

Pathways Out of Poverty:  
How Microfinance Can Revolutionize U.S. Foreign  
Aid to the Developing World.

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Pathways Out of Poverty:  
How Microfinance Can Revolutionize U.S. Foreign Aid to  
the Developing World.

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# Table of Contents

## Introduction:

Important Acronyms..... 4

## Part 1: Poverty..... 5

1.1 It Cannot Be Ignored..... 6

1.2 Intention..... 8

## Part 2: Development Aid.....16

2.1 History of Development Aid.....17

2.2 Why Give Aid?..... 24

2.3 Key Players and Types of Aid..... 26

## Part 3: Microfinance..... 30

3.1 What Exactly Is Microfinance?..... 31

3.2 The Inner Workings of Microfinance..... 36

3.3 Results..... 42

## Part 4: Problems and Solutions..... 50

4.1 Streamlining Development Aid..... 51

4.2 The Effective MFI..... 57

4.3 Conclusion..... 66

## Appendix..... 68

## References..... 71

# Acronyms

ASA- Association for Social Advancement, Bangladesh

ASCRA- Accumulated Savings and Credit Association

BRAC- Bangladesh Rural Advancement Committee

CARE- Cooperative for Assistance and Relief Everywhere

DC- Developed Country

GB- Grameen Bank

GDP- Gross Domestic Product

HDI- Human Development Index

LDC- Lower developed country (under developed country)

MC- Microcredit

MCF- Microcredit Fund

MDG- Millennium Development Goals

MFI- Microfinance Institution

NGO- Non-governmental Organization

ROSCA- Rotating Savings and Credit Association

OECD- Organization for Economic Co-operation and Development

PCV- Peace Corps Volunteer

UN- United Nations

UNDP- United Nations Development Program

USAID- United States Agency for International Development

WHO- World Health Organization

## Part 1: Poverty\_\_\_\_\_

*"Global poverty is a powder keg that could be ignited by our indifference."*

*- Bill Clinton, 42<sup>nd</sup> U.S. President (1993-2001)*

## 1.1 It Cannot Be Ignored\_\_\_\_\_

As we sit comfortably in our privileged position as members of a developed nation, it can be easy to become consumed in our own problems and limitations to the point of forgetting our minority status in the world. We are part of an elite: a relatively small portion of the world that has access to clean water, food, health care, transportation, education, and contraception; and those are only basics. A quick glance around is enough to see the computers, the air conditioning, the fine leather furniture, and the plethora of consumer goods we are accustomed to. The United States did not become a leading nation by following a formula; rather, our privileged position is the result of centuries of development. It is comprised of a multitude of cultural, historical, political, social, and economic variables that cannot be artificially replicated.

Given this, it is impossible to implement any one solution or "formula" to alleviate poverty in developing nations. As a result, a world of perfect balance, and perfect distribution of resources cannot exist. There is no fault for being born into privilege just as there is no fault for being born into a life of misery and poverty. For that reason, there is nothing inherently wrong with being a "have" so long as one remains conscious of one's position relative to the "have-nots". Being born into privilege carries with it an unspoken burden: the notion that one's position at birth is the result of pure luck. For those lucky enough to be born into a developed

area, it should be their imperative to aid those less fortunate; for after all, *we* could have very well been *them*.

Nevertheless, our everyday distance from conditions in underdeveloped areas makes us susceptible to forgetting that these even exist. Poverty issues have thus become reduced to mere "causes" for us to support and venues for the donations we give as a way to feel satisfied that we have fulfilled our social duty. The grim reality that more than half of all humans must face everyday, the same that makes us in the privileged group uncomfortable, is inescapable and should be a shared burden for all humans.

## 1.2 Intention

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A few moments spent researching poverty yields eye-opening results<sup>1</sup>:

- In 1999, the assets of the world's two hundred richest people were greater than the combined incomes of the lowest 40 percent of the world's peoples.
- The world's rich-poor gap has more than doubled since the 1960s. In 1999, the top 20 percent earned seventy-four times as much as the bottom 20 percent.
- In 1997 there were over 100 million street children in the world's cities.
- In 1997 there were 1.5 billion people without access to medical care.
- In 1999, almost 1 billion people lived in urban slums.
- Roughly three billion people live on less than two dollars per day. <sup>2</sup>

In the more than fifty years of U.S. funded developmental assistance, every conceivable effort has been made to reduce these statistics with little to moderate success. Billions have been spent, yet there is little to show for it other than relative increases in life expectancy and literacy. It is safe to assume that were another governmental program to show such a degree of historical failure relative to dollar amounts spent, it would have been phased out long ago. <sup>3</sup>

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<sup>1</sup>Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003.), 1.

<sup>2</sup> Ibid, 26.

<sup>3</sup> Ibid, 2. (The U.S. has spent over \$1.7 trillion in development aid since the 1960s.)

To be fair, the United States is the largest contributor of developmental aid out of all developed nations.<sup>4</sup> Through American led initiatives the World Health Organization (WHO) succeeded in its decade long quest to effectively wipe out smallpox throughout the world. The 1990s were witness to a decline in the average fertility rates of developing countries and a lowering of infant mortality rates. In addition, more access to primary education has improved basic literacy rates. Perhaps the most significant improvement has been the rise in life expectancy in the developing world. Without a doubt, these are gains for those living in developing countries, yet what remains to be seen are sustained increases in quality of life for the most disadvantaged, and the effective implementation of U.S. foreign aid funds.

The important questions remain to be answered: What new problems are the results of people living longer and more educated lives but with fewer opportunities for advancement? Can the U.S. accomplish its goal of reducing poverty with less money? Why, despite great investments in time and money, is poverty even more widespread than before? Are the causes of poverty being accurately assessed?

My intention is to tackle these questions, and show the limitations of U.S. developmental aid, not in its intentions, but in its implementation.

There are several key changes that would render U.S. development aid

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<sup>4</sup> See appendix for a chart comparing U.S. contributions to that of other developed nations.

more successful. Again, the problems are not the intended goals of development projects, rather, the structure and nature of the U.S. development field.

The development field has for decades preferred replication over innovation. Experimentation is considered a risky investment; a misuse of funds. The success of the Marshall Plan in Europe spawned “clone” projects elsewhere in the world, despite the striking differences between Western Europe and those countries. Though initial mistakes are part of the learning process, the U.S. government has failed to embrace experimentation as a necessary tool to improve the effectiveness of aid. Even today, a development model that was successful in Sri Lanka is all too readily applied to Bolivia.

With sufficient reform, the U.S. development industry can be worth keeping. At present, the industry is much too large to function efficiently, and the varying departments and sectors that compete for development projects work against each other for funding and expend considerable amounts of energy, time, and money in obtaining these lucrative government contracts. Instead of working together to solve problems, organizations work independently of each other, often resulting in the unnecessary replication of work. Thomas Dichter, former director of numerous development programs, including the Peace Corps, illustrates this phenomenon with a poignant example:

“There is usually no sensible sequence in third world rural development, even if there may have been in the history of the ‘first’ world. It is not inconceivable that electricity, paved roads, or even television might arrive before running water.”<sup>5</sup>

In essence, the sheer size of the development industry and the resulting bureaucracy prove cumbersome when attempting to create a coherent model of sustainable development at the local level. It is as though the development industry has forgotten the complexity of the causes of poverty and the fact that money alone is not the solution to it.

Perhaps the biggest criticism of the development industry is that it has evolved into a business. The original goals of poverty reduction have become subordinate to the needs of the development “business” to survive. For any business to survive, there must be a constant flow of customers, and a constant search for new markets. This is a normal approach for any business, but in the development field, the goal should be to eliminate the need for development aid, not to create more markets. According to President Reagan, “poverty is a career for lots of well paid people”.

By dramatically reducing the size of the U.S. Development Industry, money can be saved in terms of operating costs, yield comparatively larger returns, and not encourage a vicious cycle of dependence that

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<sup>5</sup> Ibid, 113.

many underdeveloped nations have vis-à-vis the United States. A World Bank sponsored study showed, for example, that countries which received the most aid performed the least well.<sup>6</sup> It is well documented that external aid can have negative consequences such as reinforcing policies that keep people poor and creating incentives for corruption in the recipient country. By allowing decision makers at the top ranks of government to make investment decisions for the poor in their countries, the United States is allowing for the wide misallocation of aid funds. The misallocation of aid cannot serve the interests of the poor, and as a result poverty is not abated.

Sustainable development enables communities to stand with dignity and to have ownership over the improvement of their conditions. Ownership comes from allowing the poor to make their own decisions: determine their own needs, find their own solutions, and put them into practice, using our aid and guidance. To allow ownership is to consider the desires and goals of the people for which these projects are intended. In other words, we should not direct aid programs by projecting our goals onto people of the developing world, but we should facilitate the tools they lack to invest in their own progress. At present, there are only a

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<sup>6</sup> Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003), 290.

handful of development programs that have reached this level. Chief among them are microfinance institutions (MFIs).

Microfinance is the provision of financial services to clients who are excluded from the traditional financial system due to their lower economic status. These financial services most often take the form of relatively small collateral-free loans but can include savings programs, insurance and payment services. MFIs are based on the assumption that the poor are bankable, a notion that refutes the commonly held belief that the poor are incapable of carrying out financial transactions such as repaying loans and saving money.

