

## CHAPTER 3

### IMPACT OF LIVELIHOOD DIVERSIFICATION AND INSTITUTIONAL CREDIT ON HOUSEHOLD WELL-BEING

3. The Impact of Livelihood Diversification and Institutional Credit on Household Well-Being in India

### **3.1. Introduction**

In developing countries, including India, accessibility to credit plays a vital role in the lives of rural households in several ways. In a circumstance where household income undergo large seasonal fluctuations in rural areas as majority of them are directly or indirectly engaged in agriculture, accessibility to credit sources help them for smoothing consumption and production activities (Ghosh, Mookherjee, & Ray, 2000). However, credit markets of developing nations in rural areas do not act entirely like competitive markets. The formal and informal financial institution seems two sides of the same coin in rural India. Although informal sources of credit charge a higher rate of interest, on account of the absence of accessibility to structured credit source in the rural regions, most of the households prefer to borrow from informal sources (Townsend & Ueda, 2006). The formal source of credit includes commercial banks, regional rural banks, co-operative banks, and insurance, etc. While the informal source of credit refers to moneylenders, relatives, friends, and landlord, etc. By keeping a lower rate of interest into consideration, the government forcing its credit agencies to enlarge their credit facilities with particular emphasis on supplying it into the rural areas. However, an individual cannot deny that both casual and formal industry still form an essential facet of the lending situation in rural households (Banerjee & Duflo, 2007). Madestam (2014) developed a version where they mimic how informal finance complements the banks by allowing for bigger formal loans to poor borrowers.

The financing methodologies of formal and informal sources differ significantly. The quantity of loans provided, the rates of interest charged, the depreciation of these loans, repayment programs, etc. are distinct. Bhattacharjee (2014) argues whether borrow from formal source or informal source, repayment of loans would be contingent upon the purpose of the loan and also how efficiently loan amount has been utilized. In spite of the access to formal credit sources, informal sources continue to be enormously common among rural households due to the easier and adequate access to informal sources (Pal, 2002). To make

informal credit more viable, informal lender uses third-party enforcement or standing mechanism as informal retrieval technique. This is also the underlying principle for the development of microcredit in rural India. Formal and informal loans have their terms and conditions. Therefore, household anticipates about the related punishment based on the source of credit. The purpose of forcing formal credit institution authorities to prepare rural banks is to provide easier credit access to the household, which helps to fight with high rates charged by informal sources.

As discussed, there are several formal and informal credit sources, from where an Indian household can approach to borrow for their purposes. However, in the circumstance of inability to repay their borrowed amount, the government are primarily waived off loans taken for the agricultural purposes from formal sources only, especially nationalized rural banks. Though, many questions have been raised over the effectiveness of the government interventions in the credit systems. Expanding access to formal credit at lower interest rates has also been justified to protect poor rural households from steep informal interest rates. However, the non-repayment situation could be raised due to the easier availability of credit and unproductive spending of credit amount. Hence, source and purpose both are very important for the smooth functioning of the credit market.

In this light, this chapter tries to provide an empirical evidence for the impact of livelihood diversification and institutional credit on consumption levels. The study contributes to the literature in following ways; first, it assesses the impact of both formal and informal credit accessibility on consumption pattern of the household. Second, it also investigates the role of credit sources in starting a new business venture and how accessibility to better credit sources play an essential role in diversifying the household livelihood. Third, the study also tests the variation in consumption patterns with the purpose of the loan taken. For the purpose, the study has used 2011-12 nationally representative household survey data

for India, Indian Human Development Survey (IHDS). Results show that households that borrowed from formal sources had a higher monthly per capita consumption expenditure. The rest of the chapter is organized as follows; section 3.2 discusses the related literature in the field, section 3.3 mentions the estimation strategy; section 3.4 states the descriptive statistics of the dataset used and section 3.5 discusses the regression results. Section 3.6 concludes the study.

