Social Exclusion and Enforcement in Group Lending

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Abstract: We investigate how formal credit market institutions and informal groups interact to determine the availability of credit to poor households and the structure of social networks. A number of existing studies have shown that social sanctions combined with group lending contracts can improve the access to credit, but have treated sanctions themselves as exogenous. They do not therefore permit an analysis of the effects of formal institutions on networks. We model group interactions as a set of activities that are independent of group lending. We then derive sanctions as the exclusion from the benefits of these activities, and show how lending contracts and the size and composition of social networks are jointly determined in equilibrium. While social networks do bring the poor within ambit of formal credit institutions, lending contracts can also be used by groups to infer characteristics of households and exclude some of them from participating in collective activities. Temporarily greater access to credit for some households may in fact result in their exclusion from social networks and community level public goods.