

The Commercialization of Microfinance in Mexico: Efficiency or Exploitation?

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ABSTRACT

This thesis seeks to analyze the commercialized developments of the microfinance industry in Mexico. Additionally, I will trace the history of poverty and inequality in Mexico, with an emphasis on urbanization and the informal sector. This thesis will also explore the parallels between the philosophies behind commercialized microfinance and neoliberal economics. Utilizing industry literature, academic sources, and personal interviews, this thesis analyzes the contemporary for-profit microfinance industry in Mexico, by addressing themes such as operating practices, regulation, consumer protection, collection methods, and interest rates. The microfinance institutions Banco Compartamos, Financiera Independencia, and Banco Azteca, among others, will receive considerable focus. The author concludes that a commercialized approach could potentially expand the scope of microfinance activities in a significant way, but that some operating practices are harmful to poor clientele. In order to increase consumer protection for poor customers, the author recommends that transparency laws and regulations be more strictly applied.

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1. Introduction

In the summer of 2008 I went to Oaxaca de Juárez¹, Mexico to conduct field research on microfinance² practices. My intent was to document the impact that microfinance services had on the lives of the poor clientele who were receiving the microloans. I was fortunate to have received considerable assistance from Eva, a loan officer for *Financiera Independencia*³ (FI), a for-profit microfinance institution (MFI) in Oaxaca. As we talked, Eva quickly informed me that she was not wholly pleased with her work as a loan officer, as she felt that some of FI's operational practices systematically took advantage of poor *Oaxaqueños*. I found Eva's thoughts particularly intriguing, given that her comments reflected a darker, less-advertised side of microfinance. After speaking with Eva, I found that the for-profit microfinance industry was having a more dynamic, complex impact on its clientele than most microfinance literature was portraying. While "feel-good" success stories prominently appear on the websites of both for-profit and non-profit MFIs, there was a missing narrative involving those whose lives were harmed by the debt obligations resulting from microfinance services. This thesis plans to address this narrative, while also discussing the operational practices of for-profit microfinance services and the way in which they impact poor clientele.

Eva repeatedly referred to FI's manipulation of interest payments and excessive penalties imposed on clients for late payments. When asked what sort of impact such operational practices have on poor Oaxacan clients, she responded:

In Oaxaca, salaries are minimal...so, it affects them economically. It's possible they're not going to be able to eat. It's going to affect what's in their basic food basket. They're

¹ Oaxaca de Juarez is the capital of the state of Oaxaca. From this point on I will refer to Oaxaca de Juarez simply as Oaxaca, and the state of Oaxaca as Oaxaca State.

² Banking and/or financial services targeted to low- and moderate-income businesses or households, including the provision of credit. "Glossary." ProMujer. <https://promujer.org>.

³ From this point on, this paper will refer to Financiera Independencia by using the abbreviation "FI"

not going to eat bread anymore. They're not going to eat meat anymore. No tortillas. Their children's diet will suffer.⁴

While microfinance may be a pathway out of poverty for millions around the world, the reality of its practices presents a complicated scenario. An increasing number of MFIs operate according to a commercialized⁵, market-oriented model, whose collection practices and penalties have consequences that are not beneficial to the customer. Eva described the impact that some of these loans can have on the customers:

They'll sell their house deed in order to pay back a loan to FI. If they're scared, they'll pawn the deed to their house, even if it is made of sheet metal, or whatever other property in order to pay back FI. At times they'll pawn everything they have to pay FI, and still not have enough to fully pay back the loan. So, the FI still seizes everything they have anyway and they're ultimately left with nothing.⁶

Since ninety percent of the world's poor have no access to formal credit or savings, microfinance has great potential to help the poor in developing countries.⁷ Although \$25 billion in microloans have already been dispersed, it is estimated that the world demand is \$250 billion, so there is much progress to be made.⁸ It is widely believed that a non-profit approach is not globally affordable because the demand cannot be met through donations and government-based programs.⁹ With approximately 200 million impoverished people in Latin America¹⁰, it is imperative that the microfinance industry expand in order to meet the potential demand.

A legitimate and stable microfinance industry can provide economic opportunities for a population that has traditionally been excluded from formal channels of finance. However, the

⁴ Eva. Personal Interview. 9 July, 2008.

⁵ To develop commerce in; to manage on a business basis; a market approach; a financial-systems approach. Robert Peck Christen and Deborah Drake. "Commercialization: The New Reality of Microfinance." In *The Commercialization of Microfinance: Balancing Business and Development*, eds. Deborah Drake and Elisabeth Rhyne. Kumarian, 2002: 2.

⁶ Eva. 9 July 2008.

⁷ Marguerite S. Robinson. *The Microfinance Revolution: Sustainable Banking for the Poor*. World Bank, 200: 9.

⁸ Elisabeth Malkin. "After Success, Problems for Microfinancing in Mexico." *New York Times* 5 April 2008.

⁹ Robinson 8

¹⁰ Roberto Patricio Korzeniewicz and William C. Smith. "Poverty, Inequality, and Growth in Latin America: Searching for the High Road to Globalization." *Latin American Research Review* 35.3 (2000): 15.

methods for expanding and offering microfinance services in Latin America vary widely. This thesis seeks to analyze how for-profit microfinance has been implemented in Mexico and how the commercialization of an industry that was once focused on poverty reduction has created intense controversy.

In Latin America, a large segment of the poor population currently participates in the informal economy.¹¹ Within the last thirty years most Latin American governments have come to recognize that informal economic activities can impact a nation's macroeconomic success.¹² The fact that microfinance services are directed primarily to microentrepreneurs¹³ and informal workers indicates that a healthy, expansive microfinance industry can have positive effects for the well-being and security of Latin American economies at local, regional, national, and continental levels.

A strong microfinance industry is capable of delivering much-needed financial services to a massive informal sector that has traditionally lacked access to legitimate channels of credit. Some argue that a commercial, for-profit approach would be the most feasible way to deeply impact this population on a long-term basis, while detractors claim that this market-oriented model would simply re-isolate the poor in the same way that the free market always has. This thesis will address this schism, which is the most basic point of conflict in twenty-first century microfinance.

¹¹ Refers to economic activities in which workers or entrepreneurs do not fulfill the legal obligations that correspond with the production or distribution of a good or service. Juan Froilán and Martínez Pérez. "El sector informal en México." *El Cotidiano* (Mar/Apr 2005): 31.

¹² Maria Otero. "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America." In *Contrapunto: The Informal Sector Debate in Latin America*. Cathy Rakowski, ed. Univ. of NY Press, 1994: 186.

¹³ Owners of microenterprises.

Focus of Research

When describing the operational practices of commercialized MFIs, including FI, *Compartamos*, and *Banco Azteca*, among others, Eva frequently employed the word *tramposo*, which can translate to “tricky, crooked, or cheating.” Her explanation of the operational practices of commercialized MFIs, especially their collection practices, is starkly different from the positive portrayals that typically have been prominent in literature published by industry analysts, scholars, and investors. These tend to depict for-profit microfinance activity in measurements based on financial returns, rather than social impact. Eva’s portrayal is neither comprehensive nor wholly indicative of the microfinance experience, yet it does put forth a valid interpretation that directly pertains to the contemporary debate surrounding commercialized microfinance activities in Latin America.

With its foundations as a tool for poverty reduction, how did microfinance evolve to its current position, where accusations of treachery and preference for profits over poverty alleviation are commonplace? In Latin America, microfinance emerged in the 1980s as an activity promoted by non-governmental organizations¹⁴ and governmental agencies. Many skeptics felt that providing credit to poor populations would never be financially sustainable and that such programs poorly utilized precious government and donor funds. However, by the mid-1990s, several Latin American MFIs proved that their practices were indeed sustainable over the long-term. This financial success inspired several MFIs to hypothesize that microfinance activities could in fact be profitable, and within years of the turn of the Twenty-first Century, for-profit MFIs were also operating throughout Latin America. However, with reports of questionable operating practices similar to those described by Eva, many wonder whether this current model of commercialized microfinance achieves its stated goal of poverty reduction.

¹⁴ Also commonly referred to as NGOs

This unfortunate reality represents the basic schism in the debate involving commercialized microfinance and non-profit microfinance, which lies at the heart of this thesis. Will the pursuit of a microfinance model based on financial returns inevitably and systematically marginalize the clients that it is professing to serve? Could the impoverished of Mexico be better served by MFIs that operate under a model based on social returns? Can for-profit MFIs truly improve the well-being of their customers if their two bottom lines, social returns and financial returns, are potentially in conflict? While the commercialized model is clearly superior in terms of outreach¹⁵ and portfolio quality¹⁶, it is important to ask whether these attributes truly justify diminished social returns.¹⁷

I have concluded that the commercialized model has the potential to be an effective approach to microfinance, but that its extremes could have detrimental effects on the microfinance industry as a whole. Some of these dangers include earning profits that are rooted in charging high interest rates to poor clientele, systematically accruing interest-based debt, and operating without consumer protection regulations, all of which could lead to the absence of a repeat-customer base and/or an overlending crisis. Nonetheless, I support Muhammad Yunus'¹⁸ claim that a capitalistic approach to poverty reduction is both more financially effective and personally empowering than large scale development programs and traditional social improvement programs that more resemble welfare programs than poverty reduction programs. I will elaborate on Yunus' methodology while discussing the framework of the thesis and the literature review.

¹⁵ An MFI's effectiveness in reaching its target market and distributing its product

¹⁶ An MFI's ability to foster security and stability in its funds.

¹⁷ The "bottom line" for not-for-profit microfinance institutions that primarily seek to improve the social well-being of their customers, rather than pursuing profits

¹⁸ Nobel Peace Prize winner who founded Grameen Bank in Bangladesh. He is informally credited with jumpstarting the microfinance industry. The Grameen model practices non-profit methodology, thus Yunus has been very critical of commercialized microfinance activity. Grameen Bank has distributed billions of dollars in microloans and has a near-100% repayment rate. "A Short History of Grameen Bank." 1998. Grameen Communications. 13 May 2008 www.grameen-info.org.

Research Methodology

This thesis utilizes both primary research compiled in the field as well as secondary sources, addressing the theoretical and practical framework of commercialized microfinance activities and informal economics. Due to structural fallacies in traditional, market-oriented financing, the global poor have long been marginalized from formal banking services. With the advent of market-oriented microfinance, it is possible that such marginalization could occur again and that commercialized microfinance will be transformed from a tool for poverty reduction into yet another development program that benefits the global elite. High profits earned by commercialized MFIs, such as *Compartamos*, *Banco Azteca*, and *Financiera Independencia*, are well-publicized. In the public discourse, supporters and critics of the commercialized model generally come from high-level industry insiders; the voice and opinions of the poor clientele remain unheard. In order to gain a greater insight into the thoughts of the silent majority, the clients, I conducted interviews with eight microloan borrowers in Oaxaca, Mexico. The microloan borrowers patronized *Financiera Independencia*, *Banco Azteca*, and *Caja Popular Mexicana*, which are all for-profit MFIs. Additionally, I was able to extensively interview one loan officer from *Financiera Independencia*.

As an MA student at the University of Kansas and funded by a summer research grant from the Tinker Foundation, I conducted field work in Oaxaca during the summer of 2008. While in Oaxaca I communicated personally with those involved in microfinance activities. While speaking with a supervisor at FI, I met a young loan officer named Eva who offered to help me with my research. Between July 7, 2008 and July 18, 2008, she took me to meet some of her clients who she felt would be willing to participate in interviews. Some agreed and others

declined the request. In this time period I was also able to conduct extensive interviews with Eva, discussing the positive and negative characteristics of FI's operating practices.

Eva selected potential candidates for interviews. She normally attempted to contact some of them by telephone in order to set up the interview, but sometimes we took a bus or taxi to their home or business in order to meet with them. Eva asked her clients if they would be willing to participate in a short interview with an American student who was doing research on microfinance activity in Mexico.

After talking to Eva about the scope of my research, she became more interested in learning about other MFIs in Oaxaca and how small businesses acquired their capital either initially to start their businesses or to expand their operations. Thus, we met multiple microentrepreneurs on the street and in market places. Due to the delicate nature of the conversations, it was difficult to know if the microenterprises fulfilled all their legal obligations or if they were operating informally.

Additionally, Eva and I spoke with representatives from other financial institutions, such as the downscaled¹⁹, commercialized MFI *Banco Azteca*. Representatives from these organizations explained to us the types of loans that they provided and the costs associated with them, including entrance fees, account opening fees, and interest rates.

Of the eight interviews I conducted, six participants used the loan for business purposes, one used the loan strictly for personal reasons, and another used the loan to expand the size of her home, which was also the site of her bakery. All the interviews were conducted either at the client's home or place of business. Eva was present during all three of my interviews with FI clients. Responses varied widely, so it was difficult to say if Eva's presence compromised the

¹⁹ An MFI that has gone from providing traditional, commercial lending services to the provision of microfinance services

nature of the interviews. However, of the subsequent interviews in which Eva assisted me, her status as a loan officer with FI was a non-factor due to the fact that the interviewees were not FI clients.

There were several base questions that I always posed during the interview, but I encouraged the participants to control the conversation. My goal was to find out what type of loan the interviewee had, what its intended use was, and how they felt about their experience with the particular MFI. Loans could have been for business use, personal use, or a combination, so experiences were dependent on the client's desired outcome. Participants generally spoke of how they acquired the loan and why they felt that it would improve their livelihood. I tried to create an atmosphere in which participants felt comfortable being honest and free to express themselves.

The feel of the interviews varied widely given that some participants were not expecting to meet with me. Some interviews took place at the client's place of business, and some met with me in their home. Thus, the length of the interviews varied significantly. The shortest interviews were no more than a couple of minutes, while the majority lasted between ten and twenty minutes. My conversations with Eva, which spanned nearly three weeks, addressed a multitude of issues, including microfinance activities. I typically started the interview with the same set of questions. For some of the interviews that were particularly impromptu, I was never able to move beyond the basic set of questions. However, when time and location were suitable, I was able to engage participants in a layered conversation about the matters at hand. Generally, I did nothing more than guide the interview, allowing the clients to speak as freely as possible. I documented all interviews with a small, portable recorder in order to guarantee accuracy in my research. The names of all participants have been changed in order to protect their privacy.

The field research for this thesis was conducted in Oaxaca de Juárez, the capital city of the southern Mexican state of Oaxaca. Surrounded by the states of Chiapas, Guerrero, Puebla, and Veracruz, Oaxaca State possesses extensive forests, coastlines along the Pacific Ocean, and the Sierra Madre mountain range. Oaxaca State is approximately 94,000 square kilometers and has a population of more than 3.5 million. The service sector constitutes the highest level of productivity, holding a 28% share, followed respectively by real estate, commerce, manufacturing, transport, communications, and agriculture. Compared with Mexico's national GDP per capita of \$14,200, Oaxaca's GDP per capita of \$6,200 makes it one of the poorest states in the country. Oaxaca contributes approximately 1.5 percent to Mexico's national GDP.²⁰

With more than 55 percent of the state's population living in rural villages with populations of 2,500 or less, rural life dominates the state and characterizes *oaxaqueño* life. Many of the state's inhabitants have indigenous heritage, with 35 percent of the population speaking an indigenous language, primarily Zapotec, Mixteca, Mazateca, and Mixe. Education levels are particularly low in Oaxaca. Of all adults over the age of 15, 18 percent have never attended school and the majority has never studied past primary school. Oaxaca de Juárez, the state capital, has slightly more than 400,000 inhabitants and is the state's primary urban area.

I chose Oaxaca de Juárez as the location for my fieldwork because it is both a low-income city and has a high concentration of programs for poverty alleviation. While such poverty reduction programs in the past mostly stemmed from NGOs with a social mission, recent developments in the microfinance industry facilitated the emergence of commercialized MFIs. These institutions now operate in the same market as socially-conscious NGOs and traditional banks. This dynamic was particularly intriguing when viewing how increased competition affected the operational practices of rival institutions.

²⁰ Oaxaca. <http://cuentame.inegi.gob.mx>.

Figure 4 – Location of Oaxaca within greater Mexico²¹



Additionally, literature on the informal sector and microfinance tend to focus on either major urban areas, such as Mexico City, or rural areas, such as the Oaxacan mountain communities. The profile of a relatively small urban area, such as Oaxaca de Juarez, appears to be absent in microfinance literature. Hopefully this thesis will contribute to further analysis on areas that are neither absolutely rural nor urban, but possess characteristics of both.

Theoretical Framework

The theoretical framework for this thesis is based on arguments put forth by microfinance industry leaders that I categorize into two separate groups: pro-commercialization and anti-commercialization. The pro-commercialization, or for-profit, groups can be characterized by their embrace of free-market philosophy and their drive to deliver financial returns to investors.

²¹ "Oaxaca." Encyclopædia Britannica Online. <http://student.britannica.com>.

The anti-commercialization, or non-profit, groups can generally be defined by their desire to create social returns for customers and their practice of re-investing all profits back into the MFI, rather than returning profits to investors who then can decide whether or not they want to re-invest or keep their earnings. There are some ideas that both groups promote, while some ideas remain major points of disagreement. These commonalities and differences will be discussed in more detail in Chapter 4. The pro-commercialization and anti-commercialization groups agree on these two points:

- Global poverty is so immense that it cannot be addressed solely by programs funded by governments and private donors. Not only are donor- and government-based poverty reduction programs inefficient and expensive, but they are not sustainable. Therefore, this approach does not offer a long-term solution to eliminating poverty.
- A capitalistic approach to poverty reduction that emphasizes small business growth empowers poor citizens. Traditional donor- and government-based poverty alleviation programs resemble welfare programs that contribute to the cycle of poverty because they do not offer a legitimate pathway to improvement and self-sufficiency. Microloan programs put clients in control of their own future and allow them to take more control of economic decision-making in their lives.

The pro-commercialization group is composed of industry leaders such as Maria Otero, Elisabeth Rhyne, and Marguerite Berger. These authors believe that the commercialized model of microfinance must be embraced because it will impact the greatest number of impoverished people. In pursuing this commercialized model, it is necessary to attract investors so that the MFI can expand. This type of expansion requires high returns that bring profits back to investors. It is

understood that as profits rise and clients increase in number, the loans must be meeting the customers' needs. Some of their key points include:

- If a commercialized MFI expands, it is because it has a strong product that pleases the customers. In a free-market model, if the product were poor, then customers would simply choose to patronize a rival company. Therefore, a good product would inherently improve the life of the customer who utilized it. In this scenario there are multiple winners, particularly the customers whose livelihoods were made better by access to the loan and the company whose financial model ensured that a repaid loan would result in strong investor returns and a happy customer.
- In order to provide credit access to the highest number of people, an MFI's outreach and ability to expand into new markets must be high, which requires large amounts of capital. MFIs that are dependent on government subsidies or private donations do not have such freedom to expand and respond to market needs. In order to acquire such capital, commercialized MFIs need to attract investors and generate profits. High financial returns appeal to investors who receive profits and are more likely to reinvest in a particular MFI, thus allowing the institution to grow and impact more poor citizens. This increased access to credit would potentially decrease the level of poverty in the particular market in which the MFI operates.

The anti-commercialization group, of which Muhammad Yunus is the undesignated head, is composed of leaders from socially conscious NGOs, such as Jonathan Lewis of MicroCredit Enterprises and Lynne Patterson of ProMujer. Yunus has put forth the most detailed plans for how microfinance should move forward, with poverty alleviation as its primary goal. Yunus gives several recommendations:

- Traditional free-market ideology has suffered from a conceptualization failure due to the fact that human beings are viewed as one-dimensional figures that only focus their energy on maximizing benefits for the individual or immediate family. From the free-market perspective, happiness for humanity can be best fulfilled and society can be best served by pursuing profit maximization. For Yunus, widespread poverty and economic marginalization are structurally inevitable within the free-market. In order to compensate for the shortcomings of the free-market ideology, Yunus recommends that a form of socially-conscious capitalism be introduced into microfinance and traditional business practices.
- Access to credit is a basic human right. In order to prevent financial marginalization for the poor, MFIs need to abide by two fundamental principles. First, lending needs to be based on the expectation that clients *will* repay the loans, rather than the institution distrusting the clients' ability to repay. Secondly, an MFI's structural format must mandate that *all* profits be directly re-invested into more poverty reduction campaigns. Yunus views personal enrichment from the labor of the impoverished to be ethically and morally reprehensible.

This thesis will utilize many of the ideas promoted by these two groups in order to comprehensively explain the complex dynamic of the contemporary debate on microfinance. In addition, the thesis will use literature on the informal sector and urbanization in order to explain the ways in which Latin America's poor have been financially marginalized from a formal economic system based on free-market ideology. I will address whether commercialized, free-market microfinance poses the same risk to the poor as the traditional, market-oriented economic system. Using interviews conducted in Oaxaca, Mexico, this paper will demonstrate how clients'

experiences with microfinance have either been financially inclusive or exclusive, and whether or not their microloan truly improved their economic standing.

Organization of Research

This thesis will be composed of six chapters, including the introduction. The remaining chapters are arranged as follows:

Chapter 2 will provide definitions of important ideas and practices, such as microfinance, microcredit, and microenterprises, among others. The chapter will also review important literature regarding microfinance, informal economics, urbanization, and poverty.

Chapter 3 addresses the roots of economic marginalization in Latin America and how the impoverished adapted to specific economic and political conditions by utilizing improvisational economic activities in order to survive. Themes such as urbanization, import-substitution industrialization, neoliberalism, poverty incidence, inequality, and the urban informal sector, have all contributed to the development of the non-profit and for-profit microfinance industries.

Chapter 4 will look at how microfinance emerged as a response to the failings of traditional development programs and financial institutions. It will also discuss how the microfinance industry evolved from a strictly non-profit methodology into a more commercialized industry. The chapter will analyze the theoretical operational practices of commercialized and non-profit MFIs in Latin America and demonstrate the theoretical successes and failures of the two competing methodologies. Additionally, it will discuss the parallels between neoliberal philosophy and the theory of commercialized microfinance.

Chapter 5 will look at the operating practices of commercialized MFIs in Mexico. Based on my fieldwork in Oaxaca and secondary sources, I will portray the complex dynamics of the

contemporary state of the for-profit microfinance industry. The chapter will discuss interest rates, collection practices, the entrance of profit-seekers into the industry, and the role of regulation in Mexican microfinance practices.

Chapter 6 will provide my conclusions and will include my recommendations on legislation changes and lending practices, such as increased regulation and transparency.

2. Definitions of Microfinance and Literature Review

In this chapter I will define and explain the concept of microfinance. I will also explain what a microenterprise is and how it is defined. This chapter assumes that much of Mexico and Latin America live below the poverty line. While I will briefly touch on the subjects of poverty and informality, Chapter 3 will explore the two themes in more detail. In addition, this section will superficially reference the two conflicting approaches of microfinance; Chapter 4 will discuss the two approaches in greater length.

