

## **The Economics of Poverty: How Poor People Manage Their Money**

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Economist John Kenneth Galbraith noted that money is equally important to those who have it and those who don't.<sup>1</sup> Nevertheless, most institutions such as banks and insurance companies whose job it is to help people manage their money prefer their clients to have lots of the stuff (or at least the prospect thereof). They argue it is simply not possible to make a reasonable profit by dealing in very small sums of money. In many rich countries in recent years, banks have been closing branches in poorer communities, and in many developing countries, banks simply don't bother with the poor at all.

### **Why Savings Matter**

Still, poor people urgently need financial services. Arguably, their need may be greater than that of the nonpoor. Poor people have smaller, more irregular, and often more unreliable incomes, the great bulk of which may be spent as soon as it is received on food and the means to cook it. As a result, whenever they want to buy something other than food or fuel, they often find they simply do not have the money on hand, even for quite modest expenditures such as basic clothing. This happens to poor people more often than to nonpoor people. In such circumstances poor people must go without, sell some hard-won asset, or find some way to tap into past or future income (given that present income is insufficient).

Naturally, they prefer the third of these choices, and financial services make it possible. Financial services help you manage your money in precisely that way—by helping you access past income stored in the form of savings or future income by lending you an advance against savings you plan to make in future. Therefore, managing money well turns out to be a matter of managing your capacity to save. Saving is where financial services begin and end.

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<sup>1</sup> GALBRAITH, J.K. (1975). *Money: Whence it came, where it went*. Boston: Houghton Mifflin.

### Three Ways to Save

There are three basic patterns through which savings can be converted into useful, large sums of money for spending: “saving up,” “saving down,” and “saving through.” Saving up (Fig. 1) is obvious enough: savings are stored until they have accumulated into a sum large enough to serve some expenditure need.

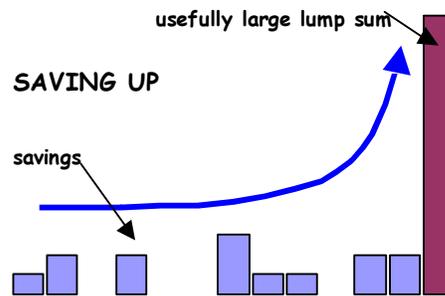


Figure 1

Saving down (Fig. 2) refers to borrowing and repaying the loan. Repaying loans depends just as much on the act of saving as does saving up. The only difference is the lump sum becomes available before, rather than after, a series of savings. The savings, of course, are used as repayments on the loan—either in intervals as income is realized or after a secondary process of saving up until enough has been accumulated to pay off the loan in a single balloon repayment.

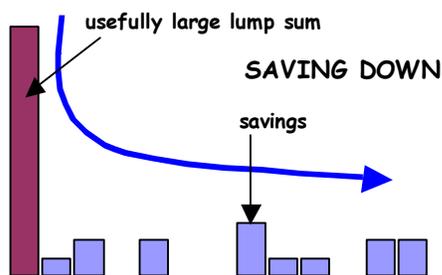


Figure 2

Saving through (Fig. 3) is a mix of saving up and saving down. A lump sum becomes available at some point during a series of savings. Good examples can be found in many types of insurance coverage: saving is performed continuously as a series of, say, monthly

automobile insurance premium payments, and the lump sum becomes available when you crash into a gatepost.

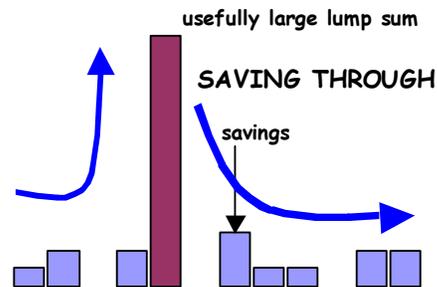


Figure 3

### **But Can the Poor Save?**

Financial services exist to help you manage your savings, but what if you have no capacity to save? How can the poor, who have barely enough money to live on, possibly save?