Bangladesh's Grameen Bank is most often hailed as the pioneer institute of microfinance. Founded in the mid 1970s by American educated economics professor Dr. Muhammad Yunus<sup>7</sup>, the bank began as a research project and soon grew into an organization with thousands of employees and millions of clients. The Grameen Bank now boasts repayment rates upwards of 98 percent<sup>8</sup> and shows this as proof of the poor's ability to improve their conditions.

Despite the apparent success of the Grameen Bank and the excitement generated in the development industry, there are several key criticisms that have emerged since their inception.

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<sup>7</sup> Ainon Nahar Mizan. *In Quest of Empowerment, The Grameen Bank Impact on Women's Power and Status*. (Dhaka: University Press Limited, 1994.), 18.

<sup>8</sup> Ibid, 17.

Similar to the criticisms of the development industry, many sociologists and economists have questioned the abilities of MFIs to alleviate poverty and create fully functioning sustainable banks. Some of the weaknesses of MFIs are their lack of sustainability, the inefficiency of group lending (as well as its social costs), and the failure to empower women<sup>9</sup>. The most important of these criticisms is that despite the phenomenally high repayment rates, most microfinance programs fail to alleviate poverty or even marginally improve quality of life for the poor. All too often, the success of a microfinance program is measured in terms of sustainability of the program, and repayment rates, which are poor indicators of the degree of women's empowerment or the improvement of living conditions in real terms. When MFIs are measured in terms of the Human Development Index, which statistically combines measurements such as daily caloric intake, fertility rates, infant mortality rates, or percentage of children attending school, they are rarely found to have substantial impact.

Given all of their faults, do MFIs have a future in the development industry? Yes. By uncovering the successes and failures of MFIs I hope to find alternative methods of implementing microfinance in the poorest of communities. The ultimate aim is not to discredit MFIs altogether or to

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<sup>9</sup> Women make up close to 96 percent of all MFI members, yet significant improvements in women's empowerment have yet to be seen.

Hontze Lont and Otto Hospes, eds. *Livelihood and Microfinance, Anthropological and Sociological Perspectives on Savings and Debt*. (Amsterdam: Eburon Delft, 2004), 29.

determine *if* they are helpful, but *how* they can be most effective in reducing poverty.

Finally, as important as MFIs are, they alone cannot substantially eliminate poverty. The proposed reforms to the U.S. development industry should involve increased cooperation and participation with only the most successful and sustainable MFIs. The strength of MFIs is precisely the weakness of the U.S. development sector: MFIs are relatively small in size and due to this they connect to local communities on a one-to-one basis. However, MFIs often require an initial capital investment which is difficult to acquire without the help of a government agency. With the appropriate government support, MFIs have the ability to dramatically improve the failed record of U.S. development agencies and more importantly the lives of the poorest among us.

## Part 2: Development Aid\_\_\_\_\_

*"America must embark on a bold, new program for making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas...I believe that we should make available to peace-loving peoples the benefits of our store of technical knowledge in order to help them realize their aspirations for a better life."*

*-President Harry S. Truman, inaugural address  
January 20, 1949*

## 2.1 History of Development Aid

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It was during his inaugural address that President Truman first formally and publicly committed the U.S. government to engage in international cooperation aimed at improving conditions in the developing world. For the first time, foreign policy objectives were not solely aimed at obtaining military or economic benefits for the developed world. Following World War II and the success of the Marshall Plan in rebuilding much of Western Europe, the U.S. had newfound confidence in economic development and the belief that all that developing nations needed to succeed was industrialization.

In the United States, the economic boom of the 1950s led to suburban sprawl and relative increases in disposable income. Americans who had grown up poor as a result of the Great Depression were able to live comfortable lives for the first time. They lived to see the fruits of their hard work and struggle to improve their economic situation and were optimistic about their future. Along with the optimism came the general sentiment that "there was no earthly reason why the benefits Americans enjoyed at home could not be enjoyed anywhere in the world."<sup>10</sup> After all, it was nations that were poor, not people. Given this method of

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<sup>10</sup> Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003), 55.

analysis, the best means of reducing poverty was to make poor nations rich. Indeed, President Truman echoed the feelings of many Americans with his Point Four proposal, "which became formalized as national policy in the 1950 Act for International Development."<sup>11</sup>

Point Four marked the beginning of the official U.S. development industry and was one the first program to use the term "underdeveloped" to refer to a third world nation.<sup>12</sup> President Truman himself outlined the way in which developed nations such as the U.S. were in the position to help disadvantaged nations:

"It is declared to be the policy of the United States to aid the efforts of economically underdeveloped areas to develop their resources and improve their working and living conditions by encouraging the exchange of technical knowledge and skills and the flow of investment capital."<sup>13</sup>

After realizing that the Marshall Plan approach that was so successful in Europe would not work for underdeveloped nations which were not re-building, but building up for the first time, many began to question the nature and scope of U.S. development efforts. The failure of the Marshall Plan outside of Europe is now a widely accepted concept. According to the economist David A. Baldwin, "it is almost a cliché to

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<sup>11</sup> Ibid, 55.

<sup>12</sup> Ibid, 55.

<sup>13</sup> Harry S. Truman. *Years of Trial and Hope*. Vol. 2 of *Memoirs* (Garden City, NY: Doubleday, 1956).

assert that Marshall Plan concepts were transferred inappropriately to the Third World".<sup>14</sup> Critics within the development industry were beginning to realize that a one-dimensional approach to the complex problem of poverty was not likely to yield substantive results. Much of the money allocated for foreign development actually ended up in the hands of Americans: "of the \$30.4 billion spent on foreign aid between 1948 and the mid-fifties, 77 percent went to suppliers in the United States."<sup>15</sup> The failure of many development projects of the 1950s led many to replace "industrialization" as the main focus of development.

The U.S. government was undeterred by the continued failures of its development efforts, and pressed forth with new programs, many of which now began to factor in new variables. Trade was the new "engine of economic growth" and human capital was finally factored in. "Education, man-power planning, and technology transfers"<sup>16</sup> gained greater attention as well.

The enthusiasm many felt for development during the 1950s made way for the boom of the development industry in the 1960s. In fact, the United Nations declared the 1960s the "Decade of Development". In addition, the 1960s were also the birth of 44 newly independent nations.

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<sup>14</sup> David A. Baldwin. *Economic Statecraft*. (Princeton, New Jersey: Princeton University Press, 1985), 290.

<sup>15</sup> Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003), 57.

<sup>16</sup> *Ibid*, 59.

Furthermore, since the 1950s, 66 new countries accounted for 40 percent of the world's population.<sup>17</sup> The many revolutions, both bloody and peaceful, that led to the independence of many nations also meant that in the 1960s, nearly half of the world's population lived in some of the most politically unstable regions. This was another boost for the development industry.

Fueled by the growth of new nations and the increasing demand for technical assistance and foreign aid, the American development industry expanded greatly during the 1960s. The United States Agency for International Development (USAID) and the Peace Corps were founded under the 1961 Foreign Assistance Act.<sup>18</sup> USAID was created to be the official branch of development aid for the U.S. government. The Peace Corps is largely seen as an innovative response to the previous failed attempts at reducing poverty. The Peace Corps was a departure from the traditional forms of bi-lateral aid. Volunteers would interact not with machines and governments but with real people, poor people. In contrast to the "trickle-down-approach" Peace Corps volunteers (PCVs) were encouraged to live, learn from, and work with local communities,

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<sup>17</sup> Ibid, 59.

<sup>18</sup> USAID [Official website]<<[http://www.usaid.gov/about\\_usaid/usaidhist.html](http://www.usaid.gov/about_usaid/usaidhist.html)>>  
Accessed March 27, 2006.

spawning the term "grass roots".<sup>19</sup> These two organizations remain the largest and most important in the U.S. development industry.

Internationally, the development industry mirrored that of the U.S. and several new programs and committees were formed during the 1960s. Among them, the most notable are the Development Assistance Committee (DAC) of the Organization for Economic Co-operation and Development (OECD)<sup>20</sup> formed in 1961 and the United Nations Development Program (UNDP) formed in 1965.<sup>21</sup>

The OECD is a multi-lateral organization focused on trade and research and supported by its advanced-economy members. It is comprised of thirty full members committed to the principles of representative democracy and a free market economy. Most of the aid to developing countries is made in terms of bi-lateral grants or loans for development on a nation-to-nation basis. Members of the OECD make up the bulk of the development industry, valued at \$55 to \$60 billion dollars a year over the last decade.<sup>22</sup>

From its inception to today, the development industry has evolved into a massive entity with the same goal: eliminating poverty. Over its

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<sup>19</sup> Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003), 61.

<sup>20</sup> Organization for Economic Co-operation and Development [Official website] <<<http://www.oecd.org>>>. Accessed March 27, 2006.

<sup>21</sup> UNDP. [Official website]<<http://www.undp.org>> Accessed March 27, 2006.