Defining Microfinance

Of all the varying definitions of microfinance that exist, ProMujer²² provides a concise explanation that summarizes and paraphrases many of the others. Microfinance is “banking and/or financial services targeted to low-and-moderate income businesses or households, including the provision of credit.” In addition, microcredit is “part of the field of microfinance” and generally is recognized as “the provision of credit services to low-income entrepreneurs.”²³ Some MFIs also offer consumer loans to their customers. As a broad field, microfinance can include, in addition to microcredit, savings, insurance, and remittance services. Microfinance originated as a tool for poverty reduction because it was believed that lack of access to credit was one of the factors that perpetuated poverty. If the poor can use credit to capitalize income-creating activities, then their income will grow and their condition will improve.²⁴

Some commercialized MFIs view microfinance as outside of the scope of social consciousness. In contrast, for-profit MFI *Compartamos* believes that “microfinance has to be

²² A non-profit MFI that provides services in Argentina, Bolivia, Nicaragua, Peru and Mexico

²³ “Glossary.”

²⁴ John Weiss and Heather Montgomery. “Great Expectations: Microfinance and Poverty Reduction in Asia and Latin America.” *Oxford Development Studies* 33.33/34 (Sept.-Dec. 2005): 395.

treated as finance, because it is no different from it.”²⁵ *Compartamos* co-CEO Carlos Danel elaborated: “A lot of people have suggested that financial inclusion can be a poverty alleviation tool. We're not out to prove that. We're out to provide financial services as opportunities to (sic) these clients, realizing that some people might make better use of them than others.”²⁶

For critics of the commercialized approach, such a decrease in social focus causes organizations such as *Compartamos* to cease to be microfinance institutions. According to Muhammad Yunus, poverty reduction is the essence and ultimate goal for microfinance. He claims that commercialized MFIs fog the meaning of what microfinance is and is not, and proposes that two categories of microcredit programs be implemented.

- a) Type 1: Poverty-focused Microcredit Programs – These are poverty-focused, collateral-free, low-interest microcredit programs. Grameen Bank was created to provide this type of microcredit. Type 1 programs charge interest rates that fit into one of two zones: the Green Zone, which equals the cost of funds at the market rate plus up to 10%, and the Yellow Zone, which equals the cost of funds at the market rate plus 10 to 15 percent. Only Type 1 programs contribute to poverty reduction.
- b) Type 2: Profit-Maximizing Microcredit Programs – These are programs that charge an interest rate higher than the Yellow Zone. They operate in the Red Zone, which is moneylenders’ territory. Because of the high interest they charge, these programs cannot be viewed as poverty-focused but rather are commercial enterprises whose main objective appears to be earning large profits for shareholders or other investors. Type 2 programs should focus their operations on people belonging to the lower-middle class and above.²⁷

Based on these descriptions, it becomes clear that both non-profit and for-profit MFIs earn a profit. In order to sustain themselves and expand, non-profit MFIs must create a financial surplus. Non-profit MFIs, especially those that follow the Grameen model, must reinvest any and all profits back into the MFI so that they may continue to grow and increase their outreach. With for-profit MFIs, some profits go back to investors, who then have the option to reinvest or to

²⁵ Carlos Danel and Carlos Labarthe. “A Letter to Our Peers.” *Compartamos*. 17 June 2008: 3.

²⁶ Keith Epstein and Geri Smith. “Compartamos: From Nonprofit to Profit; Behind Its Gentle Image Is a Tough, Highly Lucrative Bank.” *Business Week* vol. 4064 (December 24, 2007): 45.

²⁷ Muhammad Yunus. *Creating a World without Poverty*. Public Affairs, 2007: 68-9.

simply keep their profit. ACCION International²⁸ and *Compartamos* frequently maintain that most profits are reinvested into the expansion of microfinance services.

Compartamos, the largest MFI in Mexico and Latin America, acknowledges that they do not serve the poorest of the poor because that was never their intent. The poorest of the poor need more urgent financial services than *Compartamos* is willing to provide. Nonetheless, *Compartamos* believes that they are providing working capital to a low-income sector of Mexico that is also marginalized from receiving adequate financial services.²⁹

The traditional, poverty-based approach and the commercialized, for-profit approach share a common thread in that they both provide financial services to microentrepreneurs. In the next section I will explain the extraordinary importance of the microenterprise sector in the Latin American economy.

What Is a Microenterprise?

Between 1990 and 1998, 60% of the new jobs created in urban Latin America originated from microenterprises.³⁰ Additionally, the Inter-American Development Bank estimates³¹ that 50% of the workforce throughout Latin America works within the microenterprise sector.³²

Microfinance institutions are the only legal source of credit for these enterprises, many of which are informal. Yet, how does one define a microenterprise?

²⁸ ACCION International is a private subsidiary of the Inter-American Development Bank. Founded in 1961 during the Alliance for Progress, ACCION has provided counsel, channeled investment and received funds from USAID. It has been involved in Latin American microfinance for over thirty years and was a major investor in *Compartamos*.

²⁹ Danel and Labarthe 2

³⁰ Alejandro Portes and Kelly Hoffman. "Latin American Class Structures: Their Composition and Change during the Neo-Liberal Era." *Latin American Research Review* 38.1 (2003): 48.

³¹ Based on a measurement that defines a microenterprise as a business with less than 10 employees. This definition is widely used by the Inter-American Development Bank and the World Bank

³² María Beatriz Orlando and Molly Pollack. "Microenterprises and Poverty: Evidence from Latin America." Inter-American Development Bank, 2000: 3.

Based on information from Mexico's National Institute on Geography and Statistics (INEGI), the definition of a microenterprise has changed considerably, with the official categorization measures changing five times between 1990 and 2002. The first four changes were made by the *Secretaria de Comercio y Fomento Industrial*. The fifth was by the *Secretaria de Economia*.³³ Additionally, the categorization of a business depends on the specific sector in which the industry is located. It is important to note the disparities in measurement in Figures 1, 2, and 3.

Some measurements are based on the number of employees, while others are based on a company's net sales. Additionally, measurements may still vary depending on the particular economic sector in which they operate. Such diverse definitions of what constitutes a microenterprise can have serious ramifications on how governments and NGOs view the actors in a particular economy, which could potentially lead to a misallocation of resources if microenterprises are either underrepresented or overrepresented.

For example, the United States Agency for International Development, or USAID, defines a microenterprise as "a business, usually informal, with ten or fewer employees."³⁴ In 2007, USAID had a budget of \$24 billion and allocated approximately \$308 million for microenterprise development throughout the world.³⁵ With such a large amount of money to disperse, it is imperative that USAID and similar institutions accurately identify its target market.

Figure 1 illustrates how the Mexican government defines the size of all businesses, without distinguishing between the manufacturing,³⁶ commercial,³⁷ and service³⁸ industries. The

³³ *Micro, pequeña, mediana y gran empresa: estratificación de los establecimientos*. Censos Económicos 2004. Instituto Nacional de Estadística Geografía Informática, 2006: 9

³⁴ "Interim Update, 08-02." USAID. 25 April 2008.

³⁵ "Agency Financial Report Fiscal Year 2007." USAID: 12, 80

³⁶ Includes economic units that are principally engaged in the manufacturing of mechanical, physical, or chemical substances or materials, in order to create new products. The following are also considered manufacturing activities: *maquilas*, the assembly of parts and components or products, the reconstruction of industrial machinery and equipment, commercial, office and others, and the finishing of manufactured products by dyeing, heat treatment,

government places great importance on annual net sales when categorizing a business as micro, small, medium, or large. The number of employees in an enterprise seems to be a less important indicator than the enterprise's net sales. Based on the measurement of a microenterprise as one with annual net sales of less than 30 million pesos, microenterprises comprised more than 40% of all economic activity in Mexico in 2002. This is quite a remarkable unit of measurement, due to the fact that many people would not consider a company with dozens of employees and net sales of 30 million pesos (roughly US \$2.2 million) to be a microenterprise.

Figure 1 –Criteria for Categorizing a Microenterprise, without Industry Specifications³⁹

Size of Company	# of Employees	Annual Net Sales (Mexican pesos)	% of Overall Economic Activity ⁴⁰
Micro	Maximum of 100	Maximum of 30 million	42.1%
Small	Maximum of 100	Maximum of 400 million	14.7%
Medium	Maximum of 250	Maximum of 1 billion	16.1%
Large	N/A	More than 1 billion	27.1%

plating and similar processes. Also included is the mixture of materials, such as lubricating oils, plastic resins, paints and liquor, among others. In *Micro, pequeña, mediana y gran empresa: estratificación de los establecimientos*. 21.

³⁷ Includes economic units principally engaged in the buying and selling of goods (without any alteration) in a transitory stage, and activity that is comprised of economic units dedicated to the buying and selling of goods for consumption. In *Micro, pequeña, mediana y gran empresa. Estratificación de los Establecimientos*: 71.

³⁸ Includes activity in mass media, financial services and insurance. Renting, real estate services and property, scientific and technical professional services, corporate and business management, business support, waste management services, educational services, health services and social welfare, cultural or recreational sport, housing and restaurants, and other services (except government) including: 1) maintenance and repair services such as car repair or home repair, 2) personal services such as barbers, salons, laundry, 3) associations and organizations such as religious groups, political, civil, 4) household services such as maids and cleaners. In *Micro, pequeña, mediana y gran empresa. Estratificación de los Establecimientos*: 121

³⁹ *Micro, pequeña, mediana y gran empresa: estratificación de los establecimientos* 10

⁴⁰ *Micro, pequeña, mediana y gran empresa: estratificación de los establecimientos* 18

Figure 2 – Criteria for Categorizing a Microenterprise, with Industry Specifications⁴¹

Size	Sector		
	Manufacturing Industry	Commercial Industry	Service Industry
	# of employees		
Micro	0-10	0-10	0-10
Small	11-50	11-30	11-50
Medium	51-250	31-100	51-100
Large	Over 251	Over 101	Over 101

Figure 3 – Criteria Set by the EU, the OECD⁴², and CEPAL⁴³

EU and OECD		
Size of Company	# of Employees	Annual Net Sales
Micro	1-9	Under 2 million Euros
Small	10-49	Under 10 million Euros
Medium	50-249	Over 50 million Euros
Large	Over 250	Over 50 million Euros
CEPAL		
Size of Company	# of Employees	Annual Net Sales
Micro	Under 4	N/A
Small	5-49	N/A
Medium	50-250	N/A
Large	Over 251	N/A

When gauging the size of a business *and* distinguishing between industry sectors, the criteria begin to change. In Figure 2, the most obvious difference is that annual net sales cease to be an indicator. Although the definition of a microenterprise remains the same across all sectors, it is important to note the striking difference between the two governmental categorizations. Without distinguishing between sectors, as seen in Figure 1, a microenterprise could have up to 100 employees. Yet, when identifying specific industries, as in Figure 2, there is no sector that has more than ten employees and is considered a microenterprise. Perhaps the most significant fact is

⁴¹ “Micro, pequeña, mediana y gran empresa: estratificación de los establecimientos” 10

⁴² “Micro, pequeña, mediana y gran empresa. estratificación de los establecimientos” 12

⁴³ “Micro, pequeña, mediana y gran empresa. estratificación de los establecimientos” 12

that the 2004 Economic Census was only measuring formal businesses, leaving out informal microenterprises.

Outside of Mexico, the standard for measuring business sizes varies significantly. As Figure 3 illustrates, the standards proposed by the European Union (EU) and the Organization for Economic Co-Operation and Development (OECD) are distinct from those of *La Comisión Económica para América Latina y el Caribe* (CEPAL) in that the EU and OECD use annual net sales and the number of employees as qualifiers, whereas CEPAL does not concern itself with net sales. Again, the variety of categorizations may impact how foreign governments, financial lending institutions, and social investors interpret the size and importance of microenterprise activities.

International researchers take divergent approaches as well. In a study conducted for the International Labour Organization,⁴⁴ Bernd Balkenhol uses a definition of microenterprise that follows the model seen in Figure 2, which categorizes a microenterprise as having under ten employees.⁴⁵ In *The Microfinance Revolution: Sustainable Banking for the Poor*, which was published by the World Bank, Marguerite S. Robinson defines a microenterprise not necessarily by its size, but by what it does: “Businesses whose owner or employees produces, recycles, repairs, or sells goods; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicle, draft animals, or machinery and tools.”⁴⁶

Yet, under a commercialized model, the definition of a microenterprise may be unimportant due to the fact that clients are free to take out a loan based on their own purposes rather than based on the guidance of an NGO or a government program. Additionally, if the microfinance

⁴⁴ United Nations agency that promotes employment opportunities across the globe, emphasizing freedom, equity, security, and human dignity

⁴⁵ Bernd Balkenhol. *Microfinance and Public Policy*. Palgrave, 2007: 201.

⁴⁶ Robinson 9

industry continues the commercialization trend, governments and international lending institutions could become less integral to the allocation of resources for microenterprise development, thus reducing the need for a uniform definition of a microenterprise. Non-profit MFIs and governments are more likely to construct inflexible definitions for microenterprises due to the fact that they place high importance on social returns and generally have a vested interest in tracking the progress of a loan from its conception to its finality.

A History of Literature on Microfinance and Informal Economics

Bangladeshi economist and Nobel Prize recipient Muhammad Yunus is informally credited with founding the global phenomenon of microfinance. In his landmark work *Banker to the Poor*, Yunus explains that the cycle of poverty can be broken using minimal amounts of money. After distributing microloans with his own money, and following the clients' successful repayment, Yunus founded the Grameen Bank as a new type of financial institution that sought to specifically address poverty alleviation. Always skeptical of the World Bank's methodology for poverty reduction, Yunus believed that the traditional development projects pursued by multilateral financial institutions merely enriched the global elite and ignored the impoverished. Additionally, Yunus strenuously promotes the idea of alleviating poverty through capitalist enterprises.⁴⁷

Yunus is critical of assistance programs that resemble welfare and made recipients dependent on aid rather than empowering them to use their own talent to better themselves:

⁴⁷ Muhammad Yunus. *Banker to the Poor: Micro-Lending and the Battle Against World Poverty*. Public Affairs, 2003.

“I think that rich countries have fallen into this trap with welfare systems where able-bodied humans are paid to sit around and do nothing. This is a system that produces zombies...It is the system, not your conscience, that needs reforming.”⁴⁸

Financial isolation has always prevented the impoverished from demonstrating their entrepreneurship in a legitimate fashion. Based on the idea that access to credit is a basic human right, Yunus believes that the poor can be fully capable business owners and investors, if given the opportunity. In *Creating a World without Poverty* Yunus describes how capitalistic businesses can operate with a social consciousness, an idea I will develop later. Yunus’ original model of microfinance, which has experienced considerable growth and success in Grameen Bank, is frequently seen as having operational practices that effectively balance financial returns and social returns, the two bottom lines in microfinance. In the contemporary debate on microfinance, Yunus openly criticizes the for-profit model of microfinance employed in Mexico.⁴⁹

Authors Maria Otero and Elisabeth Rhyne have published important work, both separately and jointly, that address the role of microenterprises and the capitalistic approach to poverty reduction. They collaborated in editing *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor*, which shows that MFIs need to be fully sustainable in order to provide long-term assistance to the world’s poor. The authors identify the elimination of government subsidies and donor dependence as important goals. Rhyne and Otero offer a profile of microentrepreneurs, detail how their businesses typically operate, and argue that

⁴⁸ Randeep Ramesh. “Credit is a basic human right.” *Guardian Weekly*. 5 Jan. 2007.

⁴⁹ Muhammad Yunus. *Creating a World Without Poverty: Social Business and the Future of Capitalism*. Public Affairs, 2007.

microentrepreneurs need access to savings and credit for both personal and professional purposes.⁵⁰

Along with Deborah Drake, in 2002 Elisabeth Rhyne edited *The Commercialization of Microfinance: Balancing Business and Development*, which addresses the ways in which a financial-systems approach can have a greater impact on the global poor than a subsidized approach. For many of the contributing authors, the commercialization of the microfinance industry is an inevitable development that should be welcomed rather than shunned. One of the principal arguments is that commercialization will facilitate an increase in outreach, which would theoretically pull a greater number of people out of poverty, and therefore outperform the non-profit approach to microfinance. Authors such as Robert Peck Christen, Victoria White, Anita Champion, and Lisa Valenzuela explain the process by which existing NGOs would upscale⁵¹ to commercialized MFIs, while pre-existing commercial banks would downscale⁵² to serve poor clients, thus combating general criticism put forth by those opposed to commercialized microfinance.⁵³

An Inside View of Latin American Microfinance, which was edited in 2006 by IDB advisor Marguerite Berger, follows similar themes to *The Commercialization of Microfinance: Balancing Business and Development*, but differs in that it has more quantitative data to support its claims than the 2002 publication. By 2006, many commercialized MFIs had experienced significant, well-documented growth which supported the ideas Berger and the accompanying

⁵⁰ Maria Otero and Elisabeth Rhyne. *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor*. Kumarian, 1994.

⁵¹ The transformation of non-governmental, non-commercial MFIs into regulated financial institutions. Maria Otero. "A Commercial Future for Microfinance: Opportunities and Challenges." *Microfinance Matters* 17 (Oct. 2005): 25.

⁵² The process by which regulated financial institutions move down the economic scale of their client base in order to reach a poorer market. Mark D. Wenner and Sergio Campos. "Lessons in Microfinance Downscaling: The Case of Banco de la Empresa, S.A." IDB, 1998: 3.

⁵³ Deborah Drake and Elisabeth Rhyne, eds. *The Commercialization of Microfinance: Balancing Business and Development*. Kumarian, 2002.

authors had been promoting since the early 1990s. *An Inside View of Latin American Microfinance* showed that commercialized microfinance could not only be sustainable, it could also be profitable, highly efficient, and maintain a strong portfolio quality.⁵⁴ In response to critics' claims, the authors argue that commercialized MFIs have both expanded their outreach and continued to reach their target market, thus dismissing any charges of mission drift.⁵⁵ Additionally, the processes of upscaling and downscaling are addressed in considerable detail. Still, there is little quantitative or qualitative data that suggest that commercialized microfinance activities actually reduce poverty. This work primarily focuses on the financial performance of Latin American commercialized MFIs.⁵⁶

Marguerite S. Robinson's *The Microfinance Revolution: Sustainable Finance for the Poor* addresses the shortcomings that are inherent in attempting to alleviate poverty through an NGO, non-commercial approach, specifically identifying inefficiency and non-sustainability as the principal problems. Robinson also discusses the risks and high costs involved in engaging in financial transactions with informal moneylenders. Ultimately, she sees capitalistic, microenterprise development as the most viable way to reduce poverty in underdeveloped countries.⁵⁷

Multilateral financial institutions and donor organizations have also been important in the promotion of for-profit microfinance in Mexico, Latin America, and the rest of the world.

Marguerite S. Robinson and Marguerite Berger have both authored and edited works for the World Bank and the IDB, respectively; both institutions have traditionally pursued a capitalist-

⁵⁴ A determinant of how well a MFI allocates inputs (assets, staff, subsidies, etc.) to produce the maximum output (number of loans, financial self-sufficiency, poverty outreach, etc.). Balkenhol 18

⁵⁵ Refers to an MFI's "drifting" away from its initial mission, the professed desire to use microfinance only improve the well-being of the poor, and towards providing financial services to a more financially stable population that has traditionally always had access to formal banking and is generally more profitable and stable for formal banks.

⁵⁶ Marguerite Berger, Lara Goldmark, and Tomas Miller-Sanabria, eds. *An Inside View of Latin American Microfinance*. Inter-American Development Bank, 2006.

⁵⁷ Marguerite S. Robinson. *The Microfinance Revolution: Sustainable Finance for the Poor*. World Bank, 2001.

oriented model of poverty reduction and have investments in commercialized MFIs in Latin America and the Caribbean. ACCION International, a private donor organization that has ties to the USAID, has frequently invested in commercialized MFIs, the most notable being *Compartamos*. Authors Maria Otero and Elisabeth Rhyne have frequently published works that promote the superiority of the commercialized model, yet at the same time they are in the employ of such an institution. Given their considerable resources, I believe that the nature of the relationship between the authors, the ideas promoted in their books, and the source of the funding for the publications is notable. These organizations have frequently published material promoting a specific ideology and thus secured an influential position in the microfinance debate. While it is arguable whether this is truly a conflict of interest, I believe that this relationship has shaped the dynamic of the current microfinance debate.

Additionally, I will draw information from documents published by *Compartamos*, *Financiera Independencia*, and *Banco Azteca*, which are all commercialized MFIs operating in Mexico. This thesis will utilize quarterly and annual earnings statements, mission statements, and personal histories published by said companies. Due to the importance of the current debate on commercialized microfinance activity, I will also use the companies' public release statements to show how they frame their own activities.

Microbanking Bulletin measures current growth and trends, yet offers little analysis or criticism. This publication offers valuable quantitative data that is collected from many MFIs throughout Latin American and the world. As this thesis will explain later, publications such as the *Microbanking Bulletin* have been criticized because they offer little to no information on how microfinance alleviates poverty. Many of the statistics provided only relate to financial returns,

rather than also demonstrating how microfinance activities have socially impacted microfinance clientele.

Due to the fact that public perception plays an integral role in the way in which microfinance is characterized, I will draw from several popular media publications such as *The New York Times*, *The Wall Street Journal*, and *The Economist*. Such popular publications have shaped the way in which commercialized microfinance has been presented to the public. Articles appeared in *The New York Times*⁵⁸ and *Business Week*⁵⁹ that portrayed *Compartamos* and *Banco Azteca* as predatory lenders that unabashedly sought profits over poverty reduction. In response, *The Wall Street Journal* published several articles that defended *Compartamos'* and *Banco Azteca's* actions, as well as the commercialized microfinance model. Additionally, *The Wall Street Journal* provided space to Maria Otero, ACCION International's CEO, so that she could refute some of the points made in the critical articles.⁶⁰

Jonathan Lewis, CEO of MicroCredit Enterprises, an organization that counsels investors on how to make socially conscious contributions to the microfinance industry, has levied considerable criticism against commercialized MFIs, especially *Compartamos*. His article "Microloan Sharks" argues that commercialized microfinance disproportionately focuses on financial returns and neglects the aspect of poverty alleviation. Additionally, the article questions the integrity and actions of organizations such as ACCION International, which allegedly seeks to please investors more than poor clients.⁶¹

As previously noted, many small, urban enterprises are the primary recipients of microfinance services, thus this thesis will examine the urbanization and economic demography of Mexico and

⁵⁸ Elisabeth Malkin. "After Success, Problems for Microfinancing in Mexico." *New York Times*, 5 April 2008.

⁵⁹ Keith Epstein and Geri Smith. "The Ugly Side of Micro-Lending; How Big Mexican Banks Profit as many Poor Borrowers Get Trapped in a Maze of Debt." *Business Week* 24 Dec. 2007: 38-44.

⁶⁰ Mary Anastasia O'Grady. "Americas: Markets for the Poor in Mexico." *Wall Street Journal*. June 30, 2008: A11.

⁶¹ Jonathan C. Lewis. "Microloan sharks." *Stanford Social Innovation Review* 6.3 (Summer 2008): 54-59.

Latin America. Many of these urban enterprises tend to be informal, therefore it will be necessary to analyze both the empirical nature of the operational activities of such informal economic units. Additionally, a positive shifting of government attitudes towards informal enterprises, and the NGOs that serve them, has facilitated the emergence of a growing microfinance industry in Latin America.

