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Microfinance and Moneylender Interest Rate: Evidence from Bangladesh

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Summary. — The linkage between the formal and informal credit markets in developing countries has largely been unexplored. This paper addresses one important aspect of the linkage by empirically investigating the impact of the intervention of microfinance programs on the moneylender interest rates in northern Bangladesh, and finds that moneylender interest rates increase with microfinance program coverage. Higher microfinance program coverage increases moneylender interest rates in the villages in which more loans are invested in productive economic activities than consumption. Borrowers resort to moneylenders for additional funds probably because of inadequate supply, unavailability of seasonal working capital from MFIs, and tight repayment schedules, which in turn increase demand for moneylender loans.
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Key words — microfinance, moneylender, interest rate, informal sector, South Asia, Bangladesh

1. INTRODUCTION

Microfinance programs [1] were devised to mitigate credit market imperfections in developing countries. The poor do not have access to formal financial institutions mainly because of lack of collateral and are forced to resort to informal credit markets such as moneylenders, who then charge exorbitantly higher interest rates on loans. One of the arguments given for expanding the microfinance industry is to substitute for the informal credit market [2] and help poor people escape the clutches of "evil moneylenders" (Meyer, 2002). This has been a persistent problem encountered by the policymakers in developing countries. As early as the 1950s, the Indian government tried to provide positive institutional alternatives to the moneylenders (Bell, 1990). However, the effect of the expansion of microfinance on the informal credit market is unexplored although the linkage between formal and informal credit markets has been of great interest to development economists. Morduch (1999, p. 1595) raises the question, "how will the existence of a subsidized program affect the profitability of both formal and informal institutions operating nearby?" This paper addresses one important aspect of the linkage by empirically investigating the impact of microfinance program intervention on moneylender interest rates in northern Bangladesh. It should be mentioned here that Bangladesh has the largest microfinance program in the world, with approximately 20.6 million active borrowers and a US $2.3 billion gross loan portfolio in 2009 (www.mixmarket.org/Bangladesh).

Recent theoretical development points out that the response of the interest rates in the informal sector to the expansion of formal credit depends on the characteristics of both sectors, such as market structure in the informal sector as well as the repayment schedules of the formal sector. Hoff and Stiglitz (1993, p. 47–48, 1998) outline the conditions under which increasing access to formal credit may increase or decrease interest rates in the informal sector. If some borrowers can satisfy all their borrowing needs from the formal sector at lower interest rates, there will be less demand for informal credit. Under perfect competition and perfect information, this would exert downward pressure on interest rates. But in a monopolistically competitive market [3] with free entry and with one moneylender being an imperfect substitute for another, a subsidy in the formal sector may cause the interest rates in the informal sector to rise because the induced new entry drives up the marginal enforcement cost of lending in the informal sector (Hoff & Stiglitz, 1998). Bose (1998) extends Hoff and Stiglitz (1998) model by including heterogeneous agents who differ in their probability of default. The subsidized programs diminish optimal scale and siphon off the best borrowers. As a result, the informal lenders are left with a riskier pool of borrowers that leads to higher enforcement costs, and, consequently, they charge higher interest rates as a risk premium. Jain (1999) reaches a similar conclusion by considering a case in which scale advantages of the formal sector outweigh the informational advantages of local moneylenders, while Floro and Ray (1997) consider the case in which an expansion of formal credit may strengthen the ability of informal lenders to collude among themselves.

Jain and Mansuri (2003) follow an entirely different route resembling the present scenario in Bangladesh, that a microfinance program may well have a "crowding-in" effect on informal lenders. Under certain circumstances, this "crowding-in" effect might be strong enough to raise the interest rates in the informal sector. For example, the tight repayment schedule of microfinance institutions (MFIs) [4] forces many borrowers to borrow from moneylenders to repay MFI loans. Borrowers also find it difficult to finance long-gestation projects and even seasonal working capital needs for agricultural production by MFI loans.

Although there are numerous theoretical models that explain the interest rates in the informal sector as a result of MFI program expansion, empirical evidence is scant. To the best of our knowledge, this is the first paper that investigates

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this linkage in the context of Bangladesh.[5] We analyze village level survey data from 156 villages in three districts in northern Bangladesh, and find that moneylender interest rates increase with MFI program coverage. More specifically, moneylender interest rates are higher in the villages where higher percentage of households borrows from MFIs. This result holds after controlling for a rich set of variables in the regression that includes uses of MFI and moneylender loans, adoption of modern technology in agricultural production, quality of cultivable land, incidence of poverty, proxies for competition among moneylenders, cost of information collection about the borrowers, and village level fixed effects.

