

Economics and Sociology
Occasional Paper No. 2518

**MICROFINANCE:
BROADER ACHIEVEMENTS AND NEW CHALLENGES**

by

Claudio Gonzalez-Vega

October 1998

Rural Finance Program
Department of Agricultural, Environmental, and Development Economics
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099
rurfin@postbox.acs.ohio-state.edu

Abstract

This is the author's opening statement at the Second Annual Seminar on New Development Finance. It contains three parts. The first part assesses dimensions of recent achievements in microfinance. It defines achievements in terms of six dimensions of outreach (quality, cost, depth, breadth, length, and variety) and of its relationships with sustainability. A rigorous definition of expansion of the frontier is also provided. The second part discusses the reasons for gaps among current achievements, potential supply, legitimate demand, and political expectations. A distinction is made between gains in technical efficiency and innovation, and the determinants of each type of improvement are examined. Threats from unwarranted political expectations are also identified. The third part discusses recent changes in the microfinance field due to systemic risk, increasing competition, improper regulation, and attempts of return by the state to development finance. This section evaluates threats emerging from these changes.

Microfinance: Broader Achievements and New Challenges¹

Claudio Gonzalez-Vega²

In *A Tale of Two Cities*, Charles Dickens described the epoch as: "It was the best of times, it was the worst of times." The two cities in the Dickens story were not, of course, Frankfurt, Germany and Columbus, Ohio, but the sentiment related by Dickens may be appropriate to describe the current state of microfinance.

I

Dimensions of Achievement

This is the best of times for microfinance.

In several countries, results in terms of microfinance outreach can be identified that represent achievements that are far beyond any ambitious outreach outcome that could have been imagined only fifteen years ago, and fifteen years is a very short span of time. Moreover, a few microfinance programs have made significant progress, not only in terms of outreach, but also in terms of sustainability (Yaron, 1994; Christen *et al.*, 1995). Furthermore, the programs with the best outreach outcomes tend to be also the programs with the best sustainability achievements (Gonzalez-Vega *et al.*, 1997).

¹ Opening statement at the Second Annual Seminar on New Development Finance, held at the Goethe University of Frankfurt on September 21-26, 1998. The style of the oral presentation is preserved.

² The author is Professor of Agricultural, Environmental, and Development Economics and Director of the Rural Finance Program at The Ohio State University. He would like to acknowledge support from the USAID *Microenterprise Best Practices* Project, Internationale Projekt Consult, and the Department of Agricultural, Environmental, and Development Economics at The Ohio State University for recent research in this field. Special thanks go to Prof. Harry Schmidt at the University of Frankfurt, co-organizer of the Seminar, for fruitful joint efforts and for his hospitality, and to participants in the Seminar for their comments and enthusiasm. All views are the author's and not necessarily those of the sponsoring organizations.

A good microfinance program actually exhibits an attractive combination of:

- (a) quality of outreach,
- (b) cost of outreach,
- (c) depth of outreach,
- (d) breadth of outreach,
- (e) length of outreach, and
- (f) variety of outreach

Quality of outreach refers to worth, to how valuable microfinance products are for particular clients (Navajas *et al.*, 1998). *Cost* of outreach indicates how expensive these products are for the clients, once both interest and transaction costs are considered. Indeed, success results from the ability to supply microfinance products that meet actual demands (highly-valued products) at reasonable costs. At this Seminar, Harry Schmidt will discuss circumstances when high costs are simply too high. No supply at all, however, is the same as infinite cost.

Depth of outreach tells us how valuable it is to extend the supply of microfinance products to a particular target group, not from the point of view of a given client, but from the point of view of society. The political consensus is that it is socially more valuable to expand the frontier of finance for the poor than it is to further expand the frontier of finance for the rich (Morduch, 1997; Gulli, 1998). The poorer the client, therefore, the greater the depth of outreach. Experience tells us, in turn, that it is also more difficult to expand the frontier of finance for the poor. As a result, difficulty and depth of outreach go hand in hand.

Breadth of outreach counts the numbers of clients of a given depth who are supplied with a microfinance product of a given quality (worth) and a given cost. Because only a small proportion of the target group have access to formal and semi-formal financial services, the more numerous the clients reached, the better. Due to economies of scale, over an important range breadth of outreach and sustainability go hand in hand.