Alejandro Portes has significantly contributed to the study of these two elements. His article “Competing Perspectives on the Latin American Informal Sector” provides tremendous insight into the principal reasons for rural-to-urban migration and the rationalization of informal economic practices.⁶² “Latin American Class Structures: Their Composition and Change during the Neoliberal Era” specifically looks at the effects that neoliberalization has had on informal economics in urban Latin America.⁶³ “The Free-Market City: Latin American Urbanization in the Years of the Neoliberal Experiment,” co-written with Bryan R. Roberts, provides a concise explanation as to how economic development contributed to the urbanization process. Portes and Roberts detail the theoretical ideology of neoliberalism and discuss the reality of neoliberal policies.⁶⁴

John C. Cross’s *Informal Politics: Street Vendors and the State in Mexico City* profiles the legal complications of establishing and maintaining an informal business sector in the major metropolitan area. As Cross describes, many informal sector businesses in urban areas such as Mexico City have a difficult balancing act in that they simultaneously have to be visible to their

⁶² Alejandro Portes and Richard Schauffler. “Competing Perspectives on the Latin American Informal Sector.” *Population and Development Review* 19.1. (Mar. 1993): 33-60.

⁶³ Alejandro Portes and Kelly Hoffman. “Latin American Class Structures: Their Composition and Change during the Neoliberal Era.” *Latin American Research Review* 38.1 (2003): 41-82.

⁶⁴ Alejandro Portes and Bryan R. Roberts. “The Free-Market City: Latin American Urbanization in the Years of the Neoliberal Experiment.” *Studies in Comparative International Development* 40.1 (Spring 2005): 43-82.

customers and invisible to the police. His work demonstrates the difficulty that informal enterprises have in establishing and maintaining legitimacy in local economies.⁶⁵

J.J. Thomas's *Surviving in the City: The Urban Informal Sector in Latin America* addresses the popular and governmental perceptions of the informal economy. Importantly, Thomas illustrates how government attitudes towards the informal sector dramatically shifted over time, eventually allowing NGOs and MFIs to start large-scale projects with informal businesses. Thomas also addresses the impact that informal sector microenterprises have on macroeconomic performance.

In addition to her work with ACCION International, Maria Otero has also published work on the informal sector in Latin America. "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America," a chapter that appeared in *Contrapunto: The Informal Sector Debate in Latin America*, discusses the reasons why so many small enterprises operate in the informal sector, specifically detailing tax evasion and adaptation to insufficient opportunities in the formal economy. Additionally, Otero discusses the fact that many Latin American governments in the 1990s began providing assistance to both informal microenterprises and the NGOs that provide support to such businesses.⁶⁶

Victor Tokman's "The Informal Sector in Latin America: From Underground to Legality," a chapter from his edited work *Beyond Regulation: The Informal Economy in Latin America*, explores the complicated nature of the operating practices of informal enterprises in Latin America. Tokman analyzes the benefits and shortcomings of fulfilling all legal obligations for owning and operating a business, comparing how costs and bureaucratic demands vary from

⁶⁵ John C. Cross. *Informal Politics: Street Vendors and the State in Mexico City*. Stanford, 1998.

⁶⁶ Maria Otero. "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America." In *Contrapunto: The Informal Sector Debate in Latin America*. Cathy A. Rakowski, ed. State University of New York Press, 1994.

country to country in Latin America. Also, Tokman addresses the stages of legality that exist for small enterprises, noting that legality and illegality operate along a continuum rather than in a clear cut manner.⁶⁷

Also appearing in *Beyond Regulation: The Informal Economy in Latin America* is Ricardo Lagos' chapter "Barriers to Legality and Their Costs for the Informal Sector." In this chapter, Lagos details the complex way in which small enterprises must establish and maintain legality, identifying patterns that exist throughout Latin America. He details the monetary and non-monetary costs of fulfilling legal obligations, noting how these costs vary across the continent.⁶⁸

Most of the literature on microfinance details the way in which it specifically relates to poverty, gender, rural life, and/or financial effectiveness, yet there is little literature that directly connects microfinance to urban informal microenterprise activity. As this type of economic activity makes itself more prevalent in a region that is becoming increasingly urban, it is important to understand how microfinance impacts the poor clientele of Latin America. In analyzing general trends across Latin America, with a specific focus on Mexico, this thesis will profile the successes, shortcomings, and impact of an evolving campaign for poverty reduction in the developing world of Latin America.

⁶⁷ Victor E. Tokman, ed. *Beyond Regulation: The Informal Economy in Latin America*. Lynne Rienner, 1992.

⁶⁸ Ricardo A. Lagos. "Barriers to Legality and Their Costs for the Informal Sector." In *Beyond Regulation: The Informal Economy in Latin America*. Tokman, Victor E., ed. Lynne Rienner, 1992.

3. Economic Marginalization and Informality in Mexico

It is understood that microfinance services are primarily directed towards the impoverished. Yet, in this process of commercializing poverty alleviation, one must ask what structural elements have conspired to relegate so many millions of people to poverty. Several explanations quickly come forward: lack of educational services, absence of health services, economic marginalization, landlessness, inadequate housing in both urban and rural areas, and insufficient employment opportunities, among others. Not all of these reasons are isolated; in fact, they are intertwined in a complex fashion that at times seems indecipherable. In this chapter I will explain the relationship between traditional economic practices that have repeatedly isolated the poor economically and socially, the urban employment landscape, and the emergence of microfinance services in urban Latin America, paying particular attention to Mexico.

In the contemporary urban employment market, informal activity has become extremely important. Marianne Fay estimates that more than 70% of Latin America's urban poor were employed in the informal sector in 2000.⁶⁹ According to Victor Tokman, 60% of all urban jobs were created in the informal sector⁷⁰ between 1992 and 2003.⁷¹ In Mexico, the World Bank estimates that in 2000, of the poorest three-fifths of the adult population, between 50% and 80% were employed in the informal economy. At the beginning of the 21st century, NACLA⁷² reported that microenterprises accounted for half of all non-agricultural jobs in Mexico.⁷³ Joanna Ledgerwood states that policy makers now recognize that microenterprises, both formal and informal, can greatly impact macroeconomic performance, thus more programs for small

⁶⁹ Marianne Fay. *The Urban Poor in Latin America*. World Bank, 2005: 58.

⁷⁰ Refers to economic activities in which workers or entrepreneurs do not fulfill the legal operations that correspond with the production or distribution of a good or service.

⁷¹ Tokman 83, 86

⁷² North American Congress on Latin America

⁷³ Carlos Salas. "Mexico's Haves and Have-Nots: NAFTA Sharpens the Divide." *NACLA Report on the Americas* 34.4 (Jan/Feb 2002): 34.

business development have been created and funded by government, multilateral financial institutions, and private donors.⁷⁴ In *The Microfinance Revolution*, Marguerite S. Robinson argues that microenterprise activity is an important element in the economies of developing countries and that the growth of these small businesses needs to be fostered and encouraged through legitimate programs and institutions.⁷⁵

The emergence of financial institutions that exist solely to provide services to the informal sector should eventually contribute to its consolidation in the domestic and international economic framework. Due to their support from international donor organizations, as well as their own sustainability, MFIs can assist informal microenterprises in an unprecedented way. Informal microenterprises can receive credit, savings products, and other nonfinancial services from NGOs and commercial MFIs in order to make their business more mobile and adaptable to changing environments, as well as providing security for family income, which is generally indistinguishable from business income for microentrepreneurs, especially if the business owner is female.⁷⁶

Since many informal business owners and workers have little or no employment history in the formal economy, and therefore lack credit history or official income documentation, they are often ineligible for loans and credit from the formal banking industry. Additionally, the lack of real assets, such as property or an automobile, can prevent an informal worker from receiving formal credit. The growth of MFIs that are capable of distributing these loan services has presented Latin America's previously marginalized informal entrepreneurs with an opportunity for increased stability, more efficient production and lower operational costs.

⁷⁴ Joanna Ledgerwood. *Microfinance Handbook: An Institutional and Financial Perspective*. World Bank, 1999: 29.

⁷⁵ Robinson 11

⁷⁶ Elisabeth Rhyne and Maria Otero, "Financial Services for Microenterprises: Principles and Institutions," *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor*, eds. Maria Otero and Elisabeth Rhyne (Kumarian, 1994) 13.

In spite of the potential that microfinance carries for the impoverished, the real life application of specific efforts can bring varied results. For example, even though Grameen Bank's model for microlending emphasized socioeconomic improvement above all else, recent developments have shifted microfinance more towards a market-oriented formula. In Latin America, economic policies that have emphasized liberalization and commoditization as a basis for growth have been accompanied by the marginalization and impoverishment of tens of millions of people.

In this chapter I will explain the history of poverty and inequality in Mexico in order to illustrate how liberal economic policies corresponded with the rising marginalization of Mexico's poor. Additionally, I will discuss how capital-intensive import-substitution industrialization policies resulted in an increase in urban populations. I will argue that while such protectionist policies, however flawed, slowly closed the inequality gap. The entrance of neoliberal policies exacerbated pre-existing inequalities at a time in Mexico's history in which the majority of the population lived in urban areas. I will then argue that high urban unemployment, arguably caused by neo-liberal policies, led to the growth of informal employment in urban Mexico. I will show how the Mexican government began cooperating with NGOs in order to provide services to microenterprises, discussing the reasoning behind such decision-making and the approaches taken by NGOs and governments.

A History of Inequality and Poverty in post-Colonial Mexico

From Nueva España to the Mexican Revolution

According to Lorenzo Meyer, 90 percent of colonial Nueva España was poor, with the *hacienda* as the primary rural institution.⁷⁷ Due to its emphasis on social status and prestige,

⁷⁷ Lorenzo Meyer. "La pobreza en México: aproximación al gran problema histórico." *Comercio Exterior* 55.8 (Aug. 2005): 684-691.

significant tracts of land were never cultivated and production efficiency was never a priority. *Hacienda* properties were typically at least 2,500 acres in size.⁷⁸ During the colonial period, indigenous property rights were protected under Church law, but this protection ended following independence in 1821.⁷⁹ By the mid-1800s, liberal laws, sought to reduce the Catholic Church's influence and began privatizing rural landholdings, particularly under the *Ley Lerdo* in 1855. Many already-wealthy individuals began consolidating property, thus concentrating wealth into a small number of hands.⁸⁰

Such land privatization was further pursued by Porfirio Diaz (1876-1910) under liberal economic policies that emphasized exports of agriculture and other raw materials. According to John Mason Hart, in bringing progress to Mexico, Diaz sought to reduce the strong characteristics of indigenous culture, namely rural communal landholdings, which had marked Mexico since the arrival of the Spanish. And, by 1910 Diaz had expropriated and privatized more than 127 million acres.⁸¹ Large-scale privatization had created intense land concentration, illustrated by the fact that more than 40% of rural Mexico included only 8,000-plus landholdings. Landlessness and poverty were rampant as 96% of all rural families worked as indebted serfs on *haciendas*, which had become "the most conspicuous feature" of rural Mexico.⁸² Apart from issues of land access and unemployment, liberal economic policies may have contributed to serious health problems, as a consequence from malnutrition and lack of adequate housing, for

⁷⁸ Robert C. West and John P. Augelli. *Middle America: Its Lands and Peoples*. Prentice Hall, 1989: 300.

⁷⁹ Mario T. Garcia. "Mexican Immigration in US-Mexican History: Myths and Reality." In *Myths, Misdeeds, and Misunderstandings: The Roots of Conflict in US-Mexican Relations*. Jaime E. Rodriguez and Kathryn Vincent, eds. Wilmington, DE: Scholarly, Resources, 1997: 205.

⁸⁰ West and Augelli 300

⁸¹ John Mason Hart. "Social Unrest, Nationalism, and American Capital in the Mexican Countryside, 1876-1920." In *Rural Revolt in Mexico: US Intervention and the Domain of Subaltern Politics*. Daniel Nugent, ed. Duke, 1998: 73.

⁸² West and Augelli 300

Mexican *campesinos*, who on average lost more than 3 cm in height during the Porfiriato, compared to 1850 statistics.⁸³

Although the Mexican Revolution of 1910 destabilized the Mexican political system into the 1920s, the 1930s saw some of the goals of the Revolution come to fruition, particularly land redistribution. The nationalistic *Partido Revolucionario Institucional* (PRI) emerged from the ashes of the Revolution and eventually began implementing some of its ideals, due to the populist policies of Lazaro Cardenas in the late 1930s. Such nationalism translated into the adoption of protectionist economic policies of import-substitution industrialization (ISI).

Mexico during Import-Substitution Industrialization, 1950-1982

As Alejandro Portes and Bryan Roberts point out, the ISI-era was a period of intense industrialization, focused in “one or two cities,” which catalyzed large-scale domestic migration to these import-substitution industrial cities.⁸⁴ It is estimated that the urban population growth rate was more than double the overall population growth rate.⁸⁵ This intense urbanization cemented the dominant position of primate cities, such as Mexico City. Portes and Roberts identify four major characteristics of the ISI process. First, Mexico developed a “legally protected industrial working class,” as well as a strong urban middle class. Second, the imbalance between employment-seeking migrants and actual job availability led to the creation of an informal “working” class. Third, population increases led to the escalation of housing costs that were disproportionate to actual wages for low-skilled workers in the formal and informal sector. Homelessness, and the threat of homelessness, triggered the creation of improvisational

⁸³ Moramay Lopez-Alonso. “Growth with Inequality: Living Standards in Mexico, 1850–1950.” *Journal of Latin American Studies* 39 (2007): 102.

⁸⁴ Portes and Roberts 44

⁸⁵ Werner Baer. “Industrialization in Latin America: Successes and Failures.” *The Journal of Economic Education* 15.2 (Spring 1984): 128.

housing for the working class; squatter settlements and shanties became a defining characteristic of urban Mexico. Fourth, the existence of informal housing and economic activity became consolidated and intertwined with formal policies, reinforcing the existence of such provisional housing into the future.⁸⁶

In spite of its structural flaws, the ISI era in Mexico is largely seen as a period in which the economic inequality gap decreased, poverty rates dropped, and median income increased, especially when compared with corresponding post-1982 statistics. As James Rochlin states, income distribution improved, as the top 10% of all households held 49% of all income in 1952, compared to 34.4% in 1984. At the same time, the share of national income for the middle 50% of all households increased from 47.6% in 1963 to 52.8% in 1977, and poverty levels dropped from nearly 70% of the population to 34% from 1963 to 1977.⁸⁷

As Figure 4 illustrates, ISI policies corresponded with increases of urban populations across Latin America, and Mexico was no exception. During this process, increasing availability of labor in areas in urban areas spurred expansion of commerce. As national population growth increased alongside high urban growth rates, the urban economy became integral to national well-being.

⁸⁶ Portes and Roberts 44

⁸⁷ James F. Rochlin. *Vanguard Revolutionaries in Latin America: Peru, Colombia, Mexico*. Lynne Rienner, 2002: 177.

Figure 4 – Urban Population as a Percentage of Total Population of Latin America, 1950-1990⁸⁸

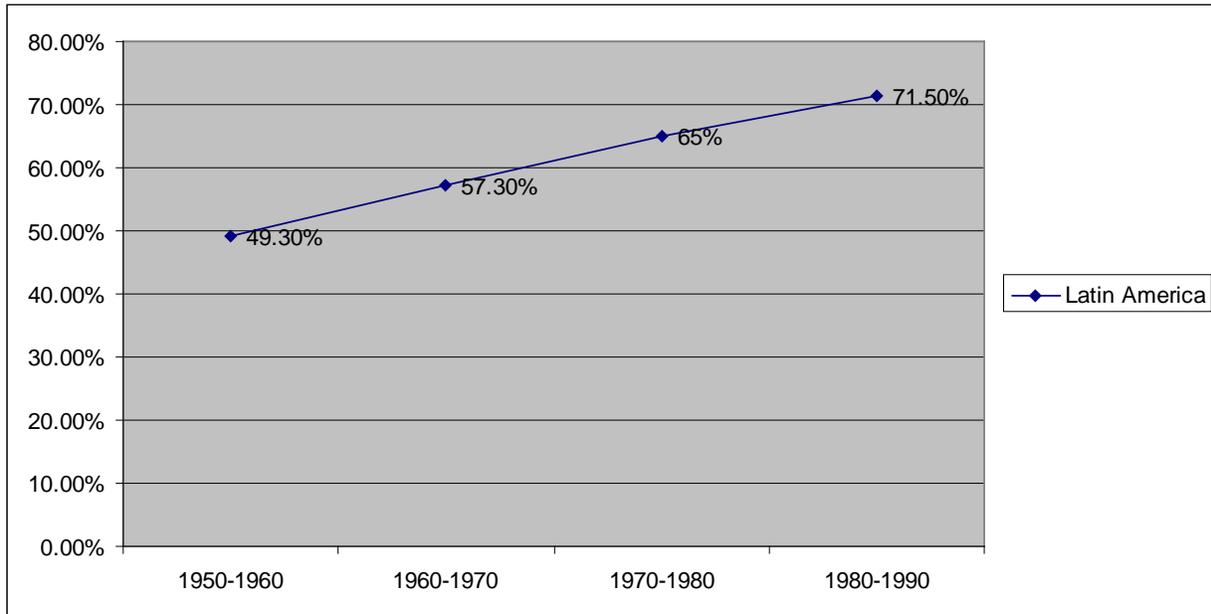


Figure 5 – Evolution of Urbanization in Mexico, 1970-2000⁸⁹

Geographic Area	1970	1980	1990	2000
MEXICO				
Total Population (millions)	48.2	66.7	81.2	97.4
Urban Population, %	59	67.1	74.3	75.8
Urban Growth Rate, %	5.6	3.3	3.1	-
MEXICO CITY				
Percent of Urban Population	29.4	29.0	25.4	24.4
Urban Primacy ⁹⁰	2.6	2.6	2.1	2.0
Growth Rate, %	3.9	1.6	1.7	-

As Figure 5 illustrates, by 1970 Mexico City's position as Mexico's primate city was well-established. Aside from Mexico City, the industrialization of Mexico during the ISI-era led to the

⁸⁸ Thomas 44; Portes and Schauffler 4

⁸⁹ Portes and Roberts 50

⁹⁰ Ratio of the population in the largest metropolitan area to the sum of the next three

urbanization of many towns and cities, particularly in the *Mesa Central* and the border. Cities in central Mexico such as Veracruz, Puebla, Querétaro, and Guadalajara grew considerably, and the implementation of the Border Industrialization Program contributed to the growth of border cities such as Ciudad Juárez and Tijuana.⁹¹

Oaxaca de Juárez lacked the strength and size of Mexico’s other major urban areas, yet within Oaxaca State, Oaxaca de Juárez’s population grew considerably during the ISI-era. Due to the heavy turmoil associated with the Mexican Revolution, Oaxaca’s population remained very low until the 1940s, when industrialization began drawing *rurales* into the state capital. As seen in Figure 6, from 1940 to 1980 Oaxaca’s population grew five-fold.

Figure 6 – Population Growth in Oaxaca de Juárez, 1920-2005⁹²

1920	1930	1940	1950	1960	1970	1980	1990	2000 ⁹³
27,792	33,420	29,300	46,700	72,300	99,530	150,000	186,000	419,770

By the end of the ISI-era in the early 1980s, an estimated 67% of the population lived in urban areas, of which nearly 13 million inhabited the capital, and another 30 million came to populate other urban cities in the *Mesa Central* and the border. This remarkable demographic shift strongly suggests that import-substitution industrialization enticed workers to urban areas in search of employment. Additionally, the fact that Mexico City was able to cement its “primate city” position is notable given that several Mexican cities were experiencing growth rates that were similar, if not higher. However, as shown in Figure 5, the termination of ISI policies in the early 1980s also corresponded with a less intense urban growth, especially for primate cities such

⁹¹ West and Augelli 295

⁹² Colin Clarke. *Class, Ethnicity, and Community in Southern Mexico*. Oxford, 2000: 51; Arthur D. Murphy and Alex Stepick. *Social Inequality in Oaxaca: A History of Resistance and Change*. Temple, 1991: 47; 1980-2000, Gustavo Garza. “La urbanización metropolitana en México: normatividad y características socioeconómicas.” *Papeles de Población* 52 (April-June 2007): 94.

as Mexico City. Between 1980 and 1990, an estimated 81 cities experienced an annual population growth rate of more than 3.5%, compared to Mexico City's growth rate of roughly 1.6% in the same time period.⁹⁴

As stated earlier, industrialization created a significant number of jobs in urban Mexico, but internal migrants were arriving more rapidly than jobs were being created. Jim Thomas describes the experience of arriving in a city with inadequate infrastructure:

When large groups of migrants reached the cities, they found themselves barred from legally established social and economic activities. It was tremendously difficult for them to acquire access to housing and an education and, above all, enter business or find a job.⁹⁵

The absence of sufficient formal employment opportunities in urban areas, accompanied by high urban growth rates, resulted in the expansion of the informal economy, an idea that will be further explored later. Informal economic activity has become a major trait of urban Mexico since the end of World War II. By the end of the ISI-era, approximately 35% of Mexico's urban workers were engaged in informal economic activity. For Oaxaca de Juárez, the proportion of informal workers had already reached 50% by the end of the ISI-era, which was considerably higher than Latin America's average of 35%.⁹⁶

In summary, the ISI period left Mexico with two noticeable characteristics. First, the urban population of the country grew substantially and made urban economic activities more salient in Mexico's overall economic activity. Second, the disproportionate population and employment growth in urban areas over a long period led to the establishment of a large urban informal workforce. Both of these ISI legacies would be amplified by neoliberal policies in the 1980s, leading to an increase in urban informal economic activity through the end of the 20th century.

⁹⁴ Garza 80

⁹⁵ Thomas 27

⁹⁶ Murphy and Stepick 88

By the year 2000, the informal workforce grew to represent 40% of Mexico's adult population, being especially pronounced in the poorest quintile, in which more than 80% of adults were employed in the urban informal economy.⁹⁷ Eventually, government policy would evolve on how best to deal with the economically marginalized in urban Mexico, allowing microfinance to emerge as a viable approach.

Neoliberalism and Austerity in Mexico, 1982-present

The end of the ISI-era is generally seen as having occurred at the onset of Mexico's 1982 debt crisis. In the subsequent restructuring of Mexico's economy, the de la Madrid administration (1982-1988) began stripping away the protectionist policies that had given preference to Mexican industries over foreign competitors. In spite of the fact that ISI policies corresponded with a decline in Mexico's poverty incidence from an estimated 65% in 1950 to 25% in 1980⁹⁸, as well as an increase in the median standard of living, such protectionist policies were not consistent with the neo-liberal, free-market system promoted by the US.

By the end of Lopez Portillo's *sexenio* (1976-1982), Mexico's foreign debt totaled US \$82 billion.⁹⁹ In order to make their short-term payments, the Mexican government took emergency loans from the International Monetary Fund. Attached to these loans were structural adjustments programs which would allegedly ensure that Mexico would efficiently manage its budget so as to increase the likelihood that the loans would be repaid. Such structural adjustment programs had the primary goal of *adelgazar*¹⁰⁰ ("slimming down") the state and curbing public spending. In

⁹⁷ Fay 81

⁹⁸ Korzeniewicz and Smith 9

⁹⁹ John Ross. *Annexation of Mexico*. Common Courage, 1998: 174.

