011) there were 421 million poor living under MPI in eight Indian states of Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh and West Bengal. This number is higher than 410 million poor living in the 26 poorest African states. That is why these states are referred to as desperately poor states.
their concentration should correspond to the concentration of poor. Should we label their relative absence from the poor states as an instance of mission drift or the manifestation of the fallouts of paradigm paranoia by taking a position ‘for’ or ‘against’ neo-liberalism? After all, a firm or two could drift from their respective missions, could we say the same of the industry as a whole?

While speaking to Time Magazine after the famed Nobel Prize for “efforts to create economic and social development from below (www.nobelprize.org)” in 2006, Professor Yunus stated the mission of microfinance industry as “creating a poverty museum by 2030.” However, CSFI (2011:1) captured the worldwide predicament of the industry in these words:

“A lot of people—well-meaning, thoughtful people who are in the microfinance industry—are now worried that microfinance has taken a wrong turn, that it has drifted away from its original mission, that had been co-opted (or even corrupted) by the pursuit of size and profitability This is new and...it leaves microfinance and individual MFIs at a ‘tipping point.’”

The Compartamos and SKS episodes force us to rethink about permitting firms providing microfinance to be modeled on Anglo-Saxon shareholder wealth maximization models. All the more so, for on the one hand while the directors and the major shareholders could write for themselves many benefits and perks, the burden of the same has to be borne by the higher interest rate which the borrowers from the concerned firm have to pay up. Like in the typical listed firms, the managers also would have incentive in getting perks for themselves as well as generating profits, as against the declared purpose of improving financial accessibility and increasing outreach. The asymmetry between the owners of the firms and the managers vis-à-vis the customers of the firms, and the conflict engendered by the same is so explicit that the organizational structure of such a nature and its utility in the social sphere needs to be seriously given a rethought.

The IPO issued by Compartamos was celebrated in financial circles as the microfinance sector coming of age, different financial newspapers encouraged investors and private-equity funds to look forward to microfinance as an important avenue of investment, not in terms of the ethical issues which were supposed to be addressed by the sector, but on the basis of the high returns which were generated by the sector. With this the borderline between business and social investment is turning out to be further thin. Investment in the MFIs
worldwide through the microfinance investment vehicles, sovereign wealth funds and private equity funds received a momentum with the listing of a few MFIs, the securitization products and CDOs which were launched by different companies in the sector towards financing their credit needs.

A study by Littlefield (2007) remarks that there are at least eighty investment funds that specialize in microfinance, thirty of which were established in the last three years. These funds are still small and highly concentrated in the leading institutions in Latin America and Eastern Europe, but their pool of capital available is growing fast. Transnational banks are in this game in a big way: Citigroup, Deutsche Bank TIAA-CREF, Morgan Stanley, ABN AMRO and Société Generale are deploying their structuring and fund-management skills to offer investment products that appeal to a broad range of investor-risk profiles and social motivations.

7.0 Concluding Observations

It is indeed amazing that at the same time while microfinance banking institutions and development financial institutions in the developing world has been able to tap finance from the global capital market, the developing country governments bogged by growing external debt, deterioration in the terms of trade and rising deficits have not been able to access international capital markets. Insofar as the provision of public goods to the people at large is the responsibility of the states in these countries, this mismatch would show up at a later period. It has already been shown in various studies that the operating costs in the private microfinance institutions have been on the increase as against the ones in the governmental sector. Accessing capital from the international capital market is also prone to the risks and volatility of the same. In other words, there would be large fluctuations in the extent of capital mobilized in the markets from time to time. Not to speak of the huge costs involved in sterilization in the case of less developed financial markets, which would lose out on the competitiveness of the exports, in case such steps are not resorted to (Roderick, 2006).

Worst of all, is the situation when an agent in the developing world in the private sector fails on its commitment to make the payments, due to a number of exogenous reason; like deterioration in the terms of trade, loss of crops due to
unfavourable weather and/or natural catastrophe, this would worsen the case of the private sector in this case having access to funds. In such a situation, the concerned state would be starved of development funds. Permitting firms engaged in interest income maximization to list in the exchanges indeed to tap capital would also not be in the fitness of things. Due regulation of the development finance sector, particularly so, the microfinance sector, would be highly appreciated in the context of sub-prime sort of crisis occurring in even countries which are reasonably regulated.

In the contemporary global economy, when government to government transactions on the development assistance plane is on the decline, private to private transactions are on the increase. This would further result in the shrinking of limited policy space which the states have in the developing world, further reducing access to public goods in less developed countries. All this makes a forceful case for ODA commitments, on an increased pace, to be routed through the governmental channels of intermediation.

The dirigiste state in India in the course of the early years of planning has made concerted efforts towards tackling the issue of poverty alleviation as well as redlining in the credit markets. While it undertook redistributive land reform to a limited extent, it also initiated priority sector lending to disadvantaged sections as well as communities, in the course of the nationalization of banks in the course of the seventies. Provision of credit through nationalized banks in India did not produce the desired impact. Evidence from other economies such as Japan, South Korea and Taiwan demonstrates that government-directed and preferential credit schemes to support officially sanctioned industrial investments have substantially contributed to successful industrialization and economic growth. Governments in these countries have had a similar system of tight interest ceilings, direct control over a number of large commercial banks and credit rationing.

In fact, the entry of government in the sphere of economic activity is not without problems. But to abandon the government in the name of government failure would be inappropriate. Decentralizing decisions to lower levels of governance, it has been shown, can play pivotal role in reducing the problem of lack of information confronted by the government (Bardhan, 1996). In the Indian case, experiments at the grassroots level have been very encouraging. Moreover, it is also representative in the sense that, it assures participation of different
deprived communities in the process of decision making, both through election as well as selection of beneficiaries. In fact, once experimented with, this will prove out to be a far superior and a cost-effective alternative towards delivery of social goods at the village level. It should also be noted that very few of the agencies in the private sector has a representative nature like in the Panchayati Raj\(^\text{11}\). On the global level, therefore, there is a case for up scaling ODA and routing the same through governmental intermediation, and at the local level, there is a strong case for greater transparency of government at the various levels, particularly at the grassroots where the social goods are delivered.

**References**


\(^{11}\) The 73rd and 74th amendments to the Constitution of India provided for representation up to 22.5% for the historically disadvantaged sections and 30% for the women.


World Bank (2007), Global Development Finance. Volumes I and II.