

The Merits of Microfinance as a Viable Solution for Poverty Alleviation: An Interview with Jeffrey Sachs

On August 20, 2008, we had the unique opportunity of speaking with Dr. Jeffrey Sachs, Director of The Earth Institute. We discussed various topics related to economic development, paying close attention to one particular aspect of poverty alleviation—microfinance.

WJDIR: In your recent book, *Common Wealth*, you go through great lengths to discuss the need to combat poverty in the coming years. What are the incentives for the developed world to work towards fighting poverty and how do we affect short-term views to make poverty alleviation a more prominent issue in today's public policy making?

Sachs: I think it's quite obvious that a lot of the world's problems come from a failure to address the crises of extreme poverty, disease, hunger, and other maladies of societies that are unable to meet their basic needs. These maladies are not only tragedies for the people involved, but often form the precursors to violence, mass migration, environmental degradation, the global spread of epidemics, many, many other problems. The United States ends up in wars in places like Afghanistan or enmeshed in conflict zones such as Somalia, Sudan, or Ethiopia, where clearly the underlying cause of these conflicts is extreme poverty. When we send in troops to try to quell unrest, there's very little success, and very few persistent solutions are found because the military obviously can't solve an underlying problem of extreme deprivation and underdevelopment. The need to put poverty reduction at the forefront, not only of our humanitarian efforts, but also of our national security efforts, is becoming more and more clear. The security "experts" don't necessarily believe it. They don't necessarily know it or recognize it, but that's not because it isn't the case. It's because they're often not trained to understand the root causes of these challenges.

WJDIR: So you're suggesting then that these human security issues can really be interpreted as state security issues?

Jeffrey D. Sachs is the Director of The Earth Institute, Quetelet Professor of Sustainable Development, and Professor of Health Policy and Management at Columbia University. He is also Special Advisor to United Nations Secretary-General Ban Ki-moon.

Sachs: Absolutely. These are failed states. These are conflict zones. They are places of violence. They are places where extremists have found a base and can create a lot of trouble in their neighborhood, not to mention in the rest of the world.

WJDIR: As we've mentioned, the next issue of the Whitehead Journal will focus on a tool of poverty alleviation—microfinance. In your opinion, where does microfinance fit in the strategy for development and poverty reduction and, if it does, can it be an effective tool in significantly alleviating poverty?

Sachs: Microfinance is one tool among many. There isn't a single magic bullet for alleviating or ending extreme poverty and each site of extreme poverty tends to require its own emphases based on its own diagnosis. Many different underlying factors, often several at a time, contribute to the conditions of extreme poverty. The problems might be extreme climatic problems, such as little rainfall and vulnerability to drought or desertification. The problems might be extreme isolation, such as mountainous or landlocked communities. The problems often involve very weak institutions, in which case microfinance might be able to play a role. Microfinance is one part of an overall approach to extreme poverty. By itself, microfinance is unlikely to be the single missing element that unlocks economic growth, but if one is simultaneously approaching the challenges of a region through basic infrastructure, such as roads and power, better public health and education, and strengthened agriculture, then the additional benefits of microfinance can be significant.

WJDIR: In *Common Wealth*, you discussed the various stages of development. Do you think that there's a correlation between the different stages of development and the efficacy of microfinance? If there is a correlation, shouldn't we focus more on assisting the progression of these development stages, rather than on individuals?

Sachs: In the most extreme cases of extreme poverty, microfinance by itself will likely not be the solution. The problems in the most extreme cases are usually biophysical and geographic (isolation, drought, disease) and sometimes political or geo-political (ethnic discrimination or conflict). In those cases, basic investments in infrastructure, roads, power, water, irrigation, which are not the kinds of things that can be addressed by microfinance, are probably key, as well as direct political or inter-ethnic settlements if needed. If you put the issue in terms of stages (always an oversimplification, by the way!), microfinance is likely to be most useful once the most basic needs—food, water, sanitation, crop productivity, basic public health, power, transport—have been put in place. At that point, there's already some economic activity; there's viability of the community. After a certain point, if you continue on this ladder of development, then there will probably come a point where microfinance is somewhat less helpful than larger-scale investments in a more traditional commercial banking system. In short, microfinance is probably most helpful not at the very bottom of the pyramid, but one or two steps above the

bottom of the pyramid.

WJDIR: It has become obvious that the global economy is experiencing what could modestly be described as a slump. Does the current economic slump affect international investment and poverty alleviation programs and are the countries in the developed world using this as an excuse to neglect their responsibility to aid development? How does the global economic downturn affect future allocation of capital and investment towards a developing world?

