Development Economics

Lecture 22: Credit Markets

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ECON 2273

This lecture

1. Lumpiness and time
    1. Savings
    2. Insurance
    3. Credit
2. Characteristics of credit markets for the poor

Lumpiness

- Much of our lives as consumers or investors revolve around having a big enough lump sum to do something
  - Example: Movie theaters require the full ticket price to watch the movie
  - It is not possible to pay a smaller amount and watch only half the movie
- The lives of the rich are rarely constrained by such "lumpiness"
  - We would never want to watch only half a movie now and half later even if we could, because we always have the full ticket price

Lumpiness

- Some places where as consumers we might be constrained by "lumpiness"
  - Cars
  - Houses
  - Large durable goods (dishwashers, big tv's)
  - Education expenses (college)
- Credit plays an important part in every one of these markets

Lumpiness

- In rich countries, lumpiness happens frequently in investments
  - Fixed cost of business is required before any money can be made
    - Example: Restaurants, for example, have to rent and remodel space, hire chefs and waiters, buy equipment, print menus, all before make any money
- Many investments can only be made or are only worth making in lumps
  - They are not divisible
  - For example: restaurants need to be big enough to have both a kitchen and several tables

Lumpiness

- For rich people, lumpiness is not much of a problem, we can afford to pay now and use over time
- Poor people do not have that luxury
  - Example: shampoo
    - Bottles of shampoo often represent 100 of washings, and possible several days wages for poor family
    - That may mean it is a big investment for a poor family
    - Markets have created individual use shampoo packets sold mainly in poor countries (but more expensive per use)
  - Some things cannot be split apart that way
    - Bullocks, bicycles, lanterns, TV's, school fees, even weddings and funeral spending

Lumpiness and financial intermediation

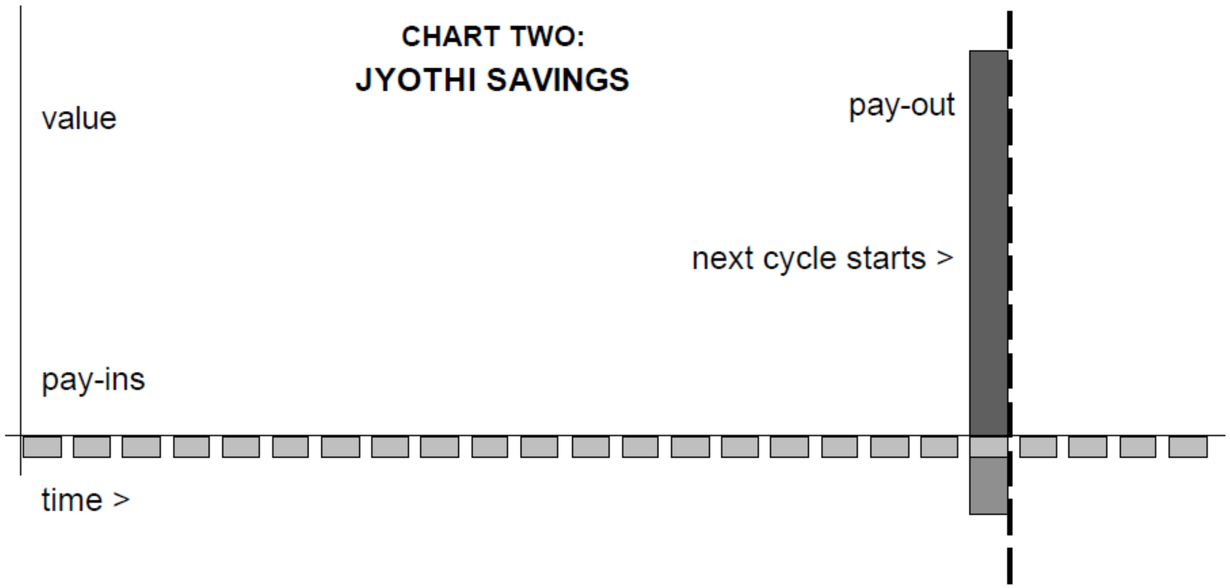
- Lumpiness requires people to gather together sizeable sums of money at one time
  - The poor, because they are poor, are particularly constrained by lumpiness in consumption or investment
- Sometimes the poor borrow directly from each other or merchants
- Sometimes they use *intermediaries* such as banks, money lenders or micro-finance organizations
- *Financial intermediation:* the process of moving funds from those who have some now, to those who want some now