Research on how poor people in the developing world manage their money shows poor people can and do save. For example, a study in Bangladesh<sup>2</sup> recruited 21 slum dwellers and 21 poor and near-poor villagers who agreed, with the help of researchers who visited them twice a month for a year, to keep diaries in which they recorded what they did with their money. They recorded not only income they earned and how they spent it, but where they saved or otherwise stored their cash, to and from whom they lent and borrowed money, and what savings or loan clubs they joined. They also explained the reasons for what they did.

The results were clear. Poor people manipulate their savings through a wide range of methods of saving up, saving down, and saving through, and they do it frequently and intensively. We found no less than 33 different money management systems in use. At the most formal end of the spectrum were banks, insurance companies, and NGOs. Less formal methods included savings clubs, moneylenders, buying goods on credit, and obtaining wage advances from employers. At the most informal end of the spectrum were loans between family members

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<sup>2</sup> Study conducted by the Institute of Development Policy and Management (IDPM) at the University of Manchester, UK, for the Department for International Development—UK Official Aid. The study was directed by Professor David Hulme of IDPM and overseen in Bangladesh by Stuart Rutherford. For more details, see the Institute's web page at [www.man.ac.uk/idpm](http://www.man.ac.uk/idpm).

and neighbors and stashing cash in clay piggy banks under one's bed. Of the 42 sample households, all used at least six money management devices during the year, and one used as many as 18. The average household used 10 different systems to manage its savings.

Most of the transactions were tiny, as you'd expect with poor households. Of all the lump sums created by storing savings or taking loans, only one in 10 was worth more than the equivalent of \$100. But relative to the economy of the households involved, the sums were not small: we calculated that about two thirds of total income was subjected to some form of money management (i.e., saved or used to repay loans). In aggregate, the sums involved are truly large. We estimated the total "microfinance market" (the total flow of deposits, withdrawals, loans, and repayments) for the approximately 72,000,000 Bangladeshis who live below the official poverty line might be as much as \$10 billion a year.

## **The Art of Do-It-Yourself Financial Services**

The successes and failures of "do-it-yourself" money management—the devices that have evolved in poor communities where there are few formal financial service providers—are instructive. A study of these devices can help identify useful working principles for developing money management services that can reach the poor and show how a formal approach might add value. Three of these devices—the deposit collector, the urban moneylender, and the rotating savings and credit association (ROSCA)—illustrate the three basic patterns of saving up, down, and through. These devices are so widespread they can be found—with local variations, of course—on every continent in countries both rich and poor.

### **The deposit collector**

You may by now be willing to believe that poor people can save, want to save, and do save. But would they be so foolish as to accept a negative rate of interest on their savings? Sometimes they do, often for sound reasons. In the southern Indian city of Vijayawada, I met many slum-dwelling women who used the services of an itinerant deposit collector named Jyothi. Jyothi is a hard-working woman whose self-employed job is to visit her 50 or 60 women clients on a daily basis and collect from each of them a tiny sum of money—5 or 10 rupees per woman per day. To each client she gives a makeshift pass book, just a card ruled into 11 columns and 22 lines to form a total of 220 cells. Each woman (clients are treated as

individuals, not as members of a group) pays a set sum of her own choosing each day for 220 days. At the end of this period, Jyothi pays back to the client the value of 200 of the cells, and keeps the value of the remaining 20 cells as her reward for the service she offers.

Why do these slum-dwelling women use Jyothi's services? One woman whose husband is a casual laborer with an irregular income gave a typical response. The couple has two school-aged children, and each July the children needed a few hundred rupees to pay for school fees, clothes, and books or they would not be readmitted to school. Unable to rely on her husband and lacking a safe place in her bamboo-sided hut to store her savings, the woman regarded Jyothi's services as well worth the cost. Expressed as an annual percentage rate, Jyothi's fee works out to about minus 30%. But her client argued that what she pays Jyothi is a mere 9% of her total deposits and that this is a cheap rate for a highly valued service otherwise unavailable in the slum.