Length of outreach tells us for how long: will the target clients be reached with only one loan and nothing else or will they be reached on a permanent basis? The poor value permanency and reliability, and they are willing to pay for these attributes of financial contracts. Length matters a lot to them. Except under very exceptional circumstances, moreover, length of outreach requires *sustainability*. One reason is that donors are unreliable suitors; they do not pursue a given assistance fad for too long. Today, microfinance is the darling of donors; it may not be (it will not be) tomorrow. Another reason is that without the desire for sustainability, clients, staff, and managers of *microfinance organizations* (MFOs) will not have sufficient incentives to make the right decisions (Gonzalez-Vega, 1994).

Variety of outreach matters because credit is not the only microfinance product demanded by the target clientele (Adams, 1983; Seibel, 1985; Robinson, 1995). The biased focus on loans of the donors does not match the central role that savings and deposit facilities play in consumption

smoothing and in the risk-coping strategies of the poor and, thereby, on objectives such as food security and other survival mechanisms (Dunn, 1997; Zeller *et al.*, 1997; Sharma, 1998). The biased focus on loans of the donors does not match the role that payments services (funds transfer) play in enhancing productivity and in allowing the poor to take advantage of productive opportunities (Gonzalez-Vega, 1998a). The poorer, the more far away, the more rural the target group, the more does greater access to full financial intermediation (both loans and deposits) matter. The poorer, the more far away, the more rural the target group, the less are the opportunities offered by access to financial intermediation available.

Because all aspects of outreach matter: quality, variety, cost, depth, breadth, and length, debates that separate outreach from sustainability are wrong (misplaced). Because all aspects of outreach are tightly linked, a biased focus that promotes only one aspect of outreach will typically ignore potentially counterproductive effects on other dimensions of outreach. A comprehensive perspective would shed more light on trade-offs and complementarities among these dimensions of outreach than the current debate does (Rhyne, 1998).

Progress in microfinance does allow improvements in one dimension of outreach without deterioration of another dimension. Thus, a trade-off of one dimension of outreach for another one may only reveal one's preferences. For example, reaching one person in the first decile may be more valuable to me than reaching two persons in the second decile of the income distribution. A trade-off of one dimension of outreach for another one is not, however, progress. Progress requires improvement at no extra cost. Progress would be, for example, being able to reach two poor households at the same cost needed to reach only one before.

This is the best of times for microfinance.

Several MFOs have made significant progress in various dimensions of outreach without having to sacrifice other dimensions of outreach. This is the true meaning of an expansion of the frontier (Von Pischke, 1991). Progress is not about trading-off one attribute of outreach for another one along a given, stagnant frontier; progress is about pushing the frontier outwards. Progress would be, for example, more breadth for the same depth of outreach, more length for the same breadth of outreach, and so on. Most of the time, as I suggested last year at the First Seminar, the movement outwards is not uniform, it is not homothetic (Gonzalez-Vega, 1997a). Indeed, policies and incentives for innovation influence the speed of expansion along different margins of the frontier. In this sense, policy and program choices matter.

This is the best of times for microfinance because several MFOs are pushing the frontier outwards. The success stories of these MFOs are being broadcast widely: from La Paz to Jakarta, from San Salvador to Kampala, from Sarajevo to Dacca. They are still only a few, but their achievements are important, are getting broader, and are a source of hope.

II

Gaps and Dangers

This is the worst of times for microfinance.

Worldwide, the distance between achievements and observed demand is long. Demand, however, should not be measured by counting the numbers of the poor. Contrary to some expectations, many poor household-firms do not demand loans. Frequently, they do not demand loans because they lack sufficiently profitable productive opportunities to generate *repayment capacity*. In these cases, they usually do not want to borrow, and they should not be burdened with debt they cannot repay. In these cases, lack of loans is not the binding constraint that limits the expansion of household income. Schools, clinics, roads, markets, and institutions would typically be more important than loans in contributing to their income and welfare. Attempts to expand credit supplies should not distract us from these essential tasks of development.

Around the world, however, there are also many poor household-firms who have a *legitimate* demand for credit that is unsatisfied. In these cases, the mismatch comes, not from lack of demand, but from an utterly insufficient supply. For this reason, the slow growth of credit supply is a matter of public concern. Moreover, the demand for other financial services that do not need demonstration of creditworthiness, in particular deposit facilities and payments services, is not being met by supply either, especially in the rural areas of developing countries.

This is the worst of times for microfinance.

While a few leading MFOs have shown that expansion of the frontier of finance is possible, in general supply has been slow, and it may be inevitably slow in catching up with legitimate demands for financial services by marginal clienteles. As a result, substantial *excess demands* for financial services remain unsatisfied, even at very high costs of the funds. Politically, this gap was easier to accept when there were no examples of success; today, a new hope widens the gap between reality and expectations.