<sup>22</sup> Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003), 104.

more than fifty year history, different approaches have been embraced yet few abandoned, and the result is still the same (or worse): a growing rich-poor gap and increased poverty. Why have such powerful and wealthy organizations failed to meet their goals? After all, \$60 billion per year is more than the entire GDP of Haiti, Chad, Benin, Burkina Faso, Central African Republic, Eritrea, Cambodia, and Laos combined.<sup>23</sup>

The failure to make any significant improvements for those in the developing world points to the fact that money alone is not the solution for poverty. This realization allowed the development industry to include “human” factors such as equity, education, health, and, nutrition into the planning process. In addition, academics and university staff became interested in development and diversified the knowledge base of the development field by becoming advisors on projects.<sup>24</sup> Through it all, the development industry evolved from the mechanized approach of the 1950s aimed at capital investment and export led growth to today’s more comprehensive approaches.

Despite any progress made since the end of World War II, what is evident in the history of development aid is that in the majority of cases, the most important players were consistently left out. In all the think tanks and project development schemes engineered throughout the years,

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<sup>23</sup> CIA World Factbook, 2003.

<sup>24</sup> Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003), 62.

most in the development industry never thought to consider the desires and opinions of the poor in the developing world. The lack of direct involvement in the decision making process of those who are meant to benefit cannot yield dramatic results. Western ideas and methods were considered superior to any because the West had wealth and power to back up the claim. For that reason, development was seen as a "giving" of Western knowledge and resources with the assumption that the poor were unable to help themselves.

## 2.2 Why does the United States Give Aid? \_\_\_\_\_

To effectively understand how development aid works (or doesn't), it is important to understand why it is given, how it is allocated, and for what purposes. The United States is clear about its motivations for providing foreign aid—the primary objective is to preserve its own territorial and political security. Furthermore, the U.S.'s OECD membership goals state the primary purpose as serving to open new markets for U.S. goods and provide investment opportunities.<sup>25</sup> The U.S. is justified in seeking to promote its geo-political or economic interests, as most other countries do. However, development aid is often seen as a humanitarian action, which may sometimes be the case but does not determine development aid policy in a majority of the cases. For example, aid is often allocated to countries that allow the U.S. to maintain military bases on their soil. Moreover, the majority of U.S. Economic Security Fund resources are allocated to Israel and Egypt, both countries with relatively little need for economic assistance.<sup>26</sup>

Economic reasons are a significant motivation for wealthy countries to provide aid. It is no secret that many developing countries are extremely dependent on U.S. goods and services and purchase nearly 40

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<sup>25</sup> Paula Hoy. *Players and Issues in International Aid*. (West Hartford, Connecticut: Kumarian Press, 1998), 5.

<sup>26</sup> *Ibid*, 18.

percent of total U.S. exports.<sup>27</sup> In fact, according to USAID statistics, trade generated from aid has more than offset initial costs; between 1990 and 1995, exports to developing countries increased by \$98.7 billion, which supported roughly 1.9 million jobs in the United States.

However, not all aid is offered with only a self-interested purpose in mind. Humanitarian concerns also factor into the allocation of aid, albeit, to a lesser degree. They are voiced by the moral principle that wealthy governments have an obligation to assist those in need, including those beyond their national borders. By giving international aid, wealthier nations can also help to reduce problems that defy national borders. Environmental degradation, contagious diseases, political instability, and population growth are concerns to all humans, and as such involve every nation's interests.

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<sup>27</sup> USAID [Official website]<<[http://www.usaid.gov/about\\_usaid/usaidhist.html](http://www.usaid.gov/about_usaid/usaidhist.html)>>  
Accessed March 27, 2006.

## 2.3 Key Players and Types Of Aid\_\_\_\_\_

The international aid industry is far more complex than it appears and consists of more than just donors and recipients. The key donors come from diverse backgrounds and sizes. The U.S.'s main branch for foreign assistance is USAID. The World Bank, the International Monetary Fund, and the United Nations, are among other chief development institutions. For the purposes of this analysis, we will only focus on U.S. development aid through USAID and the role of NGOs.

The United States Agency for International Development, or USAID is designed to “promote the foreign security and general welfare of the United States by assisting peoples of the world in their efforts toward economic development and internal and external security.”<sup>28</sup> Under USAID, aid falls into one of three categories: Economic Support Funds, Development Assistance, and Food for Peace.

NGOs, or non-governmental organizations are smaller in size relative to the aforementioned players, but are greater in number and are an increasingly significant source of aid to developing countries. They are nearly impossible to categorize as they vary in size, operating style, geographic focus, and religious background to name a few. Yet they

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<sup>28</sup> Ibid, 18.

collectively provide more aid to ailing countries than the World Bank.<sup>29</sup>

The term NGO (non-governmental organization) is somewhat of a misnomer because NGO's derive a significant part of their funding through USAID. In 1995, four hundred U.S. based NGOs collectively raised over \$7 billion...about a third of which came from government sources.<sup>30</sup>

In addition to understanding the players involved in international aid it is important to differentiate the types of aid that are most commonly distributed throughout the world. The following is a list of the most prevalent and important types of aid:

1. *Bi-lateral Aid* - lateral refers to the number of players involved in an aid transaction. This is distributed from donor government to recipient government in the form of loans, grants, and trade negotiations.
2. *Multi-lateral Aid*- Donors contribute collectively to international organizations (such as the World Bank or the United Nations) that are comprised of many member nations. The aid goes from donor governments to recipient governments collectively.
3. *Humanitarian Aid*-Short-term aid disbursed in times of crises. Natural disasters, famine, genocide, civil wars, or disease qualify for

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<sup>29</sup> Paula Hoy. *Players and Issues in International Aid*. (West Hartford, Connecticut: Kumarian Press, 1998), 95.

<sup>30</sup> "Aid: Falling Fast," *Economist*, June 22, 1996, 43-44.

humanitarian aid. It can be distributed either bi-laterally, multi-laterally, or through NGOs.

4. *Military Aid*- Used to assist an ally in its defense efforts, or to assist a poor country in maintaining control over its own territory.
5. *Development Aid*- Aid intended to improve economic conditions in a developing country in the long-term through grants or technology transfers. Specific sectors such as health, population, education, agriculture, and rural development are targets for this type of aid.

Table 1 illustrates how U.S. government funds given through USAID to various development agencies can be put to use. An overlap of donor agencies capable of carrying out the same type of aid or projects indicates the competition for niche and USAID funds that exists between them.

Table 1- Forms of Development Aid<sup>31</sup>

Type of Aid	Description/Purpose	Donor Agency	Example
Project Aid	A grant or loan provided to a government agency or NGO, designated for a specific project or outcome	Bilateral and multilateral donors, NGOs	A grant from the U.S. government for the construction of a hospital
Program Aid	A policy-based loan given to a recipient government to create certain economic conditions in that country or to support balance of payments	Bilateral and multilateral donors	A structural adjustment loan provided by the World Bank
Technical Assistance	Provides equipment and/or experts for a specific sector or outcome	Bilateral and multilateral donors, NGOs	A team of UN engineers sent to a developing country to set up a water supply project

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<sup>31</sup> Ibid, 5.

### Part 3: Microfinance\_\_\_\_\_

*"The great challenge before us is to address the constraints that exclude people from full participation in the financial sector. Microcredit offers a pivotal opportunity for the international community to engage in a shared commitment to meet this challenge. Together, we can and must build inclusive financial sectors that help people improve their lives."*

*-Kofi Annan, UN Secretary General*

### 3.1 What Is Microfinance? \_\_\_\_\_

Defined simply, microfinance is the provision of financial services to those who are excluded from the traditional financial system due to their low economic status. The services provided through microfinance consist mainly of loans, referred to as microcredit, and savings, though some microfinance institutions offer other services such as insurance and pension plans. Though this is a relatively new concept that is gaining worldwide attention, microfinance simply replaces existing forms of non-formal savings and loans within developing countries with more reliable and flexible options. Microfinance has shattered the once widely accepted notion that poor people, due to their unstable conditions, are incapable of saving and even more incapable of repaying loans. What these beliefs ignored is the fact that savings and loans have always existed in even the poorest of communities, albeit in extremely informal terms.

Poor people hold savings in many forms, including assets such as animals, grain, or jewelry. Unfortunately, savings in the form of assets has limitations. Grain can deteriorate in storage or be lost to pests; animals require attention, consume resources, and can die; jewelry is relatively illiquid as an asset and can be difficult to sell in times of need. Moreover, when any of these assets are held as insurance against crises such as drought, they are often sold at a loss due to the need for a quick sale.

Assets in these forms can also be difficult to maintain in the face of demands or claims from family or other relatives. What these difficulties signal is the immense demand for savings in cash among the poor.

Given the opportunity, the poor will save in cash. However, for the poor, there is often no choice but to store cash in their homes where it is at risk of theft or loss in case of fire. Sometimes savings in cash will be loaned to relatives or neighbors in hopes of securing it and yielding a return when interest is charged but always with the risk of conflict in the case of failure to repay. Saving is thus nearly impossible to do in cash, yet small amounts of accessible cash are always needed for emergencies, ranging in scope from unexpected guests, to illness, or death in the family. What this creates is a difficult situation for the poor, and an overwhelming need for a secure and reliable method of saving.