¹⁰⁰ Jaime Ornelas Delgado. "La política de combate a la pobreza en México, 1982-2005." *Papeles de Población* 47 (Jan-Mar 2006): 87.

doing so, the de la Madrid administration pledged in 1984 to divest 1,200 state-operated enterprises.¹⁰¹

During the ISI-era in Mexico, the state had become a leading employer, so with privatization and efficiency-minded measures came the shedding of thousands of government jobs which had carried labor protections, pensions, and other benefits for Mexico’s working class. In combination with increased unemployment were an additional structural adjustment programs that mandated reduced social spending. So, while the number of unemployed was growing throughout Mexico, austerity measures mandated that the Mexican government curb spending on programs that would normally cushion the social turmoil associated with such economic restructuring. According to the Economic Commission on Latin America and the Caribbean (ECLAC), Mexico’s urban areas were particularly struck by the drastic changes.¹⁰²

**Figure 7 – Estimates of Change in Poverty and Income Distribution
In Mexico, 1984-1992¹⁰³**

<i>Category</i>	1984 (%)	1989 (%)	1992 (%)
Poverty	34	39	36
Income Shares by Sector – Lowest 40%			
Urban	20.1	16.0	16.6
Rural	20.3	18.7	19.4
Income Shares by Sector – Highest 10%			
Urban	25.8	36.9	34.8
Rural	26.4	27.4	28.9

¹⁰¹ Ross 176

¹⁰² Korzeniewicz and Smith 8

¹⁰³ John Sheahan. “Effects of Liberalization Programs on Poverty and Inequality: Chile, Mexico, and Peru.” *Latin American Research Review* 32.3 (1997): 24.

As Figure 7 demonstrates, the mix of escalating unemployment and inadequate social services swelled poverty levels and widened inequality in Mexico. In the 1980s, the number of Mexicans living in poverty increased to 39%, an estimated 31 million people. Concentration of wealth increased as the poorest 40% of the urban population saw their share of income decrease from 20.1% in 1984 to 16% in 1989. For the richest 10% in urban areas, their share of income increased from 25.8% in 1984 to 36.9% in 1989. Additionally, Figure 8 shows how general inequality increased throughout the 1980s in all areas. Even though inequality and poverty would be reduced by the early 1990s, the relatively low levels of inequality and poverty established during the ISI-era were not maintained under neoliberal policies by 1994.

Figure 8 – Income Distribution in Mexico, 1980-1994, as Measured by Gini Coefficients¹⁰⁴

<i>Area</i>	1984	1989	1992	1994
Urban	0.321	0.424	0.414	0.405
Rural	0.323	0.345	0.341	0.330
National	0.506	0.550	-	-

Although economic restructuring in accordance with neoliberal principles caused significant social turmoil and hardship, every Mexican president has followed US recommendations that Mexico implement liberal, market-oriented policies. The 1990s would fare slightly better than the “lost decade” of the 1980s, but poverty rates, high concentration of wealth, and unemployment all would prevent stable development in Mexico. Some scholars argue that NAFTA, in particular, had devastating effects on Mexico’s economy and poor working population. Tanya Golash-Boza notes that the erosion of Mexico’s agricultural industry, which was unable to compete with government-subsidized US agriculture companies, forced more than two million Mexican *campesinos* into cities or northward to the US. Additionally, the entrance

¹⁰⁴ Korzeniewicz and Smith 8; The Gini Coefficient is the summary measure of inequality in income distribution, where 1.0 represents absolute inequality and 0.0 represents absolute equality. “Demographic and Social Statistics.” <http://unstats.un.org>.

into the Mexican market of US multi-national corporations has led to the closing of many small businesses in Mexico, increasing the unemployment rate.¹⁰⁵ Ross notes that more than 200,000 small businesses closed in the first 18 months of NAFTA and that by the late-1990s nearly 70% of all small- and medium-sized formal businesses had gone under in Mexico.¹⁰⁶ In 1995 alone, more than one million workers became unemployed.¹⁰⁷

Figure 9 – The Evolution of Labor Markets, Poverty and Inequality in Urban Mexico, 1980-2003¹⁰⁸

<i>Category</i>	1980	1990	1995	2000	2003
All Urban Areas in Mexico					
Unemployment, %	4.5	2.7	5.5	2.2	3.3
Informal Workers, %	35.8	35.1	38.2	35.4	44.1
Gini Index	-	0.470	0.490	0.470	-
Poor Population, %	28.0	47.7	52.9	41.1	39.4
Income Share of Top Decile, %	25.8	36.6	35.6	36.4	33.2

As Figure 9 shows, there is a direct correlation between informal activity and the unemployment rate. Bryan R. Roberts attributes this to the fact that Mexico traditionally has had weak labor security; such dramatic increases in informality did not occur in areas with a strong history of labor protection, such as Buenos Aires or Montevideo¹⁰⁹ Following the implementation of NAFTA in 1994 and the 1995 economic crisis, the urban unemployment rate soared. Given that this was accompanied by a rise in informal activity, one can assume that

¹⁰⁵ Tanya Golash-Boza. “The Immigration Industrial Complex: Why We Enforce Immigration Policies Destined to Fail.” *Sociology Compass* 3 (2009): 3.

¹⁰⁶ Ross 210

¹⁰⁷ Heather Williams. “Of Free Trade and Debt Bondage: Fighting Banks and the State in Mexico.” *Latin American Perspectives* 28.4 (July 2001): 35.

¹⁰⁸ Portes and Roberts 58, 64

¹⁰⁹ Bryan R. Roberts. “Globalization and Latin American Cities.” *International Journal of Urban and Regional Research* 29.1 (March 2005): 116.

newly unemployed persons survived by finding work in the informal sector, most likely in microenterprises.

Also evident in Figure 9 is the fact that inequality only stagnated throughout the 1990s. While the 1995 crisis marked a period in which the inequality gap widened, the end of the decade closed with levels of urban inequality on par with those of 1990, with the Gini Index at 0.470. This measurement is remarkably higher than the 1984 level of 0.321 in urban Mexico. By the year 2000, the urban poor in Mexico had declined to 41% of the overall urban population. While this was a remarkable reduction in a span of only five years, it pales in comparison to the fact that only 28% of urban Mexico was considered poor at the end of the ISI-era.

A study conducted by the *Universidad Autónoma del Estado De México* documents the rise in the number of urban areas¹¹⁰ in Mexico during the neoliberal-era. In 1980, there existed only 26 metropolitan areas,¹¹¹ yet by 2005 this number had risen to 57. The study notes that in 2000 there were 349 urban areas that held 65% of Mexico's population, and that by 2005 there were 367 urban areas. This indicates an emergence of 18 areas, in which nearly six million people lived, that were now classified as urban. As Figure 6 shows, Oaxaca emerged as one of the new metropolitan areas, with a population boom of more than 230,000 people from 1990 to 2000.¹¹²

By all indicators, neoliberal policies had exacerbated pre-existing problems with poverty and inequality throughout Mexico and Latin America. In 2006, approximately 37% (194 million) of Latin America lived in poverty, an increase of nearly 50 million since the end of the ISI-era.¹¹³ Inadequate employment opportunities, especially in urban areas, left poor workers to fend for themselves in the informal sector. In 2005, nearly 50% of all urban workers were employed in

¹¹⁰ 150,000 or more inhabitants

¹¹¹ 500,000 or more inhabitants

¹¹² Garza 81, 87-9

¹¹³ Simone Cecchini and Andras Uthoff. "Poverty and Employment in Latin America: 1990-2005." *CEPAL Review* 94 (Apr. 2008): 42.

the informal sector, according to the International Labour Organization (ILO).¹¹⁴ For Mexico in 2003, nearly 45% of the urban workforce was employed in the informal sector.

The urban informal sector has become a defining characteristic of cities in Mexico and Latin America. In the next section I will address how the urban informal sector exists within an atmosphere of economic marginalization. Traditionally, informal enterprises have lacked access to legitimate financial resources and have had questionable credibility in the eyes of government authorities, which has created an environment in which improvisation and adaptability are important skills.

What Is the Informal Economy?

The obscure activities undertaken in the informal economy have led to ambiguous definitions and misperceptions from the general public. Uncertainty has surrounded the informal sector throughout the Twentieth Century, with many governments unsure of how the informal economy should fit into a country's greater economic plan or if it should be eliminated entirely.

The informal sector can be defined in a variety of ways, with most informal economic activity falling into subcategories that fulfill specific roles and carry unique challenges. The shifting legal definitions also dictate the degree of formality and informality within which formal and informal microenterprises operate.

Defining the Informal Economy

“The shadow economy, also called underground, informal, or parallel, includes not only illegal activities, but also unreported income from the production of illicit goods and services, both monetary and barter transactions. Therefore, the shadow economy includes

¹¹⁴ Cecchini and Uthoff 43

all economic activity that, in general, would be subject to tax if it were declared to the tax authorities.”¹¹⁵

Most analysts have come to the conclusion that many legitimate goods and services are sold within the informal economy, but administrative infractions, such as failure to pay taxes, push a business from formality into informality. Based on the above definition from Froilán and Pérez, it becomes evident that an important distinction between formal and informal activities is not the type of business conducted, but rather *how* the business is conducted. This broad explanation indicates that the informal economy exists in a somewhat ambiguous dimension, with a plethora of operations capable of existing within its boundaries.

The ILO, which is largely credited with bringing legitimate recognition to the informal sector, provides a more concrete definition: The informal sector is “the sum of non-professional own-account workers, domestic servants, unpaid family workers and employees in firms with fewer than five employees.”¹¹⁶ Within this definition, the ILO is more concerned with the size of the enterprise rather than its operations; it is implied that urban microenterprises most likely will not fully comply with all legal obligations.

After stating that in most developing countries “the sum of the employed and unemployed” rarely added up to the total size of the urban workforce, Jim Thomas rhetorically asks: Where were the missing workers? He answers by explaining that they are employed in the urban informal economy, a sector that identifies itself with “self-employed agents” and laborers “working in small enterprises, many of which are unregistered with the authorities.” Thomas claims that the neoliberal era has been marked by “jobless growth,” which indicates that economic growth still has not translated into formal, stable jobs for the working class. In developing countries there is widespread “bottom-up informalization,” in which workers

¹¹⁵ Froilán and Pérez 31

¹¹⁶ Cecchini and Uthoff 43

alienated from the formal economy must improvise by using their available resources and skills.¹¹⁷ Portes and Roberts elaborate by saying this economic situation, in which workers have minimal options, tend to take the route of “forced entrepreneurialism.”¹¹⁸

As shown in Figure 10, an important qualification for what makes an enterprise informal is whether or not the enterprise fulfills all requirements in terms of the legality of the goods or services offered, and the legal status during the stages of production and distribution.

Figure 10 – The Structure of Informal Economic Activity¹¹⁹

<i>Sector</i>	Market Transactions	Output	Production/Distribution
Household	No	Legal	Legal
Informal	Yes	Legal	Quasi-legal
Underground	Yes	Legal	Illegal
Criminal	Yes	Illegal	Illegal

In the Household sector, labor output is focused on housework and subsistence labor, rather than the buying and/or selling of goods and services. Nonetheless, this sector is integral to survival in both rural and urban areas. The Underground and Criminal Sectors are similar, but they differentiate in the fact that activities in the Criminal Sector are illegal in all stages (the type of goods or services provided, the mode of production, and distribution), whereas activities in the Underground Sector are illegal only during production and distribution. For example, activities such as robbery and illegal drug trafficking are located in the Criminal Sector because they do not operate legally in any of their stages of production and/or distribution. The Underground Sector is distinguished from the Criminal Sector by the fact that legitimate goods and services can be sold and/or provided under some type of legality.

¹¹⁷ Jim Thomas. “What Is the Informal Economy, Anyway?” *SAIS Review* 21.1 (Winter-Spring 2001): 5-6.

¹¹⁸ Portes and Roberts 49

¹¹⁹ Thomas. “What Is the Informal Economy, Anyway?” 2

Of these four traditional subcategories of the informal economy, the Informal Sector remains the predominate feature in urban Mexico. In the Informal Sector, legal goods and services are produced, but the operations are not fully legal due to infractions during production and/or distribution. Most often a legitimate business passes into informality due to a failure to fulfill all administrative obligations, such as payments on taxes, social security, overtime, and licenses.¹²⁰ Legal maintenance remains a salient issue in categorizing and defining informal economic activity, a factor which correspondingly depends on the State's capacity or will to enforce existing laws.

The level of law enforcement and government activity is a defining variable in the informal sector's ability to operate throughout Mexico. Depending on the political climate or economic stability, the opportunity to work extralegally can be severely restricted. Within the last thirty years, three views have developed which represent opinions spanning the political spectrum. On one extreme, the informal sector is seen as a negative trait that is associated with underdeveloped economies and should be eliminated; on the other is the view that the informal sector contains talented entrepreneurs that ought to be incorporated into the formal sector. On a moderate, conciliatory level, a third opinion states that the informal sector, due to its selling of cheap goods and labor, contributes to cost-saving measures of the formal economy and should therefore remain unchanged.¹²¹ Maintaining the existing informality is the least controversial and most feasible option of the three mentioned when analyzing the potential effects for all of the parties involved. Unfortunately, within the traditional system the costs and limitations are much higher for informal enterprises and workers than for their counterparts in the formal economy.

¹²⁰ Tokman "The Informal Sector in Latin America: From Underground to Legality." 5; Lagos 103.

¹²¹ Thomas. *Surviving in the City* 11.

However, many believe that the informal sector poses unfair competition to the formal sector due to the fact that they do not pay the same percentage of taxes and fees.

Due to the ambiguous state of legality within which much of the informal sector exists, the incentives, motivations, and costs differ widely from those of the formal economy. A principal challenge to informal businesses is balancing growth and visibility, which can be categorized as evasion and harassment costs. In order to maintain an aura of low visibility and avoid attention from law enforcement, many informal businesses must restrain the pursuit of maximum growth by not investing in additional labor or capital, or by increasing their customer base. Thus, evading detection from law enforcement results in a loss of potential revenue and business growth, and can be referred to as an indirect cost of informality. Harassment, which is a direct cost, addresses the problems that arise when an informal business is unable to remain evasive and is confronted by law enforcement. Some direct costs include extortion, business closings, seized capital, fines, or imprisonment.¹²² Many proponents of microfinance contend that microenterprises need access to capital in order to meet the short-term demands that accompany their business practices. Additionally, traditional banks typically have not offered products that would fulfill the needs of informal microenterprises due to their non-formal business practices.

In summary, it can be said that as evasion costs decrease, harassment costs will likely increase; in turn, as evasion costs increase, the likelihood of paying harassment costs will diminish. Hence, unlike the cost/benefit cycle of the formal sector (where risks can be justified by profits and business growth), the cost/benefit cycle of the Informal Sector neither allows the business to grow nor to achieve high profits; at best it reaches an equilibrium that allows the informal entrepreneur to support his/her livelihood and family, while at the same time avoiding unwanted attention from law enforcement officials.

¹²² Cross 34

Operating on a Continuum: The Role of Legality in the Informal Sector

“...in Mexico the urban labor market is fluid and integrated: there is a continuum between formal and informal activities, informal jobs are found in formal enterprises, and workers often hold different types of jobs at the same time.”¹²³

In the above quote, Marianne Fay describes the complexity of the legal situation of the urban informal sector. Yet, if illegality presents so many problems, why do businesses not register legally so that they can operate without fear of being caught and gain access to formal credit? Simply, becoming legal and maintaining legality are two different variables in the informal sector, and at times, especially for the extremely poor, it is worth sacrificing one or both in order to survive. In this section, I will discuss the stages, costs, and types of legality, and why many microentrepreneurs work with one foot in the formal sector and the other in the informal sector.

Legality exists in two stages. The first pertains to initial legal recognition, which requires that the microbusiness officially register with local and national bodies, providing a legal gateway into the formal economy. Registration gives the business legitimacy and authorization in the eyes of law enforcement.¹²⁴ Concurrently, it cements the business’s obligations to meet standards of health and product quality, categorizes the business as an economic unit that may belong to appropriate trade groups or associations, and obliges the business to pay taxes.

The second stage involves the maintenance of legality, which requires that microentrepreneurs fulfill all legal obligations in every stage of their business operations. Yet, for many small businesses, maintaining legality, or permanence, can consume an extremely large portion of their operating costs. However miniscule their level of economic activity and output

¹²³ Fay 59

¹²⁴ Tokman. “The Informal Sector in Latin America: From Underground to Legality” 5

may be, legal businesses are required to accurately pay taxes, maintain records and appropriate licenses, and meet labor standards.¹²⁵

As Marguerite Berger notes, there is “no clear-cut division between a formal and an informal sector ...the complex reality could be better described as a continuum with sliding transitions.”¹²⁶ With this in mind, it is important to note that the majority of urban microenterprises fall into an intermediary category that represents both formality and informality. Victor Tokman uses 1980s urban Mexico as an example. Based on several case studies, 27% were unregistered (not having paid any entry costs or taxes), 18% were fully legal (having paid all entry and permanence fees, which would therefore pass them into the formal sector), and 55% fell in between, having paid entry costs, but not all of the permanence fees.¹²⁷ Quasi-legal informal enterprises tend to only satisfy the registration requirements because it enables them to start operations on a legal footing, gives visibility to the location of their business, and makes them eligible to receive credit. Plus, maintaining a minimum level of legality reduces the risks of severe sanctions.¹²⁸

While many hard-line critics of the informal sector view it as an economy in which illicit products are made and sold by people of low moral character, the fact is that criminal entities only constitute a small minority of Latin America’s informal sector. The large majority provide services and goods that support families and provide nothing more than a minimal standard of living. By operating along a sliding scale of legality, the informal sector continually adapts to changing political environments and economic crises in order to survive and remain afloat in a competitive market.

¹²⁵ Lagos 103.

¹²⁶ Marguerite Berger. “Microfinance: An Emerging Market within the Emerging Markets.” In *Emerging Financial Markets in the Global Economy*. Larry Sawyers, Daniel Schydrowsky, and David Nickerson, eds. World Scientific, 2000: 11.

¹²⁷ Tokman. “The Informal Sector in Latin America: From Underground to Legality” 5

¹²⁸ Tokman. “The Informal Sector in Latin America: From Underground to Legality” 7

The Informal Sector in the Eyes of the State

The role of government throughout the development of the informal economy has been ambiguous and inconsistent at best. As the massive rural-to-urban migration was taking place following World War II, most governments turned a deaf ear to the important demographic shift. As was mentioned earlier, a major determinant in what separates legality, partial legality, and illegality is how stringently legislation is enforced by police. Conversely, the governments of Latin America have a vested interest in the performance of the informal economy due to its sheer magnitude, which should help to explain an ideological shift on the part of the states in cooperating with the needs of the informal economy.

Studies undertaken by academics and NGOs in the 1970s emphasized that the informal sector was a permanent and integral aspect of Latin American economies; a fact that governments eventually came to recognize. At varied speeds throughout the 1980s and up to the present, Latin American governments began to acknowledge the importance and existence of informal economic activities and over time began to either actively work with NGOs or directly engage the informal sector bilaterally.

When analyzing the stages of government response over the lifespan of the informal economy, Maria Otero identifies four distinct roles: detached, passive collaboration, active collaboration, and directive collaboration. The detached role, which is largely extinct now, was most prominent from the 1940s to the 1970s as many governments did not have an interest in the informal sector and many believed erroneously that the informal sector carried little impact for a country's macroeconomic development. Passive collaboration refers to a dynamic in which a government acknowledges, with varying levels of ambivalence, that the informal sector exists and allows NGOs and other international donors to provide services to informal enterprises, but

serves as a multilateral mediator with very little enthusiasm or care. In this stage, the government still does not believe that the performance of the informal economy can have greater implications macroeconomically. Active collaboration marks a significant change in governmental roles because, for the first time, the informal sector is being incorporated into the domestic formal economy. In a break with the past, the informal sector is now discussed as a focus of policy that recognizes the important connection between macroeconomic policy and microeconomic production. Governments now view NGOs as channels through which funds can be sent to informal microenterprises. In the role of directive collaboration the government continues to draft policy aimed at integrating the informal economy with the greater economic ambitions of the nation. CEPAL applauds this newfound emphasis on microeconomic production, noting that 80% of the economic policies in Latin America now have a focus on domestic performance.¹²⁹ During directive collaboration the state also takes a more aggressive position in providing services to the informal sector, thus decreasing the mobility and influence of NGOs.¹³⁰

Importantly, demographic and political changes have forced Latin American governments to take a more pragmatic stance towards informal economies. For the state, cooperating with or assisting the informal sector carries the same weight as a social service. This cooperation has proven to be extremely important under the contemporary demography of Mexico. A majority of the country is young, unskilled or minimally skilled, and currently lives in urban areas, which means that the informal market is a strong employment platform for much of the population.

¹²⁹ Emilio Zevallos V. "Micro, Small, and Medium-Sized Enterprises in Latin America." *CEPAL Review* 79 (April 2003): 52.

¹³⁰ Otero. "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America" 183, 185-7

From the government's point of view, the informal economy can absorb a portion of the workforce that has been marginalized by the formal economy.¹³¹

Recent developments in policy and politics have strengthened the symbiotic relationship between the state and the informal economy. Importantly, during economic difficulties or restructuring, the informal sector can serve as a cushion against disturbance or turmoil within a recently displaced or marginalized population.¹³² However, as NGOs and international donor organizations encourage the growth and efficiency of informal businesses, these informal economic units will become more aggressive and influential, thus increasing their interdependence with the formal economy.

Conclusion

At the beginning of the twenty-first century, more than 40 percent of all urban businesses operated informally in Mexico. Unlike the informal economic activity of previous decades, governments have recently come to recognize the legitimacy of such activity, providing assistance and channeling money to organizations that profess to serve microenterprises. Microfinance institutions have emerged as important entities that provide much needed capital to microenterprises and to poor citizens who choose entrepreneurship as their pathway to survival or upward ascendancy.

During the social turmoil that surrounded neoliberal restructuring, urban informal economic activity undoubtedly provided a social cushioning and extra-legal employment outlet. At the same time, the social upheaval introduced to Mexico and Latin America by neoliberalism served

¹³¹ Otero "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America" 180

¹³² Cross 22

as a testament to the economic marginalization, aggravation of inequalities, and worsening of poverty that accompany such extreme market-oriented policies.

As the microfinance industry becomes further commercialized and neoliberalized, activists on both sides of the debate reframe arguments that were used to promote or denigrate free-market economics. Proponents of commercialized microfinance promote market-oriented approaches because they increase competition, invite foreign capital, and provide the best infrastructure for wide-scale development. Detractors of commercialized microfinance say that poverty cannot be reduced by market-oriented policies, as they believe it was free-market ideology that exacerbated such poverty in the first place.

4. The Emergence of Microfinance and the Debate on Conflicting Methodologies

Import-substitution industrialization corresponded with an improvement in the standard of living and a relative closing of the inequality gap in Mexico. Nonetheless, one-quarter of the population still lived in poverty in 1980. By 2002, following two decades of neoliberal policies, Mexico's poor had come to represent 50 percent of the population, according to World Bank statistics.¹³³ Financial marginalization and high unemployment further reduced the likelihood that many would break out of the cycle of generational poverty. The fact that poverty levels hovered between 25% and 50% in the last thirty years signifies that public and private institutions have inherent, systemic deficiencies, rather than just periodic glitches. In response to these conditions and institutional failings, microfinance emerged as a new tool to assist in the reduction of poverty.

I will discuss how the traditional banking industry has failed to provide services for a majority of Mexicans throughout the twentieth century and to the present day. Additionally, this chapter will also address how international development programs have failed to adequately reduce poverty in developing countries. Then, I will demonstrate how microfinance evolved from a strictly non-profit pursuit to a commercialized activity, prompting a heated debate about what is the most appropriate approach for poverty alleviation through microfinance. Additionally, I will discuss the ideologies behind the two approaches, as well as the criticisms that each sides' proponents have levied against one another.