This is the worst of times for microfinance because the distance between achievements and expectations is becoming abysmally long. Indeed, there are serious gaps between:

- (a) current achievements and potential supply,
- (b) potential supply and legitimate demand, and
- (c) legitimate demand and politically-correct expectations.

First, there is a long distance between present achievements and *potential supply*: the microfinance industry is not offering all the services that it could given present technologies and available resources. This is a consequence of *technical inefficiency*: input/output ratios are not favorable, given what we already know about best practices in microfinance. Too little output per unit of input reduces the actual supply of microfinance below potential supply. If too much input is required per unit of output, inefficiency keeps the supply of microfinance low.

Reducing the gap between current achievements and potential supply is the most immediate challenge for microfinance. It is not an easy challenge to meet where regulatory frameworks constrain the degrees of freedom of MFOs that want to eliminate the gap. This is why the microfinance revolution did not happen before. For a long time, *repressive* regulation stunted innovation in microfinance.

This is not an easy challenge to meet, either, if indiscriminate assistance from government and donors reduces the incentives of MFO managers to fight inefficiency. Moreover, this is not an easy challenge to meet if ownership and governance structures do not create incentives to even try. Many MFOs lack sufficient incentives to pursue efficiency.

Many MFOs are inefficient because they do not face (or do not expect to face) a *hard budget constraint*. Moreover, even when an explicit budget rule exists, many MFOs are still inefficient. They are inefficient because:

- (a) they think in terms of target beneficiaries, not in terms of clients in competitive market niches;
- (b) they think in terms of levels of subsidy (*i.e.*, grant transfers), not in terms of the quality and cost to the clients of their products;
- (c) they think in terms of the speed of disbursement, not in terms of levels of operational costs;
- (d) they think only in terms of outreach, not in terms of both outreach and sustainability; and
- (e) they think in terms of some, not all of the dimensions of outreach.

They think in this way because their goals are narrow, their aspirations are truncated, and their horizons are short. They can afford to think in this way because they are not using their own money. They think in this way because their own objectives matter more in the short term, but the interests of society should matter mostly in the long term (Adams, 1998; Von Pischke, 1998). In general, they are not concerned with efficiency because they lack the desire for permanency. The desire for sustainability matters much as a locus of incentives for efficiency.

Reducing inefficiency is the most immediate challenge for microfinance. Everything else equal, more efficiency will shorten the distance between *actual* practice and *best* practice; it will shorten the distance between a complacent *statu quo* and the frontier, but it will not expand the frontier. Expanding the frontier requires more than greater technical efficiency; it requires innovation.

Second, there is a wide gap between potential supply and *legitimate demand*.³ This gap reflects the formidable obstacles that must be overcome for a microfinance market to emerge and to expand. These obstacles are real, not imagined. They result from the intertemporal nature of financial contracts and from the accompanying uncertainty about the willingness and the ability of borrowers to repay loans. They also result from imperfections of the information available to evaluate probabilities of repayment and from the opportunistic behavior of borrowers (*moral hazard*), which changes the probability of repayment after the loans have been disbursed. Moreover they result from nonexistent or inadequate mechanisms for contract enforcement.

Typically, the greater the depth of outreach, the more formidable these obstacles and the more difficult it is for the frontier to expand (Conning, 1998). The more-acute-than-usual obstacles faced in microfinance reflect *information* problems that emerge from:

- (a) heterogeneity about the idiosyncratic features of firm-households that matter more in microfinance than in corporate lending;
- (b) the absence of documented credit histories and of credit-rating mechanisms;
- (c) the absence of standardized information that could be interpreted at low costs: there are no audited financial statements and no project feasibility studies; and
- (d) the lack of separation of the firm and the household, combined with the fungibility of funds.

Moreover, formidable *contract enforcement* problems emerge from:

- (a) lack of assets that would pass smoothly to the lender to pay off the loan in case default and, particularly, lack of *liquid* assets about which there is less asymmetric information; and
- (b) because even when these assets are available, the resolution of contracts takes time and effort, given the absence of an adequate institutional infrastructure, and it may become prohibitively expensive.

