Microfinance:
The Economics of Buying a Buffalo

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Dr. Kumar Aniket
Newnham College

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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*
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
AUDITING
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?
Case-study of a Microfinance Institution in Harayana

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

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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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