### **3.2. Review of Literature**

The findings in the existing literature are mixed. Most of the studies have found positive impact of credit accessibility on household's welfare indicators. Dodridge (2018) has found a positive impact of high-cost credit on consumption smoothing of the households during financial distress. Zaki (2016) tried to assess the impact of payday loans on the timing, levels, and compositions of consumption using difference-in-difference technique. He found that payday loan access enables consumers to better smooth their consumption between paychecks, with no detectable effect on the level of food consumption. Morgan, Strain, and Seblani (2012) find that individuals bounce fewer checks as a result of access to credit. Morse (2011) finds that loans have a mitigating impact on income shocks occurring as a result of natural disasters. Using long panel data from Sri Lanka, Shoji *et.al.*, (2012) concluded that household facing credit constraint reduce their investment in social capital which lead to further decline in trust among villagers and business partners. They suggest a potential poverty due to prevailing credit constraint. In the same line, Ma and Yang (2011) also concluded for China that private lending promotes local economic development by providing entrepreneurial possibilities as an alternative income source to farmers and increase their non-agricultural income. Studies concerning Bangladesh (Khandker, 1998, Pitt and Khandker, 1998) and India (Binswanger & Khandker, 1995) indicated increased agricultural productivity and higher income due to better rural finance.

On the other hand, other studies have found negative effects of credit accessibility. For example, Campbell, Martinez-Jerez, and Tufano (2012) concludes that access to formal loans leads to forced debit and checking account closure due to excessive overdrafts. Similarly, Skiba and Tobacman (2011) find accessibility to loans leads to increases bankruptcy and Melzer (2011) found that credit accessibility to be a leading factor in postponing of medical bills in the households. The problem of dependency on credits is also indicated by Lee and Sawada (2010). They said that having access to informal credit markets reduces precautionary savings of the households. A study by Jia et al. (2013) differentiate between the impact of formal and informal loans and suggest that it is microfinance and not formal or informal loans that increases farmers' income by increasing their off-farm working time.

Given this mixed evidence from the previous literature, there is a need for further investigation in the area especially in a developing country like India where informal credit market is more prominent than formal credit markets. The study tries to fill this gap by examining the behavior of Indian rural households in a broader framework and contributes to the literature in following ways; *first*, it assesses the impact of both formal and informal credit accessibility on consumption pattern of the household. *Second*, it also investigates the role of credit sources in starting a new business venture and how accessibility to better credit sources play an essential role in starting a new business venture. *Third*, the study also tests the variation in consumption pattern with the purpose of the loan taken.

### **3.3. Empirical Strategy**

#### **3.3.1. Data**

In this chapter, we used detailed information of accessibility to credit, sources of credit, purposes of the credit, consumption expenditure and investment, etc for 42,152 households. Out of the total sample households, our study focuses on only those households which have taken a loan from any source, thus reducing the sample size to 22,630 households. Further,

to understand the accessibility to credit to start a new business venture, it is important to look into those households whose at least one member is started a non-farm enterprise venture other than their primary source of income.

### 3.3.2. Methodology

In the first stage we explored the differences in key variables across the households taking loans from formal or informal sources using descriptive statistics. In the second stage, to test empirically the impact of net income received from livelihood diversification and credit sources on consumption levels of the household, we used multiple linear regression model. The specification of the same is as:

$$\ln Y_i = \alpha_1 + \beta_1 C_i + \beta_2 \ln BI_i + \phi_1' X_i + u_i \quad (3.1)$$

Where,  $\ln Y_i$  is the log of monthly consumption expenditure per capita (MPCE) of the  $i^{\text{th}}$  household,  $C_i$  is a dummy variable for credit source, taking value '1' if the household has taken loan from formal sources, '0' otherwise.  $\ln BI_i$  is the log of net income from non-farm enterprise,  $X_i$  is the vector (with  $\phi_1$  as coefficient vector) of other household variables impacting consumption levels such as education level, religion, caste, income, household size, number of males, number of females, etc.

