Lecture 16: Finance I: Introduction to Credit, Savings and Insurance

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14.73 Challenges of World Poverty

Introdution to Finance

- Plan for Lecture:
  - Watch film: *Small Fortunes*
  - Discuss film
  - Go over Besley (1995) reading
  - Discuss roadmap for remaining 3 lectures on Finance

Small Change: The Themes

- The effects of micro-lending
  - But are these just carefully selected anecdotes?
- Why won't formal banks lend to the poor?
  - What is it that micro-lending does differently?
  - Why are repayment rates so high among micro-borrowers?
- Why are women treated differently from men?

Why Does Finance Matter? 2 Big Answers

1. To diversify risk across people
   - This allows 'consumption smoothing', not growth. But people (especially the very poor) probably want consumption smoothing.
2. To allow those who possess profitable opportunities (with fixed costs) to exploit them even if they don't have the capital up front.
   - (Technically, this could be viewed as just the diversification of opportunities (ie 'upside risk') across people.)
   - This allows for growth.

- Besley (1995) is largely concerned with the diversification of risk

Risk in Developing Countries

- Why so inherently risky?

Avoiding Risk in Financial Autarky

- What can households do—entirely on their own—to avoid risk?

Avoiding Risk in Financial Autarky

- What can households do—entirely on their own—to avoid risk?
- Diversify Income
  - But specialization pays too
- Save...build up a 'buffer stock'
  - Inflation erodes many assets
  - Even if assets are 'indexed', may not be indexed to the prices (eg food prices) that household cares about most
  - Storage depreciates
  - Social constraints on amount of (visible) assets you own
- Clearly even income diversification and savings have their limits

Avoiding Risk Through Institutions

- Besley: Best way to think of an 'institution' in this context is something that allows people to work together
- Why would people want to work together?
  - Non-synchronous shocks to incomes
  - Different timing of consumption needs (eg dowry, celebrations, health)
  - Different production opportunities

Why are ‘market opportunities’ (ie formal systems) not available for dealing with this risk?

Non-market Financial Institutions

- "Financial institutions that make relatively little use of formal contractual obligations enforced through a codified legal system."
- Examples:
  - Credit cooperatives
  - Informal credit and insurance arrangements (eg, among friends)
  - Rotating Savings and Credit Associations (ROSCAs)
  - Interlinked contracts in agriculture
  - Sharecropping?

What Do Non-market Institutions Do Better?

- Better monitoring and enforcement
  - But why do these institutions need better monitoring and enforcement?
- Better monitoring of borrowers
  - More visibility in tighter neighborhood settings
- Better enforcement of rule-breaking
  - Social sanctions
  - No need for contracts or courts; not 'innocent til proven guilty'
  - People really need relationships in these settings, so they don't risk them

Group lending (eg Grameen, Muhammed Yunus)

- Lend to *groups*, not individuals.
- Typically, insist on joint liability (for repaying the loan) among the group
- This appears to improve repayment rates. Why?
  - Improves monitoring ability (since friends) within group
  - Improves incentives for friends to monitor one another
  - Peer pressure
- Why might joint lending backfire?
  - If person A's project works well but person B's doesn't, then this can incentivize person A to bail out person B (ie the group pays back). But it can incentivize person A to default too (so the group defaults).

Credit cooperatives

- Common in many settings throughout history. Besley discusses case of 19th Century Germany in greatest detail.
- Survive to this day: eg MIT Federal Credit Union
- How do they work?
  - A bit like a big group lending program.
  - Cooperative gets a large loan from a bank and then disburses it to its members as smaller loans.
- But many have failed. Why?

ROSCAs

- Again, very common in many societies, throughout history.
- How do they work?
  - Typically close-knit group of members forms
  - Members pay into a pot of money
  - Pot of money rotates among members until all get it
  - Rotation done either by random lottery, or by bidding (who needs it most?)
  - Allows purchase of large, indivisible items
  - Note that this is a savings technology too
- Best evidence we have suggests ROSCA participation is extremely widespread today
- Analogous institutions: ‘friendly societies’, ‘burial societies’

Decline of Informal Financial Institutions

- What explains the decline of informal institutions in rich countries?
  - Bowling Alone?
  - economies of scale in the formal sector

3 Lectures to Follow

- Credit
  - What does access to micro-credit do in reality?
- Savings
  - Do the poor want to save more?
  - If so, what is stopping them?
- Insurance
  - Examples of informal insurance systems