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# To Market, To Market: In Whom We Trust?

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**Abstract**

Nobel Laureates have argued that development does not occur in a vacuum. Ideal conditions while impossible to attain are oft still considered in policy and AID decisions. The original promise of microfinance was that it would enable the poor, denied finance through established mechanisms, sufficient capital to bring their entrepreneurial vision to life. Since its (microfinance) humble beginnings much has been learnt. Education is now considered an important ingredient in the enabling of the entrepreneurial poor. As such, government agencies and donors have placed a premium upon livelihood training and in some cases character building. In this working paper, Daley contends that explicit teachable knowledge, while beneficial, can never outweigh the tacit knowledge of the individual loan recipients. It is this knowledge of their surroundings and the institutional matrix in which they live, which will in large part, determine their prospects for continued growth and success. But if these gains are to be realized it will depend on the individual's ability to move from those personal mechanisms of exchange, so common in developing areas, towards more impersonal mechanisms. Daley argues that it is the informal learning of more formalized market mechanisms that is essential if the current educational and training emphasis is to have more than a transitory impact.

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**JEL Codes: Z13, O12, O17**

## I. Introduction

The promise of microfinance is contingent upon the idea, now commonly accepted, that entrepreneurship drives development. The practice of microfinance is enabling the entrepreneurial spirit of even the poor to grasp hitherto unrealizable opportunities. (Baumol, Kirzner) Some call for continued and greater outreach. While working to ensure that 100 million of the world's poorest families, especially the women of those families, are receiving credit for self-employment and other financial and business services by the year 2005 we must be careful[1]. To understand the full impact of any

[1] At the Microcredit summit 1998 Yunus spoke of reaching 10 million borrowers through the Grameen Trust and 100 million worldwide.

project it is insufficient to look to macro measures. We wish to understand the impact of microfinance in changing not only the borrower's potential but also of the society of which they are apart. To do so we must understand the context in which the loans occur and how the institutional environment supports or hinders the exchange that will hopefully be enabled through the business activity generated and stimulated by the loan.

It must be remembered that changes in income, and hence the standard of living, of aggregated data will always be less volatile that those changes experienced at the individual level. So it is at the individual level we wish to explore the possibilities for prospective and existing microfinance clients to be educated in the ways of the market. In dealing with the individual within the context of the market we will need to address the general market failure arguments (Stiglitz) and how they specifically relate to microfinance (Robinson).

The paper proceeds as follows. (Section II) outlines the move from personal to impersonal exchange and its impact on development. (Section III) deals with the commercialization thesis as the current emphasis within microfinance to move from informal financial arrangements and group lending to a more individualized and commercialized basis. (Section IV) introduces the Catallatic Map in an attempt to (1) understand the interaction between the formalization of financial arrangements and the move from personal to impersonal exchange, and (2) how the oversimplification of our development models may lead us to misdiagnose the problem and thus prescribe a solution, which while well meaning, may be detrimental to those we most seek to help.

## II. Personal to Impersonal Exchange

Several scholars have postulated that the introduction of markets rupture the existing social bonds of traditional society. Tonnies introduced the concepts of

Gemeinschaft and Gesellschaft. German words normally translated as community and society. In a pre-industrial community close social relationships are considered the norm as "the very existence of Gemeinschaft rests in the consciousness of belonging together and the affirmation of the condition of mutual dependence". (Tonnies)

This is contrasted with Gesellschaft in which “reference is only to the objective fact of a unity based on common traits and activities and other external phenomena".(Tonnies) Some have argued for the “reemergence of some form of Gemeinschaft” in which “people interact together on the basis of reciprocal and ‘whole person’ relationships which are to their mutual advantage”. (Jones)

In fact, in the German literature there arose an intellectual puzzle dubbed “Das Adam Smith problem”. (Witztum) As Otteson has summed this up:

> “How could the same person who wrote *The Theory of Moral Sentiments*, which apparently established a natural ’sympathy’ as the cement of human society, go on to write *The Wealth of Nations*, which seemed to argue that economic policy should be predicated on the assumption that people are fundamentally self-interested?”[2]

F. A. Hayek argued that there is an underlying tension between our moral intuitions, which are the product of our evolutionary past, and the moral demands of the great society. Hayek differentiated the two worlds he spoke of as those of the micro-cosmos “the small band or troop, or of, say out families” to that of the “macro-cosmos, our wider civilization”. With the injunction that if we “were to apply the unmodified, uncurbed, rules of the **micro-cosmos** to the macro-cosmos we would destroy it. Yet if we

[2] Otteson (p. 2)

were always to apply the rules of the **extended order** to more intimate groupings, we would crush them. So we must learn to live in two sorts of world at once."