To further close the gap between potential supply and legitimate demand, *i.e.*, to expand the frontier by shifting potential supply outwards, will require:

³ This gap reflects two sets of circumstances. First, because of *market failure*, due to adverse selection and moral hazard, even if in equilibrium, financial markets may not clear. That is, any resulting degree of *credit rationing* implies that demand exceeds supply even at equilibrium interest rates (Stiglitz and Weiss, 1981). Second, even if the market cleared, given the obstacles discussed here it might clear at very high interest rates, which would leave many attractive opportunities unexploited. In particular, some unexploited opportunities may have marginal rates of return higher than those of actual projects financed elsewhere in the economy. This *credit constraints* would prevent the exploitation of socially-valuable opportunities for income expansion which, thereby, generate unsatisfied legitimate demands for loans.

- (a) additional *innovation* in lending and deposit-taking technologies;
- (b) additional formation of *human capital* for microfinance;
- (c) additional development of new *organizational designs* (new types of owners, new roles for donors, new ways of raising funds, new regulatory frameworks, new governance structures); and
- (d) additional public investment in the physical and institutional *infrastructure* required for the smooth, *i.e.*, efficient and stable, performance of financial markets.

Greater efficiency will not be enough to expand all dimensions of outreach; several of the forms of investment listed above will also be required to expand the frontier of microfinance. In all these cases, resources must be invested, and collecting the fruits of these investments will take time. Experimentation and learning take resources and time; the public goods needed to expand the frontier of microfinance will not be available overnight; investments in microfinance require long gestation periods before they bear their fruits. Thus, reality and the expectation of immediate results will inevitably clash.

In sum, the first challenge of microfinance is to reduce inefficiency, to get actual practice closer to the best-practice frontier. The second challenge is to invest efficiently in pushing the frontier outwards. Even under the best of foreseeable circumstances, however, there will still be an excess of demand over supply at reasonable costs of borrowed funds and, as a result, socially-valuable (productive) efforts will not be undertaken because of credit constraints. Unfortunately, however, the frontier of microfinance cannot be expanded by decree, and subsidies cannot fill the gap (Gonzalez-Vega, 1993). Only the search for actual reductions in resource costs, which are passed on to the clients, can accomplish this.

Third, there may even be a gap between legitimate demand and political expectations about microfinance. A clear example of this gap are the goals of the Microcredit Summit (RESULTS, 1996). These expectations are based on wrong assumptions about the role of finance and on a disregard of the difficulties of expanding the frontier. Thus, usually:

- (a) no serious identification of demand has preceded the numbers of expected beneficiaries;
- (b) no serious acknowledgment of the obstacles faced and of the feasibility of permanently increasing supply have preceded the promises; and,
- (c) as in the old days, the assumption has been that all that is needed is the will and the funds to do it, ignoring that the special credit programs of the past failed precisely because they attempted to provide a *political* solution to what in essence is a *technical* problem.
- (d) The challenge is not to find a willing lender and endow it with sufficient loanable funds but, rather, to find a *production function* (a technology) that makes it possible to produce quality financial services at reasonable costs for the micro-client and in a profitable manner for the MFO (Gonzalez-Vega, 1997b). Successful implementation of the new technologies will only occur, in turn, if the structure of organizational incentives promotes sustainability.

This is the worst of times for microfinance because this gap between expectations and reality is a source, not just of hope, but of also impatience; and impatience leads to poor advice, poor advice leads to disbursement pressures, and disbursement pressures lead to too rapid portfolio growth, to lower standards of creditworthiness, to screening mistakes, to shallow monitoring, and to higher arrears. Unchecked arrears destroy the culture of repayment for all MFOs in the market. Rapid growth, superficial loan evaluations, and unresolved arrears do not lead to success; they lead to failure (Gonzalez-Vega, 1998b).

In *A Tale of Two Cities*, Dickens described the epoch as: "It was the age of wisdom, it was the age of foolishness." Hopefully, promoters of microfinance will have the wisdom to learn the lessons from the experiences of development finance, and they will avoid the pitfalls of foolishly attempting to use finance as a panacea (Adams and Von Pischke, 1994).

III

New Challenges

Much has changed in the past fifteen years. Some of these changes represent new challenges for MFOs. In my view, at least four of these changes pose considerable threats to microfinance as it has developed:

- (a) systemic risks,
- (b) increasing competition,
- (c) improper regulation, and
- (d) the return of the state (inappropriate government intervention).

Fifteen years ago, microfinance programs were isolated experiments, struggling to learn how to minimize some *idiosyncratic* risks of lending: attempting to understand the ability and to shape the willingness of individual borrowers to repay loans not guaranteed by fixed assets as collateral. Today, microfinance programs struggle to become significant components of formal financial systems and, with these systems, MFOs are more vulnerable to *systemic* risk.

