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Evaluating the effects of microfinance

According to the State of the Microcredit Summit Campaign Report, microfinance reaches more than 175 million of the poorest families and is helping 100 million of those families rise out of poverty. That so many have been reached shows just how far microfinance institutions (MFIs) have come since the early days in rural Bangladesh 40 years ago. Financial services are now extending beyond the conventional financial system to some of the world's poorest people.

But the hopes placed on microfinance go well beyond the expansion of the access to financial services. Supporters of microfinance believe that, among other things, it alleviates poverty, creates self-employment, promotes gender equality, empowers women (usually microfinance targets women as clients), and helps towards achieving universal primary education. Critics, on the other hand, believe that microfinance can hurt the poor by causing over-indebtedness and is, in any case, not effective at addressing the root cause of poverty.

While microfinance has enjoyed considerable public support, MFIs have recently suffered considerable backlash in Latin America, India and even Bangladesh. In other countries (such as Morocco), previously stellar repayment rates are now much lower. While the crisis in public support has its origin in politics – at least in India and Bangladesh – it remains possible that the lack of objective evidence on the effects of microfinance, evidence that could be used to bolster the case for microfinance, may be affecting the ability of the MFI to garner public support.

Until recently, there were no 'randomised' evaluations of the effect of microfinance. That is, there were no studies where one randomly selected group receives microfinance to then be compared with another randomly selected and similar group that does not. The IGC has supported two research projects that aim to provide such studies.

The first study looks at microfinance in rural areas of Morocco. Crepon et al. (2011) conducted an experiment whereby new branches were opened in 81 villages that had previously no access to microfinance. These villages were then compared with similar villages in a 'control' group that received new branches two years later.

The authors find that the microfinance banks dramatically increased people's access to loans, doubling the amount of people with loans compared to the control villages. The main result of this is to expand the scale of 'micro enterprises', such as increasing the amount people make on a small plot of land or the number of animals they keep. But the study does not find any significant rise in the number of new businesses being set up. With the extra profits people make from their existing businesses, some is saved while much of the rest is used to pay the high rate of interest on the loans.

Moreover, the authors note that a fairly low take-up of microfinance loans (16% after two years), similar to what has been found in other studies, suggests that the effect of the programme on poverty reduction and welfare is necessarily going to be relatively limited, even in the longer run. They argue that this is not sign of failure of this programme in particular, or micro-credit in general; it may well be a very effective tool precisely for the minority of households that want to expand their activity.

A second study identifies the same repayment schedule as one of the main problems in microfinance. Borrowers must start repaying loans immediately and this restricts their ability to invest, particularly in areas that give a high return but don't provide a regular flow of cash. In 2007, Field et al. (2011) partnered with Village Financial Services, a microfinance provider in Kolkata, India to run a randomised experiment to see what would happen if banks were more flexible about how and when loans can be repaid.

Clients were randomly assigned to receive either the classic microfinance loan, with repayments starting immediately, or a new loan in which clients were given a two-month 'grace' period before they had to start repaying. The study finds that:

- Allowing clients a grace period before they begin repayment can help them invest a greater part of their loan into more profitable businesses.
- Clients who were allowed a two-month grace period invested almost 10% more of their loan amount into their businesses compared with clients who had the standard microfinance loan.
- Grace period clients also reported weekly profits from their businesses that were on average 30% higher than those without the grace period.

But the study also finds that greater flexibility in repayment also raises the number of people who default on their loans. This suggests that while greater flexibility is better for the clients, it is costlier for the microfinance providers.

Field et al. suggest a possible solution might be to offer clients a choice. Either they take out a loan with a more flexible repayment schedule but higher interest rates or they take out the current loan with an immediate repayment schedule but lower interest rates. Microfinance providers may also be able to lower transaction costs if they provide more flexible repayment schedules by allowing clients to repay monthly rather than weekly.

Further reading

Crepon, B, F Devoto, E Duflo and W Parienté (2011), "Impact of microcredit in rural areas of Morocco: Evidence from a randomized evaluation", IGC Working Paper.

Field, E, R Pande, J Papp and N Rigol (2011), "Term structure of debt and entrepreneurship: Experimental evidence from microfinance", IGC Working Paper.