Failure of Traditional Financial Institutions and International Development Programs

In Mexico and Latin America the poor have traditionally lacked access to legitimate forms of credit. During the colonial period and until Nineteenth Century liberalization programs, many

¹³³ "Poverty in Mexico – Fact Sheet." World Bank. 9 June 2009. <http://web.worldbank.org>.

Mexicans lived in rural areas in which informal credit practices were the norm, with *hacendados*, the Catholic Church, and informal moneylenders in control of credit. However, as more *rurales* began relocating to Mexican urban areas throughout the Twentieth Century, formal banks were one of several social institutions that failed to provide adequate access to poor urban residents. The absence of formal financial services led many poor residents to turn to the informal “Moneylender,” the ambiguous figure that is vilified by both sides of the microfinance debate.

The inability to access formal financial services has retarded the social and economic growth of Mexico’s poor. In theory, credit is viewed as a lubricant that allows for the smoother flow of commercial and business transactions, but the reality is that credit represents socioeconomic capital that can empower its recipients. Javier Santiso elaborates:

“To grant someone a loan is to give that person “credit” in both meanings of the word. The borrower not only receives a sum of money to cover a purchase, to avoid a bottleneck, to invest in order to increase production; the future also appears in the borrower’s eyes to be a more favourable (sic) horizon. To receive credit is to enter an arena of experience that involves...a horizon of expectation and the promise of a better tomorrow.”¹³⁴

In terms of access to formal financial services, the rich have received disproportionately high levels of access in comparison to the poor, in addition to their effective monopolization of credit access. As the rich consistently exercised their credit privileges, poor populations were unable to maintain an equivalent rate of social and economic capital acquisition, thus the rich attained a distinct advantage over the poor in many aspects of life.¹³⁵ This disparity was exacerbated by the fact that many newly-arrived urban migrants found it difficult to participate in formal economic activities and acquire the official income documentation that formal banks required for gaining access to their services.¹³⁶ Clearly, credit carries more than simply a monetary value. Echoing

¹³⁴ Javier Santiso. “Markets in Virtue: The Promise of Ethical Funds and Micro-Credit.” UNESCO, 2005: 504.

¹³⁵ Yunus. *Banker to the Poor: Micro-Lending and the Battle against World Poverty* 150

¹³⁶ Lagos 102

Javier Santiso, credit represents empowerment and hope. Muhammad Yunus and others in the microfinance industry have argued that access to credit is a human right.¹³⁷

Many financial leaders, from both the private banking industry and international development institutions, have thought that the poor were poor because they lacked the necessary skills to achieve financial stability. Therefore, offering credit to the poor was seen as a bad financial investment, one that would probably never be repaid. This mindset has had a debilitating effect on the poor. Muhammad Yunus describes how the absence of fair credit has been an integral element in the perpetuation of poverty:

“...their poverty arises from the fact that they cannot retain the genuine results of their labor...They have no control over capital. The poor work for the benefit of someone else who controls the capital. It may be moneylenders...It may be landlords, factory owners, or agents who recruit poor people for work under conditions of near-slavery...Why is this the case? Because the poor do not inherit any capital, nor does anyone in the conventional system provide them with access to capital or to credit.”¹³⁸

The microfinance industry has completely disproven the misplaced theory that the poor are not credit-worthy. Microfinance institutions have shown that lending to the poor can not only be sustainable, it can be profitable. Berger, Otero, and Schor note that write-off rates are lower and return-on-equity¹³⁹ are consistently higher for microfinance institutions than formal banks. Moreover, repayment rates in microfinance institutions (upwards of 98%) are significantly higher than those in the traditional banking sector (mid-70%).¹⁴⁰

In Mexico, the traditional banking industry has consistently marginalized the majority of the population, and neoliberal reforms have done little to amend the situation. Additionally, in Mexico and Latin America, most credit is concentrated in a few very large loans, for reasons of

¹³⁷ Ramesh

¹³⁸ Yunus. *Creating a World Without Poverty* 114-5

¹³⁹ A measure of a corporation's profitability that reveals how much profit a company generates with the money shareholders have invested.

¹⁴⁰ Marguerite Berger, Maria Otero, and Gabriel Schor. "Pioneers in the Commercialization of Microfinance: The Significance and Future of Upgraded Microfinance Institutions." In *An Inside View of Latin American Microfinance*. Inter-American Development Bank, 2006: 58-9.

profitability and stability.¹⁴¹ Loaning small amounts of money to large numbers of people who lack collateral has traditionally been seen as a business venture with the potential for high losses. This mentality has had serious ramifications on Mexico’s low-income communities. As Figure 1 illustrates, Mexico’s financial institutions failed to provide financial services to 75 percent of the adult population in 2007. When compared to other developing countries in Latin America, Mexico ranked the lowest; in comparison with industrialized countries, Mexico trailed significantly.

Figure 1 – An Estimate of the Population with Access to Financial Services, 2007 (selected countries)¹⁴²

Country	Access to Financial Services, %
Mexico	25.00
El Salvador	25.73
Brazil	42.70
Spain	95.00
United States	90.90

Financial depth, which measures how deep a financial institution’s services reach into the overall population, is another indicator that demonstrates how well a society is served by its financial institutions. When financial depth is high it indicates that there is an “adequate channeling of savings toward productive investments, an efficient payment system that facilitates transactions between economic agents, and appropriate monitoring of business risks.”¹⁴³ Studies have shown that when there is greater financial depth there is a stronger likelihood for economic

¹⁴¹ Berger, Otero, and Schor 38

¹⁴² Liliana Rojas-Suarez. “The Provision of Banking Services in Latin America: Obstacles and Recommendations.” *Center for Global Development*. Working Paper 124 (June 2007): 4.

¹⁴³ Rojas-Suarez 1

growth and poverty reduction. As seen in Figure 2, Mexico ranks low in comparison to industrialized countries and other developing countries. Mexico's Deposits/GDP Ratio is considerably lower than the Deposits/GDP Ratio of most industrialized countries. However, Mexico's Deposits/GDP Ratio has been average when compared with other countries in the region.

Figure 2 – Indicators of Financial Deepening (selected countries)¹⁴⁴

<i>Country</i>	Deposits/GDP Ratio¹⁴⁵		Credit/GDP Ratio¹⁴⁶	
	Average, 1990-1999	Average, 2000-2004	Average, 1990-1999	Average, 2000-2004
Mexico	0.23	0.24	0.23	0.15
El Salvador	0.35	0.42	0.32	0.41
Brazil	0.18	0.22	0.25	0.27
Spain	0.64	0.82	0.79	1.05
United States	0.54	0.59	0.54	0.62

In terms of its Credit/GDP Ratio from 1990 to 1999, Mexico was largely average in comparison with other Latin American countries. However, between 2000 and 2004, Mexico's Credit/GDP Ratio dropped to the lowest in the region, and at 0.15 it is extremely low compared with industrialized countries. By looking at these two ratios, it can be seen that there is great disparity between Mexico and industrialized countries in terms of financial access. For the access that Mexico's financial institutions do provide, they are limited and lack depth.

At the end of the twentieth century, an estimated 80 percent of all businesses in Latin America could be considered microenterprises and they employed 120 million people. In spite of the fact

¹⁴⁴ Rojas-Suarez 3

¹⁴⁵ Indicates how deep deposit services reach into a market

¹⁴⁶ Indicates how deep credit services reach into a market

that microenterprise production accounted for between 10% and 50% of national output, depending on the country, only 5% of microenterprises had access to formal credit lines. For a country such as Mexico, in which more than 30% of its economically active population was microentrepreneurs and an additional 20% were employed in microenterprises, financial exclusion has limited economic activities for a significant part of the labor force.¹⁴⁷

International development institutions, such as the World Bank, the IMF, and the Inter-American Development Bank, have long been aware that poor citizens have been marginalized from traditional institutions. In turn, they have attempted to provide needed infrastructure, such as roads, bridges, industrial parks, and power plants. Additionally, they have implemented education and job training programs for the poor in an attempt to break the cycle of generational poverty. Yet, these efforts have largely fallen short of their goals. The fact that these massive programs have largely fallen short of their stated goals has generated much criticism.

John Perkins, a prominent critic of international development programs, has claimed that they were unsuccessful because they were never meant to be successful. According to Perkins, international financial institutions only start major development projects because it enables the governments of industrialized countries to award hefty contracts to preferred construction companies and contractors. In turn the overwhelming debt that the developing country incurs allows the lending nations to impose conditions on the debtor nation. International development projects and the loans accompanying them are allegedly meant to enrich the elites of the countries involved, with any actual poverty alleviation as a bonus.¹⁴⁸

Muhammad Yunus echoes many of Perkins' statements, saying that developmental loans are often associated with government corruption and collusion between public leaders and private

¹⁴⁷ Berger 4-5

¹⁴⁸ John Perkins. Interview with Amy Goodman. *Democracy Now!* June 5, 2007.

contractors. Yunus estimates that at least 75% of all developmental aid is spent on sources within the donor country for “equipment, commodities, and consultants.” In the receiving country, the other 25% goes to the government’s preferred contractors and consultants, as well as to politicians who helped facilitate the purchase of the loan. In Yunus’ opinion, these international financial institutions operate as a “charity for the powerful while the poor get poorer.”¹⁴⁹

While it is clear that traditional financial institutions have done little to alleviate poverty, there are few alternative solutions. Microfinance has emerged as one of the viable alternatives. In response to the failure of traditional financial practices, early microfinance institutions broke with the heavily-bureaucratic, top-down approach of development agencies, shifted their methodology and philosophy, and initiated a self-empowering, “bottom-up” strategy for poverty alleviation.

Emergence and Growth of Microfinance Activities

The institution that is informally credited with founding the microfinance industry is Grameen Bank.¹⁵⁰ It began in 1976 in Bangladesh as a university research project headed by Muhammad Yunus, who was an economics professor at the University of Chittagong. In the study, Yunus and his students lent small amounts of money, normally less than \$30, to poor residents in nearby villages. Going against traditional philosophy, Yunus lent directly to poor residents without requiring any additional employment training. The study was an unequivocal success and Yunus expanded the program to more villages, eventually founding an institution called Grameen Bank.¹⁵¹ Using a non-profit approach that primarily focused on social returns, Grameen Bank

¹⁴⁹ Yunus. *Banker to the Poor* 145-6

¹⁵⁰ ACCION International has been vocal in mentioning that they conducted microfinance programs in Latin America in the early 1970s

¹⁵¹ “A Short History of Grameen Bank”

experienced considerable growth over a thirty year-period. Grameen Bank's borrowers, of which there are 2.6 million, own 93% of the bank.¹⁵² By 2007, Grameen had distributed more than \$6 billion in loans and had a return rate of 98.6%.¹⁵³ With slight modifications to its methodology over time, Grameen Bank concentrated on social returns and empowerment through entrepreneurialism in order to grow operations and alleviate poverty simultaneously. The Grameen model has been duplicated throughout the world.

History and Development of Microfinance in Latin America

The prevailing governmental attitude towards microenterprises and the informal sector was one of indifference until the 1980s. Academic- and NGO-sponsored studies implemented throughout the late 1960s and 1970s led to the foundation of a body of information and literature that documented the work of informal businesses and their economic contribution, which made the disdainful attitude of the government difficult to maintain.¹⁵⁴ Most importantly, the founding and subsequent success of the Grameen Bank showed that large-scale lending to the poor could be a practical venture. Throughout the 1980s, NGOs, with the help of governments, began founding institutions that mirrored Grameen Bank. Some of these non-profit MFIs experienced a level of success that enabled further expansion. By the 1990s, some MFIs were ready to test the microfinance model in the commercial banking industry, thus revolutionizing microfinance methodology at its foundation.

The country at the center of the microfinance commercialization movement was the poorest country in South America: Bolivia. More so than any other Latin American country, Bolivia's

¹⁵² Yunus. *Banker to the Poor* 235

¹⁵³ Yunus. *Creating a World Without Poverty* 51

¹⁵⁴ Otero. "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America" 180

informal sector has always occupied a disproportionately large position in the country's economy. While the percentage of the urban informal workforce in relation to the total urban labor force throughout Latin America hovered at 30% from 1950 to 1970, the urban informal workforce for Bolivia occupied 56% of the total urban labor force in the same time period.¹⁵⁵ As Bolivia confronted the economic crises and the neoliberal structural adjustments of the 1980s and 1990s, 75% of the population came to depend on income generated within the informal economy.¹⁵⁶ By 2007, 80% of the population was either partially or fully dependent on income from the informal economy.¹⁵⁷ The important role played by informal businesses in the overall economy indicates that Bolivia would have an ideal climate for a competitive and profitable microfinance industry.

In Bolivia the move towards commercialization began with an NGO called *Fundación para la Promoción y Desarrollo de la Microempresa* (PRODEM). Founded in 1986, PRODEM sought to channel credit to local microentrepreneurs. After several years of successful operations, PRODEM realized that they were only meeting 2% of the potential demand for microcredit, yet constraints on capital and funding prevented the organization from expanding. Due to its status as an NGO, federal banking regulations prohibited PRODEM from collecting savings from its clients and from taking out loans from formal banking institutions. In order to expand outreach and increase mobility, the board of directors decided to transform PRODEM from an NGO into a commercial bank that offered microfinance services.

With financial support provided by ACCION International, the new commercial MFI, called *BancoSol*, opened its first four branches in 1992 and distributed \$21.7 million in loans. By 1998

¹⁵⁵ Thomas. "Surviving in the City: The Urban Informal Sector in Latin America" 44

¹⁵⁶ Otero. "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America" 178.

¹⁵⁷ "Friends, Not Clones." *The Economist*. 9 June 2007: 41-2.

it had disbursed \$135.9 million in loans, offered services to over 81,000 clients, and opened its 40th branch office. Additionally, *BancoSol*'s portfolio-at-risk¹⁵⁸ was extremely low and its outstanding loan portfolio¹⁵⁹ had reached US \$74 million. Within ten years this commercialized MFI had become the most profitable bank in Bolivia.¹⁶⁰ In an effort to emulate the success of *BancoSol*, numerous competitors sprouted up throughout Bolivia, which increased efficiency, decreased interest rates, and greatly expanded outreach and access for Bolivia's enormous informal workforce.¹⁶¹

However, problems soon arose for this young industry. As commercial MFIs began competing for profits, they began irresponsibly dispersing excessive consumer loans to poor Bolivians. This profit-seeking tactic led to client over-indebtedness and caused massive numbers of loans to default. Were it not for strong federal banking regulations, Bolivia would have faced deeper economic problems. This error in judgment helped fuel additional charges by commercialization critics. According to the critics, this over-lending crisis would not have been as severe had the element of profitability not been present. Proponents of commercialized microfinance blame the over-lending crisis on creditors who were irresponsible, abusive, and predatory.¹⁶²

¹⁵⁸ The outstanding value of loans with payments past due as a percentage of the total portfolio

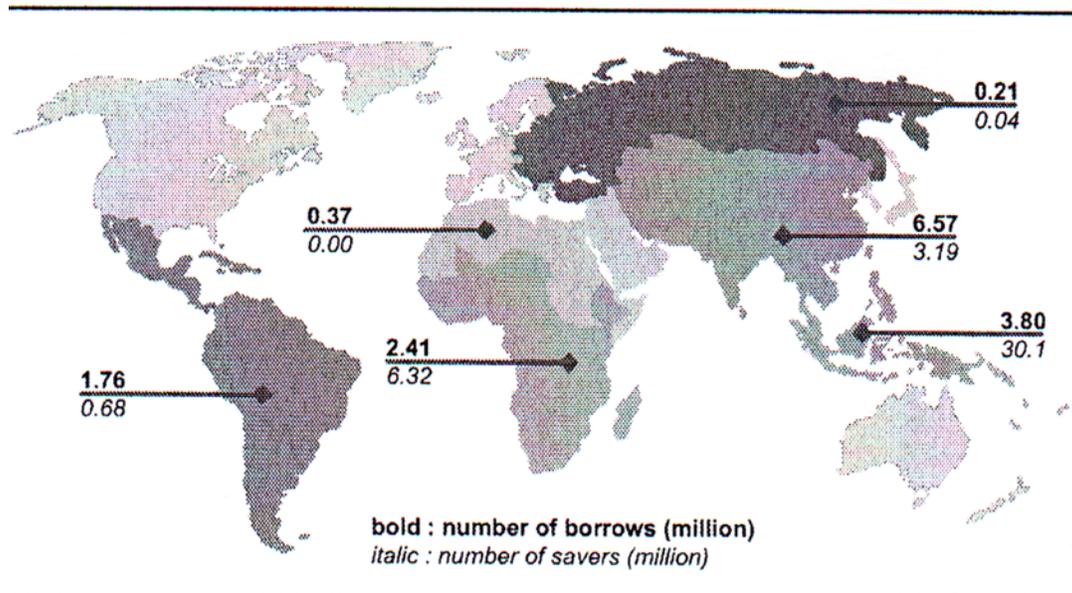
¹⁵⁹ The amount of money that an MFI has disbursed in loans

¹⁶⁰ Robinson 67-9

¹⁶¹ Berger, Otero, and Schor 61

¹⁶² Armando Muriel, Victoria Muriel, Giulissa Franco, and Elsa Martin. "Microfinance Institutions in Times of Crisis." In *An Inside View of Latin American Microfinance*. Marguerite Berger, Lara Goldmark, and Tomas Miller-Sanabria, eds. Inter-American Development Bank, 2006: 146.

Figure 3 – Global Outreach of Microfinance in 2006¹⁶³



As of 2007, Latin America and the Caribbean had at least 231 microfinance institutions¹⁶⁴ reporting more than \$12 billion in total assets and almost \$10 billion in outstanding loans.¹⁶⁵ The industry has developed into a formidable entity that can spark development in the region. As Figure 3 illustrates, more than two million customers, a minute proportion of Latin America’s population, had been served by MFIs in 2006. With this largely untapped market base, there is much potential in the future of Latin American microfinance. Since 2006, the strong growth of commercialized MFIs, such as *Compartamos*, has led to increased access to credit for millions of poor customers throughout Mexico and Latin America. Still, the principal question remains: What is the best way to both expand the microfinance industry and pull people out of impoverished situations? As the twenty-first century commences, many industry analysts are in disagreement on whether or not microfinance should continue as a non-profit entity or if it

¹⁶³ Anne-Lucie Lafourcade, Jennifer Isern, Patricia Mwangi, and Matthew Brown. “Overview of the Outreach and Financial Performance of Microfinance Institutions.” *Microbanking Bulletin* 12 (Apr. 2006): 4.

¹⁶⁴ Matthew Gehrke and Renso Martinez. “First Look: The Diverse Latin American Microfinance Market.” *Microbanking Bulletin*, 15 (Autumn 2007): 20.

¹⁶⁵ Blaine Stephens. “Large MFIs Dominate Investor Portfolios and Client Services.” *Microbanking Bulletin* 15 (Autumn 2007): 31.

should mimic Bolivia and pursue a commercialized approach. In the next section, I will explain how the commercialized track was taken in Mexico and the controversy that ensued.

The Rise of Banco Compartamos

Ever since Grameen Bank proved that microlending could be sustainable and *BancoSol* proved that it could be profitable, development analysts began exploring ways in which the for-profit model could be expanded. Mexico's *Banco Compartamos* proved to be the institution in which the commercialization experiment would experience the most success, and in turn would receive the most criticism.

For *Compartamos*, dramatic growth has taken place in a decade's time. Founded as an NGO in the early 1990s, *Compartamos* began dispersing subsidized loans that promoted microenterprise development with a focus on women in rural areas. From 1995 to 2002, *Compartamos*' customer base grew from 15,000 customers to over 140,000.¹⁶⁶ Much of its growth is owed to the fact that it has been one of the only MFIs in Mexico that focuses almost completely on microenterprise credit, which allowed *Compartamos* to expand rapidly.¹⁶⁷ In 2001, *Compartamos*' board of directors decided to upscale to a *Sociedad Financiera de Objeto Limitado* (SOFOL), which is a non-banking, finance institution that provides working capital but cannot receive deposits.¹⁶⁸

¹⁶⁶ "History." 2008. *Compartamos*. 26 April 2008. www.Compartamos.com.

¹⁶⁷ Jared Miller. "Enabling Growth: An Analysis of *Compartamos*' Expansion." *Microbanking Bulletin* 10 (Mar. 2005): 10.

¹⁶⁸ "Making a Difference: Financial Markets." 2005. International Finance Corporation. 26 April 2008. www.ifc.org.

Figure 4 – Growth of *Compartamos*: 2002-2008¹⁶⁹

Year	Active Portfolio	Amount Dispersed	Active Clients
2002	\$43,030,870	\$179,124,272	144,991
2003	\$64,213,016	\$285,256,214	215,267
2004	\$102,033,717	\$457,529,651	309,637
2005	\$183,271,404	\$795,799,010	453,131
2006	\$275,198,000	\$1,190,122,000	616,528
2007	\$383,500,000	\$1,687,600,000	838,754
2008	\$587,654,286	N/A	1,160,000

With *Compartamos*' activities expanding, *Microenterprise Americas* named it the most profitable MFI in 2005.¹⁷⁰ *Compartamos* decided that it would act as a bridge between public investors and the marginalized poor, and its initial public offering¹⁷¹ (IPO) took place in 2007, making it the first MFI to enter into the stock market.¹⁷² In the IPO, *Compartamos*' shares sold for \$467 million¹⁷³ and generated \$80 million in profits.¹⁷⁴ Net profits in 2008 rose 28% to \$112 million, up from \$87.5 million in 2007. In 2008, *Compartamos* repurchased 12.1 million shares of stock, valued at \$36.5 million, because they felt that the market value was not accurately reflecting *Compartamos*' profit potential, according to CFO Fernando Alvarez.¹⁷⁵ With more than 300 branches operating in nearly every Mexican state, the company recently started offering

¹⁶⁹ "Financial Data – Banco Compartamos." *The Mix Market*. www.mixmarket.org.

¹⁷⁰ Matthew Gehrke, Renso Martinez, and Blaine Stephens, "Championship League: The Top 100 MFIs in Latin America and the Caribbean," *Microenterprise Americas* (Fall 2005). 30 Dec. 2007. www.iadb.org.

¹⁷¹ The first sale of stock by a company to the public

¹⁷² "History." *Compartamos*.

¹⁷³ "Mexican Microfinancing Bank Banco Compartamos Places Shares for USD 467 Million." *Noticias Financieras*. 20 April, 2007.

¹⁷⁴ Elisabeth Malkin. "After Success, Problems for Microfinancing in Mexico"

¹⁷⁵ Ken Parks. "Mexico's Compartamos Sees Microfinance Weathering Tough Year." *Wall Street Journal*. 27 Feb. 2009.

remittance services and savings accounts.¹⁷⁶ As Figure 4 shows, *Compartamos*' client base rose nearly ten-fold between 2002 and 2008, which is remarkable given that the company's detractors accuse the company of predatory, harmful practices. *Compartamos* is currently the largest MFI in Latin America.¹⁷⁷

For-Profit or Non-Profit?: Conflicting Approaches for Microfinance

In this section I will address the fundamental disagreement between proponents of commercialized microfinance and supporters of non-profit microfinance. First, I will touch on two points in which the two groups find agreement:

- a) Global poverty is so profound that programs dependent on government subsidies and private donations cannot possibly have a lasting, sustainable impact.
- b) Poverty reduction programs that resemble welfare are not effective. Infusing poverty reduction with entrepreneurialism empowers poor citizens, dignifies their existence, and gives them greater control over their lives.

