



## **Alleviating poverty or reinforcing inequality? Interpreting micro-finance in practice, with illustrations from rural China**

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### **Abstract**

Academic and political discussions about micro-finance have been found lacking in predictive power, because they are based on orthodox economic theory, which does not properly comprehend the social components of credit. I take a better approach, utilizing credit theory – specifically, Ingham’s explication of how the nature of money as credit leads to social inequality. I also expound the perspective that morality is not separate from considerations borrowers make in micro-finance programmes on the micro level. I draw upon illustrations from my fieldwork in rural China, where a group-lending micro-finance programme was administered as part of a larger government-initiated effort across the country.

**Keywords:** Micro-finance; micro-credit; China; inequality; money; sanction

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### **Introduction**

Early excitement about micro-finance (which seemed like a good idea to many people in theory) has been dampened by the now-evident problems associated with its practice. Micro-credit, the most well-known type of micro-finance, is the distribution of tiny loans for the purpose of boosting profit-making among the poor. Its innovation of having the borrowers monitor each other and enforce repayment on pain of loss of future benefit has kindled interest among funders and policy makers, because this provides the borrowers a supposed no-cost collateral. If just one person in a group defaults on the loan, the others all lose access to future loans. So rather than property, participants offer what they have: social pressure.

Optimism for micro-finance was high from the late 1990s to the mid-2000s, culminating with events like the Microcredit Summit in 1997, where delegates from the United Nations (UN) and the World Bank, together with individuals such as Bill and Hillary Clinton and megastar Bono, pronounced the goal of alleviating all poverty through the practice of micro-finance. In 2006, the Nobel Peace Prize was awarded jointly to Muhammad Yunus and the Grameen Bank for their work in micro-credit. By 2007, total assets for micro-finance were \$22.44 billion, which was comparable to Yemen's entire GDP (Nelson 2007; World Bank 2008), and an estimated 150 million people were borrowing through 10,000 micro-finance institutions (PlaNNet Finance 2009). Books like *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits* (Prahalad 2005) and Yunus's autobiographical *Banker to the Poor* (1999) championed micro-credit not only as a source of profit for the poor, but for the lender.

However, things in micro-finance have not turned out as hunky-dory as expected. In 2008 and 2009, micro-credit industries crashed in Bosnia, Morocco, Nicaragua, and Pakistan. Analysts blamed various causes such as debtor revolts and political backlash. In 2010, a rash of suicides associated with micro-credit repayments in India further tarred the practice of social incentive. Yunus was removed from his position as managing director of the Grameen Bank. The 'fortune at the bottom of the pyramid' gave way to the 'mirage at the bottom of the pyramid' (Karnani 2007a) and the 'froth at the bottom of the pyramid' (*The Economist* 2009). Failures in micro-finance increasingly continue to surface (Udoh 2012).

Dispersed case studies also showed the specifics of programme failures. A once-promising Zambian micro-finance institution collapsed while seeking to become a for-profit company (Siwale and Ritchie 2011). In Kyrgyzstan, Bolivia, Peru, Mozambique, and Kenya, rural efforts seem to be prone to failure (CGAP 2005). Recent randomized studies in India, Mongolia, Morocco, and the Philippines find that access to micro-credit indeed stimulates activities such as raising chickens or sewing saris, but across the twelve–eighteen months over which progress was tracked, the loans did not reduce poverty (Roodman 2011). Rather, since incomes are unpredictable, especially for the poor, the money was often used for survival through unexpected rough patches.

Why the extreme disparity between the expectations of micro-finance and its lived reality? I point to the narrowness of orthodox theory. Because of its narrow assumptions, explanations based on it have lacked in predictive power because they do not properly comprehend the social components of credit. They point to peripheral reasons for why micro-finance hasn't been implemented well, like uncontrolled growth, systematic fraud, and bad governance (Silva and Concepcion 2012). Academics have talked about learning from failures in micro-finance to overcome what they regard as the bad implementation of a good idea (Woolcock 1999; Marulanda et al. 2010). However, when micro-finance is considered – according to the credit theory of money – as a

part of the banking system (the extension of credit) rather than of poverty-alleviation efforts or entrepreneurship, the dismal results we've witnessed not only make more sense, but failure becomes, ironically, a central and inherent component of the programmes. The theory asks us to pay attention to power inequalities, which are systemic to credit provision.

I witnessed the realities of this theory firsthand through my fieldwork in rural China, where a group-lending micro-finance programme was administered as part of a larger government-initiated effort across the country. From 2004 to 2007, I repeatedly visited the field site, conducting interviews with villagers and programme staff. The site is an agricultural region in a mountainous area, where income estimates in 2002 (for rural areas over the entire province) were an average of \$0.49 per day, which is much lower than the national rural average of about \$0.75 per day (*People Daily* 2002).

