BANERJEE & DUFLO, "GIVING CREDIT"

Facts

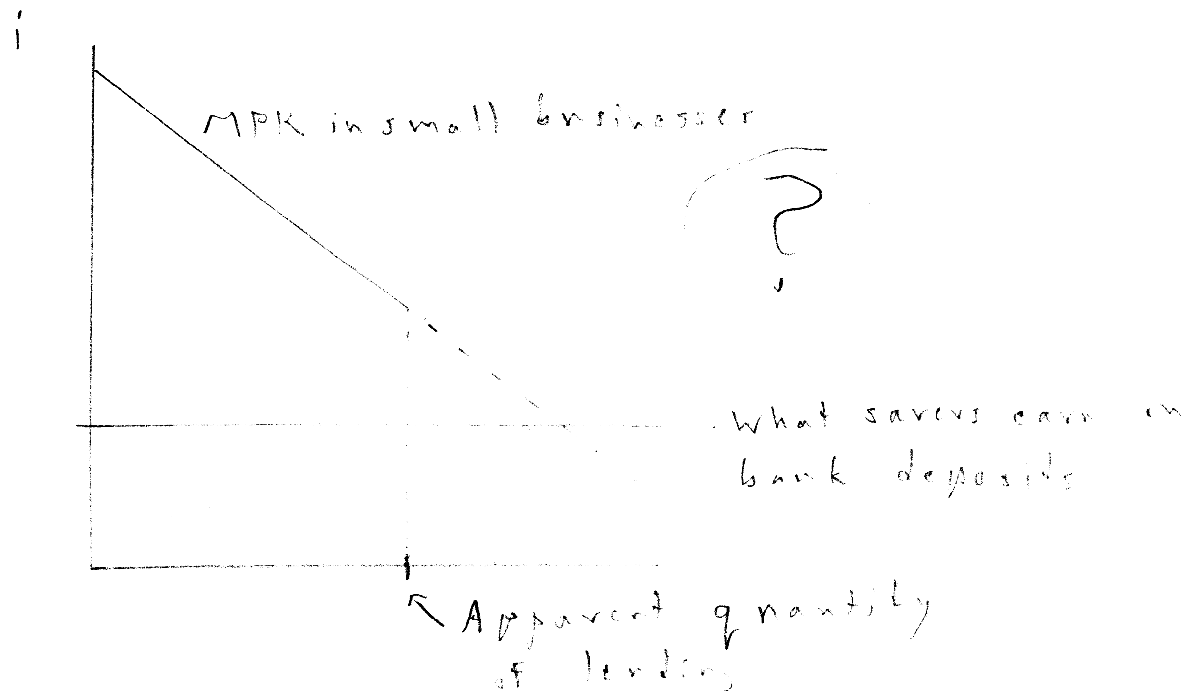
In poor countries, small businesses (i.e. people running small businesses) borrow from moneylenders, friends/family, merchants

not formal banks

low default rates

Interest rates much higher than i's banks pay for deposits

but MPK in small businesses even higher!



B&D, "Credit" (cont.)

Standard economic theory

Lending blocked by "moral hazard"
"adverse selection"

Moral hazard

After getting a loan borrower may pretend he can't repay (Romer, 866)

Or, may run his business in high risk, high return way
borrower gets possible high return, lender bears risk of default

Solutions

Collateral, seized by lender if borrower says "I can't pay"

Monitoring of borrower's behavior after he gets loan

→ Lending constrained by potential borrowers' wealth, cost to lender of monitoring, seizing collateral.

B & D

Standard theory (cont.)

Adverse selection

Not about behavior after borrowing

About different types of potential borrowers

(or borrowers' projects)

- Low risk, low expected return ← (want to lend to him

- High risk, high expected return ← (no!

If lender charges high i & takes all comers,

only high risk guys will come & borrow.

Raising i makes things worse.

Solution

Screening — collect info about potential borrower

E & D (cont'd)

Why no credit in poor countries?

Possibilities

1. Borrowers have no wealth (for collateral)
2. Legal systems (or lack of) makes it hard to seize collateral)
3. Costs of screening, etc. are fixed (not smaller for small loans)
so small loans cover costs only if i high

Group lending, joint liability

Lender gives \$ to small group of people,
each one takes some of \$
they are jointly liable for debt.

Why might this help?

— Low costs of screening, monitoring

— Punish defaulter by withdrawing friendship etc., "social capital"