Microfinance programs: Benefits not clear-cut, study shows

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(Phys.org) -- Large-scale microfinance programs are widely used as a tool to fight poverty in developing countries, but a recent study by University of Notre Dame Economics Professor Joseph Kaboski and MIT colleague Robert Townsend suggests that microfinancing can have varying results for participants and may not be the most cost-effective use of funds for many situations. The study was published in a recent issue of Econometrica. Kaboski also is a faculty fellow of Notre Dame's Kellogg Institute for International Studies.

Kaboski and Townsend used the Thai Million Baht Village Fund, one of the largest government microfinance initiatives of its kind, to evaluate and understand the benefits and disadvantages of microfinance interventions. Beginning in 2001, Thailand transferred one million Thai baht (Thai currency), or about $24,000, in government funds to create almost 80,000 village banks throughout the country. Its goal was to increase credit and stimulate the economy, but results varied significantly among and within these villages.

Some of the poorest households financed their needs with the additional available credit and did not invest it. Consumption grew, income for those in agriculture and other forms of business grew, and wages for laborers grew, but overall asset growth in the villages decreased. Other households didn't borrow any money but increased their consumption — since they were aware of the available credit, they were 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 study also identifies two major differences between the effectiveness of microfinance programs such as 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 percent more than its benefits for defaulting households.

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