Microfinance is one of those small ideas that turn out to have enormous implications. When Muhammad Yunus, an economics professor at a Bangladesh university, started making small loans to local villagers in the 1970s, it was unclear where the idea would go. Around the world, scores of state-run banks had already tried to provide loans to poor households, and they left a legacy of inefficiency, corruption, and millions of dollars of squandered subsidies. Economic theory also provided ample cautions against lending to low-income households that lack collateral to secure their loans. But Yunus vowed to one day make profits—and he argued that his poor clients would pay back the loans reliably. Today, Muhammad Yunus is recognized as a visionary in a movement that has spread globally, claiming over 65 million customers at the end of 2002. They are served by microfinance institutions that are providing small loans without collateral, collecting deposits, and, increasingly, selling insurance, all to customers who had been written off by commercial banks as being unprofitable. Advocates see the changes as a revolution in thinking about poverty reduction and social change, and not just a banking movement.

The movement has grown through cross-pollination. Muhammad Yunus’s Grameen Bank has now been replicated on five continents. Approaches started in Latin America have found their way to the streets of El Paso and New York City; experiments in Bolivia have given birth to institutions in Uganda and Azerbaijan; and policymakers in the world’s two most populous countries, India and China, are now developing their own homegrown microfinance versions. Recognizing the energy and activity, the United Nations designated 2005 as the International Year of Microcredit.

This book is about the ideas that have driven the movement. It is also about lessons that the movement holds for economics and, more
specifically, for thinking about why poor people stay poor—questions that, at some level, go back to Adam Smith’s inquiry into the wealth and poverty of nations. Microfinance successes force economists to rethink assumptions about how poor households save and build assets, and how institutions can overcome market failures. In telling the story, we draw on new developments in economic theories of contracts and incentives, and we also point to unanswered questions and ways to reframe old debates.

There is a great deal already written on microfinance, both by practitioners and academic economists, but the two literatures have for the most part grown up separately and arguments have seldom been put into serious conversation with each other. Both literatures contain valuable insights, and both have their limits; one of our aims in this book is to bridge conversations, to synthesize and juxtapose, and to identify what we know and what we need to know. In this way, this book is both retrospective and prospective.

Combining lessons from the classroom and the field is natural for us. Armendáriz de Aghion, apart from contributing to the theory of banking in her academic role, founded the Grameen Trust Chiapas in Mexico in 1996, the first replication of the Grameen Bank in Mexico. While writing this book, she devoted much time to the Chiapas project as it went through major reorganizational changes. At the same time, Morduch was carrying out research in Bangladesh, advising projects at Bank Rakyat Indonesia, and analyzing financial data he had helped collect in Chinese villages.

The result is a book on the economics of microfinance that we hope will be useful for students, researchers, and practitioners. We hope that, in different ways for different readers, the book will challenge received wisdom and provoke richer understandings of economic institutions.

Familiarity with economics will help, and we use mathematical notation where it clarifies arguments, but the main points can be understood without the math. We have especially tried to make the book engaging for undergraduates and graduate students in economics and public policy. A set of exercises can be found at the end of each chapter, written for advanced economics students with a knowledge of calculus and a desire for analytical challenge.

We have been thinking about this book since 1998, when Morduch was visiting Princeton University and Armendáriz de Aghion was visiting the Massachusetts Institute of Technology. Our common concern at the time was that our respective field experiences in Asia and Latin America did not seem to accord well with the growing theoretical
literature, with its focus on group lending contracts to the exclusion of most else. Broader ideas were needed to create workable microfinance institutions in sparsely populated areas, in urban areas, and in the Eastern European countries that were making the transition from Communism to capitalism. Even in the densely populated rural and semi-rural areas where microfinance had first taken root, we saw a variety of mechanisms that were already at work and that economists had so far ignored. This prompted us to undertake our first joint project, “Microfinance Beyond Group Lending” (Armendáriz de Aghion and Morduch 2000).

Although we had written drafts of the opening chapters in 1998, good intentions were displaced by other research projects and travel. Two events made us return to the book. One was a grant from the ESRC to Armendáriz de Aghion, and another was Morduch’s research leave at the University of Tokyo in 2001–2002. We then resumed writing the book and started rethinking what we had learned.

In doing this, we have been exceedingly fortunate with our collaborators. From the start we had the luck of counting on the intellectual support of Philippe Aghion. Our views have also been shaped and challenged by many colleagues, including Abhijit Banerjee, Patricia Armendáriz Guerra, Tim Besley, François Bourguignon, Anne Case, Maria Leonor Chaingneau, Jonathan Conning, Angus Deaton, Mathias Dewatripont, Esther Duflo, Bill Easterly, Maitreesh Ghatak, Christian Gollier, Charles Goodhart, Denis Gromb, Dean Karlan, Michael Kremer, Jean-Jacques Laffont, Valerie Lechene, Malgosia Madajewicz, Maria Maher, Lamiya Morshed, Mark Pitt, Jean Tirole, Robert Townsend, Ashok Rai, Debraj Ray, Lucy White, and Jacob Yaron. We have accumulated many debts in writing this book. Syed Hashemi, Stuart Rutherford, Mark Schreiner, Richard Rosenberg, and five anonymous reviewers provided detailed comments on an earlier version of the manuscript, and their suggestions greatly improved the manuscript. We also thank the many policy analysts and practitioners who have taken time to share their views and experience. Armendáriz de Aghion gratefully acknowledges collaboration from the Board of Grameen Trust Chiapas and, in particular, from Rubén Armendáriz Guerra, Maricela Gamboa de Lecieur, Karina López-Sánchez, Francisco and Virginia Millán, and Regis Ernesto Figueroa. Morduch thanks especially Asif Dowla, Chris Dunford, Syed Hashemi, Don Johnston, Imran Matin, Lynne Patterson, Marguerite Robinson, Jay Rosengard, Stuart Rutherford, and Muhammad Yunus. Morduch also gratefully acknowledges financial support from the Ford Foundation.
We are grateful to Minh Phuong Bui from the Midi-Pyrénée School of Economics at the University of Toulouse for having written the challenging exercises that accompany each chapter of this book—and for her very useful feedback on several chapters. Sarah Tsien provided expert research assistance on the early chapters as well as facilitating research travel in China.

Last but not least, we have no words to express our gratitude to Philippe Aghion, Amy Borovoy, and our respective children for their patience and endurance, and for having made this book enjoyable to write. Without their support, the book would not exist.

Beatriz Armendáriz de Aghion
Harvard University and
University College London

Jonathan Morduch
New York University