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PoP Briefing Note # 2

Borrowing to Save: Perspectives from *Portfolios of the Poor*[1]

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When it is difficult to save, those who manage to build up a lump sum are reluctant to draw down on it. In fact, they are often so loathe to touch their savings that they willingly borrow at expensive interest rates. While the phenomenon of borrowing while saving is puzzling from the standpoint of traditional economics, it's a regular feature in the financial diaries described in *Portfolios of the Poor: How the World's Poor Live on $2 a Day*. This brief describes simultaneous borrowing and saving, and provides evidence for an explanation rooted in the difficulty of rebuilding savings. This evidence leads to another seeming contradiction—why high interest rates on loans may in fact be a *desirable* attribute for some borrowers.

Why do People Borrow When They Could Dis-Save?

Insights from behavioral economics are helping to show why it's so hard to rebuild accumulations of savings after making major withdrawals. Research shows that many people tend to be more impatient with regard to current tradeoffs than with regard to future tradeoffs, and the resulting "present-bias" undermines saving: it always seems more costly to forgo consumption today than at some time in the future. People borrow when they have the option to dis-save because the incentives to repay a loan are stronger than the incentives to rebuild savings. The operative question, then, is why?

The repayment incentive: Seema, India

In a slum in Vijayawada, a town in southern India, Seema negotiated a loan of $20 from a moneylender, at 15% a month, just after leaving a meeting of her local savings cooperative where she had $55 in a liquid savings account. At first glance, this seems like an expensive-perhaps even an irrational-choice. When asked why she had done it, Seema said, "because at this interest rate I know I'll pay back the loan money very quickly. If I withdrew my savings it would take me a long time to rebuild the balance."

What do Lenders do?

Poor households tend to have irregular and unpredictable cash flows, making rigid repayment schedules difficult to maintain (see The 'Triple-Whammy' of Poverty Briefing Note). The financial portfolios revealed that one of the main services provided by nearly all moneylenders was an installment plan that matched borrowers' cash flows with the flexibility to delay repayments when necessary (see Creating Better Portfolios Briefing Note). Microfinance institutions provide similar features in their loan products, like weekly repayment schedules. Lenders also serve as a counterpart with a keen interest in the success of the transaction. The installment structure and the "partnership" provide discipline and a measure of support. In contrast, when you're saving, you're typically on your own, with little structure or support. If anything, family members and neighbors undermine saving strategies by asserting their own needs.

Encouraging discipline with installment payments: Khadeja, Bangladesh

Khadeja was a young mother living in Dhaka on roughly $2 a day. She took a loan at 36% interest per year and spent much of it on gold jewelry, which she saw as a vital store of value for her future. The loan had a weekly repayment schedule, which Khadeja used as an external source of financial discipline. Khadeja saw the truth of an odd-sounding paradox: if you're poor, borrowing can be the quickest way to save. She knew that without some external force to help her, her chances of saving enough money to buy the gold necklace were small. So when an MFI offered her the chance to turn a year's worth of small weekly payments into a usefully large sum, she took it.

The Discipline of High Prices

All else the same, high interest rates on loans should deter borrowers. But in a context in which discipline is desired, the opposite can be true. The high borrowing cost functions as a penalty for shirking, much as collateral functions in a lending contract. It also increases the salience and urgency of repayment.

[1] Adapted from a Financial Access Initiative Working Paper by the same title by Jonathan Mordouch.

Encouraging discipline with high interest rates: Satish, India

Delhi-based Satish earned a healthy salary of $73 a month as a chemical factory employee; he supplemented his earnings with farm income and hutment rental fees. Satish's portfolio reflected the third highest year-end cash assets of the whole Indian sample, at $1,232. However, heavy demands on his finances, such as life-cycle remittances for household construction costs and weddings, caused Satish to end the year with $575 worth of debts, over half of it interest-bearing. Satish reported that his cash flow turnover was too rapid for a bank account to maintain, and instead managed informal inflows and outflows with more substantial sums raised from interest-charging lenders and group schemes such as RoSCAs and ASCAs. Other than what he sent home, he preferred to borrow continuously from an expansive network of contacts. His explanation was that the pressure of interest charges encouraged him to repay quicker.