### 3.4. Descriptive Statistics

To increase access to credit from formal sources for poor and rural households, the government of Indian put aggressive efforts through social banking program and various other schemes. However, table 2.1 shows that wealthier households borrow from formal sources. The average income of a household borrowing from a formal source is more than twice the average income of a household borrowing from an informal source. Similarly, the average monthly per capita consumption expenditure (MPCE) and non-farm enterprise (NFE) related outcomes are higher for households borrowing from formal sources. This raises

a question whether this higher MPCE and more than doubled higher total expenses in NFE are an income effect or are households that borrow from formal sources behave differently in their consumption and investment patterns due to their source of credit.

**Table 3.1: Descriptive Statistics of Key Variables Across Different Categories of Credit Source**

	Informal		Formal		Total	
	Amount	No. of Obs.	Amount	No. of Obs.	Amount	No. of Obs.
Total consumption exp	98216	14572	147500	8004	113876	22576
MPCE	1870	14572	2781	8004	2160	22576
Total Income	80799	14380	167140	7860	108152	22240
Income per capita	17844	14575	36545	8008	23787	22583
Loan largest amount	44998	14568	145504	7993	76913	22561
Gross receipts of NFE	147478	2678	325185	1868	213124	4546
Total expenses in NFE	91709	2743	223407	1899	140018	4642
Net Income from NFE	58181	2880	111963	1980	77985	4860

*Notes: MPCE = monthly per capita consumption expenditure; NFE = Non-Farm Enterprise*

Table 3.2 shows that about 68 percent of the households still borrow from informal sources like moneylenders, relatives, and friends, etc. while about 32 percent of households borrow from formal sources like banks, Kisan Credit Card, and other formal financial agencies. Analyzing the incidence of formal and informal sources of credit, we see that about 77 percent of muslim households have borrowed a loan from informal sources followed by Hindu households with about 68 percent. Dissecting households by castes, we notice that majority of borrowers from informal sources belong to lower caste categories such as scheduled castes (SC) with 79 percent and scheduled tribes (ST) with 73 percent as opposed to forward category (general) with about 57 percent. Education plays an important role to access the credit from formal sources, table 3.2 shows that more education leads better accessibility to formal credit sources, less educated household heads hesitate to approach formal sources due to complicated process and paperwork.

**Table 3.2: Socioeconomic Distribution of Households Across Credit Source**

	Informal (%)	Formal (%)	(No. of Observation)
<i>Religion</i>			
Hindu	67.81	32.19	19285
Muslim	76.95	23.05	2441
Christian	49	51	414
Sikhs	53.61	46.39	231
Others	58.23	41.77	210
<i>Caste</i>			
General	57.47	42.53	5025
Other backward castes	67.69	32.31	10396
Scheduled castes	79.03	20.97	5470
Scheduled tribes	72.83	27.17	1273
Others	55.69	44.31	397
<i>Education</i>			
Illiterate	73.64	26.36	14,533
1 to 8	59.39	40.61	6,055
9 to 12	57.97	42.03	1,562
Graduation & above	46.93	53.07	432
<i>Income Source</i>			
Primary	62.97	37.03	9,361
Secondary	78.27	21.73	8,549
Tertiary	58.79	41.21	3,384
Others	64.52	35.48	1,285

*Notes: primary = cultivation, livestock and other agricultural allied activities; secondary = organized business, and petty shop, etc; tertiary = salaried, and other professions*