We also find that the use of moneylender loans for productive purposes rather than consumption lowers interest rates. But higher MFI program coverage increases moneylender interest rates in the villages in which more loans are invested in productive activities. An explanation of the results may be as follows. A productive use of the loan decreases the default risk which, in turn, lowers the interest rate. On the other hand, since MFIs do not supply an adequate amount for productive investment or for seasonal working capital, and repayment is required almost immediately after borrowing, borrowers resort to moneylenders for additional funds to sustain their projects. Thus, the increased demand raises moneylender interest rates. This argument supports the Jain and Mansuri (2003) hypothesis because the results are robust to controlling for the alternative channels, namely, competition and collusion among the moneylenders, and scale economies in the informal credit market. The number of moneylenders in the village accounts for the competition among the moneylenders and, to a large extent, the economics of scale in the informal credit market and the scope for collusion among the moneylenders. However, we cannot directly test the Jain and Mansuri hypothesis. There is no variation in the repayment schedule among the MFIs in Bangladesh; maturity of loan is usually 1 year and borrowers are required to begin repayment immediately after loan disbursement (usually after 1 or 2 weeks).

Since microfinance coverage and use of both MFI and moneylender loans are endogenous, we correct the bias by employing heteroskedasticity-based identification, developed by Lewbel (in press), that does not rely on exclusion restrictions. The results are robust to correction for endogeneity, and thus suggest a causal effect of microfinance coverage on moneylender interest rates.

The results have important policy implications. MFIs could enhance productive investment by allowing more flexibility in loan disbursement and repayment schedules. Borrower projects would also be more profitable if MFIs expanded their program of loan-only to loan-plus, that is, credit with skill development training, information, and provision of inputs. On the other hand, competition between formal and informal lenders would increase borrowers' access to funds at competitive interest rates.

The rest of the paper is organized as follows. Section 2 provides a brief literature review of the formal–informal linkages in the rural credit market in Bangladesh. Section 3 discusses the data collection methodology. The results are presented in Section 4 that include descriptive statistics, benchmark OLS and endogeneity corrected IV results. Finally, Section 5 concludes.

2. FORMAL–INFORMAL LINKAGES IN CREDIT MARKETS IN RURAL BANGLADESH

Very little is known about the response of the informal lenders to the MFI program expansion. However, there is widespread evidence that MFI clients borrow from informal sources as part of their financial management strategy. Sinha and Matin (1998) report that about 87% of rural households in northern Bangladesh, many of them MFI borrowers, borrow from different informal sources, such as friends, relatives, neighbors, moneylenders, and shopkeepers. Husain et al. (1998) document that 11.6% of borrowers from BRAC also borrow from moneylenders. Zeller, Sharma, Ahmed, and Rashid (2001) and McKernan et al. (2005) also document borrowing from informal sources by rural households including MFI members.

Household consumption and repayment of other loans are the two most frequently reported uses of the informal loans. Sinha and Matin (1998) point out that internal cross-financing takes place because of the large increase in MFI lending in which the proceeds from one loan are being used to repay another. Clients borrow from informal sources so they can maintain high repayment rates with MFIs and become eligible for larger future loans. Rahman (1992) also provides evidence of similar practices. Rahman (1999) observes that MFI employees are expected to increase disbursement of loans among their members and press for high recovery rates to earn the profit necessary for the economic viability of the institution. To ensure timely repayment of loans, MFI employees and borrowing peers inflict intense pressure on women clients. Many borrowers maintain their regular repayment schedules through a process of loan recycling that considerably increases the debt liability of individual households, and increases tension and frustration among household members. Zeller et al. (2001) report that 9% of the funds borrowed from informal sources were used to pay existing debt. Todd (1996) describes the complex financial management practices of women members of the Grameen Bank. Clients borrow to pay moneylenders and other informal loans, and also borrow small sums informally to meet loan installments. Although there is evidence of borrowing to repay moneylender loans, it is not documented whether moneylender loans are used to repay MFI loans.

3. DATA

Data were collected in 2002 from 156 villages in three districts in northern Bangladesh (Kurigram, Rangpur and Nilphamari) as part of the baseline survey for BRAC's (BRAC is one of the largest NGOs in the world, formerly known as Bangladesh Rural Advancement committee) CFPR/TUP (Challenging the Frontiers of Poverty Reduction–Targeting the Ultra Poor) program.[6] Before launching the CFPR/TUP program on a pilot basis, BRAC first needed to identify the extreme poor. In the first step of the selection, BRAC's Research and Evaluation Division (RED) conducted Participatory Rural Appraisals (PRAs) in the selected villages to determine the extent of poverty and also to identify the extreme poor therein.[7] Households initially selected as extreme poor by PRA were surveyed to cross-check the information gathered by PRA, and also to create a baseline for future program evaluation. Along with the baseline household survey, comprehensive village level information was collected by Focus Group Discussion (FGD).[8] This paper analyzes the village level survey data.[9]

There were several preparatory stages before the FGD. The first stage was to build rapport with the community members. This was not difficult because in most situations the community members were already familiar with BRAC programs and staff. BRAC's Program Organizers walked around the community inviting people of all walks of life to the PRA

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