More recently other Nobel laureates have tackled this issue. Vernon Smith argues the apparent contradiction between the "two faces of Adam Smith" can be reconciled by imputing differing motives to the two different types of exchange. Following North he labels the dichotomy as one between personal and impersonal exchange. North has elucidated the problem as follows:

> "Personal exchange relies on reciprocity, repeat dealings, and the kind of informal norms that tend to evolve from strong reciprocity relationships. Impersonal exchange requires the development of economic and political institutions that alter the payoffs in exchange to reward cooperative behavior. The creation of the necessary institutions requires a fundamental alteration in the structure of the economy and the polity which is frequently not in the feasible set given the historically derived beliefs and institutions of the players"[3]

These two worlds offer different opportunities. If trust in impersonal mechanisms is high then the legal strictures required to underpin entered transactions is lower. Thus, using a transactional cost argument trust can be seen as exchange enhancing. (For example see Fukuyama (), Olson (1997) or Zak ()) But as Smith rightly points out the gains from exchange are limited to the degree of specialization employed in the market. This means that as the number of people within your trusted sphere increases the potential gains from trade increase also. This however cannot continue ad infinitum. The natural limitations of our sociability imply an upper limit to the gains from exchange that

[3] North (2004)

can be captured through our personal networks. (Fukuyama) The potential gains from exchange increase as the size of the market increases but utilizing impersonal mechanisms requires something other than our personal relationships.

In a small setting where specialization is limited the case can be more easily seen. Imagine a small village within which there is some minimal level of specialization but for the most part autarky is the norm. Those choosing to engage in exchange with others will deal with those they trust, thus implying a degree of reputational knowledge. The incentives to be trustworthy in such a setting are dependant upon the wish of continued good relations and the fear of ostracism. This could be termed a desire for reciprocity (Smith). While some argue that trust is correlated with growth (Zak) and that trust determines if developmental growth can be realized (McCabe) the key question revolves around the type of trust you are talking about. Trust of the person (personal exchange) you are dealing with or trust in the environment in which the exchange takes place (impersonal exchange). For example, in any Western city you can walk into a bank and with some form of documentation proving ownership a loan can be entered into. No prior personal relationship is necessary. A credit card relies, not on personal reputation, but rather the number some credit agency assigns to represent your dealing with other equally anonymous agents. These lenders do not need to know the prospective borrower; it is sufficient that your credit rating attains to some minimally accepted level. Of course the lender may adjust the rate you face based upon the quality of the collateral and the relative and or absolute value of your credit rating.

Increasing income per capita seems an almost tautological solution to the developmental puzzle. Of course people are better off with more money but MF is generally seen as succeeding in a way that handouts do not. A serious matter oft ignored by those more interested in speaking of and to a macro vision. But the twin spheres in which any agent can operate are governed by different rules, differing levels of enforcement and differing degrees of formalization. The clear recognition of these twin spheres does not tell us how an individual moves from one to the other.

There seems to be two forces at work in each exchange, whether personal or impersonal. We maintain V Smith's differentiation is useful but goes too far when suggesting that one is driven by A while the other is driven by B with A and B being separable and different. The world cannot be so neatly divided into these two different worlds, or when considered at the individual level, exchange cannot be explicitly one and not the other. There are varying levels of interconnectedness between us and this implies differing levels of social distance. These factors impact the manner and mechanistic components we are willing to 'trust' in determining the relative merits of any exchange.

Beginning with V Smith's idea of reciprocity we can see it works in personal trade. Trust (or the notion of reciprocity) must exist in the mind of A towards B for exchange[4] to occur. In this case we can say the trust is placed in the individual with which the exchange is taking place. When we move to the impersonal exchange has trust vanished? No, but it no longer resides in or is associated with the person the exchange takes place with but rather the institutional matrix, or background in which they exchange. So, in line with Adam Smith's analysis of the gains of trade and specialization being limited by the extent of the market, if the size of the market is insufficient to generate necessary gains from specialization then the underlying institutions necessary in facilitating impersonal exchange will be absent. But as mentioned above it is important that these two realms of exchange are seen as ideal types or to say it differently as the extreme points along a continuum of possibilities. And while corruption and the arbitrary actions of rulers may stamp out the widely spread use of impersonal mechanisms, it is not



[4] In this paper when "exchange" is used it always refers to voluntary arrangement of both or all parties.

necessarily true that the absence of corruption will necessitate the rise of impersonal mechanisms. (Olson) As North tells us (quoted above) something must be learnt in the process of moving from personal to impersonal exchange.