While industry policymakers agree that poverty reduction should be the ultimate goal of microfinance activity, they disagree on how best to extend those services to the poor. On the one hand, if poor communities only needed access to affordable credit in order to improve their socioeconomic standing, then simply providing the monetary product would be sufficient. Commercialized MFIs accomplish this goal. But, if poor communities need access to affordable credit *and* social support in order to ensure that their socioeconomic well-being improves, then a non-profit approach may be appropriate. Providing both monetary and social support is more labor intensive than simply providing financial credit. Therefore, it would be less

¹⁷⁶ "Compartamos"

¹⁷⁷ Matthew Gehrke, Renso Martinez, and Maria Cecilia Rondon. "Champions League 2008." *Microenterprise Americas* (Fall 2008): 6.

profitable. Proponents of the non-profit approach state that poverty reduction is the principle goal of microfinance and that commercialization will lead the industry to choose profits over poverty reduction. Proponents of commercialization claim that they can have both: profitability and poverty reduction.

Figure 5 - Commercialized MFIs: Advantages and Disadvantages

Advantages	Disadvantages
Self-Sustaining	Temptation to focus on profits
High Mobility and Flexibility	Over-lending
Offer Diverse Products	Need for Strong Supervisory and Regulatory Bodies
High Financial Efficiency	
High Outreach	

Figure 6 – Non-profit MFIs: Advantages and Disadvantages

Advantages	Disadvantages
Commitment to Poverty Reduction	Low Outreach
Offer skill training, medical services, and education	High Losses
High Social Returns	Capital-constrained

Figure 5 and Figure 6 detail the successes and failings of both commercialized MFIs and non-profit MFIs. In both cases, the advantages are frequently trumpeted by the respective institutions, with the disadvantages highlighted by detractors. However, there is considerable evidence to support the claims made by each.

Can a “Neoliberalized” Microfinance Industry Reduce Poverty?

Supporters of commercialization contend that it is the future of microfinance. Robert Peck Christen and Deborah Drake say as much in their chapter “Commercialization: The New Reality of Microfinance.”¹⁷⁸ ACCION echoes the sentiment in their publication *Microfinance in the Real World*, which is undoubtedly a poke at traditionalists who believe microfinance should remain free of profit motives. Many key analysts and policymakers believe that a commercialized industry will impact the greatest number of people and pull the most people out of poverty. However, in order to invite the capital needed to expand the industry, investors need to be drawn into the industry and they need to be compensated for their investments. Therefore, high profits must be earned. This mentality greatly resembles neoliberal philosophy.

Under neoliberal principles, the opening of markets was meant to facilitate greater economic growth, increase employment, and reduce poverty. Initially, the heavily protectionist policies of the ISI-era had to be stripped away. Latin American governments began to eliminate tariffs on foreign imports and reduce state spending, which meant privatizing state-owned industries, downsizing employee rolls, and cutting spending on social programs. Theoretically, the elimination of tariffs and regulations should have been conducive to increased foreign investment. Although there would inevitably be “short term pain” from social turmoil rooted in spikes of unemployment mixed with reduced access to social services, the “long term gain” would consist of industry growth and job creation. Korzeniewicz and Smith note that the combination of job creation and increased productivity would lead to higher wages, which would directly reduce poverty rates. Strong market growth would then provide the state with revenue to

¹⁷⁸ Christen and Drake 2

support social programs.¹⁷⁹ Theoretically, free-market growth would provide the best way to create wealth, expand employment opportunities, and reduce poverty.

In practice, neoliberal policies had a different outcome. Whereas increased market-orientation should create more formal employment, the informal sector grew significantly. Poverty and inequality rose substantially, supporting Polyani's idea that "free markets are inherently machines for the creation and reproduction of inequality" and that their "upward" flow of wealth perpetuates "pre-existing class differences."¹⁸⁰ In discussing how the free-market inherently exacerbates inequality, Adam Smith stated that "every man's interest would prompt him to seek the advantageous, and to shun the disadvantageous employment."¹⁸¹ Former World Bank president Joseph Stiglitz echoed: "Left to itself, the market will tend to underprovide human capital. It is very difficult to borrow against the prospects of future earnings since human capital cannot be collateralized. These difficulties are especially severe for poor families."¹⁸² So, while analysts and policymakers may model economic growth around the free-market with the intention of increasing productivity and efficiency, there is overwhelming evidence that an additional consequence of such pursuits in Mexico has been both the expansion of poverty and the widening of inequality.

Similar to neoliberal philosophy, microfinance commercialization dictates that expansion of microfinance services is best achieved through conditions in which private capitalists feel confident that their investments will yield strong returns and high profits. Theoretically, what is best for the holders of capital is also what is best for society's development. Based on the reasoning of the proponents of for-profit microfinance, expanding the outreach and scope of

¹⁷⁹ Korzeniewicz and Smith 17

¹⁸⁰ Portes and Roberts 62

¹⁸¹ Adam Smith. *The Wealth of Nations*. Bantam, 2003: 138.

¹⁸² Korzeniewicz and Smith 24

microfinance can best be achieved through a model that pursues high profits. Such success will inevitably attract more investors, which will then create more MFIs, leading to higher competition and lower interest rates for customers.¹⁸³

Successful commercialized MFIs point to their growing client base to show that they have found an eager market. A near ten-fold increase of customers from 2002 to 2008 signifies that many customers are willing to try the *Compartamos* product at least once. In *Compartamos'* methodology, it is understood that social benefits are inherent in their product, therefore the next step is to introduce that product into as many markets as possible. If the product sells well, then the customers will be socially improved for having bought it and investors will be handsomely compensated for risking their capital. Within this understanding, it is a win-win situation.

Non-Profit MFIs: Maintaining a Social Focus on Microfinance

Yunus wholly supports the core idea behind capitalism: “The economic system must be competitive...” as it is “the driving force for all innovation, technological change, and improved management.”¹⁸⁴ Yet one of the central complaints that Yunus and other critics of commercialization have is that the free-market and unfettered capitalism do not take into account the multi-dimensional nature of a person’s existence, therefore the free-market suffers from a major “conceptualization failure.” Broad free-market theory states that an economic actor’s only responsibility is to pursue those interests which most benefit him/her. Yunus states:

“...since we are persuaded by the theory that the pursuit of profit is the best way to bring happiness to humankind, we enthusiastically imitate the theory, striving to transform ourselves into one-dimensional human beings. Instead of theory imitating reality, we force reality to imitate theory.”¹⁸⁵

¹⁸³ “Doing good by doing very nicely indeed.” *The Economist* 387.8586. June 28, 2008: 18.

¹⁸⁴ Yunus. *Banker to the Poor* 206

¹⁸⁵ Yunus. *Creating a World Without Poverty* 18

Yunus' original idea of microcredit was to provide a way for an individual to simply *acquire* interests that he/she could protect. The philosophy behind his brand of microcredit is that the establishment of financial services with built-in social safeguards should provide a pathway out of poverty for poor individuals. Non-profit MFIs must charge enough interest so that they can sustain themselves and be able to expand, but are ultimately beholden to the customers. Under the commercialized model, MFIs charge enough interest to sustain themselves *and* to generate profits in order to attract investors, which would then allow for more expansion; the poor clientele play a diminished role in the process. In *Microfinance in the Real World*, ACCION International wrote that "rates could not be reduced further...without sacrificing the ability to attract risk capital in the future, even from socially motivated sources."¹⁸⁶ In Grameen Bank, and other non-profit MFIs in Latin America, this conflict of interests is avoided by the fact that the clientele are the principal shareholders of the organization. However, Maria Otero, president and CEO of ACCION, justifies *Compartamos'* IPO by saying that it allowed them to stockpile "earnings in order to fund portfolio growth and expansion. Most income was reinvested in the institution rather than paid out to shareholders... all retained earnings remain at the service of clients."¹⁸⁷ ACCION International was one of *Compartamos'* original investors and earned approximately \$140 million in the 2007 IPO.¹⁸⁸

Many anti-commercialization voices take the stance that personal enrichment from the labor of the impoverished is both unethical and immoral. Non-profit MFIs justify their interest rates by claiming that all proceeds go directly toward sustaining and expanding microfinance services, rather than having proceeds pass through an investor who can decide whether or not the money

¹⁸⁶ ACCION International. *Microfinance in the Real World: For-Profit Growth Will Benefit the World's Poor*. ACCION International Media Center. 20 Dec. 2007. www.accion.org.

¹⁸⁷ "Remarks by Maria Otero, President & CEO, ACCION International." *Microcredit Summit E-News* 5.1 (July 2007).

¹⁸⁸ "Poor People, Rich Returns." *The Economist*, 15 May 2008.

will be reinvested. Richard Rosenberg, an advisor for the Consultative Group to Assist the Poor (CGAP), has said that overcharging for interest is acceptable for non-profit MFIs, rather than for-profit MFIs, because the profits are immediately reinvested in the microfinance program, rather than going into the pocketbooks of investors. Therefore, the investor variable is minimized and the poor clientele are more directly impacted.¹⁸⁹ For many non-profit proponents, the fact that commercialized MFIs make profits from loans to poor people makes them no better than moneylenders. Yunus elaborates:

“...I have serious problems when people try to justify high interest rates...on loans given to the poor. I say, ‘Make all the profit you want from your middle-class customers! Feel free to take advantage of your financial position, if you can! But don’t apply the same thinking to the poor. If you can lend to the poor, do it without concern for profit, so that they can have the maximum help in climbing out of poverty. Once they’ve completed the climb, then treat them like every other customer – but not ‘till then.’”¹⁹⁰

Yunus feels that when lending money to the poor, there intrinsically must be a “social consciousness,” as it was the lack of a social consciousness in traditional financial operations that have put the poor in their position in the first place. He goes on to say that *Compartamos*’ methodology is “socially, economically, and politically dangerous and should be morally condemned.” Some critics note that *Compartamos*’ operations could easily have continued expanding with lower interest rates and profit margins, although their growth rate would have been slower.¹⁹¹ Additionally, their IPO would have been less lucrative.

The dynamic of high interest rates and high profits is what irks most critics of *Compartamos*. What makes this point of contention so interesting is that neither *Compartamos*’ critics, nor their supporters, nor *Compartamos* itself, can identify what its interest rates actually are. Many of

¹⁸⁹ Mary Anastasia O’Grady. “Americas: Markets for the Poor in Mexico.” *Wall Street Journal*. Jun 30, 2008: A11.

¹⁹⁰ Yunus. *Creating a World Without Poverty*. 69

¹⁹¹ Robert Cull, Asli Demirgüç-Kunt, and Jonathan Morduch. “Microfinance Meets the Market.” *Journal of Economic Perspectives* 23.1 (Winter 2009): 168.

Compartamos' critics charge that their APR¹⁹² hovers around 100%. While *Compartamos* claims that their APR is closer to 70%, they also say that this APR is too high and needs to continue dropping.¹⁹³ Representatives from *Compartamos* and ACCION International are quick to point out that comparing interest rates across all markets is inappropriate. They argue that interest rates are generally high within the Mexican economy, and that within this context, *Compartamos*' rates are competitive.¹⁹⁴ However, in recognizing the flexibility of markets, Yunus counters by saying that "a true microcredit organization must keep its interest rates as close to the cost-of-funds as possible," which may be "comfortably under the cost of funds plus 10% or plus 15% at the most." Cull, Demirgüç-Kunt, and Morduch contend that *Compartamos*' rates exceed the recommendation put forth by Yunus.¹⁹⁵

Another point of contention for commercialization critics is that when information on interest rates and APR is released, it is often limited and contradictory. Jonathan Lewis says that these specific statistics are *never* available on industry performance reports, noting that information pertaining to "geographic balance, average loan size, poverty indicators, and sustainability metrics" is nearly always included, in spite of the fact that these indicators are negligible in terms of poverty reduction.¹⁹⁶ "Trend Lines 2005-2007 MFI Benchmarks," a report published by The Microfinance Exchange, which is a landmark information source in the microfinance industry, confirms the accusation that simple information on APRs and interest rates is not easily available. This report uses a plethora of indicators that pertain to efficiency, profitability, risk

¹⁹² Annual Percentage Rate: a percentage that represents the yearly cost of funds over the term of a loan

¹⁹³ "Poor People, Rich Returns"

¹⁹⁴ ACCION International

¹⁹⁵ Cull, Demirgüç-Kunt, and Morduch 183

¹⁹⁶ Jonathan C. Lewis. "Microloan sharks." *Stanford Social Innovation Review* 6.3 (Summer 2008): 57.

and liquidity, and outreach, but does not include any direct statistics on interest rates, APRs, or poverty reduction.¹⁹⁷

Still, many supporters of commercialization contend that although interest rates are high now, they will drop in the future. *Compartamos* critic Jonathan C. Lewis refers to this approach as the destitute of today paying higher prices so the destitute of tomorrow can pay lower prices. As Lewis details in “Microloan Sharks,” the proposition that such an approach will lead to a more competitive market is difficult to believe. He notes that a 2007 Microfinance Network study that analyzed microfinance market competition was only able to identify three countries with markets sufficiently competitive to satisfy the study requirements: Bolivia, Uganda, and Bangladesh.¹⁹⁸ However, *Compartamos*’ track record lends credibility to its prediction that as more commercialized MFIs enter the market, interest rates will drop due to competition; since *Compartamos*’ 2007 IPO, at least eight for-profit MFIs have been founded in Mexico, resulting in a drop in interest rates from 115% in 2001 to the upper-70s in 2008.¹⁹⁹ Claudio Gonzalez-Vega writes in a joint study by USAID-CIDE (Centro de Investigación y Docencia Económicas):

“The (Mexican) microfinance sector is experimenting [experiencing] rapid growth. There is significant growth in the number of institutions, as well as in the number of clients...The industry has attracted different actors, from commercial banks interested in the sector to credit bureaus who serve the institutions. The growing number of MFIs and the entrance of other institutions, like commercial banks and consumer lending companies have increased competition and forced the institutions to search for better products and to improve their processes.”²⁰⁰

According to ACCION International, the lucrative IPO was a “market stimulus.”²⁰¹ Álvaro Rodríguez Arregui, the chairman of ACCION International, has called *Compartamos*’ IPO a “big

¹⁹⁷ “Trend Lines 2005-2007 MFI Benchmarks.” *Microfinance Information Exchange*, May 2009. www.themix.org.

¹⁹⁸ Lewis 57

¹⁹⁹ “Doing good by doing very nicely indeed”

²⁰⁰ Danel and Labarthe 7-8

²⁰¹ ACCION International

win” in shoring up capital for the microfinance industry.²⁰² Another ACCION representative stated: “The financial markets have shown the true value created by high performance, double bottom line-oriented microfinance institutions. We hope that this is the first of many [IPOs]...”²⁰³ In a statement, Maria Otero, ACCION’s CEO, hoped that “many other MFIs will be able to replicate [*Compartamos*]’ success, demonstrating that access to financial services for the poor has truly become integrated into international financial systems.”²⁰⁴ Mauricio Hubard, CEO of *Compartamos* competitor *En Confianza*, echoed Otero’s sentiment:

“Yunus opened the eyes of the world to microfinance. *Compartamos* opened the eyes of the private sector and the financial markets. Thanks to the success of their IPO, we were successful in raising the initial capital we needed from private sector investors in less than a month. The success of *Compartamos*, even if people want to make it controversial has changed the financial sector and opened new opportunities for companies with a social commitment.”²⁰⁵

Undoubtedly, the commercialized microfinance industry in Mexico has been a hotspot for investment and growth. According to Microenterprise Americas, of the 20 most profitable MFIs in Latin America, Mexican MFIs occupy the top eight positions. Additionally, in terms of growth, Mexican firms occupy six of the top ten positions. The study notes that the disparity in profitability within Mexico’s for-profit microfinance industry has recently begun shrinking, indicating that the emergence of competitors may have led to constricting profit margins and increased efficiency.²⁰⁶ Is it possible that now Mexico has joined the ranks of Bolivia, Uganda, and Bangladesh?

The 2007 IPO signified the potential outreach of commercialized microfinance, say defenders of *Compartamos*. Wall Street Journal columnist May Anastasia O’Grady, who sarcastically

²⁰² “Poor People, Rich Returns”

²⁰³ Lewis 56

²⁰⁴ Lewis 58

²⁰⁵ Danel and Labarthe 8-9

²⁰⁶ Gehrke, Martinez, and Rondon 5, 12

labels commercialization critics “do-gooders,” posits: “Would not serving them [the poor] have been a better moral outcome?”²⁰⁷ The monetary success of the IPO caused investors to begin visualizing the impact that large injections of capital could have on the microfinance industry. Based on *Compartamos*’ lucrative IPO, the CGAP estimates that global funding for microfinance could rise from the \$4 billion raised in 2008 to nearly \$30 billion annually. This could have a dramatic impact on the global reach of microfinance. In its current state, the microfinance industry reached 133 million customers in 2006 and is predicted to reach 177 million in 2015. However, proponents of commercialization say that one billion customers could be served by 2015 if *Compartamos*’ IPO is duplicated across the globe. As one *Compartamos* supporter declared, microlending “has lost its innocence. To mourn this loss of innocence would be wrong...To attract the money they need, [microlenders] have to play by the rules of the market. Those rules often have messy results.”²⁰⁸ Yunus was less enthusiastic:

“I am shocked by the news about the *Compartamos* IPO. When socially responsible investors and the general public learn what is going on at *Compartamos*, there will very likely be a backlash against microfinance.”²⁰⁹

Conclusion

Microfinance undoubtedly grew out of dissatisfaction with traditional development programs, banking practices and economic policies. Since its inception in the 1970s, microfinance has experienced a sea change in awareness, funding, and outreach. Interest in microfinance arguably reached its highest point recently, due to the attention created by *Compartamos*’ 2007 IPO and Muhammad Yunus’ awarding of the Nobel Peace Prize in 2006. Since these two watershed moments, considerable literature on the microfinance industry has been published. Literature on

²⁰⁷ O’Grady

²⁰⁸ Cull, Demirgüçç-Kunt, and Morduch 169

²⁰⁹ “Remarks by Muhammad Yunus, Managing Director, Grameen Bank.” *Microcredit Summit E-News* 5.1 (July 2007).

microfinance faces a unique challenge in that the industry evolves at such a rapid pace that findings and opinions are quickly antiquated. For instance, Jonathan C. Lewis' article "Microloan Sharks," which was published in summer 2008, suggested that Mexico's for-profit microfinance industry did not contain enough MFIs to be considered competitive. Yet, 2008 proved to be an important year for for-profit microfinance in Mexico, with many new MFIs sprouting up. Since these enterprises do not possess the same strong name recognition as *Compartamos*, thoroughly tracking the growth of the industry across Mexico would be a difficult task.

Interestingly, it is the presence of so much risk capital that has caused dramatic changes to the microfinance industry. With many finance prospectors able to acquire the capital needed to start up an MFI, new players can quickly appear in the market and impact the industry, in both good and bad ways. The absence of well-defined and comprehensive regulation complicates the scenario even more. In the next chapter I will discuss the operational practices of some for-profit MFIs in Mexico, as well as the issue of regulation and transparency in the industry.

5. Operating Practices of Commercialized MFIs in Mexico

Estas tierras de la nación, las sembré un buey manco
These lands of the nation, I sowed them with a crippled ox
Se me reventó el barzón y sigue la yunta andando
Now the yoke strap's broke and the team just goes on walking

El Barzón, a song which was made popular following the Mexican Revolution, tells the story of a poor *campesino* who needs to acquire tools in order to farm his small plot of land. Without any other recourse, he asks to borrow from the *hacendado*, the owner of the estate on which the *campesino* is employed. As the song goes on, the lyrics tell a story of an indebted peasant who does not earn enough to pay back what he owes. Although the ox yoke fell into disrepair, the peasant's debt was still due. The song continues: "20 pesos for the rent of the oxen, five pesos for some maguey, six pesos for I don't know what."²¹⁰

This is the type of informal lending that is so often vilified by both sides of the microfinance debate. However, as the microfinance industry became more commercialized, those who supported a more traditionalist approach came to view for-profit MFIs as neither practicing microcredit nor being a positive alternative to informal moneylenders. Undoubtedly, the operational practices of *Financiera Independencia*, *Compartamos*, and *Banco Azteca*, some of the for-profit MFIs that will be discussed in this section, violate Yunus' original idea of how microfinance could be used to help the poor: "When you discuss microcredit, don't bring *Compartamos* into it...Microcredit was created to fight the money lender, not to become the money lender."²¹¹

In this section I will focus on the operational practices of for-profit MFIs in Mexico, identifying their lending and collection practices in order to see if they do, in fact, provide a needed service for impoverished and low-income communities, or if they are a reincarnation of

²¹⁰ Ross 256

²¹¹ "Yunus Blasts Compartamos." *Business Week*. 13 Dec. 2007. www.businessweek.com.

the traditional “moneylender.” As the section progresses, it becomes clear that they are a combination of the two. The primary focus of the section will be on the commercialized MFI *Financiera Independencia*. There will be a secondary focus on other MFIs in Oaxaca de Juárez, such as *Banco Azteca*, *Compartamos*, and *Caja Popular Mexicana*.

Productive or Counter-Productive?: Commercialized Microfinance in Oaxaca

Financiera Independencia

“Obviously they should make profits, because it’s a business. That’s what it’s there for... But many of these things can be avoided. The seizures, many of these problems... If in reality the clients were well informed of what the interest rate was that *Financiera Independencia* was charging them, of what would happen if they missed a payment one day...” – Eva, a loan officer with *Financiera Independencia*²¹²

Founded in 1993 in the sector of *Sociedades Financieras de Objeto Limitado* (SOFOL), *Financiera Independencia* (FI) began growing slowly throughout Mexico, basing their growth on capital acquired through government funds and international donors. By 2000, they had 30 branches and locations in 19 states. In 2004, FI began lending to clients in the informal economy, or as they call it, the “self-employed market.”²¹³ As FI’s operations continued growing, HSBC²¹⁴, one of the world’s largest banks, acquired a 20% stake in FI.²¹⁵

Financiera Independencia held its IPO in November 2007, seven months following *Compartamos*’ IPO. In publicly selling off 20% of its shares, FI raised more than US \$300

²¹² Eva. 9 July 2008.

²¹³ “History.” *Financiera Independencia*. 11 May 2009. www.independencia.com.mx.

²¹⁴ HSBC, a United Kingdom-owned bank, was recently admonished by the consumer protector group Condusef (National Commission for the Protection and Defense of Users of Financial Services) for failing to provide adequate transparency of credit products. “Mexico watchdog flunks HSBC on credit card transparency.” *Reuters*. 9 June 2009. www.reuters.com.

