



Does microfinance change informal lending in village economies? Evidence from Bangladesh[☆]



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ARTICLE INFO

Article history:

Received 28 January 2014

Accepted 5 October 2014

Available online 17 October 2014

JEL classifications:

C21

C23

G21

O12

Q00

Keywords:

Microfinance

Bangladesh

Informal loan

Long-term effects

ABSTRACT

This paper examines how availability of microfinance influences households' borrowing from informal sources in village economies. It uses a unique household level panel data set, which spans more than two decades (1987–2008), from rural Bangladesh. We find that households' access to microfinance reduces the incidence of borrowing from informal sources, but not the amount of borrowing. We find that less poor households benefit more in terms of reducing their reliance on informal borrowing and that the benefit accrues over time. We also find that having access to microfinance increases women's informal borrowing for small consumption usage, without facilitating access to new business opportunities.

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1. Introduction

Microfinance has come to be regarded as an important vehicle to reduce the incidence of rural poverty. An increasing proportion of the rural poor in many developing countries receive credit from microfinance institutions (MFIs). It is estimated that microfinance now serves more than 150 million borrowers (Hartarska et al., 2013). As noted by Servin et al. (2012, p. 2136): "Some observers [have] even called the development of microfinance... one of the main innovations in the past 25 years". No doubt, such claims reflect the increasing public recognition that microfinance has received over the last decade, stemming from the United Nations

decision to declare 2005 as the Year of Microfinance and that Mohammad Yunus and the Grameen Bank were awarded the Nobel Peace Prize in 2006. The extremely rosy view of microfinance as a means to tackle rural poverty, however, has started to be questioned in recent studies of microfinance (Servin et al., 2012).

To this point existing studies of microfinance have focused primarily on the effect of microfinance on assets, consumption, income and profits (Banerjee et al., 2013; Crépon et al., 2014; Kaboski and Townsend, 2005, 2012; Khandker, 2005; Lensink and Pham, 2012; Morduch, 1998; Pitt and Khandker, 1998, 2002) as well as the role of microfinance in mitigating the effects of health and income shocks (Gertler et al., 2009; Islam and Maitra, 2012). Other studies have focused on the effect of relationships between borrower and lender on access to finance and loan conditions in microlending (Behr et al., 2011) or on corporate governance and the relationship between economies of scale, ownership and efficiency in MFIs (Galema et al., 2012; Hartarska, 2005; Hartarska and Mersland, 2012; Hartarska et al., 2013; Hermes et al., 2011; Mersland and Oystein Strom, 2009; Servin et al., 2012).

However, these studies do not consider how successful microfinance has been in terms of reducing the reliance of poor

[☆] We thank Choon Wang, Gaurav Datt, Lata Gangadharan, Klaus Abbink, conference participants at the Australasian Development Economic Workshop at ANU, European Research Conference on Microfinance at University of Agder, Monash-Warwick Workshop on Development Economics and seminar participants at Monash University for very helpful comments and suggestions. We are also very grateful to Mahabub Hossain and Abdul Malek from BRAC for giving us access to the dataset used in this paper. The usual disclaimer applies.

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households on informal loans.¹ One of the key objectives of microfinance is to reduce the reliance of the poor on informal moneylenders. This objective, for example, is clearly enunciated in Grameen Bank documents (see eg. Yunus, 1994) and is accepted in the extant literature on microfinance (Jain and Mansuri, 2003). The extent to which microfinance has been successful in reducing the reliance of the poor on informal lenders is important given that informal moneylenders typically charge exorbitant interest rates on loans and eat into the savings of borrowers (Mallick, 2012). By contrast, microfinance programs are targeted at the poor and are designed to actively promote savings.

Evidence from the existing empirical literature on the effect of access to microfinance on informal lending among the poor, and near poor, is mixed. As noted by Besley et al. (2012), and also emphasised by Mookherjee and Motta (2013), the presence of the MFI can provide an outside option for poor borrowers that effectively reduces the level of 'exploitation' by informal lenders. Khandker (2000) finds that being a member of an MFI reduces the incidence of borrowing from an informal source. He also finds heterogeneous effects: male members reduce household borrowing from informal sources, but this is not the case for female members. On the other hand, Sinha and Matin (1998) find that microfinance member households do not reduce borrowing from informal credit sources.