Sachs: I'd say that the rich countries never miss an opportunity to neglect their responsibilities. It's really not the case that the rich countries were already delivering large amounts of aid, only to be thwarted by a recession. My colleagues and I have been urging the rich countries to honor very basic rudimentary commitments that they have made long ago, but not delivered. We are not even trying to get rich countries to promise new things, just to follow through on what they've promised to do. In recent years the Wall Street annual bonus has been bigger than the all world's annual aid to Africa. So the boom times didn't produce the boom of aid, it just produced a boom of private wealth. Now we're in the midst of a recession and, yes, politicians are commenting on 'oh, how hard it is', but it was also hard for them when we had a boom. Politicians seem to find it hard to think about poverty regardless of the condition of the global economy. I do think it will be slightly harder to argue for increased aid during these more difficult economic times, but I don't think that's for any deep reason. I think it's just one more excuse to add to the list—and a very short sighted one, at that. In fact, by aiding Africa to build more roads, power plants, and other basic infrastructure, we could give a boost to our own under-employed industries.

WJDIR: Going back to the first question, we're really hoping that this idea of state security is going to help leaders realize the need to start investing in these projects because it also affects them in the end.

Sachs: I think that's right. An interesting thing is that a number of military leaders understand this idea because they've been pushed into a military role in very difficult and unpleasant places, like Afghanistan and Iraq. Once there, on the ground, they understand they really can't do this job. It's inevitable. Their specialty is violence, not state building. It has been our politicians that are quick to embark on misguided military approaches. I think that there's already some resonance on this issue within our professional military, but not within our security community.

WJDIR: In *Common Wealth*, you make reference to the idea that some poverty alleviation projects are affected by poor governance, but most are affected by finance issues. Do you think that microfinance could be used to further work around the adverse effects of poor governance?

Sachs: I think that microfinance obviously provides a channel which is more direct than a government to government aid project. The problem is that some kinds of assistance that are needed are not private activities of the sort that can be financed by a private loan, but rather require public capital. That's the distinction that I think is critical—you can't really get a road financed through microfinance. You can't really get clinics that meet the needs of a very poor community financed through microfinance. People are trying to do it, but it's a mistake. It ends up maybe making a little business, but one that excludes a lot of the poor. So there are certain things that microfinance can do and certain things that it can't do. But what it does do better than government-to-government projects is that it's more self-enforcing because you create the incentives, at many points, not only within the group for repayment, but incentives obviously from the lender to be monitoring and attempting to collect from the borrower. It is a more natural kind of relationship than an aid project. It can keep corruption down. It keeps the money flow more direct, and I would emphasize, because sometimes I'm misunderstood on this point, I'd love to use markets whenever that's possible. I'm all for markets, whenever they are appropriate to the challenge.

WJDIR: We were actually wondering while reading *Common Wealth*, what your opinion of using the market is.

Sachs: Well, I'm all in favor, except that there's a continuing conceptual misunderstanding in some quarters. Markets are really very effective at decentralized approaches to meeting human needs, except for the fact that there are key circumstances when markets can't do the job. Markets can't do the job when people are so poor that they have no market demand or when the goods that need to be provided are public goods, such as basic infrastructure, environmental protection, or control of infectious diseases. In these cases, markets will under-provide for society's needs. The problem isn't one of ideology, whether you like markets or don't like markets. The problem is the functionality—markets can accomplish certain things, they can't accomplish other things, and we just need to keep those things very clear in our mind. One of my frequent critics is Bill Easterly, and he said that the Harry Potter novels have sold just fine without the United Nations needing to plan the readership for Harry Potter. That's absolutely correct, but selling a novel to people that are interested in reading is completely different than controlling malaria among an impoverished population or building a road in a poor community (or a rich one, for that matter). It's a kind of trivial mistake in my mind to make the comparison. When we can use markets, by the way, I would say by all means use them. They're much simpler than going through the UN or government-to-government. The problem is that they are not designed to handle certain kinds of social problems—they're not equipped for it.

WJDIR: That is really the problem because you're giving people money to start a

business; they're not going to go use it for building roads or clinics or for disease control.

Sachs: They can't. There is no suitable business model. There's a good reason in the world why our local roads are not toll roads, because excluding people from such roads would be an incredible social inefficiency, would incur huge transaction costs, and would create problems that no place in the world has undertaken. We occasionally have turnpikes that are built and require payment to use, but our local roads are generally built by the public sector. There's a very, very good and deep reason for that. The point is even truer about clinics and the control of epidemic diseases. Run them like a business, and the poorest half of the population will lack access to basic health care. This will be devastating for them, of course, but also for the community at large.

Even if you can cordon off areas such as local roads and public health, you wouldn't want to. That's the reason why you actually can't use microfinance to build these kinds of structures. I think that a lot of this gets lost because people are often very ideological and they are trained to love the efficiency of the market, but they are not as well trained to understand that the market is efficient in certain contexts and irrelevant or even pernicious in other contexts.

WJDIR: Continuing on this point then, can microfinance at least augment or supplement explicit funding for critical investment areas, such as the agricultural projects in the Millennium Village Project, which you discuss in *Common Wealth*?

