

Questions in development economics often focus on the poor's limited access to capital and, in particular, on their high interest rate for borrowing. Despite this high price for capital, many poor households borrow substantial amounts for production and consumption. This situation suggests that the poor have access to very productive investment opportunities and face periods when they have a very strong desire to consume more than their current income. This brief explores the role of microfinance in paying for unexpected consumption expenditures.

Motivated by high borrowing costs among the poor, a large number and wide variety of organizations have made efforts to expand the availability of credit and decrease interest rates. Microfinance organizations are one prominent example, and loans are often also provided by banks, moneylenders, family, friends, and other local associations. Households also finance major expenditures using cash savings, funds from rotating savings groups, the sale or pawning of household items, insurance or entitlement programs, or gifts. Indeed, financial diaries show that the poor simultaneously use a large number of formal and informal financial instruments.

It is not clear whether this large number of financial instruments represents an economic success or failure. Assuming that the poor are not simply tricked, each of these instruments is fulfilling some demand that is not met by the other instruments. This reflects a great deal of adaptability in creating and adopting different instruments, but it also reflects the limited capabilities of each particular instrument individually. Even when each source can supply only a limited amount of capital, borrowers often do not use them to the fullest extent possible, despite seemingly substantial overlap in the services provided by each instrument.

Encouraging the creation of new financial instruments to cover unmet demands is a patchwork solution to these problems. It would be useful to understand what underlying rigidities prevent some products from substituting for others. Such an understanding would both help in developing new instruments and potentially allow for more direct corrections to the underlying financing challenges faced by the poor.

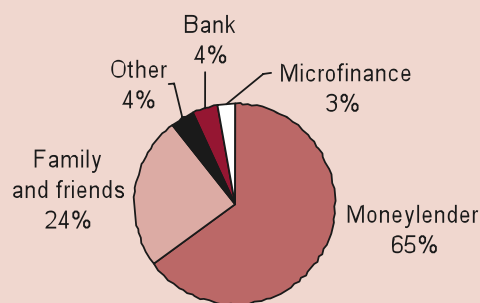
For example, for unexpected consumption expenditures, there is an inherent importance in having fast access to funds. If a household member experiences a sudden illness, accident, or pregnancy complication, receiving immediate hospital care will often require substantial upfront payments. Microfinance clients may be able to obtain funds on a regular schedule for business investments, but not necessarily for immediate health expenditures.

In early 2007 a survey was administered to 5,500 SKS Microfinance client households in rural India (the Bidar and Gulbarga districts) as part of the author's ongoing research with Professors Abhijit Banerjee and Esther Duflo of the Massachusetts Institute of Technology on the bundling of microfinance loans with health insurance. The survey asked about sources of loans used to finance expenditures on: particular major health events; weddings, funerals,

and festivals; tending animals; operating a business; and cultivating land. For each category of expenditure, Figures 1–5 report the fraction of loans coming from banks, microfinance organizations, moneylenders, family and friends, and other sources. When more than one loan source was used, fractions of the loan are allocated based on the proportion of loans from that source.<sup>1</sup>

SKS Microfinance clients do not often report using microfinance for health expenditures; rather, they report using moneylenders and family and friends (Figure 1). SKS Microfinance has an emergency health loan program, but most clients report being unaware of this program.

**Figure 1—Sources of loans for major health events**



Source: SKS Microfinance client survey, 2007.

Note: Total number of loans in this category = 8,007.

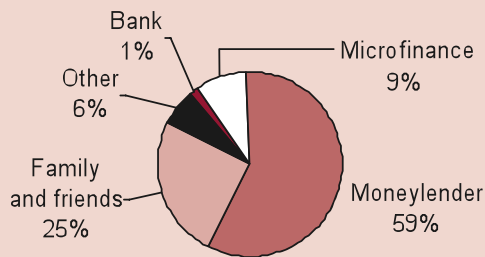
Capital may be fungible and reported sources of funds may not reflect the true long-run source of funds for these expenditures. For example, clients may take a high-interest loan from a moneylender only in the short term and then repay with a microfinance loan, a sale of assets, lower investment, or other sources of funds. Ongoing analysis of the randomized introduction of a health insurance policy will give some insight into how other debts and assets adjust to uninsured major health expenditures.

High interest costs for financing health expenditures, at least in the short run, can blur the traditional distinction between credit and insurance. Credit allows consumers to smooth expenditures over time, but it does not reduce the associated loss in permanent wealth. Insurance, on the other hand, is typically thought to reduce this risk of lost wealth. If credit is very expensive, however, then insurance may derive much of its benefit from effectively providing credit: it pays for health expenditures exactly when the consumer places a high value on capital. Indeed, SKS's health insurance policy offered a cashless network option for obtaining healthcare that was much more popular with clients than upfront payment and reimbursement. Credit and insurance may be much closer substitutes for the poor in developing countries than is typically thought in contexts with developed capital markets.