Table 3.3 summaries the behavioral patterns of household who have taken loans for different purposes from informal sources as opposed to those who have taken from formal sources. Amongst the 22,566 households who have taken loan from any source, households who have borrow for the purpose of cultivation and agricultural equipment constitute the second-largest purpose for taking loan from formal sources (64.11 percent) as opposed to buying and/or renovation of a house (38.05 percent), educational loans (36.91 percent), and marriage (19.74 percent). To purchase a vehicle, household approaches to formal sources (67 percent), usually showroom owners of a tie-up with financial service agencies to provide loans. To start a new business venture and to expand an existing business, about 42 percent of households are taken loans from formal sources, in contract to 58 percent from informal sources. However, when we restrict the sample to just those households who borrow to start



a new business, the share of formal credit as higher as 63 percent. This indicates that households who borrow to start a new business are most likely to educated, aware, and comparatively well-off households. Hence, the probability for repaying their loans on time will be higher since they are indulged in productive expenditure. To investigate these possibilities, we first empirically explore whether borrowing from formal sources as opposed to informal sources has an impact on consumption expenditure and investment patters of a household.

**Table 3.3: Access to Non-Farm Enterprise, Credit and its Purposes**

	Percent	No. of observation	
Any nonfarm enterprise	21.01	8851	
Access to credit from formal sources (1/0)	63.09	2902	
Access to credit from informal sources (1/0)	36.91	1698	
Loan purpose	Informal (%)	Formal (%)	(No. of Observation)
Buy/Improve a house	61.95	38.05	3,621
Marriage expenses	80.26	19.74	3,997
Agriculture/Agri. Eq	35.89	64.11	3,697
Business	57.74	42.26	1,632
Household consumption	81.42	18.58	3,060
Vehicle	33	67	537
Educational	63.09	36.91	1,146
Medical expense	91.27	8.73	3,884
Others	74.6	25.4	991
Total	68.23	31.77	22,566

**Figure 3.1: Sources of Credit Institution and Income received from the Non-Farm Enterprises**

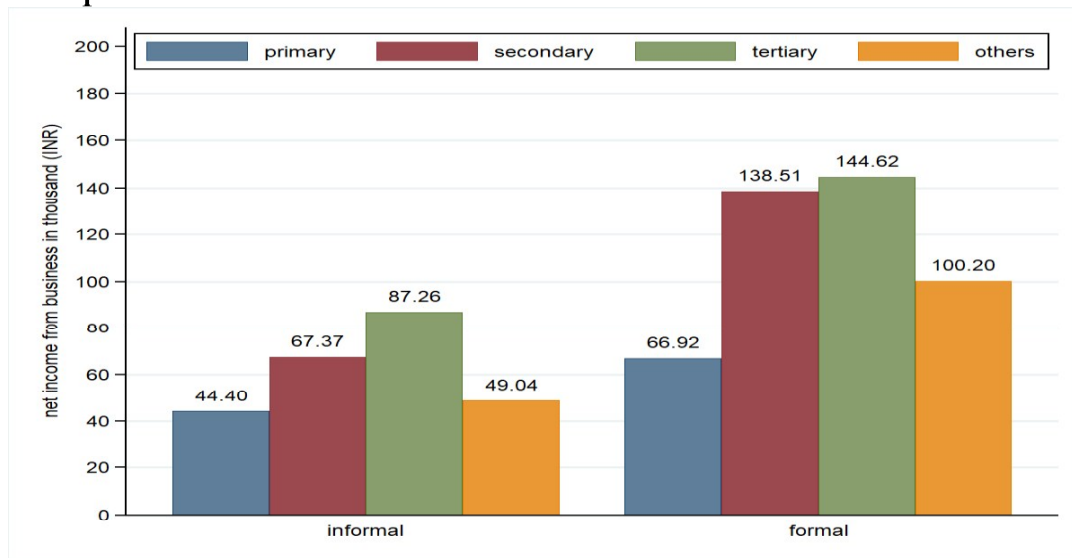


Figure 3.1 shows the net income received from different sources. We have categorized the income sources in four categories and explained it in the above paragraphs. Those working in the tertiary sector received a higher income, followed by secondary and primary. We also looked at the net income received for those who have taken credit from formal and informal sources. This indicates that those who received from formal sources, in all the income categories, they received a much higher income than the those who have access to informal credit source.