### III. The Commercialization thesis: to move to formal market relations

> "The demand for commercial microfinance is rarely met by the formal financial sector. One reason is that the demand generally not perceived. Another is that many actors in the formal sector believe, wrongly, that microfinance cannot be profitable for banking institutions"[5]

Robinson, and others, have argued that the path to sustainability is with a move toward more conventional banking practices; deposit mobilization and individual capacity lending. Robinson believes that the way to widespread impact will only come about through increasing the viability and sustainability of the microfinance institutions. This in one sense is in contrast with the 'poverty lending' paradigm. And while poverty lending may not always be opposed to sustainability there are clearly practices with differentiate them.[6]

Brand argues there is almost an evolutionary feature in the present emphasis on commercializing microfinance practices. The original landscape and belief system in which microfinance was born fostered a "governing paradigm that was not commercially oriented toward maximizing revenues and reducing costs."[7] This was in large part due to the philanthropic nongovernmental organizations (NGOs) seeing their mission as largely

[5] Robinson (2001)
[6] Rhyne Conversation with the Experts Oberdorf p 97
[7] (Brand p. 5)

to assist 'beneficiaries' rather than cater to the market demand of clients with a 'market orientated' willingness to pay. Largely formed by the twin beliefs that loans must be used to build assets, as opposed to consumer credit which was believed to reduce the asset base of the individual borrowers. Coupled with the belief the poor had no wish to save. This meant the loans for the poor could only be possible if funds from those better off could be accessed. The 'philanthropic donor mentality', itself a personal mechanism of exchange has lent itself to entrenching this type of thinking and lead further to NGOs working to appease the donors directly. This is evidenced by the continuing efforts of international AID and government agencies to professionalize the reporting procedures and reports of the MFIs. This serves to erode the self-interested reporting of MFI as they see to comply with standards that are suggested and becoming new norms in an attempt to improve the management of the MFI either directly, through legislation and regulation, or indirectly, through association educational efforts and support.

As evidence Robinson cites extensive evidence of demand for saving services from many traditionally believed to be incapable and/or unwilling to save. Coupled with a financial analysis of the Grameen Bank of Bangladesh that clearly establishes the non-sustainability of their method Robinson seems to be suggesting that commercialization is the panacea the world's poor, but not poorest, who are willing to support and in turn be supported by these newly developing relationships.

But all of this misses the importance of the borrowers capacity to enter into more formal market relations. Telling an evolutionary tale of MFIs and the employed lending methodologies while interesting and informative seems to suggest implicitly that the clients are all fully formed and waiting for service. Within the neoclassical framework we might say that welfare could be maximized if the supply of funds was appropriately matched to the demand. Overcoming this credit-rationing problem is seen as the path to welfare maximization (Stiglitz). But the problem with this type of thinking is that "it is concerned with the operation of markets, not with how markets develop" and so will not help us develop effective models in the quest to help those developing nations.

In a fully formed and developed market physical assets, such as land, can be used as collateral to obtain finance. The absence of clear and delineated property rights becomes an obstacle impeding the financing of entrepreneurial endeavors. (De Soto) The Grameen model of microfinance lending does not do away with the collateral requirements rather it uses a different form of collateral; reputation. If at least four of an individual's peers is willing to 'vouch' for them, finance can be obtained. This type of collateral is tied to the individual and the relationships (including such attributes as dependability) they have with others. But because of the costs of losing this collateral the economic risk taking is muted. Using personal mechanisms as a basis of providing financial security will be effective but also limited when compared to a more developed financial system. So as we move to more impersonal mechanisms and collateral, risk taking and markets expand further.

As will become apparent in the balance of the paper. We are not suggesting commercialization is a bad thing. On the contrary we believe it is an essential step in reducing poverty, although not perhaps on the individual stage initially. The problem with the commercialization argument is that is almost entirely about the institutions that provide MF rather than seeing them as only one-half of the transacting players in the microfinance financial marketplace.



