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(Dis)Advantages of Informal Loans – Theory and Evidence

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(Dis)Advantages of Informal Loans – Theory and Evidence*

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Abstract

We study borrowers' choice between formal and informal credit in a setting with imperfect debt enforcement. In contrast to formal loans (e.g., from banks), informal loans (e.g., from friends or relatives) can be enforced by the threat of severing social ties. If the underlying social capital is sufficiently large, we show that informal loans carry lower interest rate and collateral than formal loans, including the possibility of zero interest and collateral. This makes informal credit *a priori* more attractive to borrowers. At the same time, since physical collateral is divisible unlike the social capital pledged in informal credit, default on formal loans is less costly to both parties than default on informal loans. Because of this trade-off, formal and informal credit can co-exist depending on the loan riskiness measured by the ratio of loan size to borrower's wealth (LTW ratio). Borrowers choose formal credit for riskier (larger) loans while informal credit is preferred for (smaller) projects with low default risk. Empirical results using household data from rural Thailand are consistent with the predicted choice pattern and terms of formal and informal credit.

Keywords: informal credit; family loans; social capital; limited enforcement; default risk
JEL Classification: D14, G21, O16, O17

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