Rethinking microcredit: borrowing as a disciplined way to save?

Microcredit is not just about increasing access to credit for millions of small entrepreneurs in poor countries. Paradoxically, people also use microcredit as a costly way to save.

The Nobel Peace Prize celebrated the potential of microcredit to unleash the productive potential of small-scale entrepreneurs in need of small loans. Research from rural India suggests that women who are less able to discipline themselves in their financial behavior may voluntarily use microcredit as a savings tool. A loan can be used as a means of saving for lumpy expenses, such as education for their children or house repair. If so, there is cause for rethinking microfinance and focusing on microsavings that would enable the poor to manage their money at less expense.

research: India – microcredit / savings

RESEARCHERS Michal Bauer / Charles University in Prague, CERGE-El Julie Chytilová / Charles University in Prague Jonathan Morduch / New York University INFORMATION ABOUT THE RESEARCH where: Karnataka, India sample size: 573 subjects when: June 2007

CONTEXT

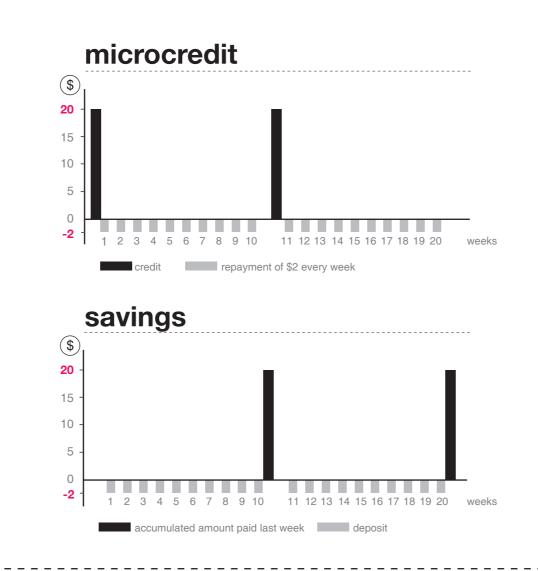
How does microcredit work?

Microcredit provides several innovations, which have proven to ensure high repayment rates by the poor. The loans are typically given to a group, which is liable as a whole. Individual members of the group thus have an incentive to monitor others' repayment discipline. Loans are repaid in frequent, low, and regular installments. The group can obtain another loan only if the outstanding one is fully repaid.

How do informal saving products work?

Deposit collector - comes to clients house-by-house and collects low, yet frequent deposits. Deposit collectors charge non-negligible fee for their service.

Rotating savings and credit associations – a group of people who save together. At regular meetings everybody deposits pre-agreed amount of money to a common pot. The collected money is taken home by one of the members. The meetings continue until each saver has taken the pot once, then the whole cycle repeats. As one member puts it: "You can't save alone."



A gym for self-discipline

Do you remember the last time one of your friends said that she was smoking her last cigarette but then she lit one just the other day? And do you remember your New Year's resolutions about exercising regularly? The poor living in developing countries all over the world experience similar problems in their daily lives. Many of them would like to save some money for future to fulfill their goals. But if the only option is to save at home where money is permanently available for spending, it is extremely hard to resist temptations and people tend to overspend.

The emergence of informal savings products such as rotating savings associations or deposit collectors demonstrates that the poor are not only willing to save but also to pay for it. These financial tools incorporate specific features: frequent, regular, small deposits or saving in a group, which support individuals with self-discipline problems. The features of these savings products and those of microcredit are remarkably similar (see the figure).

METHODS

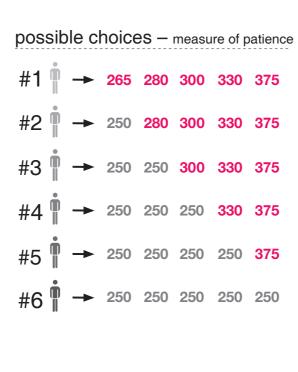
A) current choice

250 250 250 250 250 tomorrow
265 280 300 330 375 in 3 months

B) future choice

250 250 250 250 250 in 12 months 265 280 300 330 375 in 15 months

Subjects made a series of choices between a lower payoff received sooner and a higher payoff to be received three months afterwards. The researchers then randomly drew one of the choices and implemented it – the subject received the payment in the given time. 250 rupees is approximately an average weekly wage.









Less now, or more later?

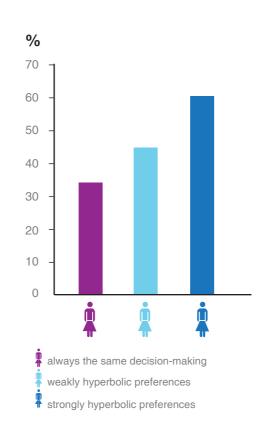
The researchers measured self-control difficulties of the poor in rural India and linked it to their financial decisions. One of the key questions of the study is how people perceive the value of current and future money. Would they rather receive a smaller amount tomorrow or a larger amount in three months? In other words: are people patient enough to wait for a higher reward? And would they choose the same smaller amount 12 months from now or the larger one in 15 months?

In real life we often observe that people have self-control difficulties. Individuals tend to be much more impatient in current choices, but patient in the future ones. In economic jargon they have hyperbolic preferences. The design of the study allows to identify individuals who exhibit such type of preferences and to test whether their financial behavior differs from behavior of people without self-control difficulties.

RESULTS

- ▶ Microcredit remarkably resembles informal saving products. Both provide support for people with self-discipline problems.
- ▶ Women with low self-control save less and borrow more using microcredit. They may use microcredit as a way to save.
- ▶ Reliable microsavings product may help poor individuals with self-control difficulties to better manage their money at less expense.

Measure of patience and decision of women for microcredit



How many subjects have chosen respective choices



Tying hands to save

Although the subjects consisted of men and women, the researchers found much stronger results for women. Women with hyperbolic preferences save less than women without self-control difficulties. These women borrow more often and do so specifically using microcredit. It seems that they are aware of their self-discipline problems and try to overcome them by seeking a tool that "ties their hands" and prevents them from over-spending. Microcredit offers exactly such a structure and provides them with desired discipline: group repayment, and small and frequent installments. Add the fact that the loans are repeated and the difference between borrowing through microcredit and disciplined saving starts to disappear. But saving through microcredit is not cheap. Monthly interest rate on microcredit often exceeds three percent. If the poor are willing to pay for saving, it would be useful to move beyond providing only microcredit. Next microfinance revolution may thus have a form of providing access to microsaving products.

INTERESTED IN THE RESEARCH? DETAILS CAN BE FOUND HERE

>>> Bauer, M., Chytilová, J. & Morduch, J. (2011): Behavioral Foundations of Microcredit: Experimental and Survey Evidence from Rural India. Forthcoming in: American Economic Review.

RELATED LITERATURE

- > Gugerty, M. K. (2007): You Can't Save Alone: Commitment in Rotating Savings and Credit Associations
- in Kenya. Economic Development and Cultural Change.

 > Ashraf, N., Karlan D., & Yin, W. (2006): Tying Odysseus to the Mast: Evidence from a Commitment Savings
- Product in the Philippines. Quarterly Journal of Economics.

 > Collins, D. et al. (2009): Portfolios of the Poor: How the World's Poor Live on \$2 a Day. Princeton Uni Press.















