

New success model for microfinance: A matter of trust

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In some countries, poor borrowers repay loans to microcredit lenders at rates of close to 100 percent while other countries see repayment rates so low that it makes microlending unsustainable - a disparity that economists have been unable to fully understand.

“Traditional economic indicators didn't predict anything, and the game theory analysis we have of it was suspect,” said Matt Jordan, AS '11, who has been working with Bill Dickens, a professor of economics in the College of Social Sciences and Humanities.

But now, the existing understanding of the economics of microlending may be changing, thanks to work by Dickens and Jordan, who, as an undergraduate, conducted field research in the Dominican Republic,

where microlending has helped bring many out of abject poverty.

“It was great that microfinance worked there, but it didn't work right across the island in a place like Haiti,” Jordan said.

Back in Boston, Jordan collaborated with Dickens, who taught a class that applied the mathematics of game theory to economics. Jordan has been working to apply the ultimatum game - an indicator of trust and cooperation that asks one participant to split a sum of money between himself and a partner, with the partner able to accept or veto the entire deal - to fields of microlending. Dickens and Jordan have identified a strong correlation between historical outcomes of the game and the success of microlending in a specific region, with cultures that are more trusting overall and more likely to repay debts.

The issue of trust is key to microlending, Jordan said, because [loans](#) are made to groups rather than individuals. Loans default when the group is unable to repay its obligations, which often occurs when members stop trusting one another after a disappointing financial outcome.

“What we think this model can do is establish new practices, even just have institutions call for a break period after bad news is given,” Jordan said. “A cooling-off period may lead to a more reasoned approach, not just one where someone thinks another person is cheating and then blows off the whole group,” leading to a default.

Dickens called Jordan's application of [game theory](#) to microfinance “a profound and counterintuitive way” to look at the problem.

The work contributes to Northeastern's focus on use-inspired research that addresses global challenges in health, security and sustainability.

Still, much work is needed, like conducting field research to gather more

information about how residents of different countries play the ultimatum game, data that is not universally available. Dickens and Jordan, who is in the process of applying to graduate schools as he works on his research here at Northeastern, plan to publish a paper on their findings.

Provided by Northeastern University

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