**IV. Catallatic Map and the development puzzle**

> "Human beings have, by trial and error, learned how to make economies perform better; but not only has this learning taken ten millennia (since the first economic revolution), it has still escaped the grasp of almost half of the world's population"[8]

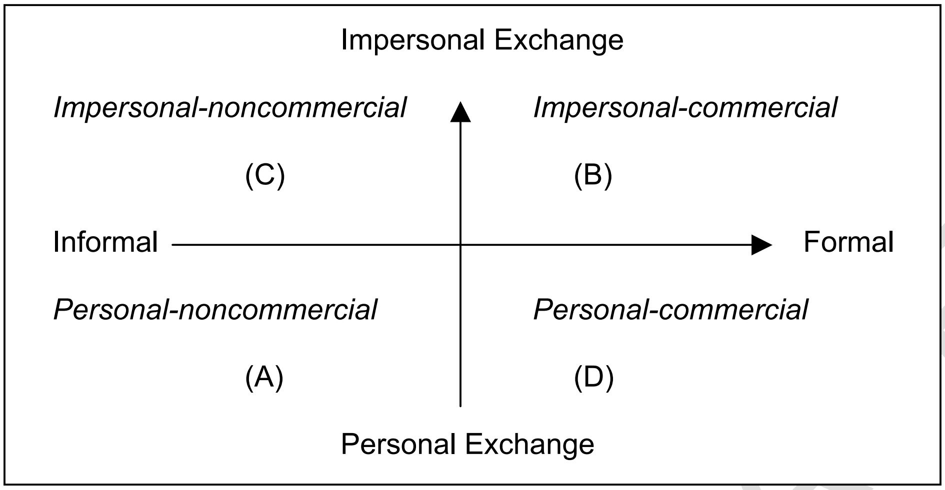
We now seek to join the analysis from the previous two sections so that we may better understand the environment within which microfinance is occurring.

This can be illustrated with the use of a **Catallactical Map.** For any exchange to occur there is some under girding mechanism; it is these under girding features we are interested in examining. For example, there has been an explosion of recent work, theoretic, experimental and empirical which seeks to examine and explain trust as contributing factor in the economic progress and growth of countries, regions and groups. But as we discussed previously 'trust in whom'? Our Catallatic map (*Figure 1*) differentiates personal and impersonal mechanisms of exchange while placing them within the same exchange space as the spectrum of market relations.



[8] North (1994)

Figure 1.




McCabe has argued that any AID or intervention must preserve the impersonal mechanisms and relations within a system to prevent the backsliding toward personal exchange. This however seems to be at odds with Smith and Hume who discuss the civilizing nature of the market process. We believe it takes time for people to learn the impersonal way of the market and it is this important dimension that is often missed in policy prescription. Just as it takes time to produce goods, they do not instantly appear once they have been thought of, it too takes time for experiences and learning to become a part of the norms of any given set of relations. And while it is beyond the scope of this paper to address the mechanism(s) by which people are able to move from personal to impersonal exchange we believe the Catallatic map provides a deep insight into the topology of exchange.

In primitive economies (A) with very little specialization and no formal market relations the economy will be characterized by personal exchange. Tribal economies using gift exchange, nepotism and patronage to make their economic decisions are far from the standard of efficiency that would be characterized in (B) where impersonal exchange under girded by the rule of law and stable political and economic systems are the norm. The developed economies of the world operate predominately in this sector (B). For those living in the developed nations this if often taken for granted. We buy our groceries from, and pay our taxes to, and in some cases ride in the cars of people we don't even know before getting in.[9,10]

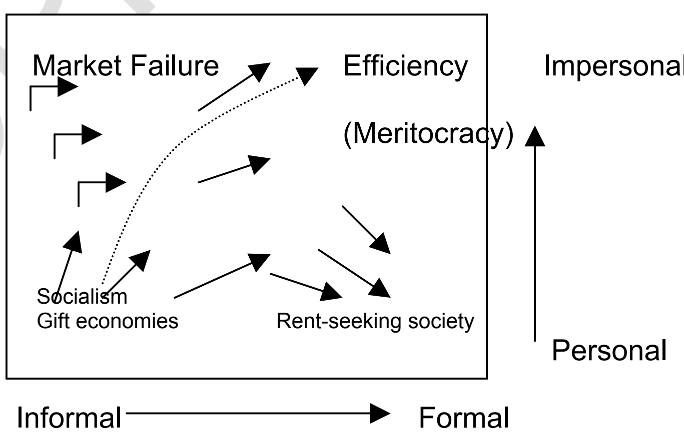
So how do we get from A to B? The oft recited mantra of Adam Smith's extent of the market would suggest that as the population density increases, holding everything else constant, the potential gains from impersonal exchange lead to the formation of norms which supports such impersonal arrangements.[11] But things are never so simple. The probability of a society moving so seamlessly from A to B is so remote it is now time for us to examine the other quadrants of our Catallatic map, C and D.