The equivalents of microcredit, or microloans in the informal sector are known as Rotating Savings and Credit Associations (ROSCAs) or Accumulated Savings and Credit Associations (ASCRA). Though many semi-formal ROSCAs and ASCRAs are in existence today, they have been influenced by the indigenous models devised by the poor.

ROSCAs consist of a group of individuals who make regular cyclical contributions to a common fund, which is then given as a lump sum to one member in each cycle. For example, a group of 4 persons may contribute the equivalent of \$20 dollars per month which can be given to

one member at the end of each month. Thus a member will lend money to other members through a regular monthly contribution. Each member takes a turn receiving the lump sum, but is always required to contribute his share to the fund. In this way there is a mutual give-and-take involved that allows members to alternate between the roles of lenders and borrowers.

ASCRAAs are a similar type of savings and credit association that operate like an informal credit union. These associations, with considerably larger groups ranging from several hundred to several thousand members, accumulate their savings for a certain period of time, usually one or several years. After this time period has ended, participants' savings are redistributed and used for a large purchase, event, investment or other purpose by an individual or group. During this saving period, loans can be made to participants. This loan process is different from that of a ROSCA, since these loans are approved on an individual basis by the group instead of being automatically granted one by one.

Through savings in the form of assets and informal ROSCAs and ASCRAAs, poor people devised ways to achieve financial stability. Before the advent of microfinance, what many failed to see is that the poor of the developing world have the same need for secure financial services as those in the developed world.

One of the few innovative thinkers who saw potential in the poor was Dr. Muhammad Yunus, a pioneer of microfinance and founder of the Grameen Bank, Bangladesh's most famous MFI. Founded in 1976 in Dhaka Bangladesh, the Grameen Bank has cumulatively lent more than \$1 billion since its inception and boasts a membership of 2.3 million people, 96 percent of whom are female.<sup>32</sup> Most impressive are the Grameen Banks' loan repayment rates at an average of 98 percent.

The rhetoric of the Grameen Bank and other MFIs is based on a set of commonly accepted assumptions that are as follows<sup>33</sup>:

1. The poor are creditworthy and bankable. Access to credit enables the poor to launch income-generating enterprises or expand their businesses and in general to participate in the free-market economy.
2. The promotion of self-employment through microenterprise is the most effective way to accomplish broad-based economic development and poverty reduction.
3. To optimize the performance and social impacts of lending institutions, women should be targeted as the primary

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<sup>32</sup> Hontze Lont and Otto Hospes, eds. *Livelihood and Microfinance, Anthropological and Sociological Perspectives on Savings and Debt*. (Amsterdam: Eburon Delft, 2004), 29.

<sup>33</sup> *Ibid*, 31.

clients- women represent a majority of the poor<sup>34</sup> and they are better clients for microlending projects than men.

4. Institutions providing lending services to the poor are able to cover the costs of their lending and be sustainable provided that they are well managed, and that they apply the appropriate lending practices, and that they enlarge their portfolios by increasing lending outreach.
5. Microcredit institutions providing small loans to poor families need to have access to public funding during the early years of their operations. The public funding will eventually be phased out as institutions achieve financial sustainability. Financially sustainable institutions will access long-term funds from national or international money and capital markets, becoming fully integrated in these markets.

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<sup>34</sup> \_\_\_\_\_. "Women and the World Economy: A Guide to Womenomics." *The Economist*, [essay on-line]. Available from <[http://www.economist.com/displayStory.cfm?story\\_ID=6802551](http://www.economist.com/displayStory.cfm?story_ID=6802551)> Internet: accessed 12 April 2006.

### 3.2 The Inner Workings of Microfinance\_\_\_\_\_

To understand why microfinance has been successful, it is necessary to outline how it is structured. Until the 1970s, there was little knowledge among formal-sector financial intermediaries of alternatives to physical collateral. The Grameen Bank was considered revolutionary for its use of social collateral as an alternative to the physical collateral that poor people often lacked. This allowed the Grameen Bank to target poorer populations than commercial banks ignored.

The Grameen Bank is mainly a microcredit institution (MCI), but it does offer borrowers other services such as voluntary (and non-voluntary) savings that go into emergency relief funds at the branch, center, and group level.<sup>35</sup> In addition, Grameen Bank borrowers receive training and health advice in the form of Grameen Banks "16 Decisions."<sup>36</sup> The Grameen Bank hopes that with adequate education and sanitation health standards (not just economic standards) can improve among their borrowers.

The Grameen Bank goal is that with a low interest and collateral-free loan, a poor individual can become an entrepreneur and reap the profits of her own business. Loans are made to small groups of individuals who

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<sup>35</sup> Andreas Fuglesang and Dale Chandler. *Participation As Process- Process As Growth: What We Can Learn from Grameen Bank Bangladesh*. (Dhaka: Grameen Trust, 1993), 105.

<sup>36</sup> See Appendix for a list of the Grameen Bank's "16 Decisions".

select their own groups. Since borrowers are required to select their own members, risky or untrustworthy people will likely not be asked to join a borrowing group. The second set of loans is not approved until the individual accounts of the first loans of each group member are settled. Thus, the group members interact in a micro-network of mutual accountabilities. To further increase accountability, all borrowers attend compulsory weekly group meetings, in which payments and other financial transactions are made. In case of default on a loan, the group arrives at a private arrangement to pay a member's installment. This results in a lower risk for Grameen Bank, and lower credit risks enable the bank to lower interest rates on loans. The social collateral system is one of the reasons the Bank has a repayment rate upwards of 98 percent. The Grameen Bank model for credit delivery in the Grameen Bank is as follows<sup>37</sup>:

- Groups of five self-select themselves; men's and women's groups are kept separate. The members of a single group should have a similar economic background.
- Membership is restricted to those with assets worth less than half an acre of land.
- Activities begin with savings of Taka 1 (Approx. US \$.01) per week per person and these savings remain compulsory throughout membership.
- Loans are made to two members at a time and must be repaid in equal installments over fifty weeks.
- Each time a loan is taken the borrower must pay 5 percent of the loan amount into a group fund.

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<sup>37</sup> Susan Johnson and Ben Rogaly. *Microfinance and Poverty Reduction*. (London: Oxfam Publications, 1997), 7.

- The group is ultimately responsible for repayment if the individual defaults.
- Between five and eight groups form a “development center” led by a chair-person and secretary and assisted by a Grameen Bank staff member.
- Attendance at weekly group and center meetings is compulsory.
- All transactions are openly conducted at center meetings.
- Each member may purchase a share in the Bank worth Taka 100 (\$US 1.47).
- Loans can be received in a continuous sequence. A new loan becomes available to a borrower if her previous loan has been repaid.

### Interest rates

Most MFIs charge interest rates on loans made to the poor. These are considered vital to the repayment of loans and to the financial sustainability of the MFI. Interest rates charged by MFIs are usually significantly lower than the interest rates offered by commercial banks.

Put simply, interest is the price of money. Interest is the means through which the lender:

- pays for the cost of the funds that are being lent (cost of capital); if these are from savers then the savers are likely to expect a return which will at least cover inflation and so maintain the value of their savings.
- recovers the costs of providing the service (operational costs). The costs of staff employed to give and recover loans, and the costs of the offices, vehicles (if any), and stationery that are necessary to provide that service.

- covers losses as a result of those who default on a loan.

The interest rate which is charged to borrowers is termed the “nominal” interest rate which differs from the “real” interest rate based on the inflation rate of the country. The rate of inflation indicates the degree to which money depreciates in value over time. If the nominal interest rate is higher than the rate of inflation, then the “real” interest rate is positive. For borrowers, a positive real interest means they pay a cost for the borrowing services; and for savers, the money they receive back will buy more than their original deposit would have done.

For many MFIs, deciding what interest rates to charge borrowers is an ongoing debate. Those that charge high interest rates are better able to achieve sustainability, yet risk losing many borrowers who cannot afford the rates. Those that charge low interest rates are able to reach out to the poorest borrowers, yet are unable to become economically self-sufficient and require constant private or governmental funding. However, trial and error has shown that attempting to recover costs in the early stages of an MFI scheme is likely to result in interest rates which are excessively high.<sup>38</sup>

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<sup>38</sup> Johnson, Susan and Bern Rogaly. *Microfinance and Poverty Reduction*. (London: Oxfam Publications, 1997), 52.

High repayment rates have been reported in schemes where interest rates are high enough to partly cover the costs of providing the services.

A recent study of 11 large established MFIs identifies three levels of financial sustainability<sup>39</sup>:

Level 1: *Subsidy dependent*- the costs of the organization are funded through grants and subsidies from donors.

Level 2: *Operational efficiency*- the non-financial costs of operation (salaries and other administrative costs) are covered out of program revenues.

Level 3- *Fully self-sufficient or profitable*-the institution is generating positive returns on assets. The financial costs of operation are also covered. Capital for on-lending is raised through commercial loans and income is enough to cover the costs of these loans.

Ten out of the eleven MFIs in the study reached level 2, operational efficiency, and five of those had reached level 3. The study's conclusion points to the possibility of MFIs achieving operational efficiency within a reasonable timeframe.

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<sup>39</sup> Ibid, 60.

