EASING POVERTY THROUGH THRIFT

Dale W Adams[1,2]

> The art of getting riches consists very much in thrift.
> All men are not equally qualified for getting money,
> but it is in the power of every one alike to practice this virtue.
>
> *** Benjamin Franklin, 1749

Abstract

In times past thrift was encouraged while debt was condemned. But more recently the notion of debt has replaced thrift as the way to ease poverty. A few recent examples demonstrate that poor people can and will save if given proper opportunities and incentives. Compared to a euro borrowed, a saved euro is more useful because it is cheaper and less risky. The benefits of savings/deposits for individuals, financial intermediaries, and the economy in general are summarized in the article. The author concludes that poor people would be better served if more emphasis was placed on deposits and less emphasis given to credit.

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1. INTRODUCTION

Once upon a time most cultures had norms that discouraged debt and promoted thrift, but these norms have weakened or disappeared. Over time the word 'debt' has experienced a metamorphosis from being seen as an uninviting caterpillar into being viewed as an attractive butterfly called 'credit.'

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With this change, terms such as thrift, parsimony, self-reliance, frugality, prudence, postponed consumption, and savings have been leached from the lexicon of development promoters. The once stigmatized debt is now viewed as the all-purpose anti-biotic for treating developmental problems, especially poverty. Nowadays tens of millions of poor women are encouraged to incur more debt, students are pestered to open charge-card accounts, poor families are urged to assume large mortgages to buy houses, and donors push low-income countries to borrow their way out of poverty. At least in the United States, this change is typified by parents who give children cell phones and charge cards, instead of the traditional savings banks.

Policymakers and donors have enthusiastically fostered credit mania and its associated risks, while ignoring thrift. The recent meltdown in financial markets worldwide, nonetheless, reminds us that debt and risk are Siamese twins: as debt increases, risk escalates. Perhaps it's time to revisit traditional views about thrift and see if there is any wisdom there that might help alleviate more poverty and create less risk than does the indebting fad that is currently in vogue.

2. WHAT IS THRIFT?

The discipline exercised by individuals who choose not to spend or consume today, but to put something aside for the future, use to be known as thrift (Blankenhorn, 2008). Savings is the general term for the something set aside and it can be held in various asset forms such as land, livestock, education, equipment, housing, and gold. In the Dominican Republic, for example, pigs are popular forms of saving in rural areas, while in Bangladesh some poor women withdraw a handful of rice each day from the family's normal consumption to accumulate reserves for emergencies.

People may also hold part of their savings in financial forms, including cash and deposits. Cash is held for emergencies and rapid transactions, but many people likewise make deposits in credit unions, in banks, and in informal arrangements. Some women in Egypt entrust deposits to informal money keepers who, in turn, may deposit the money in banks. In many low-income countries hundreds of millions of people also deposit cash in informal, self-help financial groups that are called *tontines* and *susus in West* Africa, *arisans* in Indonesia, *gam'iyas* in Egypt, *chit funds* in India, *pasanakus* in Bolivia, *solde* in Haiti, *cuchuvales* in Guatemala, and *tandas* in Mexico.

Because of credit mania, particularly in the microfinance industry, the deposit-taking side of financial intermediation in many low-income countries is stunted, especially in rural areas[3]. Credit unions and a few banks are the major exceptions to this bias in favor of lending (Richardson, 2008; Westley and Branch, 2000). In part, deposits are underemphasized because their benefits are poorly understood; it is easier to grasp the supposed benefits of borrowing than it is to comprehend the more subtle and diffused advantages of deposits. This lack of understanding has been reinforced by the myth that many people are too poor to save. The skepticism about the capacity to deposit has been called into question, nonetheless, by the successes in mobilizing deposits by a few banks in low-income countries. Other successful deposit mobilization efforts by Safesave in Bangladesh and the Village Savings and Loan Associations in Africa also show poor people will deposit if given the opportunity to do so (Allen, 2007; Rutherford, 2000). The huge popularity of the aforementioned informal self-help groups, with the acronyms of roscas and ascas, is further evidence that poor people are inclined to save (Bouman, 1995; Velez-Ibanez, 1983).