New challenges for microfinance may thus emerge from the increased worldwide volatility of financial systems (Perry and Lederman, 1998). Many MFOs may not be prepared to deal with this new source of risk (Holtmann, 1998; McGuire and Conroy, 1998). Some of the successful MFOs have shown, however, flexibility and resilience during the recent Asian crises (Ito, 1998; Patten, 1998; Reille and Gallmann, 1998; Yaron, 1998). For too long, nevertheless, microfinance has ignored the threats of systemic risk.

Fifteen years ago, leading microfinance programs were virtual monopolies. Today, the more threatening competition to existing MFOs is not coming from informal moneylenders as in the past; it is coming from private commercial banks and other regulated financial intermediaries, *i.e.*, from those commercial banks that had shown no interest whatsoever in lending to the target clientele (Marulanda, 1998).

New challenges for microfinance may thus emerge from increasing competition and client demands resulting from:

- (a) the arrival of new actors, some of them operating on market terms, some of them not;
- (b) the saturation of the original (probably easier) market locations; and
- (c) challenges from the aging of portfolios and the maturing of client relationships, where established clients have begun to demand additional services, more difficult to supply.

Fifteen years ago, microfinance was not regulated. Today, almost everybody has a regulatory itch, but not every regulation is appropriate. Repressive and inappropriate regulation may be worse than no regulation at all.

New challenges for microfinance thus emerge from inappropriate regulation due to:

- (a) regulatory technologies that are not a good match for the new lending technologies; and
- (b) attempts to use the regulatory framework to pursue objectives other than the avoidance of excessive risk (Chaves and Gonzalez-Vega, 1994).

Fifteen years ago, governments had abandoned, in failure and in shame, the field of development finance. Today, governments are too eager to return to development finance by boarding the train of microfinance.

New challenges for microfinance may thus emerge from a return of the state based on the wrong assumptions that:

- (a) the frontier of microfinance can be expanded by decree (*i.e.*, by government will);
- (b) lack of funds is the binding constraint to an expansion of sustainable microfinance; and
- (c) a system composed of many MFOs, most of which would probably be weak, is more politically correct than a system composed of a few, strong and sustainable, MFOs.

This is the best of times for microfinance. Although they are only a few, several MFOs have shown that it is possible to offer services in a sustainable manner, even at a profit. This is the worst of times for microfinance. Formidable new challenges are threatening this recently acquired sustainability. These new challenges are, in part, the consequence of success.

First, success, and particularly profits, attract *entry* into a particular market niche, and entry increases competition. Increased competition is always welcome, because competition spurs technical efficiency, competition spurs improvements in the quality of outreach and in the variety of services offered, competition spurs actions to reduce costs that, in turn, allow lower interest rates. This has clearly happened in Bolivia (Dorado, 1998).

Increased competition encourages efficiency but it also increases risk, however, and it may force some MFOs out of the market. When *exit* is due to entry of better actors in the market, it is a healthy outcome. When exit is due to negative *externalities* generated by market actors willing to behave opportunistically, which increases systemic risk, there is a social loss (Chaves and Gonzalez-Vega, 1996). Moreover, even when it is healthy, increased competition makes the already difficult tasks of MFOs even harder. When the client has too many options, it is more difficult to create a structure of incentives for repayment of loans without collateral. When the client has too many options, the monitoring of borrowers by overseeing the repayment record of the client becomes less reliable, because the client may use a loan from another lender to repay the loan from the MFO. To address the risks, MFOs may be forced to revise their policies about products offered and about market niches attacked.

Second, success also attracts new sponsors. The most important, but also the most dangerous of the new sponsors is the state itself. When politicians want to become the *godfathers* of any MFO that is already successful, the MFO is in grave danger. Most likely sustainability is not among the objectives of these latecomers, who are trying to board the train of microfinance when it is already speeding.

Moreover, politicians tend to promote MFOs that do not operate on market terms. This behavior generates another negative externality, as MFOs seeking sustainability find it hard to compete with subsidized and subsidizing MFOs.

The new challenges are in part a consequence of changes in the environment. One of these changes is increased systemic risk. Systemic risk results from events that simultaneously hurt most of the clients of one intermediary or most of the financial intermediaries in a given sector. Examples of systemic risk are macroeconomic disequilibria, political instability, natural phenomena such as *La Niña*, or the deterioration of a country's terms of trade (Gavin and Hausmann, 1996). These events have a national impact; similar events may have regional or sectorial impacts (*e.g.*, a flood, commercial reform, municipal regulation.) Stronger MFOs, with well-established financial links to pre-arranged lines of credit for liquidity emergencies and with a national outreach and broad sectorial scope for portfolio diversification, stand a better chance of surviving these systemic shocks (Gonzalez-Vega, 1997c).