In (C) people not only trust their personal connections but also the impersonal mechanisms of the market economy. The lack of formalization, in the case of microfinance this is translated as demand for funds being greater than the supply, results in a market failure. So (C) represents the situation where people are willing to move to more impersonal mechanisms and as institutions become for formal, or as MF becomes more commercialized the clients will move with them. Market failure is the oft heard cry of interventionists as justification for government production. One wonders however what the possible implications of intervention are if the failure really involves people being unwilling, at that moment in time, to move from personal to impersonal

[9] Slugging: the practice of car pooling along the I-95 in Northern VA. Willing participants park their cars at designated park and ride stations while others 'volunteer' to drive. The drivers then pick up at least two others who are waiting in a queue. This allows the driver and passengers to travel in the multi-occupant lane greatly decreasing their drive time into the nations capital. Just as there are designated park and ride pick up points there are also the designated drops off. With some drivers only going as far as the Pentagon while other journey all of the way into the capital.
[10] Fukuyama
[11] Grief's Genoa example

mechanisms so that increasing the formal aspects of the market while people still rely upon personal mechanisms of exchange lead us to (D). Increasing the supply of available funds and affecting the interest rate or even adjusting the interest rate directly will not have the intended consequences if people are not really ready to use more impersonal exchange mechanisms. Could it be that the graduation myth represents a potential unwillingness on the part of various microfinance recipients to move into impersonal mechanisms of exchange? Perhaps Grameen lending provides some of this transitional education through the access to credit and the spur of repayments (similar to the corporate finance arguments where debt is seen as a disciplining device upon managers' behavior). And over time people learn through their own experiences and from those around them how to navigate in the two seemingly different worlds of other regarding and self-interestedness.

To this point we have discussed the Catallatic map as if it were a two by two matrix with each quadrant a discrete choice. In reality of course many possible combinations exist. So it may be helpful to see our Catallatic map as depicted (figure 2).




As the size of the market grows it is inevitable that the institutions of the market will increasingly be dominated by structured formal organizations. But there is no guarantee that personal exchange will give way to more impersonal mechanisms.

Recognizing the possibility of multiple equilibria we can now see the possible consequence of misdiagnosis. The dotted line represents the hoped for path of development with the solid lines and arrows representing the directional tendency at a particular point.

The market failure area is not a stable equilibrium; it is simply an intermediate step, which serves to spur formalization through the profit incentives as new opportunities become available to those who see them. The greater the movement toward impersonal mechanisms the more likely the move toward efficiency will succeed. But if people are unwilling at a given moment in time to move toward more impersonal mechanisms exogenously determined injections of capital could only serve to further move the economy toward a rent seeking society.

**V. Conclusion**

The two central themes of this paper have been (1) without understanding the distinction between personal and impersonal exchange mechanisms it is possible for AID and any other well-meaning intervention to do more harm than good. And (2) it is essential that people learn and understand the gains from impersonal exchange. Of course the extent of these gains may be muted or entirely eliminated under an arbitrary political system. Notwithstanding a more economical or 'market educated' individual is more willing to support that type of political system and innovation which will in the end be better for all.

And while it is beyond the scope of this paper to suggest the mechanism which should be used or encouraged by AID agencies or donors in pursuit of MF recipients market education it is essential that policy makers and others understand the potential impact of a misdiagnosis of the institutional setting in which the MF recipients live.

Seeing microfinance as a means rather than an end necessitates an examination of its ability to 'do the job'. Understanding the Catallatic map is an important step in seeing microfinance as a stepping-stone on the way to mature market relations instead of simply stirring more money into the localized transacting pools of entrepreneurial but still relatively poor borrowers. As discussed above, the failure to recognize the difference between the supply-demand failures, the question of immature market relations, and the move from personal to impersonal exchange can have disastrous consequences for those who may genuinely benefit from such programs when correctly applied. While much work remains to be done regarding the move from personal to impersonal exchange the lessons from present studies are clear; trust and the institutions within which exchange takes place must be understood and recognized. It is a lesson we would do well to heed. None of us wish to see the failures of the green revolution repeated within the embryonic financial sector of developing areas.

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