Going back further in time, some of the largest banks were built on deposits made by poor people: Bank of America, Norinchukin Bank (Japan), and Caisse Nationale de Agricole (France). The once prominent Irish Loan Funds, the large Community-Based Savings Funds and the Savings and Credit Cooperatives in Germany, and the highly successful farmers associations in Japan, Taiwan, and Korea were all built on small deposits (Seibel). Despite these historical examples, policy makers, and especially donors, remain obsessed with credit as a way of alleviating poverty. There is widespread agreement that numerous poor people face credit constrains, but there is much less recognition that depositing constraints are even more common among the poor (Amendariz and Morduch, 2005, p. 148).

Despite the credit hype, it is debatable if debt is the ultimate poverty treatment. Is a borrowed euro more useful to an individual than a saved euro? Which contributes more to development, helping a person borrow a euro, or helping them save a euro? Answers to these questions provide insights into the merits of thrift versus debt. A simple example may shed light on these questions.

3. THE TALE OF TWO EUROS

Assume that one euro is borrowed and must be repaid in 12 months, along with an interest payment of 48 cents for rental of the euro. In addition,

[3] Various elements of the industry employ forced savings techniques that many borrowers view not as savings, but as additional costs of borrowing. There may be a place for some forced savings, but voluntary deposits are more useful for poor people.

the borrower incurs various transaction costs to secure and repay the loan, say the equivalent of another 12 cents.

The other euro is not borrowed and may come from various sources: an individual's earnings, sale of other assets, winning a lottery, a gift, or remittances. There is no rental payment for the use of this euro and the transaction costs of holding or obtaining the euro are negligible. An additional benefit of a saved euro is that it does not involve the risks associated with a borrowed euro – the risks of not being able to repay a loan.

Which euro is more likely to enhance a person's well being? *For me, at least, the saved euro is clearly better*; *it is less expensive and doesn't have the risk that accompanies a borrowed euro.* But, does the borrowed-euro have attributes that lend themselves to productive investments, while the owned-euro is better suited for consumption expenditures? *Not likely*. *They are completely interchangeable euros!* Are there secrets that lenders can whisper into the ears of borrowers that makes the borrowed euro especially suitable for productive investment? *If there is any whispering, it is repay your loan*! Is a person's discipline enhanced through the experience of borrowing and repaying a euro and is this a side-benefit from going into debt? *The discipline involved in repaying a loan is identical to the discipline involved in deferring consumption in order to save.*

When can one claim that the borrowed euro is a good deal for the person going into debt? It is a good deal when the borrower has an investment opportunity that yields a risk-adjusted return on her investment in excess of 60 percent, and when she lacked money to exploit this opportunity without a loan. It is a good deal when the borrower has the entrepreneurial skills, and luck, to manage the loan/investment and capitalize on her opportunities. But, it is a bad deal when the borrower's venture returns less than the amount invested, plus 60 percent, and the borrower is forced to seek other means to repay the loan, or possibly default on the debt. Another advantage of a saved euro is that the investor can use his savings in an enterprise and tolerate lower rates of return than can people who rent money. This is a particularly important point in agriculture where returns to investments are often lower than in other activities (Harper, 2007).

What percent of poor people, especially in rural areas, have these opportunities, skills, and luck? Is it 10 percent, 20 percent, 50 percent, or 100 percent?[4] Some promoters of the microfinance industry imply that it is virtually 100 percent by claiming all people have a right to debt. They view most poor

[4] Critics of the microfinance industry, such as Dichter (2007, p. 181) and Ellerman (2007), argue that most micro loans are used for smoothing consumption, and not for investments in micro businesses.

people as budding entrepreneurs with frustrated business skills that can be successfully energized with small loans[5]. Some skeptics, in turn, have argued that proponents of microfinance have exaggerated the usefulness of, and effective demand for, microloans (Dichter, 2007, p. 2). Furthermore, experience shows that most people chose to work for others, rather than manage a business of their own. As Joseph Schumpeter argued, entrepreneurship is a skill that not everyone possesses (McCraw, 2007). Additional support for this point of view comes from high dropout rates in some microlending programs, suggesting that quite a few borrowers realize disappointing results from borrowing (Wright, 2001). This suggests that one of the smaller percentages is reasonable, possibly only 10 to 20 percent[6].

In addition, research on micro and small firms in low-income countries reports substantial infant-mortality rates among these firms, 11 to 20+ percent in the first year (Mead and Liedholm, 1998). Other research on how micro and small firms traditionally finance their expansions shows that private savings normally play a large role in their birth and growth (McLeod, 1992). These observations suggest that debt may be a limited tool in lifting most people out of poverty. It also suggests that promoting savings might be closer to a universal remedy for poverty than is debt. As Benjamin Franklin noted, savers may not have entrepreneurial skills or profitable investment opportunities, but they can gain from saving, especially when the fruits of their thrift are placed in a secure deposit account.

