Micro-credit System

Why in News?

An article published in Ideas for India suggests that the existing systems of microcredit have a limited impact on the long-term wellbeing of the recipients.

What does the article say?

- Microcredit has gained much grip as a tool for ensuring the welfare of the most impoverished in society, and boosting development alongside.
- However, the article claims that certain flaws in how microcredit transactions occur have led to the outcomes having muted benefits in improving the lives of its beneficiaries in a meaningful way.
- It also suggests a number of methods of utilising microcredit outside the orthodox ones.
- These methods can bring potential benefits to a much larger section of the population that are generally not served by the traditional ones.

What is microcredit?

- Microcredit refers to the **granting of very small loans** to low-income/impoverished borrowers.
- It aims to enable the borrowers to use that capital to become self-employed and strengthen their businesses.
- Microcredit loans are often given to people who may lack collateral, credit history, or a steady source of income.
- The core idea of microcredit to **provide credit access** to people who are outside the mainstream institutions' scope.

Why should the borrowers demonstrate success?

- Microcredit agreements may not even involve a written agreement sometimes, as many recipients of microcredit are often illiterate.
- When borrowers demonstrate success in paying their loans on time, they become eligible for loans of even larger amounts, allowing them to finance expansion.

Why are microcredit institutions failing to deliver long-term benefits?

- Lack of evidence of transformative effects of microfinance on the average borrower.
- Stringent repayment schedule offered by most microcredit institutions.
- Most borrowers to whom microcredit is given have little to no credit history, so microcredit institutions cannot be sure what the risk of the borrowers defaulting will be.

What are the applications of microcredit?

- Conventionally, microcredit has been used mainly for entrepreneurs to begin production and attain self-sufficiency.
- It can act as a poverty alleviation and productivity-boosting measure.
- Small microcredit loans allow rural labourers and entrepreneurs to migrate to urban areas to find work during the lean season on farms.
- Those who migrated temporarily during this season experienced increased spending and increased their calories consumed.
- Microcredit can be used in situations where seasonal factors cause drops in income to overcome these seasonal credit crunches and avoid taking decisions which cause people long-term negative impacts.
- It can dampen the effects of shocks like floods by providing people with a form of insurance that both increases production before the shock and provides a safety net after.

What can be done further?

- Microcredit has a vast range of applications for poverty alleviation and general development, but existing systems **require reform in multiple areas** to allow for unfettered benefits that last.
- Borrowers who received the grace period in the monthly repayment schedule were more likely to start a new business.
- They also reported higher profits and higher household incomes with decreased rate of defaulting.
- Communities can be an accurate source of information about credit risk for microcredit institutions, but it should be done by eliminating the bias and incentivising accurate information.
- Furthermore, in areas were the application of microcredit is relatively new, microcredit systems must be carefully evaluated before they are put into place, so as to enable the greatest benefit from such institutions.

Source: The Indian Express



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