Do interest rates matter? Credit demand in the Dhaka slums[*]

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Abstract

Modern microfinance is built on the idea that banks serving the poor can and should earn profits. As a result, microfinance "best practices" entail raising interest rates as high as needed for financial self-sustainability, predicated on the assumption that poor households are relatively insensitive to interest rates. But, despite its centrality, there is little direct evidence on the price elasticity of credit demand in poor communities. This paper uses data from *Safe*Save, a credit cooperative in the slums of Dhaka, Bangladesh, to examine how sensitive borrowers are to increases in the interest rate on loans. Using unanticipated between-branch variation in the interest rate we estimate interest elasticities of loan demand ranging from -0.73 to -1.04 in the year after the increase. Indicators of wealth suggest that less wealthy accountholders are more sensitive to the interest rate than (relatively) wealthier borrowers (an elasticity of -0.86 compared to -0.26). We thus find substantial price responsiveness and evidence that the bank's portfolio shifted away from its poorest borrowers when it increased the interest rate.

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