MONETARY POLICY'S EFFECT ON LENDING THROUGH MICROFINANCE

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1. Background

Monetary transmission mechanism explores the channels through which monetary policy impacts the economy at large. Credit channel is an important component of that channel and its role in the transmission mechanism has generated a fair amount of debate.

It would be useful to visualise the distinct role Microfinance plays in this transmission mechanism and whether Microfinance has distinctive features that separate them from other financial institutions.

The empirical literature on the monetary transmission mechanism has found that after a tight monetary policy episode,

(1) Bank loans to households declines where as bank loans to businesses rise slightly
(2) Within firms, there is a decline in bank credit to the small firms and an increase in credit to the large firms
(3) Looking at the term structure of credit, short-term borrowing by large firms, from both bank and non-bank sources, rises substantially

In summary, there is evidence that monetary policy has a more potent impact on small firms and borrowers than it has on large ones. (Gertler and Gilchrist, 1991) Kashyap et al. (1992) show that there is a compositional change in the credit mix in the economy after a tight monetary policy episode, which adversely impacts the smaller firms and borrowers. This creates a gap that microfinance institutions can potentially fill in if microfinance institutions are distinct some ways and not subject the same pressures as the banks and financial institutions.

The obvious explanation for the adverse impact on small borrowers could be that tight monetary policy restricts the supply of bank credit. Yet, that would not fully explain why credit for some borrowers, i.e., the small ones, is more restricted than it is for others. The complementary explanation is one that emerges from the imperfections in the credit market. Some credit markets imperfection disadvantage the small borrowers, which gets amplified in the tight monetary policy episodes.[1] This could potentially explain why some borrowers are disadvantaged relative to others in face of a monetary policy tightening.

Imperfections in the credit market may force certain borrowers to rely primarily on bank credit. This in turn may stem from their inability to manage credit from other sources, i.e., small borrower's inability to directly issue bonds. Further, it may make the same class of borrowers extremely

[1]Value of collateral or value of the pledge able resources could be one explanation.

sensitive to the movements in the risk-less interest rate as well as demand disturbances. There are interesting issues to be explored here in the context of informal finance and microfinance.

2. Question

For a small microfinance organisation, a monetary policy can be taken as an exogenous shock. Since most microfinance organisations do not have to adhere to reserve requirements, open market operation by the central banks should not have a direct impact on the lending through microfinance institutions. Microfinance institutions have a very different *financial technology* of generating loans as compared to the banks and other financial institutions.

The interesting questions to explore would be whether Microfinance organisations behave like financial institutions in the way they react to monetary policy. Do their loan portfolio composition change exactly like a banks or are there differences.

The Central bank control the banks and financial institutions through reserve requirements. Recently, this control has been constrained because banks and financial institutions are able to raise funds through managed liabilities. Microfinance organisations have a very different structure where they funds themselves only through managed liabilities, donations and subsidies. So we could ask the following questions:

(1) Does the *special nature* of Microfinance organisations and their ability to use donation and subsidies allow them to offer greater protection[2] to the small borrowers in face of a tight monetary policy episode in terms of the *loan volumes*, *interest rate on loans* and *loan sizes*.
(2) Do Microfinance organisations *behave differently* from the conventional financial institutions and banks in face of tightening monetary policy?
(3) If so, how should we *regulate* them, i.e., regulating them like banks may be counter-productive if they are a special class of financial institutions that protect the small borrowers in face of tight monetary policy episodes.

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References

Gertler, M. and Gilchrist, S. (1991). Monetary policy, business cycles and the behavior of small manufacturing firms. Technical report, National Bureau of Economic Research.

Kashyap, A., Stein, J., and Wilcox, D. (1992). Monetary policy and credit conditions: Evidence from the composition of external finance. Technical report, National Bureau of Economic Research.

[2]as compared to banks and other financial institutions