

GROUP LENDING: THE SIGNIFICANCE OF MICROCREDIT AS A TOOL OF THIRD WORLD DEVELOPMENT

In the last 15 years, the microcredit 'group lending' pioneered by Bangladeshi economics professor Mohammed Yunus and his Grameen Bank has arguably become the most important new tool in Third World development, making credit available to people who lack access to the formal financial markets. What happens with group lending is that instead of lending directly to individual borrowers, banks lend to groups of borrowers, who are jointly liable for a single loan.

What explains the success of this phenomenon? Is it social ties between borrowing group members, internal group pressure to repay loans or peer monitoring? Writing in the latest issue of the *Economic Journal*, Professor **Bruce Wydick** concludes that social ties between borrowers have little significant effect on the performance of borrowing groups. What is most important is peer monitoring - the ability of borrowers to monitor each other's investment behaviour during the course of the loan. Group pressure is also important: if borrowers are unable to threaten other borrowers with expulsion from the group, there is a greater chance of misused borrowed capital.

While the success of group lending by Grameen Bank has led its adoption by credit institutions across Asia, Africa and Latin America, it has not to date had a big impact in the transition economies of Eastern Europe and the former Soviet Union. Wydick's research indicates that it may be possible to use group lending in regions where social ties are not necessarily high, such as in the efforts to foster entrepreneurialism in these formerly communist countries.

Economists have long been fascinated by group lending because it appears to be able to solve a well-known failure in the operations of the market for credit. Researchers in the early 1970s discovered that problems in the market for credit stemmed from imperfect information between borrowers and lenders, specifically regarding the quality of a borrower's promise to repay a loan.

Because promises to repay loans are not always trustworthy, a costly screening process is necessary when seeking a loan from a lending institution. Unfortunately for the poor, this screening process is only economical for large loans; hence, poor borrowers, requiring only small loans, are typically excluded from credit markets.

Group lending seems to work because it takes a group of borrowers and shifts the risk of the loan from the bank to the group: borrowers have an incentive to choose only quality borrowing partners because they are financially liable for one another's loans.

During the late 1980s and early 1990s, a number of economists proposed theories as to how group lending is able to mitigate the problems associated with small-scale credit contracts. These

include:

- *Peer Monitoring*: the ability of borrowers to monitor the investment behaviour of one another during the course of the loan, making sure that each undertakes only safe investment projects with borrowed capital.
- *Social Ties*: the social cohesion that exists in traditional societies means that the sanctions that a borrower would receive from the group for defaulting results in each member wanting to repay faithfully.
- *Group Pressure*: the pressure between borrowers to repay means that the group can expel non-paying members if they default, thus excluding them from continued access to credit.

Wydick's research confirms the importance of group pressure and peer monitoring but suggests that social ties are of little significance. He views the role of borrowing groups almost as juries, as groups help to repay loans for borrowers who cannot repay because of a verified unavoidable mishap, and expel borrowers from the group who have misused borrowed capital, replacing them with another group member.

Note for Editors: 'Can Social Cohesion be Harnessed to Repair Market Failures? Evidence from Group Lending in Guatemala' by Bruce Wydick is published in the July 1999 issue of the *Economic Journal*. Wydick is at the University of San Francisco.

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