Particularly risky is a rapid expansion of the availability of loanable funds throughout the system: such a flood of funds may result from the excessive enthusiasm of government and donors. Access to credit that is too easy devalues the client *relationships* that are at the core of the incentives to repay of existing MFOs (Conning *et al.*, 1998; Lavie, 1998).

Similar damage to the *culture of repayment* needed for the successful operation of microfinance may result from the emergence, in the same market niche, of new lending technologies that have ample tolerance for arrears/default. Microfinance as it has developed requires a *zero tolerance* of default (Christen, 1998). In countries with mature financial systems, however, commercial banks and consumer *financieras* with a large tolerance for arrears may enter this market niche, and only highly competitive (best practice/best service) MFOs will survive. Earlier, I favored many experiments that would search for innovations in microfinance. Today, my recommendation is to tilt the balance of government and donor support in favor of the quality, not the number of organizations (Gonzalez-Vega, 1998b).

Another change in the environment is the *prudential* regulation and supervision of MFOs (Trigo, 1998). This is an important innovation, which adds to the institutional infrastructure needed to develop the microfinance market, but it is also a potential threat. As with competition, prudential regulation is generally a desirable feature of financial markets. If, however, the institutional framework is incomplete, competition and regulation pose new challenges that must be addressed.

Everybody wants to regulate MFOs, most of the time for the wrong reasons. Some regulatory frameworks want to force MFOs to work against the market, not with the market. Some MFOs may seek regulation only because it provides access to subsidized funds from a government apex organization (Navajas and Schriener, 1997). These are not good reasons to regulate. In general, government regulation is justified only for deposit-taking institutions and for very specific reasons that justify a departure from market regulation (Chaves and Gonzalez-Vega, 1996).

If large numbers of not-deposit-taking MFOs are actually regulated, at worst, repressive regulation may slowly creep back into the industry; at best, costly, wasteful activities will be needed to regulate a multitude of small MFOs that do not mobilize deposits (Llanto, 1998). Even worse, regulation that is not enforceable or that is not enforced is always harmful, but most regulatory authorities do not have the resources and the skills needed to undertake this task effectively. Thus, prudential regulation and supervision are useful mostly for those strong deposit-taking MFOs that have become full financial intermediaries. Different forms of oversight, if any, may be desirable in all other cases to monitor the use of public funds, but this should not be confused with prudential regulation.

The greatest recent threat to microfinance is the return of the state. Governments had left development finance when fiscal crises had made it impossible to continue funding the losses of special credit programs. Governments had left development finance when unhappy donors had refused to recapitalize and bail out bankrupt development banks. The failure of those interventions can be traced to a wrong choice of tools: credit is not a panacea, and cheap credit is the wrong tool to pursue most of the goals of the old programs (Gonzalez-Vega, 1994). In this sense, the train of the old development finance had square wheels: it could not go easily where government and donors wanted to take it. Government and donors, however, kept pushing this train with fiscal transfers and donor programs. The more they pushed, the quicker the wheels (being square and not round) broke.

Eventually, too much pushing derailed the train. When this happened, a vacuum was created, and the children of regulatory avoidance, the NGOs that would become MFOs, began to build a new train. Because they were not regulated, the new MFOs could experiment a lot: there were no restrictions on what types of activities they could undertake. Because they were not regulated, the new MFOs were able to charge sufficiently high interest rates to begin to cover their costs. Because they were not regulated, the new MFOs could attempt to respond to client demand rather than to the planning priorities of governments. The microfinance revolution had erupted.

Soon, the new train of microfinance began to take speed. Today, in several countries, it runs smoothly and briskly, conquering new territory and expanding frontiers. Because there are many and powerful new train operators, passenger safety may indeed require some prudential regulation. Governments, however, watch with envy the rapidly passing train: they want to board it, they want to add their name to it, they want to control it and to take it where it would serve their purposes. But government is a heavy passenger; uphill, it may slow down progress; downhill, it may accelerate derailment.

This is the most dangerous time for microfinance. The best MFOs may be able to survive systemic shocks, intense competition, and constraining prudential regulation and supervision, but the microfinance industry will not be able to survive the excessive enthusiasm and impatience of government and donors.

