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BOOK REVIEW. THE ECONOMICS OF MICROFINANCE, BY BEATRIZ ARMENDÁRIZ DE AGHION AND JONATHAN MORDUCH

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During the 1990s economists discussed and analyzed the contribution that bank credit had on economic development. As a result, multiple approaches and methodologies have been developed and by now one could argue that there is a consensus: financial development greatly contributes to economic growth.

The relationship that exists between financial development and income inequality, however, has not been settled and contradictory evidence abounds in the literature. From a theoretical point of view, works such as those by Greenwood and Jovanovic (1990) explain that as result of high entry costs, the development of the financial system could give rise to an increase in inequality. On the other hand, from an empirical viewpoint, some works, such as those by Li, Squire, and Zou (1997) find quite the opposite: greater financial development reduces inequality.

Although these studies do not agree, they suggest that it is important to search for ways that may help reduce the transaction costs that institutions (and ultimately their clients) must pay when they are engaged in financial operations with populations that are characterized by their opacity—partly due to the informality under which they operate—, lack of collateral that can be sold in the market and by a demand for savings and loans of small size.

In this regard, three books have recently been published on the subject: "The Economics of Microfinance" (MIT Press 2005), "Building Inclusive Financial Systems: A framework for Financial Access" (Brookings Institution Press 2007), and "Finance for All? Policies and Pitfalls in Expanding Access" (World Bank 2007). Given their importance, each of these texts deserves our attention. However, I would like to concentrate on the first one (The Economics of Microfinance), since I used it as a text book in an undergraduate course.

The book by Armendáriz and Morduch focuses on how microfinance institutions work, what has been their impact and whether they are financially sustainable. For such purpose the book can be divided—from my viewpoint—into six sections. The first describes the environment of imperfect information that surrounds credit transactions and the consequences that this entails. First the authors define in a simple and clear manner the concepts of adverse selection and moral hazard. Then they explain how under such a context the demand for loans—of small size—by populations

that do not have much collateral and whose income level and stability is difficult to corroborate, leaves traditional formal financial institutions (i.e. banks) having little incentives to satisfy such demands.

The absence of institutionally supplied financial products gave rise to the existence of informal moneylenders, the development of financial cooperatives, and subsequently the intervention of governments through the establishment of state development banks. To some extent, microfinance represents an institutional evolution of the practices performed by the first two, and in this sense the second section of the book analyzes how rotating savings and credit associations and cooperatives operate, and the mechanisms that they established to reduce credit risks.

Following the rotating savings and credit associations experience, the most common lending methodology among institutions dedicated to microfinance has been group-lending. The reason is simple: with little access to collateral, it is more effective to exploit the externalities that emerge if arrears were to appear. By encouraging the members of a debtor group to self-select and to self-monitor, the cost and risk that lenders face is greatly reduced. This was one of the methodological principles of practically all institutions dedicated to microfinance. In this sense, the third section of the book—which I consider to be the core—explains how microfinance institutions work and which are the pros and cons of group-lending. In addition, as the authors explain, financial innovation did not stop with the creation of group-lending Thus, a whole series of additional financial products and strategies emerged as mechanisms to choose better debtors and reduce the risk of arrears. In this regard, in this section we learned—for example—about the convenience of using frequent repayments, how staggered loans work, and why social capital is useful.

Although the authors use the concept of microfinance throughout the text, perhaps it would have been more appropriate to refer to microcredit throughout the first half of the book, because that is the financial product under study. It is only in the fourth section that the authors begin to analyze savings products and insurances. Do the poor have the possibility to save? Given moral hazard issues, is it feasible to offer microinsurance to the most vulnerable segments of society? These are fundamental questions, and although these financial products are still under development, this section of the book is dedicated to analyze some of the challenges and experiences that exist on these topics.

Microfinance organizations not only seek to offer financial products, they consider their products as tools that help relief poverty and fight inequality. In this sense, it is not by chance that the fifth section of the book is dedicated to discussing the most adequate methodologies to measure the impact of financing. Without attempting to summarize the multiple manuals that exist on this subject, the authors explain some of the most important biases that result from the endogeneity of the samples. Once explained how these problems can be minimized, the authors move on to the subject of the programs' cost-effectiveness. That is, even though a financial program might be effective to fight poverty for example, it is necessary to analyze its operational cost. This leads us to the sixth and last section of the book, which discusses whether microfinance institutions can be financially sustainable. For that purpose, in the last section the authors examine the internal mechanisms that different organizations have followed for the sake of becoming more efficient.

My experience in using "The Economics of Microfinance" as a text book in an undergraduate course was a good one. It is written in a simple and clear manner, with mathematics that are easy to follow and that allow testing some of the propositions that are made throughout the text. The exercise section at the end of each chapter is useful, but I would have liked to have found a greater number of questions of a reflective nature seeking to generate more discussion. However, that said, I insist: it is an excellent text for students of economics, finance, and administration to reach a good understanding of the particularities that surround the credit markets and the innovative mechanisms conducted by some institutions in order to mitigate the risks that are inherent in their activity at a reasonable cost.

A book can hardly include all the subjects that surround the issue of how to effectively reach an optimum level of financial inclusion. However, this book is an excellent choice to understand under which premises and how microfinance organizations operate. Having said that, I must confess that I would have liked to have found more discussion regarding the impact of competition on the industry of microfinance, a more thorough discussion on the general characteristics of the regulatory framework that should govern it, and which ingredients must be in place so as to integrate this microfinance industry into the local financial system. These are certainly subjects that escape the book's scope and, in this sense, perhaps a combination of The Economics of Microfinance with the other two books already mentioned could be a very good start.

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