In a perceptive statement, Stuart Rutherford says that many people in Bangladesh are too poor not to save. Hugh Allen echoes the same sentiment by saying: "….the very poor react more powerfully to financial services that build and protect assets than they do to the chance to take on debt." This suggests that programs emphasizing deposit taking, rather than lending only, would have salutary horizontal as well as vertical effects on poverty. Horizontally, more depositors than borrowers would benefit from balanced financial intermediation that includes deposit taking. The Rural Private Banks in the Philippines, for example, have an average of 4 depositors for each borrower. Since the average depositor typically has fewer assets and income than the average borrower, balanced intermediation would also have a vertical effect by penetrating further down the poverty pyramid than does lending only.

[5] Debt promoters also often ignore the small size of the markets in which most poor people operate. All of the poor women in a village, for example, cannot prosper selling tamales. The few that can successfully expand their food businesses often do so at the expense of others who may be even poorer.

[6] Robert Litan with the Kauffman Foundation estimates that only 10 to 15 percent of the working adults in the U.S. are engaged in some type of entrepreneurial activity (Smick, 2008, p. 81).

4. HOW DO DEPOSITS BENEFIT SAVERS?

Most poor people, if they have the opportunity to do so, chose to hold a variety of assets in their savings portfolio. Deposits have several advantages in these portfolios. For example, they are almost as liquid (easy to access and spend) as cash, but often provide savers some nominal return, which cash does not. Also, like cash, deposits are divisible. The saver can withdraw small or large amounts. In contrast, savers cannot sell just a part of a cow to obtain a small amount of cash. In addition, small deposits made periodically can accumulate to the larger lump sums that poor people often want to pay for such things as funerals, weddings, illnesses, and school fees (Rutherford, 2000).

For some people, deposits are more desirable than holding cash because they are less prone to impulse spending. Likewise, savers incur few transaction costs to make and access their deposits if banking services are efficient and located nearby. In contrast, acquiring or liquidating other assets such as land and cattle can involve substantial transaction costs for savers.

Safety and security are other major advantages of deposits; cash can be stolen and cattle can die. The safety feature is enhanced in some countries by deposit insurance.

Thrift in general, and deposits in particular, can be used as ladders out of poverty; one does not need entrepreneurial skills or luck to use this ladder. Deposits are a way for individuals to gradually accumulate money to buy assets, deal with emergencies, or to start businesses without renting other peoples' money. Moreover, deposits demonstrate to lenders that a person has the discipline to save, thus enhancing the saver's creditworthiness in the eyes of potential lenders. Some individuals who steadily increase their deposits find it easier than non-depositors to leverage their assets through a loan; borrowing is something that many poor people occasionally wish to do. This process is demonstrated by financial cooperatives that require members to buy shares and save before they are permitted to borrow, and by informal self-help financial groups (*roscas and ascas*) that force new members to save with the group before they can borrow from the group (Bouman, 1995).

Another advantage of deposits, compared to debt, is that the former is liberating while the latter is constraining. If a person uses the money she has accumulated in a deposit account to finance a small business, for example, she has freedom over how the business is run. In contrast, if she mostly uses borrowed money to start the business, she relinquishes some control over her business decisions. People who make the last payment on their home mortgage experience the liberated feeling of finally owning their house.

5. HOW DO DEPOSITS BENEFIT FINANCIAL ORGANIZATIONS?

Obviously, financial intermediaries earn a small margin for intermediating between savers and borrowers, but deposits provide additional benefits to institutions that capture savings. For example, organizations that fund most of their lending out of deposits are more insulated from capricious political intrusions than are organizations that rely mostly on government or donor funds. At the same time, depositors can punish institutions that misbehave by withdrawing their funds, a discipline that is absent in non-deposit taking organizations.

Institutions that accept deposits also have the opportunity to realize more economies-of-scope and scale than do non-deposit-taking financial organizations. Typically, in a balanced financial intermediary, the number of depositors is three-to-ten times the number of borrowers, thus allowing the institution to have far more clients than organizations that only lend (scale economies)[7]. Scope economies come from spreading the institution's fixed costs over both deposit-taking and lending activities, instead of just lending alone.