Out of all the MFIs in operation today, only a small number have reached a level of complete sustainability (including some branches of the Grameen Bank), these studies urge governments and donors to invest in MFIs to provide the initial capital required for take off.

Although the Grameen Bank of Bangladesh is considered the pioneer of microfinance, many other MFIs have since sprouted, each with its own particular design. However, most MFIs follow a similar general structure as the Grameen Bank.

### 3.3 Results?

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Since its inception in the 1970s, many studies have been carried out on the effectiveness of microfinance, with particular emphasis on the success of repayment rates of the Grameen Bank. MFIs are generally considered to be an effective tool for reaching the poor and stimulating the transformation of the vicious circle of poverty into a virtuous cycle of economic advancement. Much of the legitimacy of the argument that claims that microfinance is the de facto solution to poverty rests on the perceived success of the Grameen Bank.

However, there is an apparent contradiction between the stated goals of microfinance and the measurements used to declare MFIs a success. The indicators most often used to label a MFI as successful are often outreach- the number of clients served by the lending institution, and profitability. The rationale for this measurement is that when clients pay back the full cost of the services they receive, make regular payments on their loans and return regularly for more loans, microcredit must be having positive impacts. In reality, these are measures of institutional performance and do not shed light on the impacts on clients.

MFIs claim that providing aid at the local level has significantly impacted the lives of borrowers not only in terms of increased income, but

improved gender relations (recall 96 percent of borrowers are female), outreach (helping the poorest of the poor), and improved nutrition. In the following section, I present the findings of MFI's influence on these three claims: health (nutritional intake), gender roles (women's empowerment) and outreach (helping the poorest people).

### Health-

The Institute of Nutrition and Food Science, University of Dhaka, has generated a series of data on nutritional status of a cross section of households. The following results are of a survey conducted in 1985-86 in three different villages of Bangladesh. A total of 93 households participated in the survey and their results are conveyed in daily consumption of certain food groups, in grams, per person per day. Dietary intake was collected by trained investigators and food weighed using scales.

Table 2 shows the improvements in nutrition for 1. Grameen Bank (GB) customers and 2. Non-Grameen Bank customers(Non-GB). When summed up, these results show that the differences in nutritional intake for Grameen Bank and non-Grameen Bank members are marginal. Grameen Bank members' intake more grams of most food groups per day than non-Grameen Bank members, however, the total difference amounts to only 69 grams per person per day.

Table 2 Food Intake (gram/person/day) by Grameen Bank(GB) and Control Group (non-GB)<sup>40</sup>

Food Groups	GB Intake	Non-GB Intake
Cereal	501	476
Wheat	83	59
Roots	85	99
Rice	418	417
Vegetables	157	135
Fish	19	20
Milk	20	16
Sugar	-	-
Fats& Oils	4	5
Spices	10	11
Total	1297	1228

Note: The Non-GB group includes households owning approximately less than .50 acres of land. Thus the group is comparable to the GB sample.

Another study, conducted by Aliou Dagne (1998), concluded that microlending interventions had marginal or even negative impacts on household income and household food consumption. The study was based on a year long survey of 404 households in five districts of Malawi and on four MFIs. Dagne's analysis yielded the following statement: "Microcredit institutions in general had a negative impact on net crop

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<sup>40</sup> Abu N.M Wahid, ed. *The Grameen Bank, Poverty Relief in Bangladesh*. (Boulder, Colorado: Westview Press, 1993), 100.

incomes, mainly because it let farmers respond to increases in input prices by borrowing rather than changing their farming strategies.”<sup>41</sup>

### Gender Roles:

MFIs have claimed that providing their services almost exclusively to women (96 percent of the customer base) in rural developing areas has resulted in a decrease in domestic violence, and an increase in women’s sense of empowerment. Furthermore, by placing income in the hands of women, MFIs say they have contributed to substantial changes in the number of children sent to school. While it is true that a more educated female population leads to decreases in child mortality, fertility rates, and maternal mortality as well as an increase in wages<sup>42</sup>, MFIs have yet to definitively prove they have empowered women.

It is worth noting that 91 percent of Grameen Bank employees are male, not female<sup>43</sup> and the majority of other MFI’s also employ males. The Association for Social Advancement (ASA), one of Bangladesh’s largest MFIs lists “no contact with the male relatives of the borrower” and “demoralization of the group by the worker” as two causes of failure to

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<sup>41</sup> Hontze Lont and Otto Hospes, eds. *Livelihood and Microfinance, Anthropological and Sociological Perspectives on Savings and Debt*. (Amsterdam: Eburon Delft, 2004), 34.

<sup>42</sup> Mayra Buvinic. “Women in Poverty: A New Global Underclass.” *Foreign Policy*, No. 108. (Autumn, 1997): 38-53.  
See Appendix for the costs and benefits of one additional year of schooling for women.

<sup>43</sup> Farhad Hossain. “Small Loans, Big Claims.” *Foreign Policy*, No. 132. (Sep.-Oct., 2002): 79-80+82.

repay a loan.<sup>44</sup> Furthermore the ASA employee manual states that if "a day's target is not met for any one staff, the branch manager and the other three to four field staff are required to visit the house of the defaulting member in the afternoon to reschedule payment within the same week."<sup>45</sup> The prospect of three male bank members and one bank manager paying a house call in the case of failing to pay an installment can no doubt be intimidating if not outright frightening for women who are accustomed to a lower social status.

Farhad Hossain cites a study in which repeated incidences of verbal humiliation from bank workers were severe enough to drive one woman, who was reportedly locked in a bank room, to hang herself. Even if this is but one isolated incident, the group-lending schemes have been widely criticized for creating social tensions within communities. When one member is unable to pay their portion of debt, they are ostracized by their peers. Such pressure compels many borrowers to pay installments by recycling loans. Recycling loans involves paying off old loans with new ones, and it contributes to increasing household debt and tension.

According to another study conducted by consultant Aminur Rahman in 1999, many Grameen bank borrowers used their savings and

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<sup>44</sup> Mostaq Ahmmed. *Key to Achieving Sustainability: Simple and Standard Microfinance Services of ASA*. (Dhaka, Bangladesh: ASA, 2002.), 111.

<sup>45</sup> Ahmmed, Mostaq. *Key to Achieving Sustainability: Simple and Standard Microfinance Services of ASA*. (Dhaka, Bangladesh: ASA, 2002), 113.

household assets for weekly installment payments on microloans. By pulling resources away from the household, funds are diverted away from consumption needs to loan repayments, causing further hardship to members of poor households.<sup>46</sup>

A study conducted by Anne Marie Goetz and Sen Gupta (1996) found that 63 percent of loans women borrowed were controlled by male family members.<sup>47</sup> Despite this, it was the women who bore the risks and burdens and institutional debts even though they did not benefit from the loans. Furthermore, Farhad Hossain notes that women are sometimes conduits for loans to their husbands, and banks benefit from having women as intermediaries because male borrowers are more likely to physically threaten bank workers when pressed for payment. Consultant Ross Mallick, who reviews studies on microfinance, cites that MFIs incite “domestic abuse and create gender conflict”. He adds, “ the [weekly] meetings are designed to develop peer pressure for compliance. It is a known practice for Bank workers to extend meetings until every member has paid their installment,” a practice that delays dinner preparations or other activities, increasing the opportunity costs of the loan.

#### Outreach:

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<sup>46</sup> Fuglesang, Andreas and Dale Chandler. *Participation As Process- Process As Growth: What We Can Learn from Grameen Bank Bangladesh*. (Dhaka: Grameen Trust, 1993), 33.

<sup>47</sup> Ibid, 33.

The prime goal of MFIs is poverty reduction. If microfinance projects fail to reach the poor, and do not have any poverty reduction impacts, then the issue of the financial sustainability of the institutions becomes irrelevant. Most client-level impact studies conclude that institutional financial sustainability and reaching the poorest are not compatible.<sup>48</sup> MFIs that attempt to reach greater levels of financial sustainability through full-cost pricing of credit services target the moderately poor or the non-poor, whose probability of repaying loans is higher. The evidence from studies of the two leading pro-poor MFIs in Bangladesh- the Grameen Bank and the BRAC- indicates that both are moving away from providing loans to the poorest members of the community.<sup>49</sup>

Conclusion:

The success of many MFIs in obtaining high repayment rates and advanced levels of financial sustainability has contributed to widespread interests among donors- from NGOs to government entities such as USAID. However, study after study concludes that the benefits the poor receive from MFIs are marginal at best. Despite the lack of conclusive evidence that MFIs have positive impacts on the poor, the consensus among donors is that microfinance is worth promoting. There is a massive unmet demand for financial services in the developing world, and microfinance has the

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<sup>48</sup> Lont, Hontze and Otto Hospes, eds. *Livelihood and Microfinance, Anthropological and Sociological Perspectives on Savings and Debt*. (Amsterdam: Eburon Delft, 2004), 39.

<sup>49</sup> Ibid, 39.