Lumpiness

- Basic financial intermediation for the poor takes on three forms (Rutherford 1999)
  1. a savings service that allows you to accumulate savings *first* and take the resulting lump sum *later*
  2. a loan service that allows you take the lump sum *first* as an advance against future savings
  3. an insurance service that allows you to take a lump sum *at the time it is needed* in exchange for a continuous stream of savings

Savings

- Save a small amount on a regular basis, which eventually adds up to a larger amount
- Problems for saving
  - Often no good way—savings can be stolen, lost, destroyed
  - Claims on savings—difficult to deny neighbor, friend, or husband if have the money on hand
- Simplest savings services for the poor
  - Deposit collector, who gathers small amounts from clients, and then pays out an agreed sum



Source: Rutherford, Stuart (1999) "The poor and their money" (http://www.uncdf.org/mfdl/readings/PoorMoney.pdf)

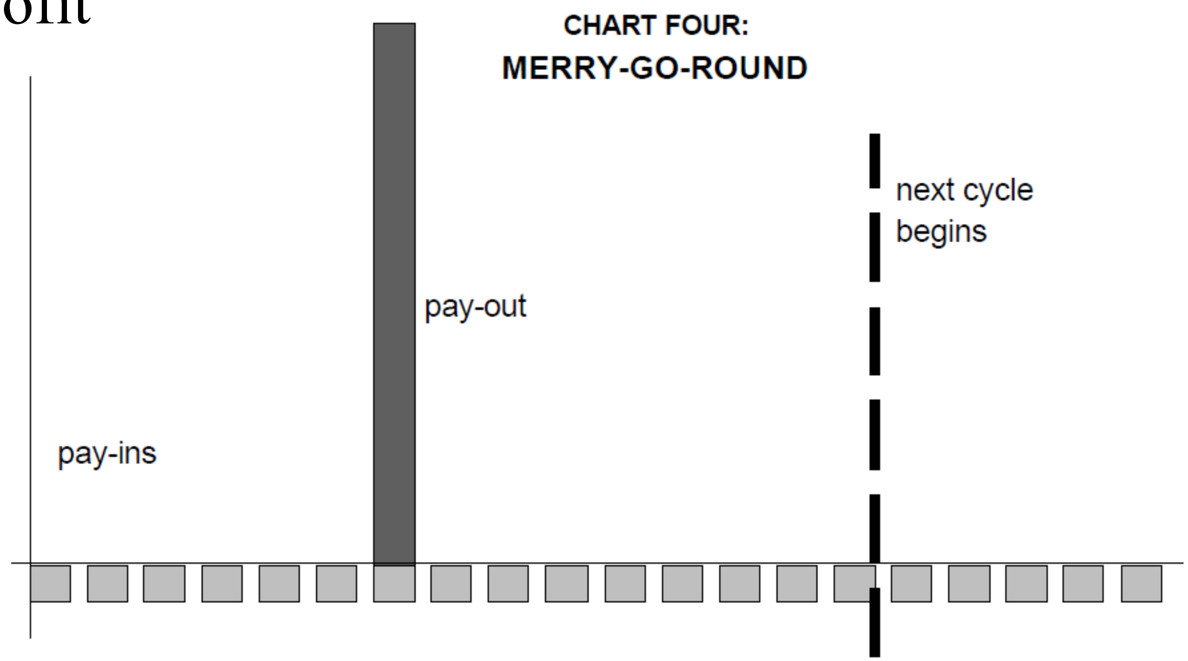
Savings: ROSCAs

- Rotating Savings and Credit Associations (ROSCA)
  - A group of people get together each week (say 14 people)
  - Each person puts in an agreed amount (say one day's wages)
  - They all agree to give the total amount to one person in the group
  - Every 14 weeks each person gets a payoff of 2 weeks wages, in return for having saved one day's wages each week
  - Group needs to decide how to pick the person who gets each payment
  - Problems with ROSCAs: flexibility, fraud