**Figure 3.2: Cumulative Distribution of Income at the Household Level**

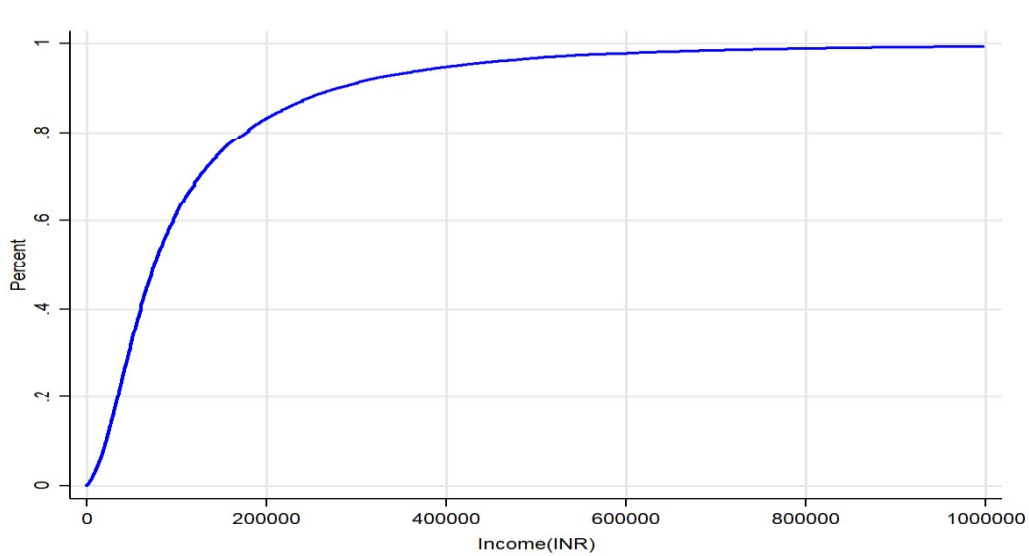


Figure 3.2 shows the cumulative density function of the annual income of households. It reveals significant disparities in the income distribution among households. An overwhelming majority of the household stays at the bottom of the income distribution, about 80% of them earn income less than rupees 200000. For another 15% of the farmers, it is in the range of rupees 200000 to 400000; and the only 5% of the farmers have per capita income exceeding rupees 400000. Majority of households have less income and therefore, less per capita income and less monthly consumption per capita (MPCE). However, our conjecture is those who get access to credit will have greater MPCE.