Jyothi's case demonstrates the strong, often unmet demand for saving up services in poor communities. It shows, too, that poor people are willing to invest scarce resources in long-term investments, such as education, that do not bring immediate monetary reward. Some technical aspects of Jyothi's services are well worth noting. Frequency is important: both Jyothi herself and all her clients told me none of them would save so much if it were not for the daily visits. Jyothi's time-bound contract is also helpful: at the end of the 220 days, clients either get their money back or lose it. This arrangement acts as a kind of ongoing audit, giving Jyothi a strong incentive to honor the terms of the contract or risk losing her clientele. Finally, most of Jyothi's clients begin another cycle of saving as soon as one is completed. Thus, clients fall into a regular rhythm of small daily savings matched by occasional large withdrawals.

### **The urban moneylender**

Urban moneylenders offer an example of the significant differences and the unexpected similarities between saving up and saving down. In another Vijayawada slum, urban moneylenders visit their clients regularly at their home or workplace, as Jyothi does. They too provide a grid passbook. Typically, for a 1,000-rupee loan (about \$20 U.S.), they collect 10 weekly repayment instalments of 100 rupees each. They take their cut by deducting interest

up front, at the time of the disbursement of the loan. An average price would be 150 rupees for each 1,000 rupees lent.

Because they provide the lump sum before, rather than after, a series of savings, moneylenders, like pawnbrokers, are in great demand by people who suffer sudden emergencies or have an unexpected opportunity to acquire an asset but do not have sufficient savings to finance the expenditure. Moneylenders are, of course, more expensive than deposit collectors, not only because they have to bear the default risk, but also because they have to finance the loan from their own resources. In India, the annual percentage rate of interest charged by moneylenders is generally on the order of four to five times greater than that charged by deposit collectors.

But many slum clients of moneylenders borrow for cycle after cycle, just as clients of deposit collectors take part in repeated cycles of saving. Indeed, after a few cycles have gone by, there is very little practical difference between the two systems. In each case, the client makes a series of deposits at regular intervals and receives in return a regular but much less frequent lump sum. Some of the regular users in Vijayawada's slums barely acknowledge the differences between the two services. This example vividly illustrates that the basic task of financial services is to turn savings into lump sums. The precise chronological relationship between the savings and the lump sum is of secondary importance, especially if you are a client in a financial services market characterized by strong demand and inadequate supply, as most poor people are.

### **The ROSCA**

To understand how a ROSCA works, take the case of Mary, a deserted mother who makes her living selling vegetables from her hut in a Nairobi, Kenya slum. Mary formed a ROSCA—which she calls a Merry Go Round—with 14 of her women neighbors. Each day, each of the 15 members deposits 100 Kenyan shillings (about \$2 at the time I first met Mary), and each day one of the 15 takes the full 1,500 shillings deposited that day. After 15 days, each of the members has made 15 daily deposits of 100 shillings and received all 1,500 shillings on one of the days. On the sixteenth day, they begin a new cycle. When I met them, they were in their 65th successive cycle.

So what is the point of the Merry Go Round? Members get back exactly what they put in—but with no profit. Moreover, members have to put up with the nuisance of making the daily deposit and run the risk that at any time a fellow member may default. The point could hardly be simpler: ROSCAs turn a series of savings into a useful, large lump sum. For example, Mary depends for her livelihood on her tiny vegetable selling business, which has a stock worth about 1,500 shillings. Like millions of small business people around the world, one of Mary's biggest headaches is having her business capital eroded by everyday needs. For example, just before I met her, her son needed 500 shillings' worth of medical attention. Mary had no other source for this sudden expenditure than her business capital, which was suddenly depleted by the accident. But as Mary points out, provided she is faithful to her Merry Go Round, every 15 days she gets 1,500 shillings in a single lump sum and can replenish her stock in full. Mary said she once joined a credit scheme run by a voluntary organization. They gave large loans that were repayable over 1 year. At first, Mary was strongly attracted by the scheme, but she left as soon as she realized the rhythm of deposits and loans was far less suitable to her particular situation than was her Merry Go Round.