### **Defining micro-finance**

Any microloan exists within a context, and so does a proper understanding of micro-finance in general; we must comprehend the operation of the broader financial system. I draw here from Geoffrey Ingham's (1996, 1998, 2000, 2004) work, where he argues that the analysis of what money *is* stands at the centre of understanding the economic system. It is a measure of value that has a social basis; money is an advantage to the individual only if others use it. Money (defined as bank and state credit) is *created* by the act of bank lending, which central banks attempt to control and regulate. In this Keynesian conception, rather than the idea that 'deposits make loans', the credit theory is that 'loans make deposits'. Banks *produce* money by the creation of credit and debt according to agreed rules and practices; banks therefore manufacture money *as* a social relation. This social relation is based on a social structure involving an institutionalized banking practice and constitutional legitimacy of the political authority – in other words, the promises of banks and the reputation of states *is* the currency. In fact, the central dynamic of the modern capitalist system is the tension between the expansion of value through the elasticity of the credit-money supply and the breakdown of monetary stability. Micro-finance is born of the decline of credit rationing in the past 40 years, along with the subprime mortgage crisis.

Ingham describes three positions in relation to means of credit production. At the top are those who borrow in order to make more money. These people tend to receive favourable lending terms, and the highest levels involve a significant degree of lender dependency. The collapse and rescue of Long-Term Capital Management in 1998, as well as the many bailouts in 2008, were meant, for instance, to protect the US banking system. As the saying goes, 'If you owe the bank 5,000 pounds, you're in trouble. But if the sum is 5 million

pounds, *the bank's in trouble*'. At a middle level are people who borrow for consumption – prudently in the sense that current income will service the interest. At the bottom are the 'unbanked', those excluded from the formal financial system, who must borrow at higher interest rates than everyone else because of the risk of default.

The system maintains and exacerbates inequality. Although he was describing scientific research rather than wealth, Merton (1968) called these tendencies the 'Matthew effects', from the Bible's Matthew 25:29: 'For whoever has will be given more, and they will have an abundance. Whoever does not have, even what they have will be taken from them'. Micro-finance fits into this conceptual frame as a (mostly well-intentioned) effort to reach the unbanked, bottom layer of the global economy.

If the credit theory of money is accurate of what micro-finance does in practice, micro-finance is neither entrepreneurship nor economic development; rather, it would inherently create, maintain, or exacerbate inequalities as part of a larger economic system of credit and debt. In that sense, it would bring about not poverty alleviation but its own round of Matthew effects, taking from the poor and giving to the rich.

### *Not Schumpeterian entrepreneurship but usury*

Champions of micro-finance have claimed that it helps the poor by fostering entrepreneurship. In Yunus's autobiographical book about founding the Grameen Bank, he tells about a meeting held in Cherokee territory in Oklahoma, describing his dialogue with a future borrower:

'Could I get a loan to raise and sell puppies?'

'Well, if you think you could succeed economically and that you could earn enough to pay back a loan, why yes, of course we could lend you the money. How much would you need?'

'Well, I don't know. To get a kennel, to advertise, and to buy dog food, I suppose I would need \$500 for my first litter'.

'Well, now we are in business. I will lend you \$500'.

'You agree! Just like that?'

'Just like that'.

Everyone in the room started laughing. I could see people's eyes lighting up. Others were now raising their hands and sharing their money-making ideas.

'I would like to sell potted plants', said one. (Yunus 1999:193)

In this passage, there is a sense of optimism directed at any idea as long as it is some sort of business. Other passages describe potential borrowers' plans to sell homemade coffee cake, audiotapes of one's stories, and handmade clothes.

'All human beings are entrepreneurs. When we were in caves, we were all self-employed. We were finding food, we're feeding ourselves', Yunus said in

an interview with Paul Solman on PBS NewsHour on November 22, 2006, shortly after receiving the Nobel Prize. The hope for microlending, then, was a reliance on individual entrepreneurship. Borrowers, brimming with ideas, would pull themselves up by their own bootstraps and embody economic individualism: anyone can make it if she works hard enough in the marketplace (Isserles 2003). Entrepreneurial activities were considered something that poor women all over the world were already engaging in, only in the informal economy rather than the market. Therefore, channeling their work, through micro-credit, into the free market would propel them to become bona fide entrepreneurs. And this belief was reflected in the discourse across United Nations departments (such as the UN High Commission for Refugees, the UN Capital Development Fund, the UN Development Fund for Women, the Food and Agriculture Organization of the UN, and the UN Development Programme for Gender Equality) (Allspach 2006).

However, the actual theory of entrepreneurship and its linkage to economic development was quite different. Schumpeter (1983[1911]) argues in *Theory of Economic Development* that there are normal cycles in economic life, but what makes a lasting change is when the entrepreneur, who is fueled by capital, sparks a whole movement of new stuff that gets made and sold (think Steve Jobs) or a service or experience that revolutionizes the industry (think Mark Zuckerberg). The banker supports the entrepreneur by funding his efforts.

The types of activities fostered by micro-finance, even in its ideal state, do not usually have much to do with Schumpeter's theory of entrepreneurship; there is little if any creation of innovative products or services. Most poor people are not entrepreneurs – they are just self-employed (Bateman 2011). If and when micro-finance loans are used to start a business, these businesses operate at too small a scale to produce long-term change. The self-employed poor usually have low skills, little capital, and plenty of competition. Most micro-credit clients would rather take a job at reasonable wages if they had the choice (Karnani 2007b). It is unreasonable to expect that people living in poverty would have the mental energy to be truly creative without the resources of extra time, long-term money, education, and a supportive peer culture.

