Zahid Husain Memorial Lecture Series - No. 18

Micro Credit & Financing of Small Business

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Thursday,
22nd December, 2011

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(Power Point Presentation)

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Financial Access for the Poor

Poor Financial Access

- All over the world the poor face very high interest rates:
  - 4% per month or more (often much more)

- And very low returns on savings
  - Most of them do not have bank accounts
  - Use savings collectors, hold cash or join Chit Funds, all of which offer negative interest rates. Negative 20% are not uncommon

Why?

- "Transactions" costs
- There is a minimum cost associated with any loan
  - The borrower has to be verified
  - Repayment has to be collected
- And loan amounts tend to scale with assets
  - And hence small for the poor
  - Because the your own investment secures the loan
- The interest on the small loan has to cover that minimum cost
  - Which pushes up interest rates
- Which gives the borrower further incentive to default and raises "transactions costs"
- Which pushes up interest rates further: Vicious cycle

At the same time

- A saver wants a reliable record of his saving
- The regulator wants the record to protect the save
- And to prevent money-laundering
- But the costs of record keeping loom large relative to
- the amounts the poor save
- Hence the interest rates tend to be negative (or where that was not possible accounts were rationed).

Improving credit access

- Microfinance
- Has brought down interest rates from about 60% to 30% or less
- Involves lots of different steps
  - Group loans, singing songs etc.
- Not much evidence that group liability matters
  - From experiments where group liability was relaxed
- The key seems to be a reduction in transactions costs
  - Everyone in a group repays at the same predictable time

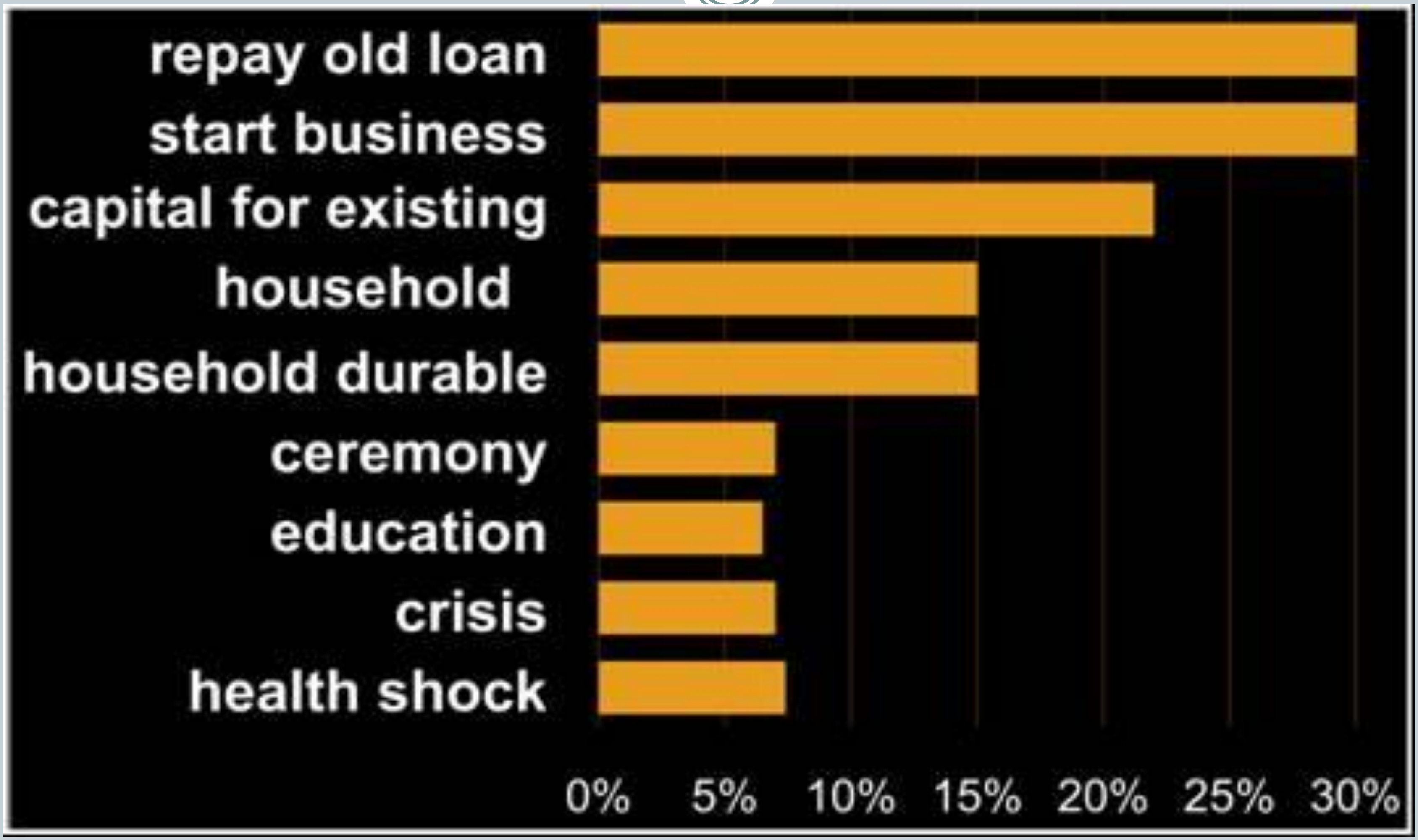
What are the impacts of microfinance?

- Not easy to tell
- Cannot compare borrowers with non borrowers
- Recent results from field experiments
- Where one set of borrowers chosen at random got credit access

The impacts of microfinance

- In Hyderabad
- Increases business creation by 30%
- However no impact on standards of living even after 3 years
- No impact on health, education, women's empowerment
- Similar results in South Africa (urban), Morocco rural.
- Consistent with a small part of the money getting invested.
- The rest gets consumed, often in durables.

Why do you want a loan?



Why?

- Not because the marginal returns on capital are low
- Returns on investment for existing business owners based on randomly giving them 100 dollars are 5-7% per month in Sri Lanka. 10-12% returns in Mexico
- Why don’t they use microcredit for investment?
- One reason is the rigidity of the microcredit contract
- Making repayment start a month later raises returns on investment substantially based on a randomized experiment
- Another reason is that tiny businesses are just too much trouble to be worth it--very limited scope for growth
- No poor parent wants their child to be an entrepreneur
- Those who were given 200 dollars in Sri Lanka invest only a 100.

On the other hand

- Savings accounts seem to have very large effects on investment
  - They allow people to accumulate savings that they can then use as a flexible source of investment
  - In Kenya access to savings accounts doubled capital invested in business
- They also allow people to deal with uncertainty better
  - In India poverty went down with improved access to a bank branch in the area induced by branch opening regulation.
- Provide some commitment especially if there are withdrawal fees
  - Evidence that commitment products promotes savings among those who opt for them

What is to be done?

- Improving access to savings opportunities is the obvious priority: Lots of action on this front in recent years
  - Bank Correspondents
  - Phone banking
  - Relaxation of KYC norms for small deposits
  - Commitment products
- How about credit?
  - The fact that it does not contribute much to business growth does not mean that it is a bad thing
  - Lower interest rates increase real incomes
  - The purchase of durables makes people happy
  - No clear evidence of wasteful spending (if anything the reverse)
  - There is almost surely some over-borrowing but that can and should be regulated

In the end

- Financial access is probably more important for helping the poor manage poverty better
  - Than in making them rich
- Ironically the best way to use finance to promote the well-being of the poor may be to find ways to lend
- More effectively to small and medium firms that have a chance to grow fast
- But no attention is being paid to this problem in India