²¹⁵ “HSBC sells 18.68% stake in *Financiera Independencia* for \$145 million.” *MarketWatch*, 19 Sept. 2008. www.marketwatch.com.

million.²¹⁶ By the end of 2007, FI had an outstanding loan balance of \$252 million and operated 152 branches in 105 cities throughout Mexico.²¹⁷ In April 2008, FI announced that it would buy back more than \$112,000 of its own stock, possibly reflecting what *Compartamos* felt in 2008: the profit potential of the company was not properly reflected in its market price.²¹⁸ In September 2008, HSBC sold all of its shares to JP Morgan for an estimated \$145 million.²¹⁹ In March 2009, FI listed its total assets at \$254 million, a total loan portfolio of \$337.7 million, and an average loan balance of \$300 among a client base of more than 1.1 million. At the time of this writing, FI operates 197 offices in 143 cities and employs more than 7,900 people.²²⁰

Microenterprise Americas ranked FI as the seventh most profitable MFI in Latin America. In terms of client base, FI was the second largest MFI in Latin America that offered consumer loans.²²¹

Eva, the Loan Officer

Clearly, FI has attained a financial success that most businesses would envy, but it is unclear whether or not this brand of MFI is socially responsible and/or effective in reducing poverty. While in Oaxaca in 2008, Eva, a loan officer with FI, gave me a unique insight into how the operations of her company were perceived by the clientele, as well as its employees. Due to the fact that the majority of her salary is based on commission, she has an inherent interest in seeing that she sells as many loans as possible. As she explained to me, this meant that she has an

²¹⁶ Jacob Keller. "Microcapital Story: Microfinance Institution, Financiera Independencia, of Mexico Announces 2007 Earnings." *Microcapital*, 22 Feb. 2008. www.microcapital.org.

²¹⁷ "Financiera Independencia." *The Mix Market*, 11 May 2009. www.mixmarket.org.

²¹⁸ "Financiera Independencia Announces Resolutions Approved at the Annual Extraordinary and General Ordinary Shareholders' Meeting Held on April 29, 2008." *Reuters*, 29 April 2008.

²¹⁹ "HSBC sells 18.68% stake in Financiera Independencia for \$145 million"

²²⁰ Sally Levy. "Mexican Microfinance Institution, Financiera Independencia, Reports First Quarter Net Income of Ps. 117.2m (USD 8.9)." *MicroCapital*, 11 May 2009. www.microcapital.org.

²²¹ Gehrke, Martinez, and Rondon 9, 12

incentive to keep many clients in the dark about certain details of the microloan. For example, when explaining the details of the loans to customers, she frequently failed to fully illustrate how profoundly the interest rate can impact the total amount due, especially if there are penalties for late payments. This tendency is widespread throughout the for-profit microfinance industry; this section will document similar cases with FI's competitors *Banco Azteca* and *Compartamos*.

Eva explained that FI, as well as *Compartamos* and *Banco Azteca*, frequently manipulated the clients' interest-based debt. According to her, FI systematically found ways to add on to the client's debt so that they could draw profit from the interest payments. At first, many clients start with a MXN \$4,000 peso²²² loan, which comes with an account-opening fee of \$400 and an value-added tax of 15% on the opening fee, which costs \$61. This brings the total amount that the client initially owes to \$4,461. While clients believe that interest will only be charged on the original \$4,000, many are unaware that interest will actually be charged on the *full* \$4,461, in spite of the fact that they only have access to the original \$4,000. Eva believes that this is the most basic *trampa*, or scam, a word that she frequently used when talking about FI and FI's competitors.²²³

Antonio and Rigoberta

Eva took me to meet with Antonio and Rigoberta, a married couple who took out a personal loan in order to help pay for their daughter's university tuition. They sustained a very humble existence and were excited at the prospect of having a daughter with a professional degree. Antonio worked in a factory that made uniforms for security guards and earned a minimum hourly wage. While he was willing to help his daughter pursue a university degree, he found it

²²² All monetary amounts shown are in Mexican pesos, unless otherwise indicated

²²³ Eva. Personal Interview. 7 July 2008.

difficult to meet the demands of the loan: “They take advantage and the interest is too much. In Oaxaca no one can earn more than what they owe.”²²⁴ In the process of paying off their second loan with FI, the two of them had become frustrated with FI’s policies regarding interest rates. Antonio said to me, “The interest is too high...it’s 10%.” Quickly his wife interjected:

“No, it’s 100% or 95%. Every 15 days we have to pay...MXN \$206. But on the capital you only have to pay MXN \$48. And the interest...it’s MXN \$158 of just interest. And the capital...they’re just charging MXN \$48 pesos. The interest is a lot. It’s 100% or something, I think. The interest is very expensive.”²²⁵

In spite of the fact that Antonio told me they were also punctual with payment, the arrear penalty proves otherwise. The receipt of their last payment read as follows:

Capital	\$36.56
Interest	\$162.04
Arrear charge	\$3.40
Total	\$202.00

Based on this receipt, interest costs accounted for 80% of their payment to FI. Unlike many creditors in the United States, interest payments with for-profit MFIs do not decrease as the principal amount decreases. Throughout the life of the loan, interest payments remained based on the original amount borrowed, rather than always adjusting to reflect the most current balance.²²⁶

One can easily see the lack of clarity regarding the clients’ knowledge of FI’s interest rates. Antonio thought that the interest rate was 10%, while his wife felt that it was between 90% and 100%. Even though Eva was with me during this display of confusion, she failed to clarify the situation by telling the two of them that FI charged 6% monthly. This exchange illustrated the clients’ lack of understanding of loan terms, even for two-time clients such as Antonio and

²²⁴ Antonio and Rigoberta. Personal Interview. 7 July 2008.

²²⁵ Antonio and Rigoberta

²²⁶ Keith Epstein and Geri Smith. “The Ugly Side of Micro-Lending; How Big Mexican Banks Profit as many Poor Borrowers Get Trapped in a Maze of Debt.” *Business Week*. 24 Dec. 2007: 44.

Rigoberta. My assumption is that Antonio was referring to FI's monthly interest rate, while his wife was referring to the APR.

Manipulation of Interest-based Debt: A Method for Profit Accumulation?

Consequences for Late Payments

The penalty for late payments seemed to highlight the disconnect between client expectations and the reality of FI practices. "They think that turning in a late payment will result in a penalty of a few pesos, but it's not like that at all...If today a person owes 74 pesos, but is four days late, they (FI) charges 130 pesos. Double." The monetary penalties associated with late payments are added to the total amount due, with accruing interest.²²⁷

Eva explained that FI finds ways to add multiple costs onto the total amount due. In addition to the basic punishment involved with late payments, FI also has in-house operators that call a client's home, or the home of a co-signer, to warn them that they missed a payment that day. The cost of the phone call and the wage of the operator are added to the client's amount due, all of which will be charged with interest. The process is repeated again the next day. Eva says that such penalties can have a strong impact in a poor city such as Oaxaca: "It affects them economically. Perhaps they won't be able to eat. They won't have *la canasta basica*²²⁸ ...They won't be able to have bread. They won't be able to eat meat. Nor tortillas. Feeding their kids will be difficult..."²²⁹

Even though Eva claims that FI charges 6% monthly, the situation is still a bit vague. She explained to me the full costs of only making the minimum payment on a personal loan from FI. Most clients can only afford to make the basic payment every *quincena* (15 days) because, like Antonio, they earn an hourly wage that leaves very little extra money to put towards larger

²²⁷ Eva. 9 July 2008.

²²⁸ "Basic food basket"

²²⁹ Eva. 9 July 2008.

payments. On a MXN \$4,000 loan, a client can make 44 basic payments of \$198 every *quincena*. By only fulfilling the minimal obligation, a \$4,000 loan would cost the client \$8,712, more than double the original amount, by the final payment.²³⁰

The convoluted nature of buying and selling microloans exists from the first stages of the transaction process. Although Eva says that she wishes clients were better informed, she acknowledges that she never warns the clients of the potential harm that could come to them for late payment or loan default, such as excessive fines, termination of credit lines, and/or property seizure. According to her, many clients would be scared off, she would lose her commission, and the clients would go to one of FI's competitors, whose loan officers would most likely not fully inform the clients of the loan's potential harms. She preferred to repeatedly remind them how much they owed and when the payment was due. If they fulfilled this obligation, then the other potential problems would be non-existent.²³¹ *Compartamos* co-CEO Carlos Danel echoes this idea: "What matters [to most borrowers] is: 'How much do I have to pay every week or every month or up front?'"²³²

Collection Practices on Delinquent Accounts

Property seizure can occur if a loan is far past due. In order to qualify for a loan, for-profit MFIs, such as FI, require that a customer register some collateral, which could be the property of the loan recipient or the co-signer. Eva noted that some clients placed their *ejido*²³³ certificates as collateral for the microloan. Clients whose payments are past due are reminded that they signed a

²³⁰ Eva. 9 July 2008.

²³¹ Eva. 9 July 2008.

²³² Keith Epstein and Geri Smith. "Compartamos: From Nonprofit to Profit"

²³³ The *ejido* is a small communal landholding once protected under Article 27 of the 1917 Constitution. Recent privatization measures, such as PROCEDE, commoditized landholdings throughout Mexico and eliminated the social value of land. During the *ejido* privatization process, the Mexican government issued a certificate of ownership to the landowner, who is then free to sell the plot of land if he/she chooses. Formerly, the social value of the land protected the land against being bought and sold.

promissory note, which obligated them to pay what they owe or sacrifice their belongings. As Eva explained, some clients begin pawning less valuable possessions to come up with the money owed to FI. In some cases clients even put the deed of their house up for collateral in order to acquire an additional loan so that they can meet their payment with FI. When it becomes clear that a client is not going to make the appropriate payments, FI's in-house collection agency repossesses some of the client's property whose value is considered equal to the amount due. According to Eva, only around half of FI clients make their payments punctually.

Institutions such as FI, *Compartamos* and *Banco Azteca* all claim loan repayment rates in the upper-ninety percentile, which is much higher than traditional banks. However, this repayment rate is reinforced through repossession tactics. If a payment is past due, the financier reclaims some of the client's property, and the loan is considered repaid. For example, when *Banco Azteca*, a subsidiary of the retail giant Elektra, vets a customer for a potential loan, a bank representative takes down the serial numbers on any valuable property the client may have: stereos, refrigerators, DVD players, or televisions. The property must add up to twice the value of the loan in order to be approved. If the client fails to repay the loan, then *Banco Azteca* simply repossesses the client's property, sometimes putting them up for sale in an Elektra used-goods store.²³⁴

According to Eva, these loan conditions are prevalent in all for-profit MFIs, but clients are not aware because they do not fully understand the contract terms. She stated that "they read it [the contract], but the amount of time that they [FI] allow is not enough for the clients to understand it."²³⁵ A *Banco Azteca* customer elaborated: "They never tell you what the interest rate is. They say, 'Sign here,' but they don't give you time to read everything." A *Banco Azteca* administrator

²³⁴ Epstein and Smith. "The Ugly Side" 43

²³⁵ Eva. 9 July 2008.

echoed the sentiment: "Terms are explained to them, maybe not as clearly as they should be, but many clients don't understand...They take on financial commitments they can't meet."²³⁶

Life after *Compartamos*' IPO: The New Face of For-Profit Microfinance

The Emergence of Pure Profit-Seekers into Microfinance

Of the for-profit MFIs in operation, *Banco Azteca* rivals *Compartamos* in terms of outreach and portfolio size. Following its simultaneous opening of 800 branches in 2002, *Banco Azteca* quickly grew into a banking behemoth.²³⁷ While *Banco Azteca* makes small business loans, it found its market niche providing consumer credit for products, mostly electronics and appliances sold in Elektra, a retail store that has frequently been compared to Wal-Mart. *Banco Azteca*'s gross loan portfolio stood at nearly US \$2 billion in April 2009.²³⁸

Banco Azteca has never professed that they entered the market in order to alleviate poverty, which is an important difference from *Compartamos*, which attempts to strike a rhetorical balance that appeals to both social investors and financial investors. The fact is that *Banco Azteca* and *Compartamos* share the same low-income client market, which both institutions point out has been financially marginalized by traditional banks, just like the poorest part of the population. *Banco Azteca* is more forthright than *Compartamos* in identifying its target market, saying that it seeks to market loans to those earning between US \$5,100 and US \$33,600 a year.²³⁹ According to *Business Week*, *Banco Azteca* charges APRs between 50% and 120%, which is considerably higher than the average international rate of 31% charged by non-profit

²³⁶ Epstein and Smith. "The Ugly Side" 42

²³⁷ Miriam Bruhn and Inessa Love. "Grassroots Banking: The Effect of Opening Banco Azteca on Economic Activity in Mexico." World Bank, 2009: 3.

²³⁸ "Outstanding Quality of *Banco Azteca* Mexico's Loan Portfolio, Delinquency Rate Decreases..." *Reuters*, 29 Apr 2009. www.reuters.com.

²³⁹ Epstein and Smith. "The Ugly Side" 42

MFI. *Banco Azteca*'s store employees encourage customers to buy on credit, especially over long pay periods, and receive pay bonuses when they successfully do so.²⁴⁰

Regarding profit-seeking newcomers, critics of for-profit microfinance have been skeptical and question their commitment to social returns. While *Compartamos*, especially during their years as an NGO, has a proven track record of providing socially-conscious credit, other for-profit MFIs lack the credibility that would instill confidence in their plans for social improvement. *Banco Azteca*'s billionaire owner Ricardo Salinas has recalled his grandfather's advice to him: "If you want to become rich, sell to the poor."²⁴¹ *Banco Wal-Mart*, a newcomer to the "microloan" industry, has drawn immediate skepticism, and statements by its CEO Julio B. Gomez fail to instill confidence that the company's intentions have anything to do with poverty reduction or social improvement: "We are not saints... We've come into this business for volume and profitability similar to our other businesses, or else we wouldn't invest."²⁴² This mentality does less to support the idea that microcredit can reduce poverty than to reinforce the old Mexican expression: "Poor businesses, rich businessman."²⁴³

The entrance of so many new for-profit MFIs has highlighted a shortcoming in the Mexican banking industry: lack of transparency. Eva, Antonio, and Rigoberta noted how FI does a poor job of informing people of the conditions and costs of the loan.²⁴⁴ CONDUSEF (National Commission for the Protection and Defense of Users of Financial Services) has received many complaints regarding FI and *Banco Azteca*, and has warned customers of making uninformed

²⁴⁰ Epstein and Smith. "The Ugly Side" 38

²⁴¹ Epstein and Smith. "The Ugly Side" 42

²⁴² Geri Smith and Ketih Epstein. "Wal-Mart Banks on the 'Unbanked.'" *Business Week*. 13 Dec. 2007. www.businessweek.com.

²⁴³ Elisabeth Malkin. "Charges Raise Questions About Mexico's Adherence to Securities Laws." 27 Jan. 2005.

²⁴⁴ Eva. 9 July 2008; Antonio and Rigoberta.

decisions that could lead to financial trouble.²⁴⁵ Due to the fact that Mexican banking regulations do not require MFIs to inform clients of the specific interest rates or overall costs, most for-profit MFIs simply stress the weekly, bi-weekly, or monthly payments that the clients must make. A new 2007 regulatory law required that lending and credit institutions inform clients of all the financing costs they will incur by taking out a loan. *Banco Azteca* strenuously fought the government and eventually won a judgment that granted them an exception to the transparency regulation.²⁴⁶ Analysts have suggested Mexico would be a great lending market to enter because “in Mexico...the regulatory environment isn’t as tough.”²⁴⁷

Some may claim that FI’s practices are exploitative and take unfair advantage of a vulnerable clientele. Still, FI’s client base has grown extraordinarily, in addition to their portfolio and outreach. Supporters of *Compartamos* could make the same argument in attempting to silence critics of the commercialized practices: If customers are systematically being exploited, why do they continue coming to us in such large numbers?

Two interviewees told me that they would not return to institutions that previously loaned them money. Maria, an entrepreneur who sold nursing uniforms, took a personal loan in order to pay for a medical emergency. The lending institution, *Caja Popular Mexicana*, was the third most profitable consumer-loan MFI in Latin America in 2007.²⁴⁸ She emphatically said that she would never return to a similar institution for a loan, mostly due to the high interest rates involved.²⁴⁹ I asked Antonio and his wife if they would ever go back to FI for another loan. Antonio told me “no” and that he would look for a place with lower interest rates. Ideally,

²⁴⁵ Epstein and Smith. “The Ugly Side” 44; Israel Rodriguez. “Comprar opciones antes de contratar un credito personal, sugiere Condusef.” *La Jornada*. 19 Feb. 2007.

²⁴⁶ Epstein and Smith. “The Ugly Side” 44

²⁴⁷ Smith and Epstein

²⁴⁸ Gehrke, Martinez, and Rondon 9

²⁴⁹ Maria. Personal Interview. 5 July 2008.

though, he would prefer to just borrow money from friends or family members because it is much easier.²⁵⁰ This comment surprised me, given that in microfinance literature such informal lending is often conflated with the villainous loan shark.

A study of informal money lending in Oaxaca by Ralph Beals argues that interest rates never exceed 5% or 10% monthly, which Beals believes is unfair.²⁵¹ FI charges 6% monthly. The fact that Antonio prefers the informal method indicates that the commercialized model of microfinance could lack legitimacy and staying power. However, it also indicates that if interest rates of commercialized MFIs continue dropping, then they could arrive at a point in which they have a loyal client base, with repeat customers maintaining the core of the business.

On the other hand, I interviewed a woman who owned a small food cart in a central plaza in Oaxaca who was completely satisfied with her loan from *Banco Azteca*. She had formerly worked on a farm picking vegetables. The \$4000 peso loan from *Banco Azteca* allowed her to buy her food cart. Due to her business venture's success, she was able to quickly pay back the loan and eventually attain the financial independence that her previous position as an agricultural laborer would not have afforded her. She emphatically told me that she would gladly go back to *Banco Azteca* for another loan.²⁵² While *Banco Azteca* appears to be the easy villain for critics of for-profit microfinance, it does seem to have happy customers. I asked Eva her thoughts on *Banco Azteca*: "It's like choosing between two evils. At least they're cheaper than *Financiera Independencia*."²⁵³

Nonetheless, FI has happy customers. I interviewed two FI clients who were small business owners: one woman who ran a bakery which was located inside her home and a man who owned

²⁵⁰ Antonio and Rigoberta

²⁵¹ Clarke 113

²⁵² Maria. Personal Interview. 5 July 2008.

²⁵³ Eva. 9 July 2008.

a tire repair shop. Both businesses appeared to be successful, which undoubtedly increased the likelihood that the owners could pay back their loans in the appropriate time frame, if not sooner. Both owners told me that they would easily go back to FI for an additional loan if necessary.²⁵⁴

Compartamos recently released an in-house report on customer loyalty. Following face-to-face interviews with 805 *Compartamos* clients, results showed that 94% of *Compartamos* customers were totally satisfied with *Compartamos* and that 98% were totally satisfied with the credit that *Compartamos* offers. On a loyalty index based on a scale of 0 (-) to 100 (+), *Compartamos* scored 74, which was higher than other financial institutions domestically and internationally. Credit unions in Chile and Canada scored 62 and 56, respectively. In 2007, traditional banks in Mexico scored 48.²⁵⁵

How Do Contemporary For-Profit MFIs Measure Their Impact on Poverty Reduction?

There is little evidence that convincingly demonstrates a correlation between microfinance and poverty reduction. While one of the central tenets behind microfinance has been the idea that financial inclusion and access to credit will reduce poverty, both for-profit and non-profit industry leaders are quick to say that microfinance alone cannot eliminate poverty. It must operate among complementary services, such as programs for health and education.

As of yet, the microfinance market with the strongest drop in poverty has been Bangladesh. Muhammad Yunus has attributed this in part to Grameen Bank's operations, which empower women and indirectly have led to a decrease in fertility rates, an important factor in a country with one of the highest population densities in the world.²⁵⁶ Grameen Bank's in-house surveys

²⁵⁴ Vicente. Personal Interview. 10 July 2008; Juana. Personal Interview. 12 July 2008.

²⁵⁵ BIMSA IPSOS Loyalty Mexico. "Índice de satisfacción y lealtad." www.compartamos.com.

²⁵⁶ The population density of Bangladesh is such that it would be equivalent to the entire world's population residing in the United States

claim that 58% of their clientele have moved out from under the poverty line. Since 2002, poverty in Bangladesh has been reduced by 10%, which is double the previous rate. Yunus believes that Bangladesh will be one of the few countries in the world to actually meet United Nations' Millennium Goal of halving poverty by 2015. Yunus points out that strengthening democracy and political institutions are integral to achieving that goal and, once met, sustaining it.²⁵⁷ Grameen Bank has shown strong results, which lends credibility to its non-profit methodology and practices.

With respect to for-profit MFIs in Mexico, there is little proof that shows that commercialized microfinance activities impact poverty in any way, which is probably due to an absence of literature that covers the issue of poverty reduction as it relates directly to commercialized microfinance. Young companies such as *Financiera Independencia* are likely not willing to invest in a study of whether or not their product reduces poverty. And, unlike Grameen Bank whose stated mission is to reduce poverty, many commercialized MFIs claim that they strive to expand their product's outreach into the market, which customers are free to utilize to their best abilities. Therefore, MFIs with an implicit social mission, such as Grameen Bank, will always be more likely to measure how their product impacts poverty in the market within which they operate.

Notwithstanding, industry publications, such as *The Microbanking Bulletin*, and academic literature disproportionately focus on financial performance, rather than analyzing the aspect of poverty reduction. To their credit, *Compartamos* conducted an in-house survey that measured the social impact of their loans. Entitled "The Impact of the Transmission of Values to *Compartamos Banco* Customers" and conducted by the de la Riva Strategic Research group, the survey measured five values: self-esteem, financial education, solidarity/family integration,

²⁵⁷ Ramesh

respect, and responsibility. Researchers surveyed 1,000 *Compartamos* customers and 400 non-customers. Both groups showed very similar results regarding responsibility and respect. Non-customers scored higher on the specific attitudes of solidarity/family integration and financial education. However, using a “General Value Index” the researchers found that *Compartamos* customers scored collectively higher in self-esteem, solidarity/family integration, and financial education.²⁵⁸

This one-page summary of the survey provides little statistical overview and presents ambiguous results. The report lacks any questionnaire samples, charts, or graphs. When compared with the depth at which *Compartamos*’ financial performance is scrutinized, this survey on social performance is unconvincing, superficial, and all-too-brief. While *Compartamos* should be commended for attempting to measure social performance, this report leaves much to be desired. In what seems to have been the trend in industry and academic research, the number of reports measuring financial performance dwarfs the number of reports on social performance of for-profit MFIs. Outside of “feel-good stories” that often appear as investment recruiting tools on websites, little hard evidence exists that convincingly proves that for-profit microfinance has significantly reduced poverty.

The Drive for Increased Regulation

Jacques Rogozinski, one of the key officials in the Salinas administration’s Unit for the Divestiture of Parastate Entities said that “one of the best ways to prepare the private sector to operate efficiently as the new owner of public firms is to protect it as little as possible.”²⁵⁹

²⁵⁸ De la Riva Investigación Estratégica. “Impact of the Transmission of Values to Compartamos Banco.” *Compartamos*. www.compartamos.com.

²⁵⁹ Dag MacLeod. *Downsizing the State: Privatization and the Limits of Neoliberal Reform in Mexico*. Pennsylvania State University Press, 2004: 69, 81.