### **Auction ROSCAs**

Mary's case shows that people need access to *flexible* financial services, in which the values and frequencies of the pay-ins and the pay-outs can be determined by the individual user to suit his or her particular circumstances. Some variations of the ROSCA are much more flexible than Mary's simple Merry Go Round. In Mary's ROSCA, the order in which the members take the "prize," or pay out, is predetermined. This arrangement is quite suitable in ROSCAs with a relatively small membership and short cycles, especially if the ROSCA runs for cycle after cycle.

In the more flexible "auction ROSCA," members bid against each other for the privilege of taking the prize. Imagine a ROSCA of fifteen members meeting weekly when each member brings 100 shillings to the meeting, for a total of 1,500 shillings. The right to take this money is auctioned among the members. For example, a member with a very urgent need may offer 300 shillings for the right. She then walks off with just 1,200 shillings, and the remaining 300 shillings is divided up and returned equally to the other members. In this way, bidding allows

the member with the most urgent need for the prize to take it and compensates the remaining members. Auction ROSCAs reward savers: if I choose to be the last person to take the prize, I get the full value of the prize because nobody is left to bid against me, and I will have enjoyed my share of the discounts from earlier, successful bidders. I will have taken out more than I put in as a reward for my patience. Good financial service devices—of which the auction ROSCA is a splendid example—provide flexible opportunities to borrowers and good returns to savers. Moreover, the price borrowers pay for their loan is set automatically in an auction ROSCA as an outcome of the bidding process. Such ROSCAs are therefore inherently good at evaluating the market price for money at a particular time within a particular community. Finally, we should note the effective prices paid by borrowers in auction ROSCAs are often quite high, though not as high as those taken by moneylenders. It's worth remembering that money is expensive: in any well-run financial service, interest rates may reflect the high value that both savers and borrowers place on money, without squeamishness, and without deterring good clients.

### **Sustainable, But Not Always Reliable**

The examples described here represent just a handful of the dozens of money management devices that have evolved over the centuries (more elaborate treatments are listed in the end notes<sup>3</sup>). Each of these devices has its strengths and weaknesses.

None of these systems enjoys any kind of subsidy—they are all inherently sustainable. The full cost of the services is met by their users, either directly through fees and interest charges, as in the case of deposit collectors and moneylenders; through management services provided by the users themselves, as in the case of Mary's Merry Go Round; or a mix of both as in an auction ROSCA. The sustainability of these systems is guaranteed by a simple acid test: if they don't cover their costs, they disappear.

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<sup>3</sup> Stuart Rutherford's *The Poor and Their Money* (2000, Delhi: Oxford University Press) contains detailed descriptions of various kinds of devices. Stuart Rutherford's *A Critical Typology of Financial Services for the Poor* (1996, working paper #1, London: ActionAid), contains a listing of 57 different devices, with brief descriptive notes. See also *Money Go Rounds*, edited by Shirley Ardener and Sandra Burman (1995, Oxford and Washington DC: BERG), a collection of essays about ROSCAs; Fritz J A Bouman's *Small, Short and Unsecured* (2000, Delhi: Oxford University Press), which describes informal finance in India in some detail; and *Informal Finance in Low-Income Countries*, edited by Dale W. Adams and D. Fitchett (1992, Boulder, CO: Westview Press).

Also, these devices have only one purpose: to turn savings into useful, large lump sums. They are not distracted from this purpose by any political or social agendas (although membership in any given system may be restricted to certain groups).

In general, these devices do not place any restrictions on the use of the lump sums, recognizing the very wide range of needs and opportunities that induce poor people to save. Individuals may be concerned about managing life events, such as birth, marriage, old age, or death, all of which may require large expenditures. Or they may need the lump sum for a personal emergency, such as sickness, accident, or theft, or some impersonal emergency, such as a flood, fire, drought, or municipal destruction of one's slum home or business. Finally, the lump sum may be needed to finance some opportunity to acquire an asset or to start or grow a business.

