Economists demonstrate one size does not fit all for microfinance programs

March 21 2012

Large-scale microfinance programs are widely used as a tool to fight poverty in developing countries, but a recent study from the Consortium on Financial Systems and Poverty suggests that they can have varying results for participants and may be the most cost-effective use of funds only in limited situations.

The Thai Million Baht Village Fund is one of the largest government microfinance initiatives of its kind. Beginning in 2001, Thailand transferred one million Thai baht ($1.8 billion) in government funds to create almost 80,000 village banks throughout the country. Their goal was to increase credit and stimulate the economy.

The study, by economists Joseph P. Kaboski of the University of Notre Dame and Robert M. Townsend of the Massachusetts Institute of Technology and published in a recent issue of *Econometrica*, notes that, overall, households increased their borrowing and their consumption roughly one for one with each dollar put into the fund. Yet, the authors also report, there was considerable variance in how individual households were affected by the available credit.

Some of the least affluent households financed their current needs with the additional available credit and did not invest it. Other households didn't borrow any money but increased their consumption; this is likely because their awareness of the available credit made them more comfortable dipping into their "rainy day" savings. Still others reduced their consumption in order to save up for larger investments, and they ended up gaining substantially.

The authors also identify two major differences between the effectiveness of microfinance programs like the Thai fund and direct transfer programs. First, a large-scale microfinance program is potentially less beneficial because households face the interest costs associated with the increased credit. As households borrow more and carry more debt, they are left with larger interest payments. Interest costs remain particularly high for otherwise defaulting households whose debts grow with the more liberal borrowing limit.

On the other hand, the authors argue, a large-scale microfinance program is potentially more beneficial than a direct transfer program because it can provide more options to those who can make the best use of the increased credit. As a result, the program is relatively more cost-effective for non-defaulting households with urgent needs for money for consumption and investment. Otherwise, the program costs 20% more than its benefits for defaulting households.

The study also represents the first structural attempt to model and evaluate the impact of large-scale microfinance programs. Structural models are an economic evaluation method that incorporates a blend of economic theory and actual data to estimate and evaluate complex policy programs. The authors used data they captured as part of the Townsend Thai Data project, a monthly household panel survey that Townsend has led since 1997.

The paper, "A Structural Evaluation of a Large-Scale Quasi-Experimental Microfinance Initiative," was published in Volume 79, Issue 5 issue of the journal *Econometrica*.

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Provided by Consortium on Financial Systems & Poverty

Citation: Economists demonstrate one size does not fit all for microfinance programs (2012, March 21) retrieved 3 May 2024 from https://phys.org/news/2012-03-economists-size-microfinance.html

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