*potential* to successfully meet this demand if schemes are oriented around customer-centered products and methodologies. Ironically it is the initial success of the “first wave” of MFIs (Grameen Bank) that is the greatest obstacle to future experimentation within the microfinance industry. Most designers and sponsors of new initiatives have abandoned innovation in favor of “replication” of schemes due to the assumption that a successful program can be replicated elsewhere to achieve the same results. Microfinance itself was an innovation, yet failure to adapt to local needs is its biggest weakness. With properly designed schemes, a commitment to experimentation, change, and effective implementation, microfinance could once again lead the way in the development industry, and produce significant improvements in the lives of the poor.

## Part 4: Problems and Solutions\_\_\_\_\_

*"Credit without strict credit-discipline is nothing but charity. Charity in the name of credit will destroy the poor, not help them. Credit institutions must make sure that the loans get paid back in full, and in due time. If it does not happen that way, one should not be quick to blame the people for the failure, rather one should blame the designer of the credit institution which fails to do the job"*

*-Mohammed Yunus, 1996. Founder and Designer of the Grameen Bank, Bangladesh.*

#### 4.1 Streamlining Development Aid

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One of the best methods of improving the success rate of U.S. development aid is to reduce it dramatically. Since its inception in the years following World War II, the central argument for foreign aid has been that without it, developing countries would cease to develop, if they developed at all. External donations have never been a requirement for the development of any society anywhere. Economic prosperity depends on personal, cultural, social, and political factors within a country that are influenced by people's wishes, talents, and motivations. In essence, economic achievement depends on the conduct of governments and their people.

For over fifty years, the development industry has tried to apply aid from the outside, assuming that what caused poverty was the condition of not having and that by simply supplying what the West had, all would be solved. However, the state of not having is not the cause of poverty, but the condition of poverty itself. Real development should aim to give people choices. Choices can only occur when poor people can live above mere subsistence and accumulate wealth, no matter how small. To be meaningful, wealth must be maintained long enough to become widespread in the community.

Furthermore, providing bi-lateral (or multi-lateral) aid can produce unintended negative results. In many poor countries, development work has raised expectations that cannot be met, sometimes creating incentives for corruption and theft or adding a heavy debt burden to countries with no resources. Unsatisfied with local conditions, many people move elsewhere, either within developing countries, or into developed regions, as a way to alleviate their economic struggles.

USAID is the premier source of funding for U.S. development projects. It works closely with bi and multi-lateral agencies, religious charities, for-profit development organizations and U.S. NGOs—funding for NGOs exceeds \$450 million a year. Despite being the largest donor (in real amounts) of development aid in the world, the main U.S. development agency is hampered because it has evolved into a business, and the business mindset exists in all levels of the organization, from the main direction of USAID, to the employee level.

When considering development projects it is ultimately USAID that decides the overall parameters. The idea for a project can originate from a variety of sources, some of which may have little interest in development. Some examples have been from the political concern of an ambassador or from a new AID mission director seeking to make a mark for career reasons. Consequently, the prospective contractor or

NGO has little choice about the grand design of a development project but goes into the bidding process regardless.

Once won, the USAID development project contract is an attractive source of money for any organization in the non-profit world that believes it's "survival depends on building its capacity or its track record. And for a for-profit [organization], winning contracts is its lifeblood." <sup>50</sup> Overall, the job of a development agency, whether an NGO, for-profit, or religious charitable organization is not to convince USAID of what it believes makes sense in developmental terms, but simply that it is the best-positioned organization to carry out the project efficiently. The more USAID contracts an organization succeeds in winning, the more likely it is that it will have a longer and more impressive capability statement.

Perhaps the oddest practice of USAID occurs at the employee level. USAID consultants, or development directors receive what is termed as a "hardship differential". This added bonus can go as high as 25 percent of the base salary of a USAID employee positioned abroad. What this is intended to cover is the additional "hardship" that Americans may encounter when placed in overseas jobs when these are not located in developed, Christian nations. If an employee is stationed in a remote

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<sup>50</sup>Thomas W. Dichter. *Despite Good Intentions, Why Development Assistance to the Third World Has Failed*. (Amherst, Massachusetts: University of Massachusetts Press, 2003), 82.

location, his or her "hardship differential" must make up for the difficulty or scarcity of clean water, decent housing, and electricity. If the employee is fortunate, he or she will be assigned to a post that has inadequate schooling. If an employee can demonstrate that this is the case, then USAID will cover the costs of private boarding school in the U.S. in addition to the "hardship" caused by the required separation of the family.

Furthermore, these added bonuses sometimes cover what is termed as "Sunday differentials", or the financial compensation of not being able to attend church on Sunday. The "Sunday differential" is especially designed for Americans stationed in Muslim countries where Friday is the holy day and the normal workweek gives Americans Thursday and Friday off. Even though these employees have two days in which to pray with fellow Christians, the loss of Sunday is enough to warrant extra pay at the expense of American taxpayers.

The most apparent benefit for USAID employees working in an underdeveloped country is the vast differences in cost of living. A person making a mere forty-five thousand dollars in an overseas "hardship" post could end up with one hundred thousand dollars saved or invested at the end of three-year assignment. This would mean that the cost of living would have been roughly eleven thousand dollars a year. In many places, eleven thousand dollars a year would enable a relatively lavish lifestyle complete with maids, drivers, and gardeners.

Indeed, the poorer or less developed a country is, the better benefits it provides the typical USAID employee. Former USAID employees recount how much they disliked the occasional required positions in Washington. In the U.S., employees receive no “hardship differentials”, no private schooling for their children, no paid housing, food, and utilities, and worse, they must maintain their own vehicles and homes—in essence, they are reduced to living the ordinary American life. Compared to that, living in a poor country, but with amenities paid, personal drivers, maids, gardeners, and additional “Sunday differentials” is overwhelmingly appealing.

These perks seem to say something about the third world itself and the work of development assistance. It is a tacit but real message that the third world is not worth living in and that no real compensatory satisfaction exists in the work itself. The structural distortions and contradictions within the development industry lead one to question the real purpose of the development agencies and organizations. Are they truly able to help the poor, or have they become more interested in their own survival? Do the poor need the development industry, or does the development industry need the poor?

The possibility that the development industry is not necessary for development has yet to be seriously debated. The bureaucratic nature of the industry lends itself well to the misallocation or misuse of funds, and to

the continuation of poverty. The poor have devised innovative ways to improve their conditions, with or without our help. In an increasingly globalizing world, millions of poor have acted on their desires for a better existence, and whether legally or not, moved to areas where they could improve their economic situation. While those with the energy, determination, and courage to move may represent a minority of the poor, the leverage they represent (through their example or remittances) has unprecedented power for change. If anything points to the growing irrelevance of the development assistance industry it is the contrast between our attempts to engineer development from the outside, and the poor having created it themselves from within.

## 4.2 The Effective MFI

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Currently, Microfinance institutions provide the only hope for the development of poverty-stricken areas of the world. MFIs by definition, give the poor say in their own economic development by providing the liquid assets they need to finance investments. Research has shown that MFIs have a great potential for financial sustainability, and sometimes profit. The excitement generated by MFIs has also yielded more money in the form of donations and investment, yet these investments often place a burden on the MFI to remain financially sustainable, even when this means that the poorest borrowers must be excluded from the system. Over time, this has caused MFIs to digress from their original intentions of helping the poor who have no access to financial services, to that of seeking customers who are more likely to repay—or the better off among the poor. As Aminur Rahman, one of the participants in the 2001 Wageningen conference on 'Livelihood, Savings and Debt,' states, "there is a growing fascination with the mechanics of microfinance, with the vehicle. There is less and less concern about the passengers and their destination."<sup>51</sup>

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<sup>51</sup> Hontze Lont and Otto Hospes, eds. *Livelihood and Microfinance, Anthropological and Sociological Perspectives on Savings and Debt*. Amsterdam: Eburon Delft, 2004), 3.

By increasing their understanding of how and why poor people save and borrow under different livelihood conditions, MFIs can adapt to the needs of their borrowers, and not the needs of their donors. MFIs originated out of the observations that the poor held a high demand for financial services yet the MFIs of today are increasingly geared towards expansionism (increasing the number of loans disbursed and loan recovery rates) and to accumulating assets in order to safeguard their own existence. As a result, the needs, interests, knowledge, culture, and goals of the people MFIs are geared to help are becoming marginalized.

Factors often not taken into account by MFIs are the priorities that poor people identify; the different strategies they prefer to adopt in pursuit of their priorities; the institutions, organizations, and policies that determine their access to resources and opportunities; their access to social, human, physical, financial, and existing capital, and the context within which they live, including external trends, unexpected setbacks, and seasonality.

Given the daunting complexity of providing a suitable and flexible financial system for the poor while under the pressure of donors how can MFIs achieve sustainability without compromising their purpose?