Another advantage of deposit taking is that it allows the intermediary to access cheaply information on the potential creditworthiness of a client, the mirror image of the earlier mentioned benefits realized by depositors. If a client has regularly added to her deposits it demonstrates that she has the discipline needed to repay a loan.

Still another advantage of relatively small deposits is that they tend to stay put during economic emergencies, rather than taking flight for safer havens. Intermediaries such as the Bank Rakyat Indonesia, as a result, are able to weather financial crises better than banks that depend on the deposits of people who are relatively well off.

6. HOW DO DEPOSITS BENEFIT THE ECONOMY AS A WHOLE?

Financial markets play an important role in supporting capital formation in an economy through deposit-taking, lending, and providing venture capital. They also provide two other critical services: they supply convenient methods of payment and they help to allocate resources more efficiently (Gonzalez-Vega, 1980). The capital formation and payment benefits are obvi-

[7] Banrural in Guatemala, for example, has about five times as many depositors as borrowers, and many of the credit unions around the world have an average of 3 to 5 depositors or shareholders for every active borrower.

ous, but the resource allocation contribution is less well understood. A simple example illustrates the important allocation issue.

Assume we have two peasants who live distant from each other. Juan is an elderly man who has a small farm on a hillside where his pasture is rocky, sparse, and dry. He is mostly supported by remittances he receives from a son who works in another country. Pedro, in contrast, is a young man who has recently inherited land that has excellent pastures. Both men have problems: Juan receives more money each month from his son than he needs to pay his basic living expenses. His choices for the surplus are to buy a second radio, to invest in a milk cow, or to deposit his excess funds in a local bank. The problem with buying another radio is that it would not give him much additional enjoyment, and the difficulty with investing in a cow is that it would give little milk because of Juan's bad pastures. Pedro's problem is different: he doesn't have enough money to buy a cow to turn into his luxuriant pasture.

What does society gain if Juan deposits his surplus money in a bank and Pedro, in turn, borrows the money and buys a cow? Juan gains because the interest on his deposits is greater than the enjoyment he would have gotten from buying another radio, and the interest is also greater than the economic returns he might obtain from selling a small amount of milk. Furthermore, by depositing his money he avoids the risk of his cow dying or being stolen, and he does not have to tend a cow and maintain fences. Pedro gains from the intermediation by buying a cow that gives lots of milk, earns him enough to repay his loan plus interest, and still have a profit left over. Society's gain is more milk because resources (the cow) are reallocated by financial intermediation from poor pastures to good pastures. Without financial intermediation Juan would consume "too much," or commit his surpluses to low-return uses, and Pedro would have a wasted pasture.

Efficient financial intermediation "destroys" sub-optimal consumption and investment choices and results in better investments for Juan, Pedro, and society. An efficient financial system is the only mechanism that is supple enough to perform this vital function among millions of heterogeneous agents in a complex economy[8]. It can only perform this function, however, if deposit facilities are widely available, something that credit mania has suppressed, particularly in rural areas

[8] Financial intermediation quietly negates bad consumption and investment decisions, much as the more obvious "creative destruction" that occurs in capitalistic systems when inefficient firms are replaced by those that are more efficient. Both processes foster efficient resource allocation and economic growth.

7. WHY ARE DEPOSITS IGNORED?

Given the benefits associated with deposit mobilization, why has there been no mania for thrift in the development community?[9] The myth that poor people are unable to save, and the lack of understanding of the benefits of deposits, are only part of the explanation for this omission. Some people argue that small deposits are too expensive to mobilize and administer, especially in rural areas (Wright and others, 1999). But, "too expensive" is a relative term: small deposits are too expensive relative to what? They are, of course, more expensive than the huge amounts of grants or concessionary-priced loans or inexpensive capital infusions that have been available to the microfinance industry. Microlenders have rightly concluded that deposits are a more expensive source of funding than are "outside" funds, including capital raised through initial public offerings and private placements.

In addition, the management problems for organizations that only lend are simpler than are those of intermediaries that lend and accept deposits. Lenders-only have fewer clients than if they also served depositors. Deposits also place more demands on data management systems because of the large number of transactions involved. Managers of intermediaries are likewise forced to worry about matching terms on assets and liabilities, managing their liquidity, and providing physical security for money deposited, issues that are less troublesome for managers of lending-only organizations.