**Figure 3.3: Relationship between the Loan Amount and Net Income from Non-Farm Enterprises**

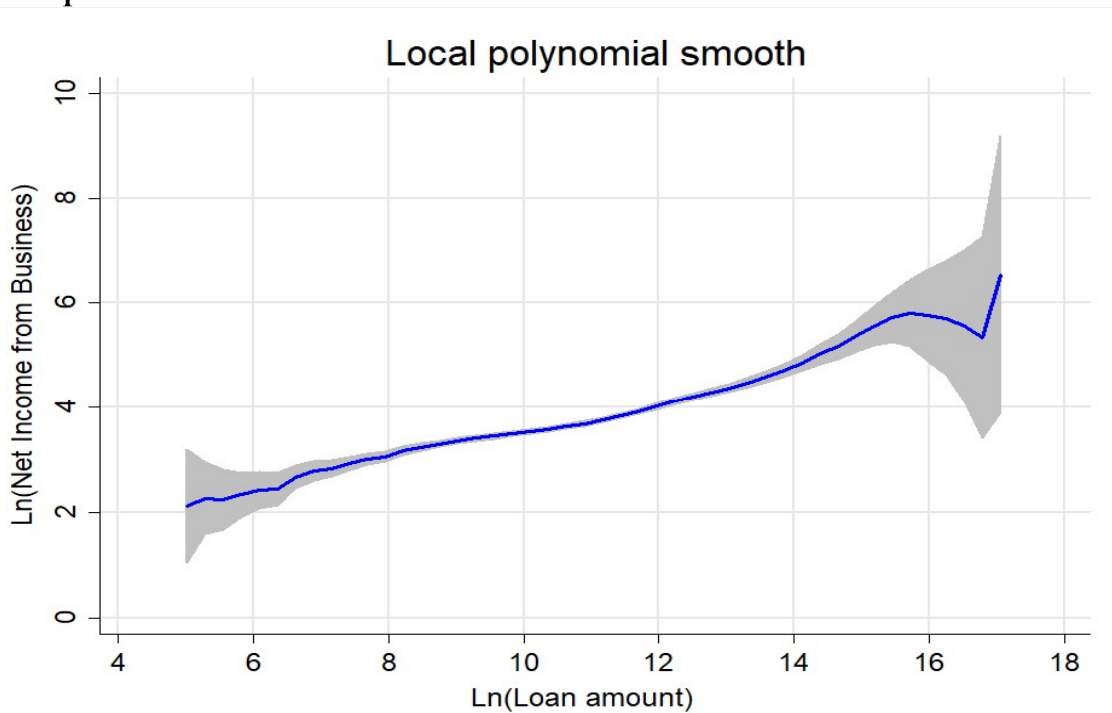


Figure 3.3 shows the relationship between the loan amount and income from the enterprise. The horizontal axis has the log of largest loan amount, and the vertical axis is the log value of net income received from enterprise. The expectedly higher loan amount is a monotonic function of the net income from the enterprise. There is indeed a positive relationship between these two variables of interest. Higher the loan amount has a higher net income, or else it could be higher the new return from the enterprise for households who has

more loan amount. This has the reverse causality from both sides. However, we conclude that these two have positive associations with each other.