In the villages I studied, those who participated were given a loan of 1,000 RMB (about \$125). Ideally, a villager might buy four piglets at the beginning of the year for a total of 800 RMB, raise them for about eight months, and then sell the adult pigs for 1,100 RMB each, generating a profit of 3,400 RMB (\$425). As mentioned earlier, the average income was about \$0.49 a day (only \$179 per year). Of course, piglets can get sick (requiring costly medicine) and sometimes die, so the profit is not guaranteed. But raising pigs is something that most villagers do anyway, so they know what to expect and how to navigate these challenges.

But is this entrepreneurship? It certainly doesn't drive the economy in the way that Schumpeter described. It aims to create money not out of innovation

but out of a perpetually renewed debt. Ironically, what micro-finance seems to match in Schumpeter's writing is usury.

In his *History of Economic Analysis* (1954), Schumpeter describes how the scholastic doctors made a distinction between two ways of charging interest: one was usury, which was deemed unfair because lending for consumption would be difficult to repay. The second type was lending for a productive enterprise, where the borrower gains or can gain. Whereas Thomas Aquinas had argued that charging interest was wrong, 'Capitalist evolution created circumstances in which the cases that came under the prohibition of usury rapidly decreased in importance' (1954: 103). Simple exegesis of Aquinas's teaching sufficed to justify compensation for the lender's risk or trouble or for money's loss of value. From these cases emerged the principle that a charge was considered unobjectionable whenever the lender incurred any threat of loss. When a lender employs one's savings in a productive enterprise at communally agreed upon levels of profit, that is not usury (Long 1996). Orthodox theory focuses on these gains, forgetting that unfair kinds of lending can also exist. Micro-finance rhetoric accordingly emphasizes only the benefits of the programmes to the borrowers who are assumed to use the money for productive purposes rather than consumption.

Usury, the lending of money at an unreasonably high interest rate, is hard to define, since what is reasonable to charge is debatable. Simmel (1978[1907]: 383) observes, for example, that merchants considered it a sin to practice usury in the sixteenth century if they were using their own money, but not other people's money (which they had borrowed). This distinction, Simmel argues, shows that there was some kind of ethical consideration – yet that consideration was also conspicuously tractable.

Of course, it's perfectly reasonable for organizations to charge enough interest to keep the organization afloat. Micro-finance can be expensive; loan officers have to expend lots of time and energy to get, say, a \$30 payment. I spent four weeks following micro-finance loan officers in a large Chinese city as they made loans, checked on their clients, and ran group-lending meetings. Visiting a client at his noodle stand in the outdoor market was trouble enough, but checking in on the pig farmers at the outskirts took us an entire afternoon. These are college-educated staff who would spend hours and days tending to clients who had borrowed \$100 or \$500. In the eyes of the typical Westerner, this sounds more like charity work than business. But from the poor's point of view, the interest rates are still high.

Some other micro-lending programmes charge interest rates that are high enough to make a handsome return. Banco Compartamos in Mexico charged enough to give investors an internal rate of return of roughly 100 per cent a year, compounded over eight years (Lewis 2008; Rosenberg 2007). But even in the programme I observed, where the staff told me outright that they weren't trying to make any money and that their goal was poverty alleviation, the

interest rates (though perhaps unavoidable) could still be burdensome to the villagers.

In this case, the government-subsidized interest rate in the micro-finance programme was 2.88 per cent (contrast this to the market rate of around 8 per cent at Chinese banks at the time). But 2.88 per cent of a typical annual loan of 1,000 RMB was 28.8 RMB, and the going rate for a day's labour was 20 RMB. This means that the interest the poor had to pay on the loan is a day and a half's worth of wages, a substantial sum for someone who wonders daily how to make ends meet. As one Mrs. Zhang told me, repaying the loans took some effort because she had to pay interest. Musing about whether the loans were generally helpful or not, she reckoned that they were not too helpful:

I repaid by selling my chickens. The loans are good and bad, I guess. It wasn't really very good for us, actually. I didn't do anything with the money, and then I had to pay interest. . . . When we had the loans, my sons were small, so I had no extra time to try to do something new. I just used the money for daily purposes or whatever.

#### ***Not economic development but cash for survival and consumption***

If the ideal of a micro-finance loan does not live up to the Schumpeterian model, the actuality of what happens with the loaned money can be even further from it. The poor may (understandably) view the money as a means to survival.

Muhammad Yunus famously said, 'These millions of small people with their millions of small pursuits can add up to create the biggest development wonder' (Grameen Foundation 2012). However, in reality – like subprime lending and other elements of the credit explosion – these loans are usually consumed in a less-than-wondrous fashion. Todd's (1996) inquiry into the lives of sixty two women in two Bangladeshi villages found that of the forty who had taken micro-credit from Grameen Bank, all had stated business plans in order to get their loans: they would buy cows to fatten or rice to husk and resell. A few actually did those things, but most used the money to buy or lease land, repay other loans, stock up on rice for the family, or finance dowries and weddings.