References

- Adams, Dale W (1983), "Mobilizing Household Savings through Rural Financial Markets," in J.D. Von Pischke, Dale W Adams, and Gordon Donald (eds.), *Rural Financial Markets in Developing Countries .Their Use and Abuse*, Baltimore: The Johns Hopkins University Press.
- Adams, Dale W (1998), "The Decline of Debt Directing: An Unfinished Agenda," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Adams, Dale W and J.D. Von Pischke (1994), "Microenterprise Credit Programs: Deja Vu," in Fritz J.A. Bouman and Otto Hospes (eds.), *Financial Landscapes Reconstructed: The Fine Art of Mapping Development*, Boulder, CO: Westview Press.
- Chaves, Rodrigo A. and Claudio Gonzalez-Vega (1996), "Principles of Regulation and Prudential Supervision and their Relevance for Microenterprise Finance Organizations," in María Otero and Elisabeth Rhyne (eds.), *The New World of Microenterprise Finance. Building Healthy Financial Institutions for the Poor*, West Hartford, CN: Kumarian Press.
- Christen, Robert P. (1998), "Keys to Financial Sustainability," in Mwangi S. Kimenyi, Robert C. Wieland, and J.D. Von Pischke (eds.), *Strategic Issues in Microfinance*, Aldershot, England: Ashgate Publishing.
- Christen, Robert P., Elisabeth Rhyne, Robert C. Vogel, and Cressida McKean (1995), "Maximizing the Outreach of Microenterprise Finance: The Emerging Lessons of Successful Programs," USAID Program and Operations Assessment Report No. 10, Washington, D.C.: AID Center for Development Information and Evaluation..
- Conning, Jonathan (1998), "Contract Design and Incentives in Microfinance Lending: A Framework for Analysis," unpublished paper, Williamstown, MA: Williams College, Department of Economics.
- Conning, Jonathan, Sergio Navajas, and Claudio Gonzalez-Vega (1998), "Adverse Selection, Lending Modality, and Competition in the Market in Microfinance in Bolivia," forthcoming paper, Columbus, Ohio: The Ohio State University.
- Dickens, Charles (1859, 1985), *A Tale of Two Cities*, London: Penguin Books.
- Dorado-Banacloche, Silvia (1998), "Financial Services for Micro-entrepreneurs after Microfinance: The Relevance of Learning from the Bolivian Experience," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.

- Dunn, Elizabeth (1997), "Diversification in the Household Economic Portfolio," AIMS paper, Washington, D.C.: Agency for International Development.
- Gavin, Michael and Ricardo Hausmann (1996), "The Roots of Banking Crises: The Macroeconomic Context," in Ricardo Hausmann and Liliana Rojas-Suarez (eds.) *Banking Crises in Latin America*, Washington, D.C.: Inter-American Development Bank.
- Gonzalez-Vega, Claudio (1993), "From Policies, to Technologies, to Organizations: The Evolution of the Ohio State University Vision on Rural Financial Markets," Economics and Sociology Occasional Paper No. 2062, Columbus, Ohio: The Ohio State University.
- Gonzalez-Vega, Claudio (1994), "Stages in the Evolution of Thought on Rural Finance. A Vision from The Ohio State University," Economics and Sociology Occasional Paper No. 2134, Columbus, Ohio: The Ohio State University.
- Gonzalez-Vega, Claudio (1997a), "The New Development Finance," Economics and Sociology Occasional Paper No. 2398, Columbus, Ohio: The Ohio State University.
- Gonzalez-Vega, Claudio (1997b), "The Challenges of Transferring the New Lending Technologies to Reach the Poor from the Urban to the Rural Areas: Questions from Theory, Lessons from Microfinance Best Practice," paper presented at the XXIII International Conference of Agricultural Economists, Sacramento, CA, August.
- Gonzalez-Vega, Claudio (1997c), "Pobreza y Microfinanzas: Lecciones y Perspectivas," Economics and Sociology Occasional Paper No. 2392, Columbus, Ohio: The Ohio State University.
- Gonzalez-Vega, Claudio (1998a), "Do Financial Institutions Have a Role in Assisting the Poor," in Mwangi S. Kimenyi, Robert C. Wieland, and J.D. Von Pischke (eds.), *Strategic Issues in Microfinance*, Aldershot, England: Ashgate Publishing.
- Gonzalez-Vega, Claudio (1998b), "Microfinance Apex Mechanisms: Review of the Evidence and Policy Recommendations," CGAP Occasional Paper, forthcoming.
- Gonzalez-Vega, Claudio, Mark Schreiner, Richard L. Meyer, Sergio Navajas, and Jorge Rodríguez (1997), "A Primer on Bolivian Experiences in Microfinance: An Ohio State Perspective," unpublished manuscript, Columbus, Ohio: The Ohio State University.
- Gulli, Hege (1998), "Microfinance and Poverty. Questioning Common Beliefs," Washington, D.C.: Inter-American Development Bank.
- Holtmann, Martin (1998), "Microfinance in Russia," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.