This relationship between credit, insurance, and unexpected consumption expenditures is intuitive, but additional survey results

<sup>1</sup> Household heads were asked details about each income-generating activity and major health event in the previous year; in each section, these questions included the sources of all funds and, when loans were used, the sources of loans. Loans from family and friends were reported separately from gifts; although these loans may have differed in repayment terms from other loans, they were the reported source of capital.

**Figure 2—Sources of loans for weddings, funerals, and festivals**

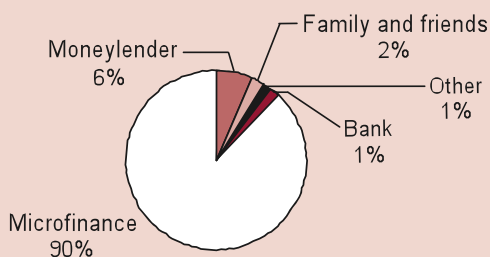


Source: SKS Microfinance client survey, 2007.  
 Note: Total number of loans in this category = 1,068.

present a more puzzling situation. If microfinance were simply too inflexible to fund unexpected health expenditures, then it might be more commonly used for anticipated consumption expenditures. However, microfinance was only slightly more common among loans used for weddings, funerals, and festivals; loan sources for these uses are similar to those for health expenditures (Figure 2).

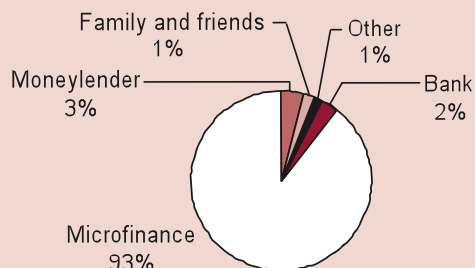
Perhaps microfinance is simply ill suited to financing consumption expenditures. Microfinance organizations often attempt to fund production rather than consumption, even though the two are closely linked through household financial decisions. Production loans may attract people that are lower risk ex ante, and production may be easier to monitor ex post. When clients take out loans to

**Figure 3—Sources of loans for buying and tending animals**



Source: SKS Microfinance client survey, 2007.  
 Note: Total number of loans in this category = 839.

**Figure 4—Sources of loans for operating own business**



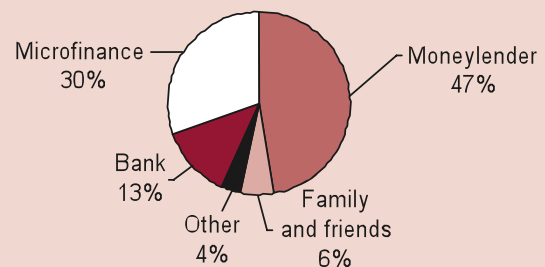
Source: SKS Microfinance client survey, 2007.  
 Note: Total number of loans in this category = 1,546.

buy and tend animals or support their own businesses, they mostly use microfinance loans (Figures 3 and 4).

The group structure of microfinance loans may prevent their use for consumption expenditures. Whereas production decisions have a natural seasonality, large consumption expenditures are less correlated between households, and it may thus be difficult to coordinate group borrowing. If group liability is not particularly important for maintaining microfinance repayment, as some recent research suggests, changing to individual microfinance loans could encourage their use for consumption.

Although buying and tending animals is somewhat seasonal, operating a business does not have an obvious seasonality. If borrowers tend to use microfinance only for production because of seasonality and group coordination, then one might expect microfinance to be common among loans for cultivating land. Borrowers, however, use moneylenders more often than microfinance loans for cultivating

**Figure 5—Sources of loans for cultivating land**



Source: SKS Microfinance client survey, 2007.  
 Note: Total number of loans in this category = 772.

land (Figure 5). They also sometimes use banks, which could reflect the use of land as collateral.

Overall, some aspects of the data suggest that microfinance might be used more for health events or other unexpected consumption expenditures if funds were available quickly and without group liability. Other aspects of the data discourage this interpretation, however, and much remains unknown about what factors influence the poor's access to credit. Introducing new financial products (such as insurance) can potentially fulfill unmet financial demands and, by changing a variety of borrower behaviors, new products also provide an opportunity to learn about what underlying factors influence the availability and use of different credit sources. Understanding the root causes of imperfect credit access would help in the design of future public and private initiatives. ■

**For further reading:** D. Collins, J. Morduch, S. Rutherford, and O. Ruthven, *Portfolios of the Poor: How the World's Poor Live on \$2 a Day* (Princeton, N.J., U.S.A.: Princeton University Press, 2009); X. Giné and D. S. Karlan, *Group versus Individual Liability: Long-term Evidence from Philippine Microcredit Lending Groups*, (World Bank, Washington, D.C., and Yale University, New Haven, Conn., U.S.A.), <http://karlan.yale.edu/p/GroupversusIndividualLending-May2009.pdf>.

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