The MFI *SafeSave* has the ability to answer that very question. Founded by Stuart Rutherford, a researcher of microfinance and Senior Fellow at the Institute for Development Policy and Management at Manchester University, *SafeSave* serves the poor of the slums of Dhaka,

Bangladesh. In its fourth year of operation, *SafeSave* has a staff of 40, four branches, and about 5,000 clients, all of whom are residents of poor city slums.<sup>52</sup>

*SaveSave* began with the observation that the poor do not all have the talent or abilities to become entrepreneurs, as assumed by the Grameen Bank and other large MFIs, and as a result cannot all benefit from the loans offered to them for that purpose. Furthermore, the poor have the smallest, most irregular, and most unreliable incomes, so more often than others they find themselves needing or wishing to buy things without having money immediately at hand. Unfortunately, this irregularity does not fit the standard MFI model requiring a scheduled, regular loan payment for a pre-determined amount with the risk of social ostracism looming overhead. The consequences of an ill-fitting MFI model cannot be positive under such pressure. Many poor choose not to participate, or are automatically disqualified in group-lending schemes that require participants to self-select their groups for lending.

The best method for developing an effective MFI is to continually assess the needs of the poor. A recent study conducted in 1999-2000 by the Institute for Development Policy and Management at the University of Manchester, UK attempted to shed light into the financial needs of the poor. The study consisted of taking 'financial diaries' for a full year for a

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<sup>52</sup> *Ibid*, 277.

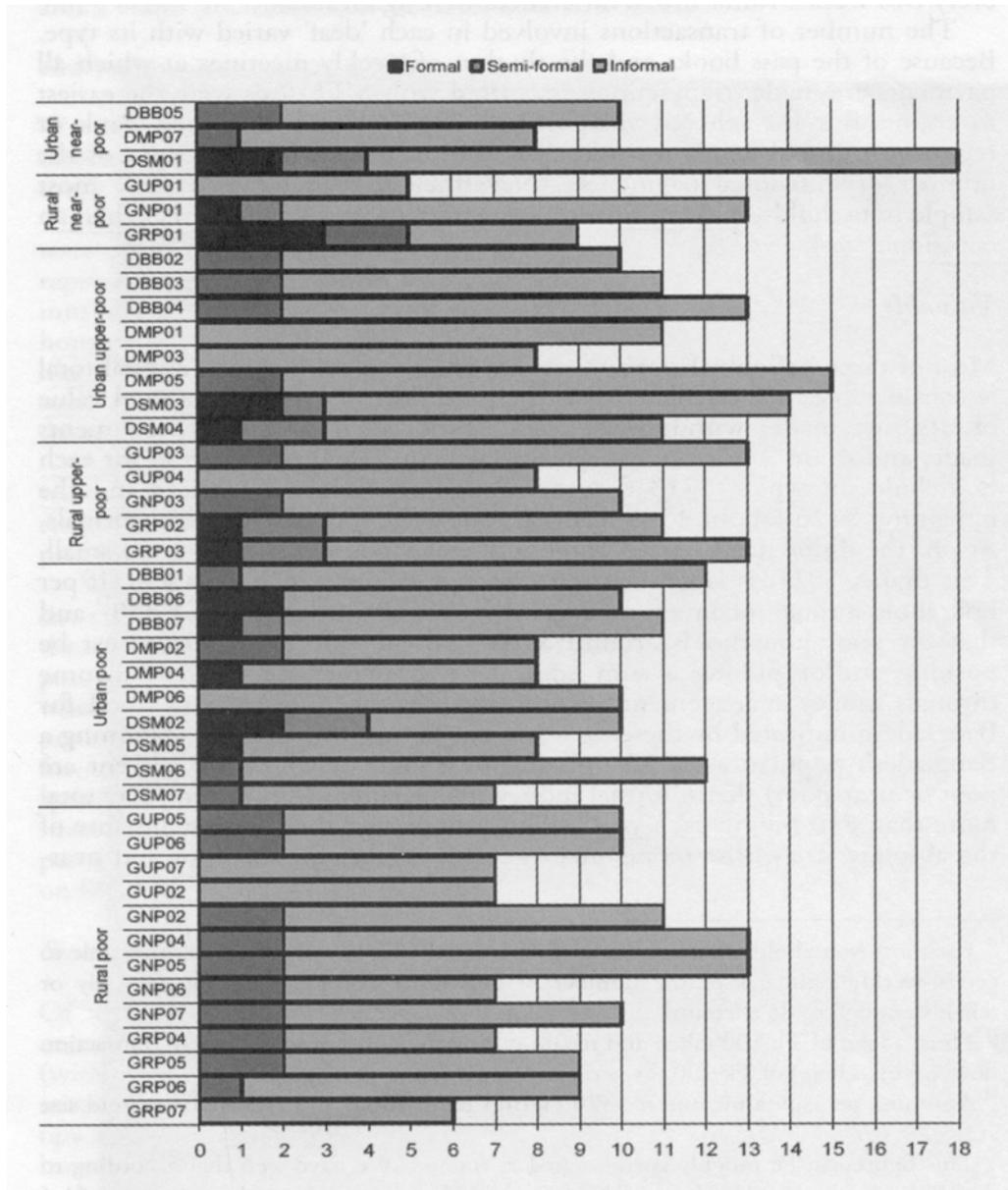
number of poor and near-poor households to determine the methods and frequencies of different uses of money, and what method (formal, semi-formal, or informal) was used most often. Of the forty-two households in the study, twenty-three were categorized as poor or very poor, and thirteen as upper-poor. The remaining six were 'near-poor' or very near the international poverty line. Half the sample was drawn from a village location and half from the Dhaka slums.

The overall findings of the study were that for most sample households, making financial transactions was a daily, rather than an occasional task. The different kinds of financial transactions were varied, intensively used, and more tellingly, MFIs share of the total transaction market was modest and rather concentrated among the upper-poor. Table 3 present the findings of this study in graph format.<sup>53</sup>

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<sup>53</sup> Ibid, 267.

Table 3: Number and Type of Service/Device Used, by Household.



Frequency of Use

Formal = Commercial Banks and insurance companies

Semi-Formal = MFI loans and savings and MFI sponsored ROSCAs or ASCRAs

Informal = local ASCRAs or ROSCAs, lending between family members, saving cash in the household etc.

What Table 3 shows is the overwhelming use of informal financial services. The fact that many of the households that were already members of MFIs still had use for informal services points to the failure of the MFI to satisfy all the needs of the client. The average study household used between nine and ten different kinds of services or devices during the research year. No household, not even the very poorest, had used fewer than four, and one household used no less than sixteen different ones during the year. On this evidence, using money management services seems to be a universal or near universal matter for poor people in Bangladesh.

The study went further than just showing numbers of different financial schemes most often used by the poor, and showed also the different uses for which people needed loans. Out of 515 cases (or transactions), representing all forty-two households, sums borrowed were put into three categories—1. life cycle uses like birth, education, marriage, homemaking, death and general household maintenance, 2. emergency uses like health, theft, and natural or man-made calamities, and 3. opportunities such as investments in productive assets, businesses, and land or consumer durables.

According to the results, almost two-thirds of all sums were spent on life cycle uses, twenty five percent on opportunities, and eleven percent on emergencies. Furthermore, 88 percent of these sums were produced in

the informal sector, a figure which was as high as 92 percent for the poorest households who spent the biggest proportion of their sums on life-cycle uses.

In order to produce an effective MFI it is important to know and understand the needs of the poor. According to a ranking exercise conducted by Bank Rakyat Indonesia (BRI), when the poor prioritize their needs, what results is the following:

1. Safety: Will their savings be held safely by the bank or other depositor?
2. Ease of withdrawal: Can they get quick access to their money when they need it? (especially during emergencies).
3. Proximity: to home or workplace. Ease of access in terms of distance and time.
4. Prizes or bonuses: for good saving.
5. High interest rates: worthwhile monetary return on saving.
6. Informality of procedures: and polite treatment when making deposits or withdrawals.

One of the few MFIs to have considered the above data is Bangladesh's *SafeSave*. *SafeSave* argues that the majority of financial service needs of the poor could be met by a simple, basic, highly flexible product very similar to the financial services for the non-poor in the formal

sector. *SafeSave* outlines three major processes: 1. the collection of pay-ins from clients, 2. the conversion of those pay-ins into take-outs, and vice-versa, and 3. investment of pay-ins in the form of financial assets. The job of MFIs should be to execute the three main processes in ways which maximally suit the poor.

To accomplish this *SafeSave* is structured as follows:

- *SafeSave*, unlike Grameen Bank, does not expect its clients to be loyal to its services alone- many clients are also members of conventional MFIs.
- Deposits, withdrawals, repayment or service loans are available *daily*, not weekly or semi-annually like conventional MFIs.
- Clients can deposit, withdraw, or make loans in any amount they please.
- Clients do not pay fees nor receive interest on their deposits.
- *SafeSave* loans operate like a line of credit or an overdraft in that they have no fixed term and no fixed repayment schedule.
- Loan values have no lower limit and are determined at the upper end by the client's transaction history and account balances.
- The more intensively a client uses *SafeSave* products, the higher become the range of conversion values on offer.
- *SafeSave* does not use group-lending, and poses no threat of enduring social costs to the client.
- *SafeSave* employees require no special or sustained training, enabling locals to work as bank workers. This enables *SafeSave* to reduce costs since slum dwelling bank workers work in their own slums, there are no transport costs.
- *SafeSave* has invested in full computerization from the state. Every client transaction is logged into branch computers to make it possible to follow up on problem cases quickly and to watch aggregate behavior evolve and respond to the changing needs of the poor.
- Clients may be men, women, or children (who may only save) and all are dealt with as individual account holders.