- Ito, Lucy (1998), "Restructuring the Credit Union System of Korea: Effects of the East Asian Crisis," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Labie, Marc (1998), "Assessment of Microfinance Institutions Sustainability: What Have We Learned from the Corposol-Finansol Case," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Llanto, Gilberto (1998), "Risk-Based Management and Supervision: Comments from the Philippine Experience," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Marulanda, Beatriz (1998), "Consumer Lending in Latin America. Competition Coming from Foreign Investors," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- McGuire, Paul B. and John D. Conroy (1998), "Effects on Microfinance of the 1997-1998 Asian Financial Crisis," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Morduch, Jonathan (1998), "The Microfinance Schism," unpublished paper, Cambridge, MA: Harvard University, Department of Economics.
- Navajas, Sergio and Mark Schriener (1997), "Apex Organizations and the Growth of Microfinance in Bolivia," Economics and Sociology Occasional Paper No. 2500, Columbus, Ohio: The Ohio State University.
- Navajas Sergio, Mark Schreiner, Richard L. Meyer, Claudio Gonzalez-Vega, and Jorge Rodríguez-Meza (1998), "Microcredit and the Poorest of the Poor: Theory and Evidence from Bolivia," Columbus, Ohio: The Ohio State University.
- Patten, Richard H. (1998), "The East Asian Crises and Retail Finance," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Perry, Guillermo and Daniel Lederman (1998), "Financial Vulnerability, Spillover Effects, and Contagion: Lessons from the Asian Crises for Latin America," unpublished paper, Washington, D.C.: The World Bank.
- Reille, Xavier, and Dominique Gallmann (1998), "The Indonesian People's Credit Banks (BPRs) and the Financial Crisis," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.

- RESULTS International (1996), "The Microcredit Summit Declaration and Plan of Action," *Journal of Development Entrepreneurship*, Vol. I, No. 2, pp. 131-176.
- Rhyne, Elisabeth (1998), "The Yin and Yang of Microfinance: Reaching the Poor and Sustainability," *The Microbanking Bulletin*, No. 2, July.
- Robinson, Marguerite (1995), "Indonesia: The Role of Savings in Developing Sustainable Commercial Financing of Small and Microenterprises," in Ernst A. Bruggen and Sarath Rajapatirana (eds.), *New Perspectives on Financing Small Businesses in Developing Countries*, San Francisco, CA: International Center for Economic Growth.
- Schmidt, Reinhard and Claus-Peter Zeitinger (1998), "Critical Issues in Microbusiness Finance and the Role of Donors," in Mwangi S. Kimenyi, Robert C. Wieland, and J.D. Von Pischke (eds.), *Strategic Issues in Microfinance*, Aldershot, England: Ashgate Publishing.
- Seibel, Hans D. (1985), "Savings for Development: A Linkage Model for Formal and Informal Financial Markets," *Quarterly Journal of International Agriculture*, Vol. 24, No. 4, pp. 390-398.
- Sharma, Manohar (1998), "Access to Financial Services, Household Food Security, and Risk Management: Some Emerging Evidence," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Stiglitz, Joseph E., and Andrew Weiss (1981), "Credit Rationing in Markets with Imperfect Information," *American Economic Review*, Vol. 71, No. 3, pp. 393-410.
- Trigo Loubiere, Jacques (1998), "Supervision and Regulation of Financial Institutions of Microenterprises: Bolivian Experience," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Von Pischke, J.D. (1991), *Finance at the Frontier. Debt Capacity and the Role of Credit in the Private Economy*, EDI Development Studies, Washington, D.C.: The World Bank.
- Von Pischke, J.D. (1998), "Lessons vs. Lessons Learned: Donors and Credit Projects," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Yaron, Jacob (1998), "Comparison: BAAC Thailand and BRI-UD Indonesia Performance under Crisis," paper presented at the Second Annual Seminar on New Development Finance, Frankfurt, September.
- Zeller, Manfred, Gertrud Schrieder, Joachim von Braun, and Franz Heidhues (1997), *Rural Finance for Food Security for the Poor. Implications for Research and Policy*, Washington, D.C.: International Food Policy Research Institute.