Micro Finance: Introduction

1. Introduction

- Because of information problems and transaction costs (adverse selection, moral hazard, monitoring and enforcement) credit markets are imperfect, and these problems are more severe in developing countries.

- The standard solution (in the absence of non-monetary punishments) is to use collateral.

- There are two problems associated with the use of collateral.
  - A large fraction of the population in developing countries is poor and do not own any assets.
    - Policy Implication: Credit subsidy; redistribution.
  - Even those who own assets do not necessarily have formal titles, and also foreclosing on collateral is costly because of inefficient judicial system.
    - Policy Implication: Titling; rewriting bankruptcy codes; legal reform.

- The evidence on subsidized lending is not very encouraging.
  - Low repayment rates: 30% in Pakistan, 41% in India, 51% in Bangladesh.
  - Debts are expected to be written off due to political reasons; subsidized credit is also captured by the rich.
- The evidence on titling is mixed.
  - Some studies find large effects on credit supply (for example, Feder and Feeny (1991) for land titling programme in Thailand);
  - while Field and Torero (2005) find moderate effects in urban housing titles in Peru.
- More generally, like asset redistribution (as we have seen in case of land reforms) titling involves significant political and administrative costs.

- Easier way out – convert “social capital” that exists in social networks in close-knit societies into “invisible” collateral.
  - Members of a community know more about one another than an outside institution such as a bank.
  - While a bank cannot apply financial or non-financial sanctions against poor people who default on a loan, their neighbours may be able to impose powerful non-financial sanctions at low cost.
  - An institution that gives poor people the proper incentives to use information on their neighbours and to apply non-financial sanctions to delinquent borrowers can out-perform a conventional bank.
    - Achieve goals of both efficiency and equity (conventional lending programmes being merely redistributive).

2. Micro Finance

- The Grameen Bank of Bangladesh lends to about 2 million people, most of whom are rural, landless women; operates in 36,000 villages, or about half of all villages in the country.
- Worldwide 13 million clients were served in 2000 with other major Micro Finance organizations being FINCA (Bolivia), BANCOSOL (Bolivia), BRI (Indonesia), BKD (Indonesia), ACCION (Venezuela), and BRAC (Bangladesh).
- Small loans for self-employment projects (e.g., poultry, paddy husking, handloom weaving, grocery or tea shops, dairy farming).
- No collateral is charged; interest rates though high are less than those charged by local moneylenders.
- Borrowers organize themselves into self-selected groups of five people from the same village.
- Loans are given for individual project, but group is jointly liable for each other's loans – if any member of a group defaults, all members are ineligible for credit in the future.

- Micro finance stands out compared to conventional lending approaches in terms of (a) reaching target groups and (b) loan repayment.
  - In the Integrated Rural Development Programme (IRDP) in India, on average, percentage of ineligible beneficiaries is 15-26%, the highest reported being 50%. In contrast, for the Grameen Bank, only 5% borrowers were outside the target group.
  - The repayment rates in IRDP is around 41% for India as a whole. For the Grameen Bank, even according to conservative estimates (Morduch, 1999) it is 92%.

- Economists argue that joint liability induces borrowers to
  - monitor each other (“peer monitoring”),
  - put pressure on delinquent group members (“peer pressure”), and
  - induce better group selection (“peer selection”).

3. References

1. Feder, Gershon and David Feeny (1991), “Land Tenure and Property Rights: Theory and Implications for Development Policy”, *World Bank Economic Review*, 5, 135-153.

2. Field, Erica and Maximo Toreo (2005), “Impact of Land Titles over Rural Households”, OVE/WP-07, Inter-American Development Bank.

3. Morduch, Jonathan (1999), “The Microfinance Promise”, *Journal of Economic Literature*, 37, 1569-1614.