Throughout the 1990s, privatization and deregulation of markets were commonplace in the Mexican economy. During its *sexenio*, the Salinas administration divested more than 700 previously state-owned enterprises, including banks. President Salinas' brother, who was the principal bureaucrat charged with divesting state companies, earned the nickname "Mr. 10%" due to the fact that allegedly collected a 10% commission on every company he privatized.²⁶⁰ In 1990, the Mexican government realized approximately \$1 billion from selling off state companies; this figure jumped to \$10 billion in 1991.²⁶¹ An emphasis on deregulation and investor-friendly policies has characterized many Mexican industries, including the for-profit microfinance industry.

Recently, intense pressure, scrutiny, and negative press have caused microfinance analysts to reevaluate their operating practices. One point of contention has been the lack of strong regulatory measures or any appropriate regulatory body for MFIs. The polarized nature of the microfinance industry has left many analysts and investors unsure of how to address the issue of regulation in the industry.

In April 2008, the German-based Deutsche Bank organized a 2-day conference of 25 microfinance industry leaders who work all over the globe in both the for-profit and non-profit sectors. The idea was to find common goals within the diverse microfinance industry. As Elisabeth Rhyne put it, "The level of disagreement was probably not as great as it seemed... You have people who have common ground for 75% of what they do." The agreement, which came to be called the Pocantico Declaration, emphasizes regulation and transparency and cautions against predatory lending, using the US subprime lending crisis as a portent of the consequences of

²⁶⁰ Ross 183

²⁶¹ MacLeod 82-3

irresponsible credit practices. Lynne Patterson, founder and CEO of ProMujer, said that the Pocantico Declaration represents the fact that all signees “want to protect the client.”²⁶²

Of the leaders involved in Latin American microfinance activities, signatories include Carlos Danel of *Compartamos*, Elizabeth Littlefield and Rich Rosenberg of Consultative Group to Assist the Poor, Lynne Patterson of ProMujer, Elisabeth Rhyne of ACCION International and Alex Counts of the Grameen Foundation.²⁶³ Several key points in the document include, in summary:

- A concern that disproportionate attention, in an effort to appeal to investors and the supply-side of microfinance, has been paid to financial performance and profitability, which has led to an inadequate understanding of how microfinance activities affects poor clientele.
- A desire for increased transparency in regards to costs, performance, outreach, and impact
- A concern for the risk of over-indebtedness and the lack of a uniform code of conduct
- Recognition that excessive profits may generate a public backlash and that interest rates must continue to decrease.²⁶⁴

Since its IPO, *Compartamos* has remained largely silent amidst substantial criticism, allowing the public, the press, and the microfinance industry to dictate the tone of the debate. However, *Compartamos* was very involved in the Pocantico Declaration and has been more open about its vision for the future of microfinance. In its June 2008 publication “A Letter to Our Peers,” *Compartamos* state its desire that for-profit microfinance operations be regulated more stringently. *Compartamos* touts its role in implementing Consumer Protection Pledges in

²⁶² Elisabeth Malkin. “Lender to the Poor Adopt Guidelines.” *New York Times*. 25 Sept. 2008.

²⁶³ The Grameen Foundation is a sister organization to Grameen Bank.

²⁶⁴ *The Pocantico Declaration*. 23 April 2008

*ProDesarrollo*²⁶⁵ and the Microfinance Network²⁶⁶ and in supporting the Transparency Law in Mexico.²⁶⁷ *Compartamos* co-CEO Carlos Danel says that the push for increased uniformity “comes out of the worry that the industry is more diverse...we can set up some rules of the game over how we treat people.” Alex Counts of the Grameen Foundation understands *Compartamos*’ aggressive stance in establishing regulation and protective policies: “If we’re able to establish a microbanker’s code of conduct and if *Compartamos* is at the center of delivery on that, that would go a long way to address their critics.”²⁶⁸

Conclusion

Muhummad Yunus often uses an easy-to-understand analogy in order to describe the dangers of an unregulated market:

“Global trade is like a hundred-lane highway, criss-crossing the world. If it is a free-for-all highway, with no stoplights, speed limits, size restrictions, or even lane markers, its surface will be taken over by the giant trucks from the world’s most powerful economies. Small vehicles – a farmer’s pickup truck or Bangladesh’s bullock carts and human-powered rickshaws – will be forced off the highway. In order to have win-win globalization, we must have fair traffic laws, traffic signals, and traffic police. The rule of “the strongest takes all” must be replaced by rules that ensure that the poorest have a place on the highway. Otherwise the global free market falls under the control of financial imperialism.”²⁶⁹

It would be reasonable to see how a new industry initially develops without a comprehensive plan to regulate excesses, protect customers, and operate efficiently. In the case of the microfinance industry, a disproportionate amount of attention has been paid to measuring financial performance and growth, which has resulted in a deficiency of data that measures the

²⁶⁵ *ProDesarrollo* is a Mexican network whose members promote financial culture among popular sectors. The network includes other networks, financial institutions, individuals and members from the academia.

²⁶⁶ The MicroFinance Network (MFN) is an international association of leading microfinance institutions. Through the MFN, 37 members from 31 countries share ideas, experiences, and innovative solutions to the challenges they face in search of continuous growth and progress.

²⁶⁷ Danel and Labarche 2

²⁶⁸ Malkin. “Lender to the Poor Adopt Guidelines”

²⁶⁹ Yunus. *Creating a World without Poverty* 5

socioeconomic impact of microcredit on poor clientele. Perhaps only now, after it has been convincingly shown that lending to the poor can lead to exorbitant profit margins, will for-profit MFIs open themselves up to stronger regulations.

As Yunus describes above, for-profit microfinance, without any real consumer protections, could easily run roughshod over poor customers who lack legal recourse and possess little banking knowledge. Developments in regulatory measures, such as the Pocantico Declaration, should be seen as a positive progression and the organizations who signed the document should be commended. However, it must be noted that the Pocantico Declaration lacks any teeth; it is more of a collection of ideas that relate to how the industry should develop, what practices should be encouraged and discouraged, and what commonly shared goals exist for all microfinance institutions. Several features remain absent from this non-binding resolution: specific definitions regarding over-indebtedness and predatory lending, a strict explanation of the boundaries of transparency, agreement on what constitutes excessively high interest, and how best to deal with non-punctual and/or delinquent borrowers. Importantly, several major MFIs remain absent from the Pocantico signees: *Financiera Independencia*, *Caja Popular Mexicana*, *Conserva*, *Financiera Conser*, *Invirtiendo*, *COCDEP*, *Alternativa Solidaria*, *Banco Azteca*, and *Banco Wal-Mart*. The first seven institutions, along with *Compartamos*, are included in the top ten most profitable MFIs in Latin America.²⁷⁰ It is unclear if these organizations turned down invitations to attend the Pocantico conference or if they were simply not invited.

Based on the experiences of some for-profit MFI customers, it is clear that borrowers lack understanding of loan conditions. In some cases customers are not even aware of the most basic aspect of their microloan: the interest rate. Transparency laws regarding overall costs, interest rates (perhaps including both the monthly rate and the APR), and potential property seizure

²⁷⁰ Gehrke, Martinez, and Rondon 12

consequences will contribute to a more open for-profit microfinance industry. While *Compartamos* ought to be given credit for actively bringing increased regulation to the industry, it cannot make a comprehensive impact without the help of its competitors. If *Banco Azteca* continues its practice of opposing transparency legislation, which could give it an unfair advantage over *Compartamos* in the market, then other for-profit MFIs may follow *Banco Azteca*'s lead. *Compartamos* occupies a unique position in the two worlds of microfinance; its founding and years of operation in the non-profit sector gave it credibility in the eyes of social investors, yet its successful IPO inspired many profit-seekers to enter the microfinance industry. If *Compartamos* can capitalize on the influence they exercise over both social investors and profit-seekers to bring increased regulation to the industry, then it will have shown itself to be very relevant in the microfinance industry's next stage of development.

6. Conclusions

My initial goal for this project was to better understand who commercialized microfinance clientele were and how their lives were impacted by microfinance. Although this information was somewhat available on MFI websites, it was generally tailored to appeal to potential investors and promoted a meticulously cultivated appearance. More so, critics and proponents of commercialized microfinance often over-generalized and inaccurately portrayed each other. It was my hope that in Oaxaca I would gain a more comprehensive and subtle understanding of commercialized microfinance practices and how they impacted the lives of the customers.

Of course, the definition of what microfinance is, and is not, muddles the impression that one may have when interpreting the effectiveness or failure of a particular MFI. Yunus' Type 1 and Type 2 categories do well to distinguish how we should interpret the effectiveness of an MFI. Type 1 programs are poverty-focused, do not require collateral, and charge low-interest (the cost of funds at market rate plus an additional 10 to 15 percent). These programs are targeted to the lower class and the impoverished. Type 2 programs cannot be considered poverty-focus programs because they charge excessively high interest rates in order to maximize profits and appeal to investors and shareholders. Type 2 programs should only target the lower-middle class and above.

One of the central points of conflict in the microfinance debate involves whether or not microfinance should strive to alleviate poverty or to expand financial access, or both. Proponents of commercialization would argue that an expansion of financial opportunities could potentially reduce poverty. The anti-commercialization camp would argue that, in order for poverty reduction to actually occur, an expansion of financial opportunities needs to be coupled with safeguards that would protect poor customers from the dangers associated with debt.

As illustrated in Chapter 3, Mexico's ISI policies correlated with decreases in poverty and inequality over three-plus decades. However, the emergence of neo-liberalism in the 1980s brought with it deregulation, decreased social spending, and other austerity measures. As the decade went on, Mexico's national debt increased and conditions attached to emergency loans, which led to the privatization of state-owned industries, increased unemployment, and the cancellation of social programs. These actions had the collective effect of raising the unemployment rate at the same time that social services for unemployed workers were disappearing. These simultaneous occurrences pushed a large segment of the Mexican population into the informal economy.

The informal economy in Mexico employed 44% of the nation's urban workforce in 2003. Many of these workers either owned or were employed by microenterprises, which have become one of the preeminent sources for employment in Latin America and Mexico. During the 1990s, an estimated 60% of all jobs in urban Latin America originated in the microenterprise sector, in which most businesses operate in the informal sector. With many of these businesses lacking formal access to capital, stability and growth were frequent problems for microentrepreneurs and their employees.

Large sectors of the Mexican population have frequently been marginalized by structural fallacies in economic and labor policies. Formal employers failed to generate adequate employment levels for large portions of the population and formal financial institutions only provided access to a small percentage of the population. Additionally, international development institutions, such as the World Bank and the Inter-American Development Bank, implemented programs that did not provide adequate infrastructure for poverty reduction. The collective

shortcomings of so many institutions led early microfinance industry leaders to develop a cheaper, more direct way to assist the poor in improving their livelihood.

Traditional financial philosophy held the belief that the poor were poor because they were not financially responsible and therefore were not credit worthy. Early MFIs did not believe that this idea was accurate and felt that the poor could effectively manage credit under the right circumstances and conditions. Rather than requiring collateral for loans, many MFIs incorporated group-lending methodology into their practices, using the intangible element of social pressure to insure that clients would pay back their loans. These early MFIs faced tremendous scrutiny from the traditional banking industry and development institutions, but over time their financial performance proved that microfinance institutions could not only be sustainable, they could also be profitable. As MFIs in Latin America, particularly in Bolivia and Mexico, have shown, their financial performance consistently ranks higher than that of traditional banking institutions.

Although the Bolivian *BancoSol* was the first commercialized MFI in Latin America, Mexico's *Banco Compartamos* took commercialized microfinance to a new level with its 2007 IPO. Much in the same way that *BancoSol*'s financial success inspired other for-profit MFIs to begin competing in the market, *Compartamos*' successful IPO catalyzed investors and financiers to start up a multitude of for-profit MFIs throughout Mexico since 2007. The hundreds of millions of dollars of profit that for-profit MFIs have earned has put to rest any skepticism that microfinance may not be profitable. Now the debate has clearly shifted to whether or not microfinance activities *should* be profitable and if profiting from poor customers is ethical.

Supporters of commercialized microfinance posited that high profits were necessary because it was the only way in which MFIs could acquire the capital needed to rapidly expand

microfinance operations. Commercialization theory for microfinance greatly resembles neoliberal philosophy, both of which suggest that markets needed to be as appealing to investors and capitalists as possible. If capital were able to flow freely, then investors would feel confident in providing risk capital for industries. As investment and industry grow and stabilize, both employment and wages would do the same. Similarly in commercialized microfinance, for-profit MFIs need to produce high profits in order to appeal to investors, who will then re-invest and give for-profit MFIs the capital they need to expand their outreach. In a similar vein with neoliberal philosophy, what is good for the investors is good for everybody. However, neoliberal theory differed greatly from neoliberal practice. As Chapter 3 explained, the opening and deregulation of the Mexican economy did not create the jobs that were promised, which corresponded with an increase in unemployment, poverty, and inequality.

Similarly, commercialized microfinance has brought with it some questionable consequences. The accumulation of debt and the manipulation of interest have created a polarized division in the for-profit and non-profit microfinance sectors. Collection practices and manipulation of interest remain strong points of contention. These issues tended to be overshadowed by the rhetoric used to promote poverty reduction through market expansion. Representatives from *Banco Azteca*, *Compartamos*, and *Financiera Independencia* have all lamented that they would like an alternative way to ensure that clients repay their loans, which suggests that they recognize a flaw in their model.

The lack of transparency in Mexico's commercialized microfinance industry is a serious problem that has been recognized by many. The absence of consumer safeguards in Mexico's commercialized microfinance industry has led many clients to be in the dark about interest rates, arrear penalties, and the full cost of their loans. Additionally, the fact that loan officers work on

commission creates an incentive for them to not fully inform clients of the full conditions of the loan, out of fear that they may lose a potential sale or that clients may simply take out a loan with a competitor.

Recently there have been efforts to increase transparency and decrease predatory lending practices. The *Compartamos* publication “A Letter to Our Peers” details its belief in bringing more transparency to commercialized microfinance, decreasing client over-indebtedness, and establishing safeguards throughout the entire industry. And agreements like the Pocantico Declaration indicate that industry leaders have the will to begin implementing regulatory measures that protect the clients they profess to serve. However, with the Pocantico Declaration being a largely symbolic document, there remains much to be done if the commercialized microfinance industry truly wants to avoid predatory lending and the pitfalls associated with it.

Recommendations for Improving Operations

The commercialized microfinance industry is very young and, like most young industries, lacks the maturity to comprehensively protect its own interests and those of its customers. For this reason it is imperative that commercialized MFIs operate under a strong regulatory body that has clear authority. This regulatory body should implement several mandates over all for-profit MFIs. These might include the following provisions:

- Clearly define what constitutes a microfinance institution. Due to the fact that many for-profit MFIs remain ambiguous as to whether or not they are primarily pursuing poverty reduction or profit maximization, the regulatory body should define an institution based on the income levels of its customers. If a strong majority of its customers are poor, then it could be defined as a microfinance institution. However, if a majority of its customers

are of the lower-middle class then the institution should be categorized as a lending institution, which would strip away the pretext of poverty reduction and more accurately present the institution as a traditional profit-seeking lending institution. Interest rates and collection practices would correspond with the MFI's categorization. If an MFI's customer base changes, then its status would change. This would resemble the upscaling and downscaling that is already taking place.

- Impose an interest rate ceiling for poor clientele. Most MFIs already have systems in place to gauge a client's earning power. This same system could be used to classify clients into two possible groups: the lower-middle class and the absolute poor. The lower-middle class would be charged the interest rates currently in place (which have been dropping over the last several years) and the poor would be charged the interest rate of a Type 1 microfinance program, which would be the cost of funds at the market rate plus an additional 10 or 15 percent. This would leave the
- Transparency laws need to be well-defined and widely implemented. For a healthy, for-profit microfinance industry to exist, customers need to be fully aware of loan conditions, which include the full cost of the loan, penalties for late payments or non-payments, and collection practices on delinquent accounts. Customers will always suffer from insufficient understanding as long as loan officers fear that full disclosure of loan conditions will push potential clients away and towards their competitors. This unhealthy practice should end once all for-profit MFIs are held to the same standard. Transparency laws should be applied to all for-profit MFIs that deal with both the lower-middle class and the absolute poor.

If the Mexican federal and state governments were able to put a strong regulatory system in place and follow the above recommendations I believe that most of the ambiguity and confusion regarding for-profit microfinance practices would diminish. It is clear that many poor and lower-middle class Mexicans are willing to take a chance with MFIs such as *Compartamos*, *Banco Azteca*, and *Financiera Independencia*, but the probability of such companies having a long, stable future will depend on whether they can find a repeat-customer base and/or minimize negative experiences for customers.

Closing Thoughts

Through the study of microfinance one can see multiple themes correlating with one another: poverty, banking practices, neoliberalism, female empowerment, employment, entrepreneurialism, development economics, political economy, and the colonial legacy, among many others. Microcredit acted as a catalyst in bringing so many themes together into one analysis.

Perhaps the most salient themes in the study of microfinance are poverty and inequality. While these two themes are frequently grouped together, they have one important difference that greatly distinguishes them: it is not necessary to have poverty in order to have inequality. Poverty consistently resides within unequal societies, but it does not have to. This is to say that a poverty-free society could exist, but most likely it would still be an unequal society. The fact that poverty exists alongside great wealth tends to amplify the unsettling nature of its presence. However, if an unequal society were to exist free of poverty, the inequality would be less glaring and disturbing. The absence of poverty allows inequality to be more easily accepted. Microfinance alone cannot eliminate inequality, but it can reduce poverty.

This thesis largely deals with the theme of inequality in order to illustrate how unregulated markets expanded inequality in Mexico from 1980 to the present day. One can find loose parallels in ISI economics and poverty-focused microfinance programs due to the fact that they both implemented safeguards for the poor and acknowledged the social value of labor and resources. In turn, similarities exist between neoliberal economics and commercialized microfinance: both seek to commoditize resources, appeal to investors, and prefer deregulated markets. Neoliberal economics corresponded with sharp rises in poverty and inequality, so it would be difficult to believe that a “neoliberalized” microfinance industry could truly reduce poverty. As of yet, little to no evidence exists that convincingly demonstrates that commercialized microfinance has directly or indirectly reduced poverty in Mexico in the last several years. However, measuring poverty reduction is a complicated venture. The Oaxacan food vendor who had taken out a loan from *Banco Azteca* saw her livelihood quickly improve after using the loan to assist her with a career change. On the other hand, Antonio’s loan from *Financiera Independencia* was used to pay for part of his daughter’s university tuition, which is an investment that will take years to come to fruition and is difficult to measure because it is not the life of Antonio, but that of his daughter, which will improve. Perhaps it is necessary to acknowledge that poverty should sometimes be measured by generation.

I hope that this thesis has touched on some important ideas and will contribute to a greater debate on how we view the microfinance industry, poverty reduction, and international development. In addition, I feel optimistic that in microfinance literature there will be a greater analysis of the effectiveness of poverty reduction measures in commercialized microfinance. As a body of literature that has developed in distinct stages, this would be the next logical step.

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Glossary

- Annual Percentage Rate (APR): A percentage that represents the yearly cost of funds over the term of a loan
- Commercialization: To develop commerce in; to manage on a business basis; a market approach; a financial-systems approach
- Commercialized Microfinance (also known as for-profit microfinance): Microfinance methodology that implements the principles of commercialization
- Credit/GDP Ratio: Indicates how deep credit services reach into a market
- Deposit/GDP Ratio: Indicates how deep deposit services reach into a market
- Downscaled: Microfinance institutions that have gone through the transformation of downscaling
- Downscaling: The process by which regulated financial institutions move down the economic scale of their client base in order to reach a poorer market.
- Efficiency: A determinant of how well a MFI allocates inputs (assets, staff, subsidies, etc.) to produce the maximum output (number of loans, financial self-sufficiency, poverty outreach, etc.).
- *Ejido*: A small communal landholding once protected under Article 27 of the 1917 Constitution
- Financial Depth: A measure of how deep finance services reach into a country's population
- For-Profit Microfinance (also known as commercialized microfinance): Microfinance activities that implement a market approach and pursue profit maximization
- Gini Coefficient: A measure of inequality, with 1.0 representing absolute inequality and 0.0 representing absolute equality.
- Grameen Bank: Stemming from a 1976 project at the University of Chittagong in Bangladesh, Dr. Muhammad Yunus started a program called the Grameen Bank Project that sought to break the cycle of poverty among the Banladeshi poor, especially women. The project was successful and slowly expanded into additional regions. In 1983 Grameen ("rural" in Bangla) became an independent bank that was majority-owned by its borrowers. It has distributed billions of dollars in microloans and has a near-100% repayment rate.

- Import-Substitution Industrialization: Economic plan that sought to develop domestic industries in Latin America, reduce dependency on foreign imports, and protect Latin American interests against foreign influence
- *Impuesto al valor agregado (IVA)*: A 15% tax placed on new account-openings in Mexican for-profit MFIs
- Informal Economic Activities: Economic activities that occur within the informal economy
- Informal Economy/Informal Sector: Refers to economic activities in which workers or entrepreneurs do not fulfill the legal obligations that correspond with the production or distribution of a good or service.
- Informal Workers: Laborers who operate within the informal economy
- Initial Public Offering (IPO): The first sale of stock by a company to the public
- MFIs (See Microfinance Institutions)
- Microenterprise: A small business, which typically has fewer than ten employees and operates in the informal economy
- Microentrepreneurs: Owners of microenterprises.
- Microfinance: Banking and/or financial services targeted to low- and moderate-income businesses or households, including the provision of microcredit.
- Microfinance Institutions (also known as MFIs): Lending institutions that provide microfinance services, including the provision of microcredit
- Microloans: Small loans provided to poor segments of the population that have been marginalized by traditional financial services. In Mexico, microloans may range from \$300 to \$1,000.
- Mission Drift: Refers to an MFI's "drifting" away from its initial mission, the professed desire to use microfinance only improve the well-being of the poor, and towards providing financial services to a more financially stable population that has traditionally always had access to formal banking and is generally more profitable and stable for formal banks.
- Neoliberalism: Late-20th century economic philosophy that advocates maximum and efficient exploitation of the world's resources through privatization, deregulation, and minimal social spending

- Outreach: An MFI's effectiveness in reaching its target market and distributing its product
- Outstanding Loan Portfolio: The amount of money that an MFI has disbursed in loans
- Pocantico Declaration: An April 2008 microfinance conference that brought microfinance leaders together from all over the globe, with the goal of finding common goals among for-profit and non-profit microfinance industries.
- Portfolio-at-Risk: The outstanding value of loans with payments past due as a percentage of the total portfolio
- Portfolio Quality: An MFI's ability to foster security and stability in its funds
- Primacy Rate: Ratio of the population in the largest metropolitan area to the sum of the next three
- Primate City: The city with the highest primacy rate. For Mexico, the primate city has traditionally been Mexico City.
- Return-on-equity: A measure of a corporation's profitability that reveals how much profit a company generates with the money shareholders have invested.
- Social Returns: The "bottom line" for not-for-profit microfinance institutions that primarily seek to improve the social well-being of their customers, rather than pursuing profits
- *Sociedad Financiera de Objeto Limitado (SOFOL)*: a non-banking, finance institution that provides working capital but cannot receive deposits
- Upscaled: Microfinance institutions that have gone through the process of upscaling
- Upscaling: The transformation of non-governmental, non-commercial MFIs into regulated financial institutions.
- Urban Informal Economy: Informal economic activity that takes place in urban areas