**Figure 3.4: Distribution of MPCE across the different Sources of Credit**

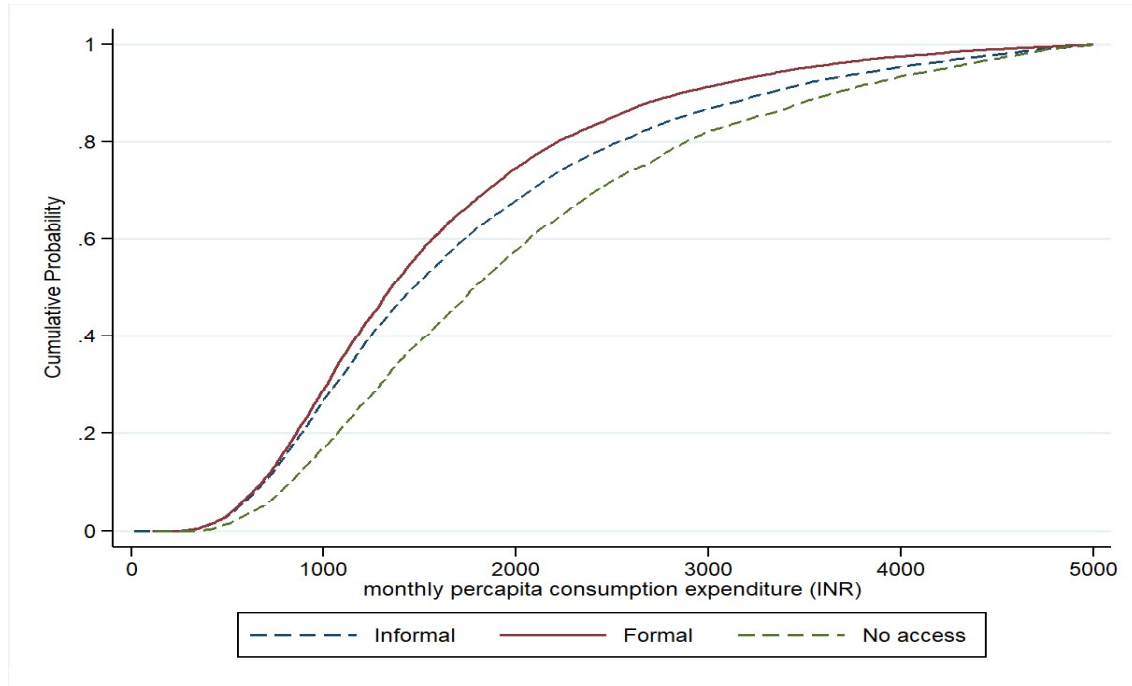


Figure 3.4 shows the cumulative probability or distribution of monthly per capita consumption expenditure (MPCE) across two categories of credit source. The Kernel density for those who have access to credit from formal sources has highest MPCE while those who have taken from informal has the lower than these groups. We also have plotted the MPCE distribution for those who have no access to credit. Households who are taken a loan from formal sources have greater MPCE. Around 20 percent of the households have less than INR 1000 monthly per capita consumption expenditure, and around 40 percent have less than INR 2000 while 15 percent have less than INR 3000, and the top 20 percent has more MPCE which is greater than INR 3000. The distribution is revealing significant disparities in the MPCE distribution among households. An overwhelming majority of the household stays at the bottom of MPCE distribution.

### 3.5. Regression Results

We begin by examining whether households with similar characteristics, consume differently if they borrow from different credit sources. Consumption has been measured as the monthly per capita consumption expenditure (MPCE) for a household. It is calculated as a sum of total expenditure on food, non-food, and household assets every month. Column [1] in table 3.4 reports the baseline estimates after controlling only for access to formal credit and net income from the non-farm enterprise. To standardize continuous control variables, we transposed them in logarithm form, which helped us to minimize their variation as well. Since wealthier households are more likely to have better access to formal financial institutions, at the same time, they are like to have higher consumption expenditure. Hence, we must control for net income from the non-farm enterprise even in the very sparse specification. The estimated results suggest that, for a similar level of net income from a non-farm enterprise, if a household has borrowed credit from a formal source as opposed to an informal source then it is likely to have a higher MPCE by approximately 24.68 percent on average. Column [2] controls for main source of income and findings suggest that households whose main source of income belongs to the secondary category have negative and insignificant coefficient while the coefficient of tertiary sector suggest that they have about 29 percent higher MPCE as compared households who belong to the primary sector.

Column [3] additionally controls for household size, total income, number of adult members in the household, religion, caste, and education of the household head. Previous studies suggest that household from different socioeconomic backgrounds tend to focus more on consumer goods as a signaling mechanism (Khamis, Prakash, & Siddique, 2012). The estimation suggests that there is a significant difference in consumption expenditure of households depending on the source of their borrowing even after controlling for the additional variables. Compared to column [1], the coefficient is almost halved, and households borrowing from formal sources still have a higher level of consumption compared

to households borrowing from informal sources. However, the difference is now approximately 12 percent. Other control variables also have a logical and significant effects. The results also suggest that Hindus have a higher consumption as compared to Muslims. However, Christians and Sikhs have about 36 percent and 23 percent higher consumption respectively than Hindus. OBC, SC, and ST have lower consumption as compared to households that belong to the general category of caste.