Further studies of micro-finance in Bangladesh and elsewhere have shown that funds are still not really being used for making money – never mind spurring on the economy with innovations in Schumpeterian style. Many of the loans are used for housing or traveling costs for migrant-worker family members, even though the bank approved the money for rice-husking projects or small-business activities. That borrowers did not use the money for making profit is also obvious in the way they got the money to repay if they repaid at all. A greater proportion of the repayment money comes from relatives than from profits made in business efforts: in Rahman's study, 7 per cent of repayment

money came from moneylenders, 39 per cent from relatives, 2 per cent from peers, 9 per cent from capital, and 36 per cent from profit (Rahman 1999: 119).

Similarly, villagers I interviewed consistently told me that the loans were helpful. But when I asked what they did with the lent money, they answered that they used it for daily living, medical costs, and educational expenses for their children. One man told me that in his village, most of the borrowers had not repaid:

About two-thirds of the families who participated [in micro-finance in our village] have not yet fully repaid. After they borrowed the money, they didn't have any plans for using it for development; they just used the money for daily needs. Then, when the time came to repay the money, they didn't have it. By now, the interest on those loans would add up to be as large as the loan itself.

When I asked a 60-year-old woman named Mrs. Jin about whether she had had trouble repaying the loans, she replied, 'Some people had trouble repaying, so they borrowed money from kin to repay. Everyone in the small group had trouble and borrowed money'. This was a common response.

### **Inequality and micro-finance in rural China**

Understanding the connections between money and the structural conditions of its transaction is vital to understanding micro-finance, which in my field sites was an instrument of government economic policy.

#### ***The creditor–debtor relationship***

In micro-finance, the relationship between creditor and debtor determines the outcome of the programme as much as any other factor. Two studies of Grameen repayment rates found that they were high, not because of mutual monitoring and peer influence, but because of a great deal of pressure from higher up – the bank officers – to repay (Todd 1996; Rahman 1999). The bank had experienced increasing repayment problems with male borrowers, so it began shifting its loans to women, who were viewed as submissive, shy, passive, and immobile. Bank officers were more successful in persuading them to attend weekly meetings or to make their loan repayments. Bank officers were also wielding control over the exclusion, inclusion, or replacement of borrowers within a group – even though the group members themselves were supposed to decide on the recruitment of new members.

Other studies of micro-finance in Bangladesh show that credit is a resource used in maintaining the lender–borrower relationship which can be described as that of patron–client. It is a one-sided power relationship where 'the



structure of brokerage integrates access to formal development resources into networks of patronage' (McGregor 1989). An NGO even took its borrowers to court in order to induce repayments when peer pressure failed in micro-finance programmes (Devine 2003: 238). In contrast, the micro-loans I studied in China were government programmes with directives at the national level and implementation by local officials. The local government's relationship with the rural population during the past few decades has therefore been a crucial factor in how the loans were perceived.

While I was walking around the villages, various individuals took opportunities to pull me aside and tell me about grievances they had against the government. One woman insinuated that her local officials had pocketed national funds that had been earmarked for village development. A group of men and women pleaded with me to publicize the way that local officials had allowed a mining company to dig into the mountainside in a way that would eventually make their homes cave in.

In this atmosphere, local officials were, from one perspective, just trying to survive. From another, they catered to – or were in cahoots with – the more influential villagers, and they brought unrest between the government and the population. The sense I got from fieldwork was that the government has had an incredibly all-pervasive grip on the lives of the people, whether it's the fact that they must sell their crops to the government at a fixed price, or the fact that officials were, at the time I was there, still forcing abortions on village women known to be pregnant. After the collective era ended in the early 1980s, the Communist government has continued to control the allocation of key resources in the countryside. The institutional structures have been changing across rural China as particular local institutions determine a great deal (Chen 2012), but any type of government programme is perceived by the villagers in light of this history. While I observed many government-initiated efforts toward economic development, such as the planting of seedlings and the encouragement of certain crops, villagers did not look necessarily optimistic or enthusiastic about them – they appeared tired of it. They also seemed to feel like they had been left out of the economic growth nurtured in the cities and on the coast and therefore that the government owed them and *should* give them money.

But township officials didn't spend a lot of time winning over the little people. They needed the co-operation of the leaders only – those at the top of the village authority structures or 'grassroot[s] cadres' (see *Anhui Today Magazine* 2010 article). These cadres play the role of the village police, documenting households and implementing government policies (such as the one-child policy). Additionally, they control the allocation of land, labour contracts, and licenses in the village, which are especially important where neither property rights nor legal systems are clearly defined. Economic reforms have made these cadres less directly supervised by the next-higher administrative level

(the township officials), so their co-operation has become even more important. Moreover, since kinship networks are the basis of social organization – for both power and wealth – in rural China, co-operation from one important member of a family can mean co-operation from an entire constellation of their relatives.

Micro-finance in China, then, operates in the climate of this structure: the national government has certain results it demands, doesn't provide much funding, but pretty much leaves villagers alone as long as they see the required results. This was a top-down initiative that township administrators then ran in whatever way they saw fit.

Though it was international organizations that first introduced micro-credit to China, the national Chinese government initiated several large-scale micro-finance programmes across the country in the 1990s and early 2000s. The government had established the Leading Group Office for Poverty Alleviation (LGOP) in 1986 and began subsidized poverty-loan programmes administered to poor counties by the Agricultural Bank of China (ABC), a state commercial bank. By 2000, the government had disbursed \$775 million worth of subsidized microloans (Tsien 2002). I observed these ABC loans in one county I visited.