The main weaknesses can be summed up in one word: unreliability. Unreliability takes many forms, including access. You may live in a village or a slum that lacks deposit collectors, moneylenders, and ROSCAs. Even if they do exist, they may not wish to transact with you, for a wide variety of reasons. Friends, family, and neighbors may offer you a loan—or they may not, and even if they do they may not offer enough, especially in hard times when everyone is short of money at the same time. When you reciprocate with a loan, you are likely to be paid back eventually, but exactly when is a matter for uncertainty and anxiety. While ROSCAs usually work well, they may fail, leaving members scrambling to adjust the accounts and get their money back.

Some strengths may, paradoxically, make a device less useful to potential users. Take, for example, the use of fixed equal periodic deposits. Paying a fixed sum every week for a full year makes accounting easy, makes the system more transparent, and makes it easy for illiterate poor people to keep track of their obligation. But many poor people have irregular or unreliable incomes and simply cannot pay a fixed amount every week throughout the year. Many of the devices are time-bound or consist of a series of short cycles, which has advantages and disadvantages. Long-term needs, such as saving for retirement or a child's

college education, require long-term saving. Informal devices are more adept at dealing with short-term needs.

## **Room for New Players in the Field**

Informal money management devices have much to teach us about the real financial service needs of poor people, and they leave the door open for a more formal approach to offering more widely accessible and reliable services. Over the past 25 years, institutions have established financial services for the poor, with some success. Among the great pioneers of such services is the Grameen Bank of Bangladesh. *SafeSave*, also of Bangladesh, offers an example of the later generation of microfinance institutions (MFIs) that are just now finding their feet.

### **Grameen Bank**

If you talk to Bangladeshi villagers about moneylenders, you will find their main complaint is not that they charge too much interest or exploit their clients, but that getting money out of moneylenders is like getting blood from a stone. Obtaining a loan is hard work: it's time-consuming, it's humiliating, and it's frustratingly unreliable. Imagine the villagers' astonishment when, starting in the late 1970s, polite young men and women began to arrive in their villages offering to lend them money at very modest rates of interest and to let them pay the loans back in a series of tiny weekly instalments. Even more astonishingly, they kept their word. Rain or shine, flood or drought, these Grameen Bank workers turned up in the village on time every week and handed out the loans exactly as promised. The villagers loved it. They quickly saw that if they had the capacity to find quite small amounts from their weekly cash flow they could use them to repay a series of annual loans big enough to solve many of their pressing day-to-day problems. This affordable, accessible, and above all wholly reliable system for turning a year's worth of savings into a lump sum made Grameen very popular in the villages.

As Grameen grew, it attracted the attention of many researchers, and soon these observers pointed out some interesting differences in the way that Grameen and its clients viewed this excellent service. Most of the customers made a simple calculation: they estimated how much money they could safely pay into this system each week and then calculated the loan size they

could afford. Grameen looked at the matter from the opposite perspective: it assumed the loans would be invested in businesses that would produce a stream of revenue out of which the weekly loan repayments could be made. In Grameen's view, the bigger the loan the bigger the business and the better able clients would be to repay the loan. Grameen's initial assumption was that poor people had little or zero capacity to save and that their finances needed to be kick-started with a loan that had to be invested in some activity that would quickly produce a stream of new income. With this in mind, Grameen tried to restrict the use of loan to so-called 'income-generating' activities.

As examples described above show, this assumption overlooks two practical facts of life for the poor. First, they have many uses for lump sums, and it is unrealistic to assume they will always be in a position to invest in businesses. Second, the incomes of the poor are often irregular and unreliable; so many poor people are simply unable to pay a fixed repayment instalment week after week. Many poor people instinctively understood the shortcomings of the Grameen system and chose not to become members. Others took a chance but dropped out when faced with the embarrassment of turning up at weekly meetings unable to make the full payment. Clearly, Grameen was ideal for those clients whose household cash flow was robust and regular enough to meet the fixed regular weekly payments – whether or not they actually ran a business – but less useful to the many poor with irregular and unreliable incomes and a wide variety of needs for lump sums.