Menkhoff and Rungruxsirivorn (2011) analyse the role of village funds in rural Thailand. Their findings suggest that loans from informal sources are more likely to be used for shock absorption than loans from village funds. They do not find any evidence that village funds act as a substitute for informal lenders. Similar studies, in the context of village funds in Thailand, also find that borrowers from village funds do not reduce their level of informal borrowing (Kaboski and Townsend, 2012; Kislat and Menkhoff, 2011). Karlan and Zinman (2010) show a positive impact of marginal loans on households having a credit score, but no impact on the score itself over a 15 to 27 month period. This seems contrary to the existence of a vicious circle of debt. However, given the existence of asymmetric information, the credit score that is assessed by the lender might not fully reflect the borrower's debt situation, due to debt underreporting and exclusion of informal borrowings from friends and/or family.

The purpose of this paper is to examine whether access to microfinance reduces the reliance of the poor, and near poor, on informal lending among rural households in Bangladesh. To do so, we use a unique panel data set, collected over three rounds spanning more than two decades (1987–2008). The availability of detailed borrowing data at the household level in 1987 enables us to compare the outcome before and after microfinance was available to these households. The long time span allows us to examine the effect of microfinance on informal lending in the very long run and over a much longer time period than previous studies. We also examine heterogeneous effects of microfinance across occupations and poverty status. We take advantage of having data at the individual level to identify heterogeneity in access to microfinance between male and female household members. The availability of household level panel data allows us to address the concerns of potential selection bias regarding the decision to be a member of an MFI and placement of an MFI at the village level.

In order to circumvent potential selection bias, the ideal approach is to randomly assign participants into treatment and control groups of microfinance programs. However, this also means that randomization would have to be in force over a long

period, and not be contaminated, to estimate the long-run effects. In practice, it is extremely difficult, if not impossible, to implement randomized controlled trials (RCTs) over a long time horizon. We thus believe our approach of using a two-decade-long panel data set with pre-program level information addresses shortcomings in extant studies and allow us to examine the effect of microfinance on informal lending over a much longer time period than previous studies.

The paper closest to our own work is Berg et al. (2013). This paper uses the same dataset as us and addresses a similar question. However, our contribution differs from that of Berg et al. (2013) in several important respects. First, the dataset contains three rounds of surveys (1987, 2000, 2008). Berg et al. (2013) only use data from the 2000 and 2008 rounds, while we use all three rounds of surveys. This is an important difference because the 1987 survey predated the introduction of microfinance in the villages. Thus, employing the 1987 round provides us with pre-program level information on informal borrowing, which is crucial in addressing the selection bias when identifying the effect of microfinance on informal borrowing. Microfinance was virtually non-existent in our sample villages in 1987, but, by 2000, it had expanded to almost all parts of Bangladesh, including a majority of the villages in our sample. Without the pre-program data, it would be impossible to perform clean before-and-after comparisons in treatment versus control villages (Armendáriz and Morduch, 2010). This is an issue that has hampered most non-experimental evaluation studies of microfinance, due to the lack of clean baseline data.

Second, our study also differs from Berg et al. (2013) in that we examine both the intensive and extensive margin of the extent of informal borrowing while the latter focuses on the intensive margin. Third, unlike Berg et al. (2013) we examine the welfare implications of microfinance, and investigate the heterogeneous effects between husbands and wives (intra-household borrowing) and across different occupations and poverty status. This is an important point of difference because we do indeed find heterogeneous effects of access to microfinance on the incidence and amount of informal lending.

A fourth point of difference between our contribution and that of Berg et al. (2013) is in terms of the methods used to address selection bias. The availability of pre-program level survey data in 1987 and three rounds of panel data allow us to address the concerns of potential selection bias regarding the decision to be a member of an MFI and placement of an MFI at the village level.² We use a household level fixed effects regression method, and also use the propensity score matching (PSM) method, to address selection based on observed and unobserved determinants of participation in microfinance. Fifth, we also differ in terms of defining the long-run effects as our sample spans two decades of participation status, while Berg et al. (2013) define the long-run based on only eight years of survey data.

Our results show that access to microfinance reduced households' propensity to borrow from informal sources, but it did not reduce the amount of their informal loans. However, there are heterogeneous effects, in which relatively less poor MFI members are found to benefit more in terms of reducing their reliance on informal borrowing, both in the propensity to borrow and the amount of borrowing. The benefit also accrued over time, commensurate

¹ In this paper, we define informal loans as all loans that stem from sources other than either formal financial institutions or MFIs. Thus, informal loans include loans from moneylenders, landlords, friends and relatives. More details on this definition are provided in Section 3.

² Because of the absence of baseline data, Berg et al. (2013) used new MFI members who joined the program after 2000 as the treatment group. They also omitted 234 households from the analysis, considering these households were MFI members in both 2000 and 2008. They used drop-outs from the program as the comparison group. However, these people were participants in microfinance, and it is not clear how one can use these households as the comparison group given that they were already microfinance members. A major advantage of our study is that we do not need to rely on such sample selection as we have data that predates these households becoming microfinance members.

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