Keynote Luncheon (Day 2 of AFF 2020)

Professor Banerjee, Ford Foundation International Professor of Economics of Massachusetts Institute of Technology, who spoke at the keynote luncheon, was awarded the 2019 Nobel Prize in Economic Sciences, along with his two co-researchers, "for their experimental approach to alleviating global poverty".

"In some ways, finance has an incredibly important role in the bottom half of the world's distribution, which is mostly in developing countries," he said. They invest, for example, and 31 per cent of them describe themselves as self-employed. When agriculture workers are included, about 50 per cent of the world's poorest are entrepreneurs, who need resources to buy consumer goods and homes, arrange weddings, and so forth.

High interest rates result in a mismatch between talent and money

These entrepreneurs need access to credit, but it is incredibly expensive for the poor. The formal financial sector does not serve them because their businesses are too small, so a number of local microlending systems exist to fill this gap: rotating savings and credit associations (ROSCAs), village money lenders, neighbours, etc. A low interest rate would be 3–4 per cent a month. But fruit vendors in India, for example, pay 5 per cent per day to wholesalers. The interest rate on savings is only 0–5 per cent per year. Semi-formal non-banking financial institutions charge 60 per cent a year for loans, but offer only 5–10 per cent per year to depositors.

As a result, if people have money, they prefer to start a small business instead of depositing it in a bank. But this leads to a massive mismatch of talent and money, said Professor Banerjee, and large gaps in the productivity of capital and distribution are extremely spread out compared to developed countries. In the US, a business must be competent to survive, but in India or Kenya, for example, incompetent businesses can survive because competent people cannot afford to enter the business.

How the mismatch affects productivity

His team conducted a study of two groups: in one group voluntarily, because they wanted to start a business (Group A) and, in the second, people went into business because they had excess capital and wanted to invest it somewhere (Group B). Group B started a business about three times as big as that of Group A, but after five years, Group A had caught up with Group B. "This is a symptom of an economy where capital is massively misallocated," he said. In a study led by professors at the University of Chicago and Stanford University, researchers calculated what would happen if you eliminated the mismatch between talent and money, and they found that it would double productivity and more than double the country's GDP.

The point of finance is to move capital from those who have it to those who need it, he said, and when this doesn't happen, inefficiency results. Talented people don't get what they need, and untalented people have money they can't use efficiently.

Why the mismatch exists

There are many reasons for this mismatch, he said, but one is that since talented people don't have secure property, all they can get are small loans, and administration is a very high percentage of the loan. So in a country like Mexico, where property rights are not very well secured, interest rates of 100 per cent per year are normal. This is exacerbated by two things: the borrowing relationship is often informal, and the payments are often delayed and unpredictable, so time is wasted monitoring and collecting the loans.

Microfinance was a great idea for dealing with this. The idea was to inject discipline into loan repayments, with a fixed payment every week at a specific time, and the lender could collect payments from a group at the same time. This resulted in lower administration costs and therefore much lower interest rates, from about 4 per cent per month to about 2 per cent per month. Microcredit was therefore considered the basis for a revolution in financing for the poor, allowing them to start businesses and providing an income basis for a large population.

Comparing communities with and without microcredit

Professor Banerjee's research group conducted large-scale randomised control trials of neighbourhoods that had access to microcredit, and others that did not. They conducted the experiments in many countries, including India, Mexico, the Philippines, Mongolia and Peru, and found the results disappointing. Access to microfinance did not really make anyone richer. The reason for this was that a lot of people borrowed money to buy consumer goods, such as refrigerators or motorcycles, and set up a business just big and long enough to repay the loan, and when the loan was repaid, they shut down the business. So these businesses generated no income. This increased happiness, but not sustainable businesses for the most part.

The reason for this was the very structure and discipline the microcredit system was intended to instil. There is a lot of uncertainty involved in starting a small business, and the microcredit system had no flexibility. The village money-lender, in contrast, is very flexible regarding repayments. In an experiment by Harvard researchers, they went to a microcredit organisation and asked them to change the repayment starting schedule from a week after loan issuance to any time within the first two months. When they did that, profits went up by 40 per cent. "So it is the design of microcredit that makes it a relatively ineffective way to generate entrepreneurship," he said.

Who benefits from microcredit?

This suggests that opportunities are being missed. The data shows that about 5–7 per cent of borrowers benefited quite a lot from microcredit. After 10 years, they were substantially richer, with much larger businesses. But most of these successful entrepreneurs started their micro-businesses before microcredit became available, so they are people who really wanted to start a business, not just because money was available.

Some of Professor Banerjee's students visited communities, formed groups of five or so and asked the group members to identify the best and worst entrepreneurs in their group. Based on the results, they graded the people into three groups: top, middle and bottom. They gave a random group of these people a $100 grant to invest in a business. A year later, they looked at revenue growth, and found that the returns for people in the bottom third were slightly negative, income for people in the middle third was unchanged, and income for people in the top third went up about 25 per cent per month. But the banking system and the financial system has not taken advantage of this community knowledge, he said. It exists, but it is not used.

The challenge is for lenders to identify these talented entrepreneurs and provide what they need. "In this way finance can really change the world," he concluded.