Funding was distributed by large government bureaus to township finance offices, which then administered the programmes to rural borrowers. The township finance offices were forced to bear the credit risk; *they* had to repay the loan funds back to the county finance bureau. In addition, they were asked to provide training (presumably, on how to use the funds) to the borrowing households. The funds were given to the local officials with instructions to distribute them according to three principles: lend to the poor, not the rich; lend to women, not men; and lend in small, not large, amounts. Township offices administered the loans, set their terms, and approved extensions to repayment schedules.

So the local government administrators were working under pressure from the township offices to succeed but received little support and guidance. Even the policies that had been established were not enforced. The allocation of the loans hinged not on policy but on the investment strategy of the local officials.

From the perspective of the villagers, it wasn't clear what the criteria were for borrowing. In one township, I asked a 35-year-old man named Mr. Ma whether everyone in his village got micro-finance from the government. 'No, they didn't', he replied. 'There were three to four families that didn't get micro-finance. One family didn't have enough money'. What did it mean that one family didn't have enough money for micro-finance? Wasn't this loan supposed to go to the poorest of the poor? It seemed that the local officials, under constraints to repay the funds, were assessing borrowers by their low perceived risk, not their need. Those with little money to begin with were denied. This plan might seem shrewd at first, but it had a tendency to backfire, as the richer people would use their influence and power to delay their own repayments.

Mr. Wang had lived in his village since birth, so for forty years, and the village was similar to others I had gone to: friends and kin helped each other, everybody celebrated weddings and mourned at funerals together, and people usually did collective work. He helped with the administrative task of distributing and collecting loans:

If someone asks to borrow from me, . . . he'll repay the money to me. If he borrows from an individual, he'll repay. But if the loan is from the government, some people think that we don't need to repay the money. In the past, the government said they were loaning things to the villagers, but later, they didn't ask for it back – if you wait long enough, you won't have to repay it.

Mr. Ma had told me much the same thing when describing people who didn't repay: 'They said to themselves, "If the government gave me this money, I don't need to repay it." ' (Why doesn't the government try very hard to get the repayments? None of us could begin to guess at the inner workings of the Chinese government and why repayment is not more thoroughly regulated.)

Ingham asks whether micro-finance and other new forms of alternative financial organization actually fulfill the intention of countering exclusion and reducing inequality, or whether they instead ironically become the basis for further 'Matthew effects' (2000: 76), and I would say that the latter seems to be the case in China. The state was surely genuinely interested in reducing inequality – if for no other benefit than social stability, as the rural protests show is precarious. However, this programme ends up serving more as a tax than a relief effort. It reproduces the power relationship between the state and the peasants. One NGO staff worker pointed out to me that the government can always get the loans back, since they can always withhold subsidies from another source.

What about reproducing inequality on a global scale? This is probably not happening. Initial startup funds seem to have come from outside of China (all those UN organizations) to develop programmes and train personnel (these would be considered development costs, with no repayment required). Some may have been passed down for lending, but the national government also set aside funds for these programmes, passing them to the counties, townships and finally to the local officials.

So who ultimately gets the payments from the villagers? The answer is unclear. Some 'uncollected' funds could have been pocketed without much worry that harm would come either to the 'non-payer' or to the dishonest collector. The year before I finished my fieldwork, I heard about a scandal where one of the officials had run off with the money after collecting it.

Micro-finance, then, reproduces the main inequality that has been in China for the past six decades: the state's power over the population. In this sense, micro-finance is ironic; it's an attempt at distributive justice that, when

analysed, seems to do the opposite work of funneling money to the powerful rather than the disenfranchised.

But what of the argument that the loans, since they are based on group co-operation, actually empower the villagers? Unfortunately, the only empowerment I witnessed was for the already powerful. Just as the villagers who had no money to begin with were unlikely to be loaned any, the ones who had little power to begin with had no avenue to gain any. There was no process in place of legal redress and little auditing if any of local loan administrators. The officials do depend on the co-operation of villagers, but this dependence only pertains to the already powerful ones. What do non-powerful villagers do? They appeal to the powerful villagers on the basis of personal relationships, which is where the cultural history and social realities of China itself turn the microlending theories on their ears.

### **The social and moral costs of sanctioning**

Georg Simmel's (1978[1907]: 79) study of money, and in particular his attention to distinguishing between objective and subjective values, makes the case that an analysis of money must deliberately consider how money is perceived. Additionally, Simmel focuses on exchange as the primary form of social and economic life (see Dodd 1994: 55). These two theoretical insights are precisely the reality missed in most microlending theories. Recall that group-lending micro-finance programmes, based on orthodox economic theory, attempt to transfer the cost of monitoring and punishing potential defaulters to the borrowers themselves. But we must focus on how the borrowers perceive the loan given as well as the sanctions they are expected to apply – and the costs have to be understood in terms of reciprocity.