Savings: ROSCA

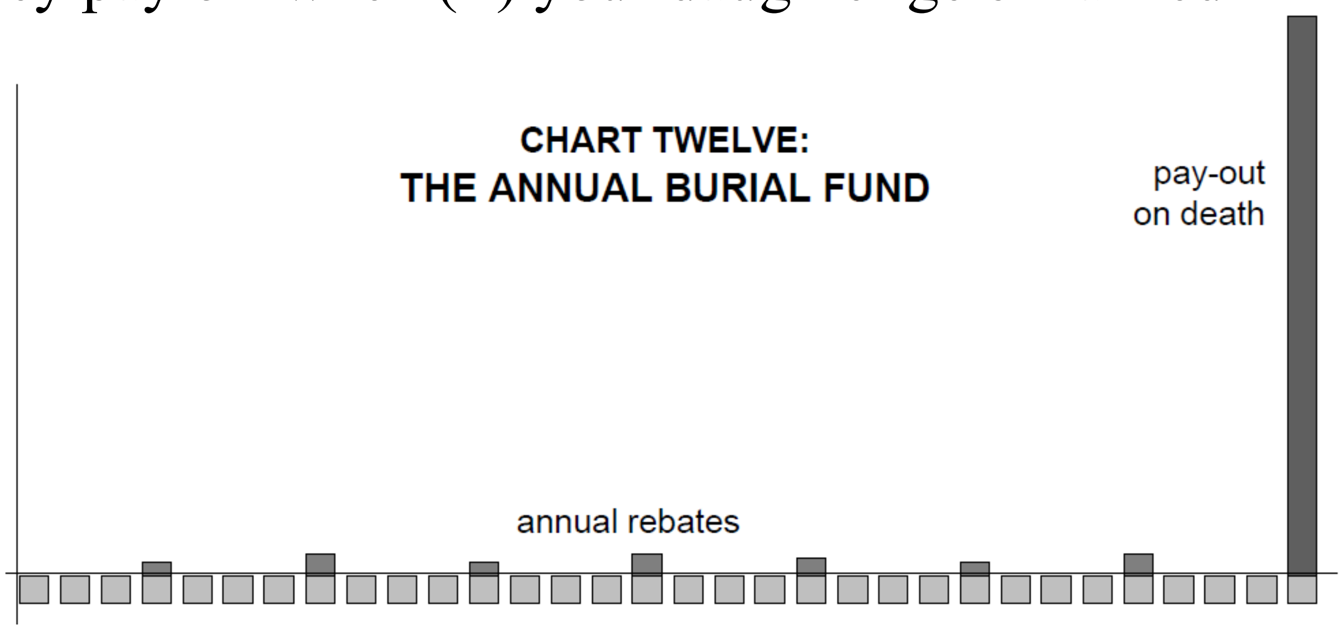
How to decide who gets money when:

- Sometimes randomly: shuffle names, everybody gets a turn over 14 weeks, then repeat in next 14 weeks
- Sometimes group decides to let people move ahead, so it becomes a credit association
- Sometimes group lets people bid on how much they need it—so group can make profit