Regulations are a further impediment to deposit mobilization. In some cases, high legal reserve requirements dampen deposit taking, and in other cases branching laws block banks from taking deposits, especially in rural areas. In some countries anti-money-laundering rules further complicate deposit taking. Most importantly, many micro-lenders are prohibited from accepting voluntary deposits because they are not regulated and supervised by a central banking authority.

It is noteworthy that institutions that have been most successful in mobilizing deposits from poor people, aside from credit unions, are large banks: Bank Rakyat Indonesia, Grameen Bank, Khan Bank in Mongolia, Equity Bank in Kenya, and Banrural in Guatemala[10]. These banks are large enough to

[9] The tilt in favor of lending is shown in information published in a recent issue of the MicroBanking Bulletin, The Microfinance institutions included in the issue had about 64 million borrowing clients, but only 34 million depositors. Lending amounted to about US$64 billion, while deposits summed to only about US$15 billion. The deposit numbers were likely mostly made up by a couple of large banks such as Bank Rakyat Indonesia.

[10] See Robinson for an excellent description of deposit mobilization by the Bank Rakyat Indonesia.

make it economic for central authorities to regulate them; scale is important in large-scale deposit mobilization[11]. In contrast, the providers of microloans in many countries are too small and numerous to regulate efficiently. (For example, imagine the impossibility of bank regulators attempting to supervise deposit-taking activities in one or two thousand NGOs in Bangladesh.) Few of these organizations will be allowed to mobilize deposits until they grow larger through mergers or internal expansion.

This leads to the question of why there is not more agitation in the microfinance industry for members to merge and qualify to mobilize deposits?[12] Would this change if the flood of "outside" funding, currently available to the industry, shrunk to a trickle?

8. CONCLUSION

Several decades ago Vogel argued that deposits were the forgotten half of rural finance, but only after decades of neglect are savings/deposits finally attracting attention as a way of helping poor people. The Bill and Melinda Gates Foundation, the John Templeton Foundation, the Institute for American Values, the Ford Foundation, the Global Asset Project, SafeSave, the Village Savings and Loan Associations, Catholic Relief Services, and Microsave are belatedly directing attention at thrift[13].

What changes must occur to facilitate more deposit mobilization among the poor? First, leaders in the microfinance industry must acknowledge that far more poor people can benefit from promotion of thrift than can be helped through debt, and that poor people can and will save. Second, major segments of the industry must be weaned from outside funding. Third, there must be consolidations and mergers in the sector so more organizations are large enough to qualify for prudential regulation and supervision by central banking authorities. And, fourth, commercial banks must be encouraged to expand deposit services, particularly in rural areas.

A balanced microfinancial system that gives most poor people access to quality deposit services, along with loans, would produce at least five major

[11] Scale is also critical when banks attempt to make agricultural loans because of risk diversification.

[12] Several recent mergers and acquisitions among microfinancial institutions in Peru and Colombia are signs this process may be beginning. In addition, large microlenders, such as ProCredit, Banco Aztec, and FINOSOL are expanding their branches in additional countries.

[13] In 2005 Catholic Relief Services began retreating from micro lending and, instead, began to stress savings/deposits (Wilson, 2007).

benefits. First, a much larger number of poor people would be benefited, especially in rural areas. Second, microfinancial services would penetrate further down the poverty pyramid. Third, financial intermediaries would be strengthened and become more efficient. Fourth, resources within the economy would be allocated more efficiently, boosting economic growth. And, fifth, deposits would substitute for much of the outside money that is currently flowing into the microfinance industry, thus releasing funding that could be used to alleviate poverty through investments in such activities as education, health, housing, infrastructure, and law and order.

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Résumé

Dans le passé l'épargne était encouragée alors que l'endettement était condamné. Tout récemment la notion d'endettement a remplacé celle d'épargne comme moyen pour alléger la pauvreté. Des exemples récents ont montré que les gens pauvres peuvent épargner s'ils reçoivent des opportunités et des incitations économiques appropriées. Par rapport à un euro emprunté, un euro épargné est plus utile parce qu'il comporte moins de coûts et moins de risques. Les bénéfices de l'épargne et du dépôt de l'argent pour les individus, les intermédiaires financiers, et pour l'économie en général sont présentés dans cet article. L'auteur conclue que les gens pauvres pourraient être mieux servis si l'accent était posé sur les dépôts et moins sur les crédits.