People know, instinctively, that if you sanction someone, you will probably get something bad in return. It doesn't necessarily make a difference that there is this external structure or constraint now being imposed (by the micro-finance programme). How many of us don't feel a twinge of discomfort pressuring our neighbours to curb their dogs, even in places where it's the law? If we are reluctant in the West, where individualism is valued as a moral good, imagine the resistance elsewhere. Yet the models bank on an idea that putting a sanctioning requirement on the promise of future loans will make such a difference that people will disregard their established and ingrained social patterns, including basic reciprocity. This clearly isn't happening on the ground.

In Stiglitz's (1990) model of peer monitoring, he argues that the transfer of risk is good for the welfare of the borrower. The model focuses on finding the line where the risk burden of a fellow (co-signed) borrower is compensated by the reduction in interest rate. In this model, sanctions are costless to apply; they just happen. This, of course, is an extremely limited picture of social

relationships. They are complex, with histories and specific expectations that we cultivate apart from loan agreements. Most of us have weighed the costs and benefits of whether to sanction someone on a relatively trivial matter, where money isn't involved at all ('Please don't pick your teeth at the table'). How much more so would people consider the costs of punishing (or threatening to punish) another person when the stakes are so much higher?

Similarly, Armendáriz de Aghion and Morduch's (2010) prominent book predicts repayment as a factor of the costs of monitoring to the borrower and the cost of the sanction to the peer (whom she is monitoring), but it does not pay much attention to what goes into the cost of the sanction to the borrower:

Group lending with peer monitoring can, however, induce each group member to incur a monitoring cost  $k$  ex post to check the actual revenue realization of her peer. We assume that with this information, the partner can force the peer to repay. Let us assume that by incurring a cost  $k$ , a borrower can observe the actual revenue of her peer with probability  $q$ , and let  $d$  denote a social sanction that can be applied to a borrower who tries to divert due repayments. Then, if  $R$  denotes the gross interest rate set by the bank, a borrower will choose to repay if and only if

$$y - R > y - q(d + R),$$

or equivalently,

$$R < [q/(1-q)]d.$$

... Specifically, a borrower will choose to monitor her peer whenever the monitoring cost  $k$  is less than her expected gain  $qy$  from avoiding the need to assume responsibility for her peer's repayment. (Armendáriz de Aghion and Morduch 2010: 98–99)

The fact that it costs the borrower something to say something negative, threatening, or punishing to her co-signer is not considered: 'We assume ... the partner can force the peer to repay'. But we all know that force often results in pushback, and we know from micro-sociology that avoiding embarrassment is a highly motivating factor in how people behave (Goffman 1959). We cherish a good public image of ourselves and work hard to maintain it. This includes being a good, pleasant friend and an agreeable neighbour, relative, co-worker, etc. So it incurs a cost to be unpleasant – to be threatening or sanctioning – depending on our own community's unwritten rules of interaction. It can deplete our stores of goodwill to break social rules, and this affects not only our own self-image but also our public image, and our interactional relationships with other people (three things that are all interrelated).

The extent of the costs of sanctions will depend on social expectations. For poor people like those in the villages I studied, the ability to access and utilize effective personal relationships constitutes an invaluable resource in their struggle to maintain or improve their livelihoods. It's crucial for villagers to work together during the frequent natural calamities that befall them, such as

floods (which wash out roads). In agricultural life, planting and harvesting – not to mention house building and maintenance – require working together vigorously. So people, if they want to survive and keep a roof over their heads, cultivate their relationships carefully. Like other people around the world, ‘What is uppermost in poor people’s considerations is not money, goods, or services per se but the quality of the relationship that they can establish with the source of these goods and services (McGregor 1989). In China, the policies of the Chinese Communist Party have made it so that people rely even more on their personal networks for survival (Whyte 1995).

Here, lateral relationships are an issue of great urgency as the villagers have little access to relationships that bridge them to resources outside of the rural areas. (If their children go out to look for work, they are at the bottom rung of the ladder, not a source of political connections.) As an example, one man told me he had found his neighbour’s wife unconscious and had brought her from the village to the hospital in the town, saving her life. In a place where there are no ambulances to call, having a friend with a car, and the ability to it down the unpaved roads, can mean the difference between life and death.

### **Social relationships in Chinese thought**

Scholars distinguish the cultivation of relationships in China from other places by the centrality of the concept’s place in society (developed to the intricacies of an art form), the sense of individual identity wrapped up the practice, and the mixing of affective and instrumental components (Yan 1996). While reason and the grasp of fixed truths, making deductions, and exercising free will has been regarded as the means to self-fulfillment in the West, Chinese ethics focus on cultivating proper relationships and responding to people according to the type of relationship and situation (Munro 1985:16).

Graeber (2010) contrasts *human* economies with *commercial* economies, arguing that in most societies throughout human history, the foundations of what we consider our humanity is not essentially a matter of commercial calculation (the market economy is a relative newcomer). When Laura Bohannan arrived in a Tiv community in rural Nigeria, neighbours brought her gifts. She was expected neither to bring back the exact same gifts nor to return nothing at all. Instead, if a neighbour brought her, say, three eggs, she should bring something *besides* three eggs back, something of approximately the same value (even money, if discreet, but not the exact cost of the eggs). To precisely repay the debt would have suggested that she no longer wished to have anything to do with the neighbour.