**Table 3.4: Regression Analysis: Dependent Variable = Ln (MPCE)**

	(1)	(2)	(3)	(4)
Access to credit from formal source (1/0)	0.2468*** (0.0189)	0.2370*** (0.0190)	0.1181*** (0.0169)	0.0947*** (0.0294)
Ln (Net income from Enterprise)	0.1654*** (0.0078)	0.1669*** (0.0079)	0.0451*** (0.0093)	0.0457** (0.0204)
Secondary (1/0)		-0.0003 (0.0233)	0.0192 (0.0208)	0.0034 (0.0487)
Tertiary (1/0)		0.2888*** (0.0359)	0.1165*** (0.0314)	0.0398 (0.0716)
Others (1/0)		0.1859*** (0.0518)	0.0598 (0.0445)	-0.0360 (0.0908)
Household size (In numbers)			-0.1357*** (0.0049)	-0.1414*** (0.0092)
ln (Income)			0.2333*** (0.0118)	0.2688*** (0.0241)
Adult male (In numbers)			0.0849*** (0.0111)	0.1008*** (0.0211)
Adult female (In numbers)			0.0605*** (0.0127)	0.0414* (0.0231)
Muslim (1/0)			-0.0120 (0.0225)	0.0212 (0.0391)
Christian (1/0)			0.3558*** (0.0605)	0.2884*** (0.0963)
Sikhs (1/0)			0.2324*** (0.0549)	0.1404 (0.1029)
Others (1/0)			0.0335 (0.0829)	0.1069 (0.1325)
Other backward caste (1/0)			-0.0813*** (0.0187)	-0.0513 (0.0326)
Scheduled caste (1/0)			-0.1882*** (0.0262)	-0.2161*** (0.0479)
Scheduled tribe (1/0)			-0.3120*** (0.0412)	-0.2376*** (0.0738)
Others (1/0)			0.1002 (0.0610)	0.1293 (0.1024)
Class 1 to 8 (1/0)			-0.0227 (0.0174)	-0.0336 (0.0313)
Class 9 to 12 (1/0)			0.1402*** (0.0294)	0.1102** (0.0490)

	(1)	(2)	(3)	(4)
Graduation and above (1/0)			0.3149*** (0.0543)	0.3668*** (0.0964)
Constant	6.8531*** (0.0299)	6.8186*** (0.0320)	5.2134*** (0.1156)	4.8028*** (0.2277)
No. of Observation	4848	4848	4823	1398
Adj-R <sup>2</sup>	0.1327	0.1488	0.3781	0.3990
F statistics	371.7988	170.4661	147.5683	47.3693

*Notes: Asterisks denote significance: \*  $p < .10$ , \*\*  $p < .05$ , \*\*\*  $p < .01$ . Standard errors are in brackets.*

*Omitted categories: main source of income = primary; religion = Hindu; caste = general; education = illiterate*

Column [4] estimates the same specification as column [3], but we restrict the sample to only those households who have borrowed for business purposes only. These households have borrowed from either a formal source or an informal source, especially for investment in the business. The findings are similar, especially households who have borrowed for investment in business purposes from formal source as opposed to an informal source spend about 9.47 percent more per person in the household on consumption every month. Overall, we find a significant difference in consumption behaviour of households depending on the source from which they borrowed their loans.

### 3.6. Concluding Remarks

This chapter examines the dynamics of credit sources and how accessibility to formal and informal sources affect consumption expenditure in India. We use nationally representative data from the India Human Development Survey (IHDS) collected in 2011-12. We explored the role of livelihood diversification and institutional credit sources as opposed to informal credit sources to start a new business venture and smoothing consumption expenditure. Empirical results suggest that households that borrow from formal sources have a higher monthly per capita consumption expenditure which shows that these are the relatively better off households who are able to get credit from the formal sources. Further, net income from a non-farm enterprise, the main source of income, household size, total income, number of adult members in the household, religion, caste, and educational status of

household head are used as control variables. Since households start to new business are less likely to borrow from formal credit sources, urgent policy intervention is required in this direction. Variances in social groups are identified in the analysis show the urgent need for policy intervention measures to emancipate in lower castes where demand for and access to formal credit is lowest. There should be greater regulations and awareness programs to protect and promote lower caste households from unwittingly trapping themselves in high-cost loans that lead to foreclosure, bankruptcy, or other financial problems. Hence, the strong policy is urgently required for the formal access of credit to the SC and ST households. As an enabling strategy and confidence-boosting measure, the government needs to enact laws to protect the rural credit applicants/recipients and streamline credit demand and credit taking relationships.



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