Microcredit: Impacts and Limitations

Introduction:

The advent of microcredit interventions have sparked deeper analysis into its performance. In the early 2000s, researchers started to conduct randomized evaluations to contribute to the body of evidence on this topic.

Background:

Historically, microcredit had been a controversial development tool. On the one hand, it featured as one of the most important financial products to help small-scale entrepreneurs invest more in their businesses, increase profits, earn additional income, and potentially lift themselves out of poverty. On the other hand, the validity of such potential impacts have been questioned.

Details of the Intervention:

Evaluations of microcredit interventions question the methods used to assess its performance. Studies claim that early reports were based on anecdotes or simple before-and after comparisons. Others suggested potential negative effects of expanding credit access. This comes with the natural risks of business expansion, which can pull entrepreneurs deeper into a poverty trap when activities are not profitable, and debt increases.

Impact:

Randomized evaluations in seven countries find that giving small loans through microcredit does not have transformative impacts on income or long-term consumption for the average borrower. However, product innovations to target high-potential entrepreneurs, offering more flexible lending products, and lending at lower costs may lead to larger positive impacts on borrowers.

- Demand for many of the microcredit products was modest. Borrowers use microloans for consumption and/or risk mitigation rather than investment, suggesting that there were high non-entrepreneurial returns to credit.
- Innovations to target high-potential entrepreneurs and offer more flexible lending products may lead to more high-return entrepreneurial investments.
- More flexible lending products may also lead to higher-return entrepreneurial investments.

In a randomised evaluation in West Bengal, India, researchers found that giving clients a two-month grace period before beginning repayment allowed them to invest more in their businesses, resulting in higher profits and nearly 20 percent higher income after three years, but raised the default rate from 2 percent to 9 percent.

Source: J-PAL and IPA Policy Bulletin. (2015). "Where Credit is Due." Cambridge, MA: Abdul Latif Jameel Poverty Action Lab and Innovations for Poverty Action.; Field, Erica, and Rohini Pande. (2008). "Repayment Frequency and Default in Microfinance: Evidence from India." Journal of the European Economic Association 6(2-3): 501-09.; Field, Erica, Rohini Pande, John Papp and Y. Jeannette Park. (2012). "Repayment Flexbility Can Reduce Financial Stress: A Randomized Control Trial with Microfinance Clients in India." PLoS ONE 7(9): e45679.; Field, Erica, Rohini Pande, John Papp, and Natalia Rigol. (2013). "Does the Classic Microfinance Model Discourage Entrepreneurship Among the Poor? Experimental Evidence from India." American Economic Review 103(6): 2196–2226.