*Guanxi* is a Chinese term that literally means ‘connections’, and it encompasses a wide range of dyadic ties and relationships central to Chinese social and economic life (Gold, Guthrie, and Wank 2002). The concept belies the way

that the self is conceived of as a dynamic process of cultivating relationships through gifts and favours. Yang (1994) uses the term *guanxixue* (literally, 'guanxi-ology', or the art/science of social connections) to describe what she studies. Knowing when and what to exchange is an art that accompanies the development of the relationship:

Since there is no fixed value for each gift, but a value arising out of the context of each gift-giving situation and contingent on the particular persons involved, repayment often causes anxiety and lengthy deliberations over how and how much to repay. The indeterminacy of value may cause Chinese to agonize over what to give, but the concern to prolong social relationships constrain them always to give generously. (Yang 1994: 143)

Consider this social reality in the context of the micro-finance programme presented to the villagers. They consciously regard fulfilling important obligations to particular people as the very definition of behaving morally (Oxford 2011).<sup>1</sup> So yes, it is only proper to repay a 'gift' with a comparable (or more generous) one – *if* you want to maintain a good relationship. But it is up to the receiver to determine the value of the return gift, taking into account 'the context of each gift-giving situation' and the relationship shared by the giver and the receiver. As we've seen, the villagers' relationships with the government are problematic. Good *guanxi* with their neighbours, however, is priceless. Why would a neighbour want to make a mess of the relationships that he has so carefully cultivated over the years? It would not be because of a loan from a micro-finance programme. Interviews I conducted indicated that villagers considered it either unimaginable or extremely costly to apply social pressure to those defaulters whom they were not in certain types of relationships with.

Mr. Chen told me that there was one household that defaulted on their micro-finance loans. However, people considered it an affront to ask defaulters about the loans and therefore would not apply social pressure, as it would alter their carefully built relationships:

There was one family that didn't repay. . . . No one wanted to have a bad relationship with them, so no one said anything. . . . In their hearts, they might be unhappy and angry about this, but they wouldn't show it to the family that didn't repay.

So although they had a strong cash incentive, the villagers had an even stronger social incentive in the other direction. As one villager put it, 'Without the loans, we can get by. But if the *guanxi* is not good, then we can't get by'.

In another village, Mr. Chen (not related to the one above) explained that it was necessary, in order to preserve relationships, to remain inside the

boundaries of what was acceptable social behaviour. Asking about the loans or attempting to pressure people to repay was outside those boundaries:

Some others in the village thought that it wasn't good for those people not to repay, but they wouldn't say so to their face. They don't want to endanger their relationship. They try not to say anything negative or critical. It's a habit of ours. We're always like that. We don't say anything critical in order to keep the relationships good. You know in your heart what's wrong, and that's good enough.

This did not mean that villagers never told each other what to do, but the people seriously consider the consequences that verbal exchanges have on their relationships.

Mrs Sun conveyed to me the fact that participants in the micro-finance programmes felt a moral duty *not* to press defaulters. She was a 'small group leader' responsible for collecting repayments from the members of her group. She told me that outside of her group, there were two households whom everyone knew did not repay the loans. She seemed reluctant to talk about the two families, but as the interview progressed, she finally explained:

If I go ask about those two families, people will hate me. They will ask, 'Have you eaten too much and is that why you are trying to boss me around?' And not only will the two families dislike me, but all the kin of the two families will also hate me. I don't want people to hate me, so I don't ask.

An NGO staff person in the area remarked to me that if one of the villagers were to ask another one about repaying the loans outside of an appropriate relationship (one in which the asker already enjoyed a sense of dominance over the other, or in which the two were extremely close), it would be an embarrassing situation for the defaulter, causing that person to lose face. She explained to me that causing a specific person to lose face was a worse offence than causing the village to lose out on essential financial resources. In this context, losing face in the village is a blow to one's very humanity. (As mentioned earlier, public image is interrelated with self-image. Likewise, *guanxi* formation is also about self-formation.) Therefore, people are usually deliberate with their words, vigilant about only making someone else lose face when it is intended as retaliation.

Mr. Wang pointed out to me that despite the consequences to the community, someone defaulting on a loan just isn't important enough to warrant any real loss of relationship:

He did lose face. But everyone still talked to him, because they won't want to have a bad relationship with him. We all live together here in the village, and we've all been here for a long time. In their hearts, they might be unhappy and angry about this, but they wouldn't show it to the family that



didn't repay. The small group members talk to each other about it. But these loans are a small matter, not a big deal, and are not worth ruining relationships in the village for. The relationship is more important than the loans we miss out on.

'This is a small matter', Mr. Wang repeated later. It was merely a difference of opinion: 'People think differently – some think that they don't need to repay this loan'. Later, however, Mr. Wang revealed his resentment when he described those people as *xiao ren* – small people – which, in the Confucian sense, means that they are not moral.

'Do you mean *xiao ren* like Confucius said?' I asked. Mr. Wang responded, 'Yes, those people only think in the short-term, that they can keep this bit of money, rather than thinking about the long-term advantages of having loans every year'.

In this field site, then, people do not justify applying social pressure on the basis of financial incentives alone. All social pressure risks the loss of face, and causing people to lose face still destroys a relationship, even if everyone knows that there are financial incentives involved. Moral rules always apply.