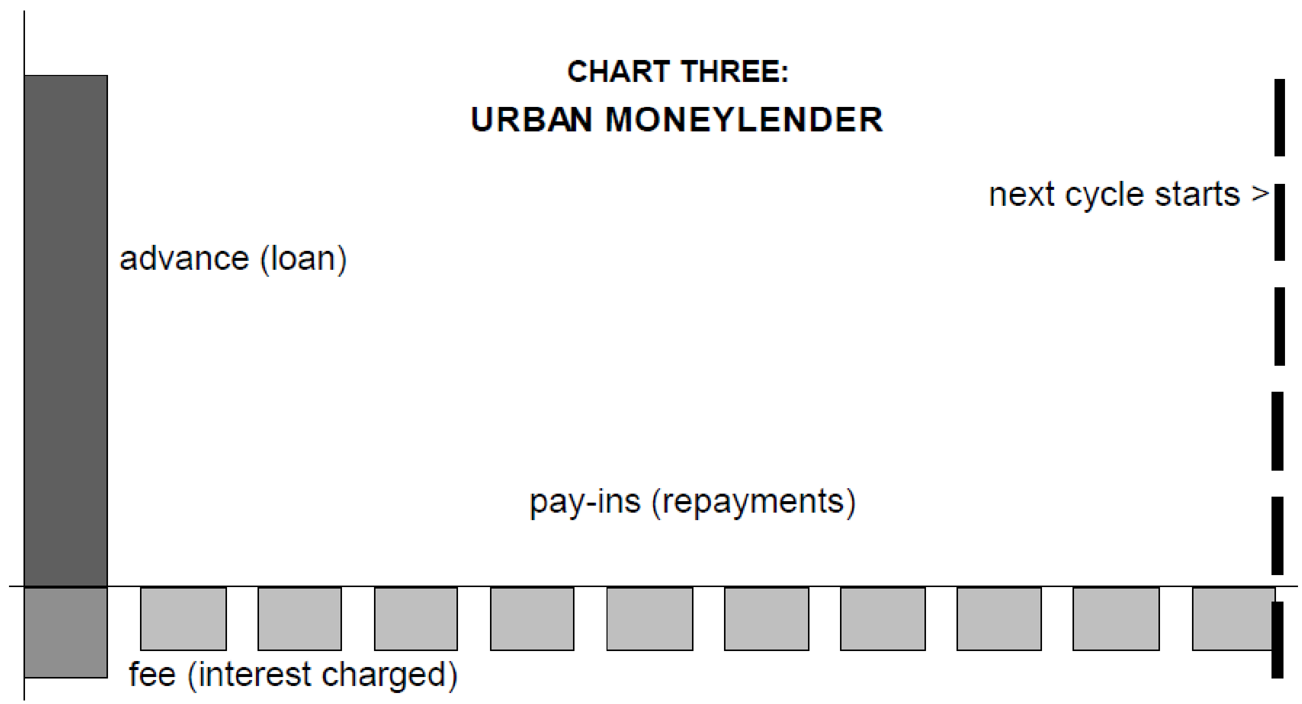
Insurance

- Save a small amount on a regular basis, and then get a big payoff when it is really needed
  - Example: funerals are very expensive in many parts of Africa, but it is uncertain when they will occur
    - Very common to form burial associations, which payout on death for a big funeral
  - Example: Marriage funds for daughters have a similar purpose in South India—they pay off when (if) your daughter gets married



Credit

- Get a big lump sum now, in return for payments in the future (often small payments)
- Simplest form: the local moneylender
  - Go to the local moneylender for a loan, have to pay back, with interest, over time