Through its continued attempts to respond to the needs of the poor *SafeSave* has demonstrated it is flexible enough to accommodate a certain level of experimentation. Robert Hickson conducted a study in 1999 in a slum where *SafeSave* was working and concluded that *SafeSave* “has shown that it [is] possible to provide financial services profitably to poor slum dwellers...on a sustainable basis without cross subsidy from lending to the less poor”.<sup>54</sup> The study also shed light into the popular practices of MFIs and how these are perceived by the poor. amazingly, 70 percent of the poor sample disliked the mandatory group meetings, 60 percent stated that they preferred variable loan terms, and more than 40 percent stated that they disliked joint liability systems and appreciated the chance to make variable pay-ins. The findings of Hickson’s study show that *SafeSave* meets the needs and preferences of the poor the best compared to traditional MFIs, and should therefore be hailed as the most suitable MFI for effectively improving the lives of the poor.

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<sup>54</sup> Ibid, 281.

#### 4.3 Conclusion

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Poverty is a growing problem that has eluded many experts in the development industry for decades. Every progress has brought with it new issues, or unintended consequences. For example, the “Green revolution” that allowed many to maximize crop output has indirectly helped to increase life spans in the developing world, however, the unintended consequences were increased fertility rates, and overpopulation.

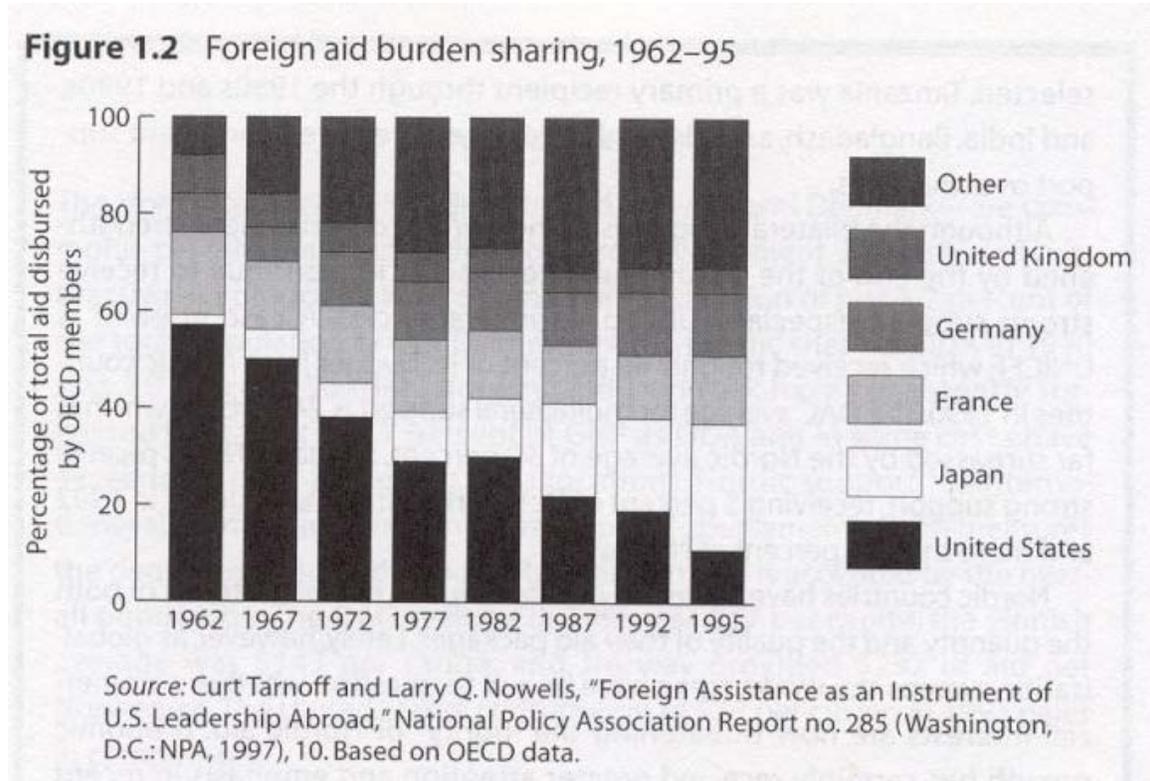
For over fifty years, the development industry has attempted to respond to the challenge presented by poverty with little, if any, sustained progress. Over the years, many lessons were learned, and aid shifted in focus or intentionality, yet even this has failed to yield promising results. The main weakness of large scale government aid has been its inability to connect with the poor themselves, at the local level, and in their terms. In fact, it is the large-scale of the development industry itself that hampers its ability to remain flexible and accessible to the poor. Fifty years have led to a growing development industry, and along with that growth, comes unfettered bureaucracy that contributes to the lack of improved conditions for the poor. The best solution for a project that has been proven to fail is not to invest in it more but to reduce or eliminate it. Likewise for the U.S. development industry, the best method of eliminating the rampant bureaucracy now hopelessly embedded in the system is to eliminate the development industry itself and to concentrate any

assistance to the humanitarian realm (i.e. money for natural disasters, genocides, or other emergencies).

The challenge of poverty is best understood by those who live with it daily. MFIs that are deeply connected to the poor, are able to respond their changing needs. These needs in turn are responses to the challenges of poverty. For an MFI, these challenges involve understanding what exists, deciding on an appropriate role, designing in relation to local circumstances, focusing on sustainability, and being willing to learn from experience. Responding effectively offers the prospect that microfinance interventions will play an important role in reducing poverty. Furthermore, when not only government funding, but government *attention* is placed on successful microfinance programs, the challenge of poverty will meet an equally powerful and pervasive condition among the poor : the desire for self-improvement.

# Appendix

Chart showing U.S. foreign aid burden compared to other developed countries.



Formulated in a National Workshop of one hundred women center chiefs in March 1984, the 16 Decisions might be called the social development constitution of Grameen Bank. All Grameen Bank members are expected to practice and implement these decisions.

1. The Four Principles of Grameen Bank- Discipline, Unity, Courage, and Hard Work- we shall follow and advance in all walks of life.
2. Prosperity we shall bring to our families.
3. We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses at the earliest.
4. We shall grow vegetables all the year round. We shall eat plenty of it and sell the surplus.
5. During the plantation seasons, we shall plant as many seedlings as possible.
6. We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.
7. We shall educate our children and ensure that they can earn to pay for their education.
8. We shall always keep our children and the environment clean.
9. We shall build and use pit-latrines.
10. We shall drink tube well water. If it is not available, we shall boil water or use alum.
11. We shall not take dowry in our sons' wedding, neither shall we give any dowry in our daughters' wedding. We shall keep the center free from the curse of dowry. We shall not practice child marriage.
12. We shall not inflict any injustice on anyone, neither shall we allow anyone to do so.
13. For higher income we shall collectively undertake bigger investments.
14. We shall always be ready to help each other. If anyone is in difficulty, we shall all help him.
15. If we come to know of any branch of discipline in any center, we shall all go there and help restore discipline.
16. We shall introduce physical exercise in all our centers. We shall take part in all social activities collectively.

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<sup>55</sup> Andreas Fuglesang and Dale Chandler. *Participation As Process- Process As Growth: What We Can Learn from Grameen Bank Bangladesh*. (Dhaka: Grameen Trust, 1993), 121.

Options Open to *SafeSave* and to Conventional MFI Clients<sup>56</sup> \_\_\_\_\_

Domain	Options open to <i>SafeSave</i> Clients	Options open to conventional MFI clients
<b>Saving Deposits</b>	<ul style="list-style-type: none"> <li>-Save Frequently or occasionally</li> <li>-Save Sums of a similar or varying value at regular or irregular intervals</li> <li>-Save without borrowing</li> </ul>	<ul style="list-style-type: none"> <li>-Compulsory saving in regular equal amounts</li> </ul>
<b>Savings, Withdrawals, and Borrowing</b>	<ul style="list-style-type: none"> <li>-Withdraw any amount, frequently or rarely</li> <li>-Choose not to borrow</li> <li>-Borrow regularly or irregularly at any interval</li> </ul>	<ul style="list-style-type: none"> <li>-Withdraw only when closing the account</li> <li>-Borrow continuously at regular intervals</li> </ul>
<b>Investing</b>	<ul style="list-style-type: none"> <li>-Choose to buy or ignore long-term investment instruments</li> </ul>	<ul style="list-style-type: none"> <li>-Compulsory savings act as a de facto forced investment</li> </ul>
<b>Repaying</b>	<ul style="list-style-type: none"> <li>-Repay quickly or slowly, with no fixed term</li> <li>-Repay in installments or in lump sums</li> <li>-Repay at regular or at irregular intervals</li> <li>-Repay by direct payment into the loan account or by transfer from the savings account, or both</li> </ul>	<ul style="list-style-type: none"> <li>-Repay in regular equal installments over a fixed term: no pre- or post-payments accepted</li> </ul>

<sup>56</sup> Hontze Lont and Otto Hospes, eds. *Livelihood and Microfinance, Anthropological and Sociological Perspectives on Savings and Debt*. (Amsterdam: Eburon Delft, 2004), 282.

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