In a different society, it might be completely acceptable to approach a neighbour and say, 'Your actions are costing me money, and I was wondering if you could do something about that. It's not personal'. But in this field site, such talk is ridiculous. Of course it's personal; everything is.

## **Conclusions**

I have used sociological theories as well as results from my fieldwork in rural China to help explain why micro-finance may not reduce inequality at all but actually reinforce it because of its inherent space in the overall structure of credit and money. The failures that have occurred when micro-finance organizations try to make profits is suddenly no surprise; it's a systemic problem. Because economic forces of contraction and expansion facilitate inherent inequities, asking people at the bottom to participate in the system isn't necessarily going to help them. Interest rates will likely be too steep, even with charity loans, where the interest charged is not enough to cover the operations. Further, the loans do not actually spur the entrepreneurship of Schumpeterian theory; he was not talking about poor people raising pigs or peddling fruit. The loans, however, might serve to augment consumption needs, to help a person of modest means weather the irregularities and shocks of poor harvests or illness.

When it comes to micro-finance – understanding how things work on the micro-level is necessary to *any* claims that things will perform as hoped on the macro-level. Local officials administering the micro-finance programmes do so in a specific cultural and historical environment where there is a particular

relationship between the state and the peasants. Also, the fieldwork indicates the importance of Simmel's point that the analysis of money must contain a set of interpretive techniques sensitive to how money is perceived. People will be making their decisions based on how they view money in the social context that they live in, and we cannot understand what they do apart from that context.

The group-lending structure, which transfers the monitoring and enforcement of the repayments onto fellow borrowers, was not something that fit into the social context of rural China. The villagers prioritized relationship cultivation – indeed, it was a matter of survival – over monetary gain. The lack of mobility in rural life and the nature of agriculture (which requires mutual help during planting, harvesting, and the vicissitudes of weather) makes social relationships particularly important to daily life in a way that those who design micro-finance programmes may not fathom. Also, the way the villagers talked about their social relationships was quite consistent with traditional ideas about *guanxi*, which encompass a particular (and longstanding) moral understanding of the proper way to treat other people.

The villagers, like most reasonable people, were interested in keeping up collaborative relationships, and this is certainly something that would be observed in other communities where people do not want to take on what they may perceive as the job of the outside lender in chasing after repayments. Improving quantitative models of micro-finance will require including the non-monetary and monetary costs of applying social pressure. Models that do not include the cost to the borrower of sanctioning defaulters are missing an essential component (Stiglitz 1990; Besley and Coate 1995; Armendáriz de Aghion and Morduch 2010), and neglecting to account for the cost incurred in applying social pressure can muddy a determination of whether there is, in fact, a mechanism in place at all to ensure repayment.

In this field site, pressuring someone to repay would cause that person to 'lose face', and bringing such shame to another person is considered immoral and will certainly damage a very valuable relationship. Other reasons that social pressure may incur a cost include a blow to social hierarchy, lack of conformation to social roles, or other types of moral trespasses. Additionally, whenever it is considered wrong for someone to pressure someone else, efforts to do so will likely be ineffective. Even without specific cultural rules, there are costs in applying social pressure arising from basic reciprocity wherever people are interested in maintaining relationships with their neighbours or other borrowers.

Beyond trying to improve programmes and the specifics of the case examined in rural China, however, perhaps the most valuable thing this article has offered is an explanation – based on credit theory – for why micro-finance inherently (if unintentionally) does not serve the poor. Six years after receiving the Nobel Peace Prize jointly with the Grameen Bank, Muhammad Yunus is

being named one of *Fortune's* twelve greatest entrepreneurs of our time (Byrne 2012). This is both ironic and fitting: ironic that in promoting micro-finance, his use of the term 'entrepreneur' had very little to do with the actual Schumpeterian notion of the entrepreneur as an innovator. But it is fitting that he is receiving a congratulatory title from a bastion of capitalism (as opposed to the Nobel Peace Prize, which is for fraternity between nations, abolition of standing armies, and peace congresses). The new title is given to Yunus not because he helped create entrepreneurs, but *as* an entrepreneur himself – meaning that he is being recognized for spawning an innovative new profit-making industry.

Some authors have similarly been turning the micro-finance model around so that the lending institutions themselves are the Schumpeterian heroes. Then the image of micro-finance becomes reduced from that of an agent of the world's economic development and poverty alleviation to simply a source of extra cash for the poor as they weather life's unexpected storms (Roodman 2011). This award from *Fortune* actually makes more sense – Yunus did innovate a new blend of services and products that changed the industry – but the money made, apparently, is not for the poor.

(Date accepted: October 2013)

## Note

1. It is well known that moral ideas play an important role in how people deal with money. Bloch and Parry argue that viewing money as neutral, impersonal, and damaging to interpersonal bonds is a product of particular cultural assumptions. Money has powers to depersonalize only in societies

where it 'signifies a sphere of "economic" relationships which are inherently impersonal, transitory, amoral, and calculating' (1989: 9). In reality, people use money (including credit) in a way that is consistent with the things they find morally significant (Guyer 2004; Maurer 2006; Peebles 2010).

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