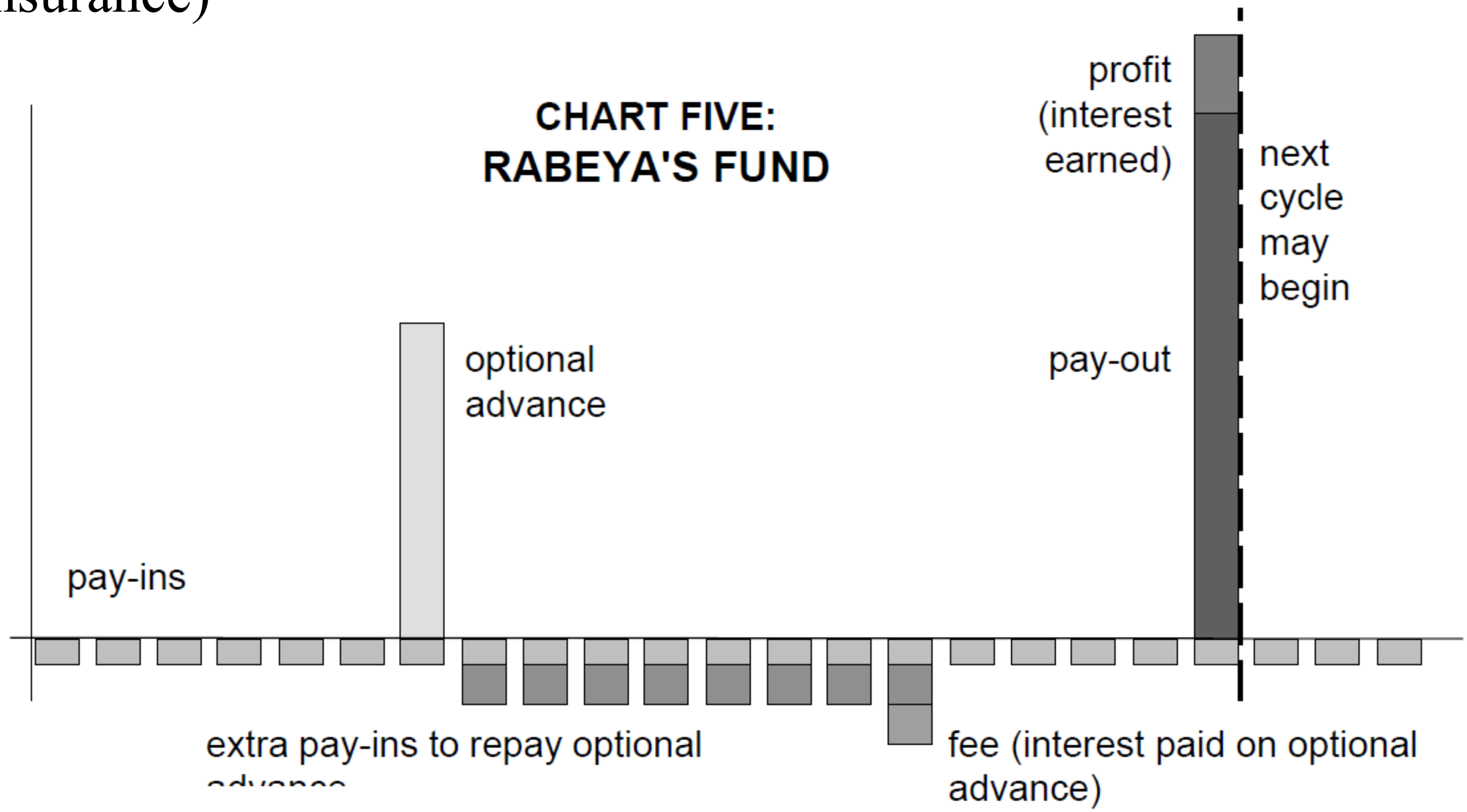


Complex financial instruments

- The poor, just like the rich, are very creative in coming up with new financial instruments to suit their needs
- Combine savings, credit, and insurance
- Examples
  - Deposit collector may give an advance on the big payout (savings+credit)
  - ROSCAs may allow people to jump in line, or bid on who gets the lump sum (savings + credit + insurance)
  - Moneylenders may be willing to delay payment if something bad happens (insurance+credit)

Complex financial instruments

Save, but can borrow when need to (so the advance works like insurance)



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Credit Markets for the poor

- In Banerjee and Duflo (2007) "The Economic Lives of the Poor"
  - Poor often take loans, but generally not from formal lenders
  - Often from friends and family at low rates of interest
  - Often from moneylenders at very high interest rates
  - Low rates of default, that we can observe
- Credit from may not be the most important instrument the poor use to manage their finances
  - But it has received most attention

Characteristics of credit markets for the poor

- Tend to be informal
- Difficulty of legal enforcement: lenders often have little legal recourse (but may often use extra-legal approaches)
- Informational constraints: can't observe all necessary/ useful information
- Segmentation: moneylender tends to serve a group mostly from the surrounding area, not much competition
- Repeat lending: lenders more likely to lend to previous clients
- Interlinkages: lending may be part of a larger relationship

Characteristics of credit markets for the poor

- Interest rate variation: Interest rates are generally high, but can vary substantially
- Rationing: borrowers are limited in how much they can borrow, at any rate of interest
- Exclusivity and monopoly: moneylenders typically want to be the only source of credit for their clients
  - A monopoly on lending allows rates to be high by restricting supply
  - Explains rationing and high interest rates
  - Probably part of the problem for poor, but not all of it
    - Moneylenders seem to be common in developing countries
    - Even in US, payday loans are competitive, with many companies competing yet still charge high rates