Source : www.livemint.com Date : 2019-12-09

THE MICROFINANCE MESS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Capping interest rates on microfinance will lead to the same perverse outcomes that inevitably follow any price controls

The Royal Swedish Academic of Sciences, the institution behind the Nobel Prize, held its 2019 award ceremony on Sunday. The winners in economics for the year, as declared earlier, are Michael Kremer and the husband-wife duo of Abhijit Banerjee and Esther Duflo. The trio won the Nobel for their experimental approach to alleviating global poverty. Duflo, in her lecture at the ceremony in Stockholm, spoke on micro credit in India. Her slide presentation during her 33-minute long speech carried a reference to a 26 October, 2010 article in Mint written by the newspaper's former executive editor Niranjan Rajadhyaksha. The article, titled 'The Microfinance Mess', is posted below.

Microfinance has had a quick slide down the popularity charts— from being celebrated as a magic wand against poverty to being condemned as a business riddled with loan sharks.

Indian microfinanciers are facing the regulatory heat right now, for the high interest rates they charge and the strong-arm tactics some have used to recover loans given to poor borrowers. The power struggle at SKS Microfinance has added further spice to the current controversies. The shares of the largest microfinance institution in India and the only one listed on the stock exchange fell below its issue price on Monday.

The attempts to cap the lending rates charged by microfinanciers are based on muddled thinking. The key question to ask is not how much microfinance institutions charge, but whether a poor borrower is better off after he has access to microfinance, even when the small loans he gets are more expensive than bank credit. In other words, do microfinance lenders charge lower interest rates than moneylenders do?

Various economists have shown that the poor and the small businesses they run tend to be severely credit-constrained. The poor do not have the adequate choice to smoothen cash flows through savings and borrowing —something that more fortunate people take for granted when they, for example, buy a car or a house by drawing down their savings and taking bank loans.

The poor have a very tenuous access to the formal banking sector and have to depend on informal sources of finances such as family loans and moneylenders. Access to loans that are cheaper than those offered by moneylenders is of immense value to poor households and informal businesses.

Capping interest rates on microfinance will lead to the same perverse outcomes that inevitably follow any price controls. Supply of microfinance will fall and demand will rise. The market will not clear. The gap between demand and supply will mean that some borrowers will not be able to get loans. They are likely to be the poorest or those living in the most inaccessible areas, where the high cost of servicing them will make them unprofitable clients.

While the current attacks on microfinance are unwarranted, the overblown claims about its efficacy also need to be tempered. There is little empirical research on the effects of microfinance on national poverty. Standard economic theory tells us that higher incomes come in the wake of higher productivity, which, in turn, is dependent on machines and technology. Access to credit has only an indirect role to play in this story. It is sobering to note that

Bangladesh, home of Grameen Bank, has remained a desperately poor country despite the spread of microfinance. Some critics of microfinance even believe that it traps people in the informal sector when they should be migrating into jobs in organized enterprises.

One of the few bits of empirical evidence comes from work done by the Poverty Action Lab at the Massachusetts Institute of Technology (MIT) in collaboration with microfinance institution Spandana in the slums of Hyderabad. Fifty-two slums were selected at random to get new Spandana branches while another 52 slums did not have microfinance facilities. The MIT researchers kept track of what effects the opening of a Spandana branch had in the first set of slums.

Abhijit Banerjee, Esther Duflo and their colleagues concluded that microfinance “does allow households to borrow, invest, and create and expand businesses". There is little evidence that microcredit forces households into a debt trap; even those who borrow but do not start a business use the money to pay off more expensive loans. Spending on “temptation goods" such as alcohol and cigarettes drops in certain types of households. But the MIT economists also found that there was little impact on health, education, female empowerment or average consumption.

These are some of the findings of the impact of microfinance after around 18 months. The record is mixed, neither justifying the hoopla nor the scare stories. And what of the longer term that has not been covered by the MIT study? There is reason to believe that microfinance plays an important role in helping poor families start businesses, pay off expensive loans, see through health shocks and buy durable goods. None of these is likely to make a dent in the national poverty numbers. What microfinance can do is act as the first stepping stone for millions who neither have the skills to join the modern sectors nor have access to cheap capital for their start-ups.

The Indian microfinance sector— with $2.6 billion of loans to 70 million borrowers—has grown big enough to attract regulatory attention. But the current rush to smother it with price controls and criminal action is likely to hurt poor borrowers, either denying them access to credit or sending them back to moneylenders.

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