Sachs: That's a great, great question—it's a core question. Microfinance forms part of that Millennium Village Project, and is built in as a target objective for all of the sites. It is indeed a core intervention, though generally not in the first year. In the first year, as we get the project off the ground with the community, we focus on getting the clinics built, the food production increased, and other very basic things put in place. But we start with the idea that every single one of these sites ought to have microfinance as one of the tools. We do believe that microfinance is going to add a lot of value that public finance could never add. I don't want the public sector making small businesses because it can't—we need microfinance. But then the question you ask is really a very good and very important one.

What are the limits of microfinance? Certain areas, including agricultural finance (so that farmers can buy seed, fertilizer, and equipment in advance of the planting season), are borderline issues. Normally agricultural finance would be considered a private-sector banking issue, but when you're dealing with people who are so impoverished that they have nothing, it turns out that normal banking certainly doesn't work for agriculture, and yet microfinance has not cracked the agricultural finance challenge. I find it one of the most interesting practical development

challenges around. If someone is looking for a senior thesis to write or a development project to test, I would put the challenge of microfinance for agriculture at the top of the list.

We're trying to create microfinance for agriculture in the Millennium Villages right now, but if you look at how normal microfinance works, you give a loan and then starting even the next month you start repaying small amounts. For agriculture, it sometimes takes eight months from the time you have the fertilizer to the time you are able to start repaying the loan—a very different structure, with a very different risk profile as well. If the rains fail, there's no way to pay back the loan. In practice—and this is just an empirical point, not a theoretical point—microfinance institutions, such as Grameen or BRAC, have not really succeeded in providing microfinance for fertilizer and seed on a large scale. I'm very interested in the question of whether there's a way to overcome that observed gap in microfinancing. We're trying right now in Kenya to do a microfinance project that finances basic agriculture. The truth is, we're not sure if this will succeed because there is no easy proof it can work.

WJDIR: The Grameen Foundation and similar organizations frequently bring up the importance of individual empowerment in alleviating poverty. How important do you feel is this notion of individual empowerment in alleviating poverty?

Sachs: I think it's quite important, but I also think that it's exaggerated in that it's not the only thing that's important. Empowerment can also be channeled through the community and national level. A community depends on its roads and power grid. It lives off of an organized public health system, an infection surveillance and disease control system, a national highway system and national ports. The hardest thing for many Americans to remember, especially in light of our predilection for free-market solutions, is that economies need both private markets and public goods.

WJDIR: There is a general focus amongst investors on ensuring that their donated funds are indeed going to dealing with poverty and issues of poor governance and misconduct on the part of governments and project managers.

Sachs: Yes and there should be that focus because aid cannot be a matter of trust. It's got to be a matter of systems. I think the relevant idea is not whether people are trustworthy or honest or whether the government is good or bad. Those questions are relevant, but only up to a point. The main question is whether there is a credible management system to translate aid of whatever kind, whether it's in-kind or in cash, into on-the-ground investments and results. So the operative word that I would emphasize is management—and by management I mean that it's no good asking if we can trust these people. What one wants to know is: what are the milestones, what's the reporting, what are the means for verification of an investment program? We need to do that in this country and in every country. Payments should be made

in increments; complete disclosure should be built in the process; due diligence is required. I think that a lot of the aid debate is at a very general level about quality of institutions and not at the specific practical level of management and information systems that are needed to run any kind of project.

A lot of what we're doing in the Millennium Villages, for example, is thinking hard and working hard every day at creating and developing delivery systems so that we know what and when things are going on. There are cases of corruption, but these are caught early on, and tend to be at a petty scale. Money or a product can go missing in small amounts, but that's true of any project anywhere, at any construction site. The question should focus on how carefully things are being monitored, and how able is the monitoring system to redress problems. How was the project set-up? How was it designed? Do you have an IT system that's effective, with real-time reporting and frequent audits?

We need to focus more on management as the real category of project design, not on classifying countries as good or bad. There are extreme cases that I wouldn't exactly describe in this way, such as Zimbabwe right now. It's a country that's just not possible to monitor. There is too much chaos and too much corruption and violence. For most other countries, a mechanism can be set in place that has clear, measurable inputs, outcomes, milestones, deliverables, and methods of verification.

WJDIR: Lastly, is it a smart idea to invest in microfinance institutions? Is this a possible option to help countries give more people access to microloans?

Sachs: I think that investing in microfinance is certainly part of any effective overall aid program for the reasons we talked about, but it is only one part of a portfolio of development financing. What we're stressing all the time is that you have to do several things simultaneously to address the ills of an extremely impoverished place. That means that the holistic approach is needed, almost as with a checklist, to attend to the roads, power, clinics, schools and microfinance. This is a valid way to approach the issue, as well as a way of performing the diagnostic assessment of each particular to understand its very special characteristics and challenges. Microfinance is absolutely one of the areas to invest in. Is it the critical barrier for the reasons we've been talking about? Rarely would you want to put it that way. Microfinance is one of the tools at our disposal and perhaps not the first one to be used when the other preconditions aren't there. In other cases, communities may be ready for exactly what microfinance has to offer.



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