OPINION

A microfinance meeting in Northern Togo. Photo: Godong/UIG via Getty Images.

Can the Microcredit Model Be Improved?

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Microcredit is frequently touted as an effective policy tool to fight global poverty. But studies suggest that the long-term impact on recipients' lives is limited. Yale SOM's Mushfiq Mobarak and the University of Chicago's Vikas Dimble write that microcredit can help more people by modifying and extending its model.

SOCIAL ENTREPRENEURSHIP

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The microcredit industry is due for a re-evaluation.

Microcredit is frequently touted as an effective policy tool to fight global poverty. Its global profile was elevated in 2006 when Muhammad Yunus and the Grameen Bank won the Nobel Peace Prize for pioneering microcredit. And the industry is now estimated at $60-100 billion with as many as 200 million clients. It has been generally seen as a way to open credit markets to the poor and unleash their productive capacities.

The conventional microcredit model involves making small loans to some of the very poorest people in the world to enable them to start or run a small income-generating enterprise. Many organizations have used microcredit to target female clients, and have made credit available to them while achieving high overall repayment rates, exceeding 90%.

However, questions remain about how much this approach ultimately benefits the people it is intended to help. Indeed, a series of careful, empirical evaluations in recent years have shown little or limited impact of microcredit on household welfare in developing countries. One analysis, for instance, looked at six studies that provided microcredit expansion through seven different lenders in six countries—Bosnia, Ethiopia, India, Mexico, Morocco, and Mongolia—during 2003-2012 and found a lack of evidence of transformative effects of microfinance on the average borrower. Another researcher studied the impact of access to microcredit on six indicators: household business profits, business expenditures, business revenues, consumption, consumer durables spending, and spending on temptation good. She found the average effects of access to microcredit on these outcomes are small and uncertain, probably around 5%. She also found moderate to high probability of zero impact.

The problem here is not a lack of microcredit programs or their execution but rather something in the model itself. This leads us to ask: Can we modify or extend certain aspects of the microfinance model to achieve better outcomes for recipients?

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Many microcredit programs require that repayment starts almost immediately and then follows a strict weekly schedule. These strict requirements can make it difficult for borrowers to use the money they receive for productive investments that may take time to be realized. Introducing flexibility in repayment schedules can increase business investments and profits. One study looked at what happened when borrowers were given a two-month grace period at the beginning of a contract. The result? Borrowers were more likely to start a new business, and three years after the grace period, business profits and household income remained higher than for clients under the conventional model. The downside was that with increased risk-taking, more grace-period clients defaulted on loans.

In another study, simply switching from a weekly repayment schedule to a monthly one led to significant improvements in household income for the recipients without any increase in defaults.

These results suggest that some simple changes to contract design could be a significant way of enhancing the effectiveness of microfinance.

So why do most microfinance institutions not offer a grace period or flexible contracts at higher interest rates given the likelihood of bigger business profits for clients? The rigidity surrounding repayment is largely a response to lack of information about the creditworthiness of clients. But another innovation backed by empirical findings could help alleviate this worry.

Many microcredit borrowers have little or no formal credit history, and so lenders have been unable to screen out unproductive borrowers. They've demanded immediate repayment and used group lending as ways to reduce the risk of default and keep administrative costs down. But a number of recent studies show that the information necessary to make good judgments about borrowers already exists in the community. One study looked at what happened when local traders or shopkeepers with significant experience in a community made lending decisions. The study was conducted with potato-growing farmers in the Indian state of West Bengal, and the recipients selected by these knowledgeable agents proved particularly successful in increasing potato cultivation and output. Their farm incomes increased significantly, without any offsetting decline in income from other sources.

Another study similarly used community information to identify productive entrepreneurs and assess credit risk. In an experiment in the Indian state of Maharashtra, the researchers asked entrepreneurs to rank their peers on various metrics of business profitability and growth and entrepreneurial characteristics. While the average marginal return to the grant was about 8% per month, entrepreneurs ranked by their peers in the top third of the community earned returns between 17 and 27%.

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The idea that social networks—friends, family, colleagues, and local leaders—are a rich source of information has deep roots in development economics literature. And these studies indicate that community information can be harnessed to better target microcredit lending to those who will make the best use of it. Of course, any implementation of this idea will have to consider how to prevent bias in decision-makers and incentivize the production of accurate information, but it is an avenue ripe for exploration.

One final area we think can be further explored is the use of microcredit for a wider range of purposes. Conventional microcredit has focused on providing small loans to fund small businesses. However, there are likely many more employees than entrepreneurs in the world; they might prefer a job with a stable income over the risk of starting a business. Microcredit has the potential to improve these people's lives as well, if it is used for purposes such as supporting borrowers who are migrating or finding jobs, or for smoothing consumption during difficult seasons.

For example, a series of recent studies in Bangladesh found that a small loan or grant could effectively incentivize rural laborers to temporarily migrate to the city during the lean season—the period between planting and harvest when many farm laborers don't have work. The families of workers who chose to migrate increased their food and non-food spending, as well as calories consumed per day.

The study reveals that microcredit can overcome the barriers preventing poor rural households from taking advantage of seasonal migration. This approach faces ongoing evaluation—it must be determined how well it can be scaled up and used in other locations—but the initial results suggest that microcredit can ease people through difficult times.

In another study, researchers found that access to subsidized microcredit during the lean season in Zambia had a number of benefits, including higher wages and increased consumption. In Kenya, other studies show that providing timely access to credit allows farmers to buy at lower prices and sell at higher prices, increasing farm revenues and generating higher return on investment. In other words, microcredit can help people overcome seasonal credit crunches which force them to make decisions that don't benefit them in long run.

Microcredit can also be useful for helping poor communities cope with unpredictable shocks. In a recent experiment, microfinance clients were randomly pre-approved for loans that would be made available in the event of local flooding. The study showed this unique type of microcredit improved household welfare through two channels: a "pre-event" insurance effect, where households increased investment in productive but risky production such as land rented and area under cultivation, and a "post-event" effect, where households were better able to maintain consumption and asset levels after a shock such as flooding occurred.

In all of these settings, microcredit was able to alleviate a severe existing constraint and promote welfare gains without focusing on entrepreneurship.

Policymakers and microfinance institutions should experiment with all of these changes to the microcredit model and carefully evaluate what really benefits the communities they want to help. If you want to be sure you're doing the most good you can, the time for evaluation and re-evaluation is always now.

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