

Credit

Why do people need credit?

Fixed capital: for new start-ups or expansion of production lines (factories, machines, warehouses...)

Working capital: for ongoing production activity (because there is a lag between the outlays required for production and sales receipts) (for farmers: seeds, fertilizers, etc.)

Consumption: because sudden need for cash, downturn in production, illness, death, etc. (same motivation as insurance: smooth consumption over time)

Rural credit providers

Institutional (or formal) lenders

government banks, commercial banks, etc. (including special banks set up to finance rural production.

Problem: formal lenders usually don't have information on characteristics and activities of their clients, and can't precisely monitor how loans are used. (risk, diversion to other use than stated project...)

Interests of lenders and borrowers not aligned. In particular, borrowers often have limited liability: a borrower pays if her business is successful, but does not repay anything if it fails.

So borrower benefits from project if success, but is protected if it fails. Then, she's encouraged to undertake riskier projects than the bank would like. (the bank is the one losing money if project fails)

Relatively rich borrowers have money/assets they can dig into to repay even if their project goes badly.

Formal lenders require collateral, something that poor borrowers don't have. Or at least, not the kind formal banks would accept (a small quantity of land, or pledging one's labor as collateral...)

It's thus easy to see why formal banks trying to make profits only lend to the rich.

Informal lenders

Informal moneylenders such as landowners, shopkeepers, traders, can provide credit to poor borrowers, in a way that formal banks cannot:

They may accept labor or a small piece of land as collateral

Have better information about clients' characteristics and activities.

Non-Government Organizations

lots of examples in Bangladesh:

Grameen Bank (Nobel Peace Prize 2006!)

BRAC

ASA

and many more...

Characteristics of rural credit markets

Informational constraints

Lack of information on:

use of loan

repayment decision (in particular, characteristics of borrowers that matter for the decision)

Segmentation

Credit relationships are often personalized: a given moneylender tends to lend to a fixed clientele; information already acquired, history of lending to them, lend to people in same village or somehow connected to them.

Interlinkage

Most village moneylenders are also wealthy landlords, shopkeepers, traders, etc.

So a borrower's lender is also often her landlord and/or employer

In other words, people trade in different markets (land, labor, credit) with the same partners, and make terms in one market depend on conditions in the other.

Interest rate variation

Not surprising given the segmentation. Great variation by geographical location, source of funds, and personal characteristics. Often quite higher than rates in formal banks. Sometimes up to 200 percent per year!!!

Sometimes, informal interest rate are low, or even zero, not uncommon. But then interest may be hidden in other interlinked transactions with the lender on other markets (trade of crops, labor...)

Why can't people take advantage of arbitrage opportunities? (some people should try to borrow at low rates and lend to others who are willing to pay more, to make a profit) Again, information and segmentation: personal characteristics of borrowers, as well as the type of borrower/lender relationship, matter for lenders' decision to lend

Rationing

at the going interest rate, the borrower would like to borrow more but cannot. Why? If market functioned well, lender could grab some more surplus by raising interest rate and lending more if borrower is willing to pay.

A special case is the exclusion of some borrowers, who would like to borrow at the going interest rate but are denied credit.

Exclusivity

Moneylenders often insist that borrowers only borrow from them exclusively. So if a borrower wants to borrow more, she has to ask the same lender.

So given all this, you can see that simply counting the number of agents on credit market somewhere is likely to give you a wrong idea of how competitive things really are. Many factors allow moneylenders to exploit a local monopoly due to informational, locational and historical advantages.