

Microfinance: The Economics of Buying a Buffalo

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21 November 2014

EVALUATING AN INTERVENTION

Analogy from Medicine

- *Symptoms*: Alleviating the symptoms
- *Diagnosis*: finding the root cause
- *Cure*: Curing the root cause

Analogy from physics

Concept of steady state or equilibrium

- *The swinging pendulum*

Economic systems are complicated

- Endogeniety, feedback loops, multiple equilibria

WHAT IS LACK OF ECONOMIC DEVELOPMENT

The macro view: the collectives matter

- *The swinging pendulum ...*

The micro view: the individual matters

- *The swinging pendulum ...*

What is the appropriate *unit of analysis*?

PROBABLE ROOT CAUSES OF LACK OF DEVELOPMENT

Human Capital

Public Goods and Infrastructure

Economic Opportunity

Access to markets

Adequate Financial Services

- Matter on their own
- Exert influence on each other
- Multiple equilibria

DESIGN OF AN APPROPRIATE INTERVENTION

The macro view: is it the collective?

- *The swinging pendulum ...*

The micro view: is it the individual?

- *The swinging pendulum ...*

- Attack the roots cause(s)
- Move from one equilibria
- Education, roads, law and order, property rights ...
- Credit alone insufficient
- Microfinance *plus*

DESIGN OF AN APPROPRIATE INTERVENTION

Designing an ideal poverty alleviation intervention

- attacks the causes and not the symptoms of poverty

Design an optimal microfinance intervention

- attacks the particular cause of entrenched poverty.

HISTORY OF INFORMAL FINANCE

German Credit co-operative

- Initiated by *Hermann Schulze-Delitzsch* and *Friedrich Raiffeisen* in mid 19th Century
- By start of 20th Century, one-third of German households belonged to credit co-operatives

Rotating Saving and Credit Organisations

- Called *Chit funds* (India), *Susu* (Africa), *Kye* (Korea), Origins of the *US Savings and Loans Associations*

Microfinance

- *Grameen Bank* (Bangladesh), *Banco Sol* (Bolivia), *Bank Rakyat* (Indonesia), *Kredit Desa* (Indonesia), *Foundation for International Community Assistance* (Latin America), *SHG Linkage Programme* (India)

PROBLEMS IN LENDING

Adverse Selection

Moral Hazard

Auditing

Enforcement

ADVERSE SELECTION



MORAL HAZARD



MORAL HAZARD



MORAL HAZARD



AUDITING



PSEUDO-COLLATERAL

Microfinance contracts:

- Compressed repayment period
- Borrowers forced to **invest** in their own projects
- The wealth-less cannot borrow

SAVINGS

Poor have extremely volatile income streams

Require savings instruments to be able to

Smooth consumption

Self-insure

Save towards lumpy investments

Poor are offered no saving instruments in the rural credit market

Moneylender lends but does not take any saving deposits. Why?

Covariate Risks

Transaction Costs

How can Microfinance institutions help?

CASESTUDY IN HARYANA, INDIA

⊙ *Case-study of a Microfinance Institution in Hararyana*

Documents the innovative design features of India's new national microfinance programme.

○ Lender offers saving opportunities

...by *restricting* loans to the group

...creates *intra-group* competition for loans

○ Individuals can join a *group* as either a *borrower* or a *saver*

- *Borrower* partly self-finance's the buffalo

- *Saver* co-finance's the borrower's project

...and gets a premium interest rate on her savings

⊙ We observed

- *Intra-group income heterogeneity*

- *savers were poorer than borrowers*

ROLE OF SAVINGS IN MICROFINANCE

Offering saving opportunities in group lending

- leads to *negative assortative matching* along *wealth* lines:
 - Rich and poor match in the same group.
- Could potentially initiate a chain where the poor who get wealthier match with the other poor people and uplift them out of poverty
- *Macro view*: Move from a bad equilibria to a better one

EPILOGUE



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