During the 1990s all this became better understood, and the major Bangladeshi MFIs, including Grameen itself, took appropriate steps to make their services more attractive to a wider group of poor people. They moved away from a "business credit only" approach and introduced voluntary savings products that gave their clients opportunities to save up as well as save down for a wide variety of uses. They introduced longer-term contractual savings products, so clients could systematically save for long-term needs like education or widowhood. Many MFIs experimented with more flexible repayment schedules and loan terms.

## **SafeSave**

*SafeSave*, a financial services provider that began in the slums of Dhaka in 1996,<sup>4</sup> deliberately seeks to learn from the real behavior of poor people struggling to use homemade money management systems. It develops products flexible enough to be attractive to many poor people, including the very poor. It does not stress microenterprise lending, nor does it claim that its services will, of themselves, bring its clients out of poverty. It seeks instead to make a dramatic improvement in the quality and reliability of basic banking services for poor and very poor people.

*SafeSave* seeks to emulate the strengths of the informal systems, such as their single-mindedness, flexibility, proximity to clients, and frequency of client contact. To this end, each of its bank workers visits about 200 clients daily. At each visit, clients may deposit savings in any amount (including zero) or withdraw money on the spot from their account. Thus, clients enjoy the equivalent of a current account with the added convenience of a daily visit from the bank. This system helps clients maximize their saving capacity by squirreling away tiny amounts of money, sometimes as little as 2¢ U.S.

In addition, *SafeSave* offers longer-term savings products with accumulating interest. Clients who wish to save down can receive loans, which they repay in exactly the same way as they save—by paying in as much or as little as they choose (including zero) at each daily visit. Loan values depend on the transaction history of each individual client and the client's savings balances. Active clients who make deposits or repayments frequently soon have access to relatively large loans.<sup>5</sup>

*SafeSave* derives income from interest payments on the loans it provides to its clients. These borrowers pay their interest each month, and interest is charged on the so-called 'declining basis' so that as the amount of the loan still outstanding declines, the amount of interest to be paid also declines, giving clients a clear incentive to pay down their loans as quickly as they comfortably can. Using cost-efficient working methods, *SafeSave* covers the full operational

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<sup>4</sup> *SafeSave* was founded by the author of this article, who remains its chairman. For more about *SafeSave*, see its regularly-updated website, [www.SafeSave.org](http://www.SafeSave.org).

and financial costs of this service and makes a small surplus. Cost-cutting measures include employing bank workers who live in the slums they serve and so incur no transportation costs. Branch offices are modest low-rent rooms, and the software for the fully computerized management information system was developed at low cost in house from proprietary packages. While *SafeSave*'s products appear very flexible to the user, the rules that govern them are simple and inflexible. As a result, bank workers do not have to use their discretion about whether a withdrawal or a loan can be approved, nor about its value. This allows *SafeSave* to employ bank workers with minimum education levels and also restricts the opportunities for bank workers to be tempted into money-making behavior, such as taking bribes in return for providing loans.

### **The Future: Real Banking Services for Poor People?**

*SafeSave* is young and still very small.<sup>6</sup> It is by no means clear whether the kinds of services it offers can be made available on the massive scale required to bring banking services to poor and very poor people worldwide. Nevertheless, that ambition sums up the key challenge for microfinance in the first decade of the 21st century. After an exhilarating 25 years of experimentation with credit for microenterprise development, we must now embrace the bigger task of making basic flexible banking services as available to poor people as they are to the world's more prosperous populations.

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<sup>5</sup> For full details about *SafeSave*'s products, e-mail [mail@SafeSave.org](mailto:mail@SafeSave.org).

<sup>6</sup> *SafeSave* had fewer than 6,000 clients as of mid-2001.

The Corporation for Enterprise Development fosters widely shared and sustainable economic well-being by promoting asset-building and economic opportunity strategies – primarily in low-income and distressed communities—that bring together community practice, public policy, and private markets in new and effective ways. It has offices in Washington, DC, San Francisco, CA and Durham, NC.