

## *Chapter 1*

# Introduction

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Even when they are just as creditworthy as others, poor and minority borrowers are sometimes excluded from formal credit markets. As Oded Galor and Joseph Zeira (1993), Abhijit Banerjee and Andrew Newman (1993), and Philippe Aghion and Patrick Bolton (1997)—among others—have argued, excluding such individuals is all the more troubling if it permanently impedes their rise from poverty.

The exclusion of poor borrowers can indicate inefficiency in credit markets and the existence of credit rationing. Economists and policy makers have long worried about problems related to credit rationing. A large literature in economics and finance establishes a fundamental link between it and imperfect information (Stiglitz and Weiss 1981; Jaffee and Stiglitz 1990). The key assumption underlying early ideas of credit rationing is that lenders are imperfectly informed about borrowers' creditworthiness. Coupled with that assumption is the observation that, with rising interest rates, the risk pool of credit applicants worsens, because only riskier and more desperate borrowers are willing to borrow at the more onerous terms. A fairly intuitive conclusion is that under such circumstances lenders may prefer to ration credit at lower interest rates than to extend loans to the highest bidders. The main concern with this form of credit rationing, then, is that it might exclude the poor and minorities from formal credit markets even when many of them are just as creditworthy as other borrowers. A related concern is that credit rationing may also arise from discrimination and out of lenders' exaggerated concerns about minority borrowers' creditworthiness. Although it is difficult to substantiate these claims conclu-

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sively, there is some recent evidence supporting this view (see Blanchflower, Levine, and Zimmerman 2003).

The recent literature in development economics has put the spotlight on this potential inefficiency and identifies credit rationing as a key cause of underdevelopment (see Banerjee 2003 for a recent survey). On the policy front, many also see the emergence of Grameen Banks—which specialize in small, short-term loans to relatively poor individuals or groups—as the main innovation in development policy in the last two decades and the new hope for the poor in developing countries (see Armendariz and Morduch 2004).

Another cause of credit rationing is imperfect enforcement of loan repayments and strategic defaults (see, for example, Hart 1995). According to this view, the poor are more likely to be excluded from formal credit markets because they are less able to provide collateral to alleviate the risk of default. This perspective also emphasizes that the poor may often be the main victims of excessively lenient loan enforcement policies, weak courts, and weak debt-collection rights. While these policies obviously help a poor borrower in dire straits, they can also raise the cost of borrowing and lead to poor borrowers' being excluded altogether from credit markets. The contrast between the thriving market for automobile loans and the anemic mortgage market in Brazil provides a telling illustration of this problem. While under Brazilian law it is relatively easy to repossess a car following default on an automobile loan, it is very difficult to evict occupants of a dwelling who have defaulted on their mortgage. This latter source of credit rationing calls for different policy responses, such as improving debt collection or enforcing debt contracts. Another proposed response, emphasized especially by Hernando de Soto (2003), is to give legal ownership claims to poor squatters that could be used as collateral in a loan agreement. In chapter 5, Daniela Fabbri and Mario Padula present evidence of the effects of inadequate procedures for debt collection in Italy, a developed economy.

More generally, despite the wide acceptance of the notion that credit rationing is an important problem in economic development, little is known on how the poor are dealing with barriers to borrowing in developed economies. The same is true on how policy intervention should be designed to best address inefficiencies in credit markets. The contributions in this book are an attempt to fill this gap.

As the chapters by John P. Caskey (chapter 2), Lisa J. Servon,

Robert Kaestner, and Antwuan Wallace (chapter 3), Timothy Bates (chapter 6), and Robert M. Townsend (chapter 7) vividly illustrate, there is an extensive set of credit markets for the poor in the United States that is almost entirely separated from the mainstream. They operate below the radar screen of most researchers, who study the larger, more formal, financial markets. But, as this volume highlights, these markets are very important for the poor, who rely on them. Improvements in these markets could bring substantial benefits. It is also apparent from the studies in this volume that credit rationing in practice does not simply manifest itself as a sharp dividing line between those who have access to credit and those who have not. In reality, there is a range of alternative credit options open to poor borrowers, some involving fairly sophisticated institutional arrangements.

These markets are especially important in nations with weak social safety nets. The United States, in particular, is widely acknowledged as providing only minimal redistributive transfers to the poor. Credit markets, albeit imperfectly, can substitute for the lack of direct redistribution. They have the potential to provide both for short-term consumption smoothing in the face of job loss, unexpected health care expenses, and other personal reverses. Credit is also thought of as a motor for entrepreneurship, providing the funds to allow the poor to escape poverty.

The poor who borrow to smooth consumption have limited access to formal credit markets. They are likely to have bad credit histories or to have reached the limit of their borrowing capacity. They therefore might face rates as high or higher than 350 percent if they engage in payday loans, a popular form of short-term "bridge" lending (see chapter 2 for a detailed description). If they are members of a marginal racial, ethnic, or immigrant group, they may depend more on informal credit channels. They may also lack the wherewithal to benefit from low-cost transactions available via the Internet. If they borrow to finance a subprime residence, such as a mobile home, they will borrow at higher rates than their more affluent peers. These poor, it should be stressed, are nonetheless not the very bottom of the economic ladder. A checking account, for example, is required to obtain a payday loan or subsidized use of the Internet. The homeless, by definition, do not have mortgages on dwellings, whether mobile or fixed.

A basic shortcoming of credit markets as a vehicle for redistribu-

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tion is that they require the participation of lenders. As capitalists, lenders lend only if the loan is expected to be profitable. To start a small business the poor often need government subsidies or loan guarantees. But to ensure that a business looking for a subsidy is at least minimally viable, government programs may demand minimum training and skills in the borrowers. Inevitably, these requirements often mean that the loans wind up going to only a subset of the targeted population.

Nonetheless, even if credit markets for the poor are only an imperfect substitute for redistribution, they can have an important impact on poverty levels and social inequality. It is therefore important to consider how these markets operate, how they affect poverty and inequality, and how they might be made more efficient.

This book reports on research in the operation of these markets along several dimensions. The writers have backgrounds in economics, political science, business, law, urban planning, and government. Their work here addresses three broad issues.

First is the exclusion of poor households from the banking sector and more generally the mainstream formal credit markets. This volume asks what types of credit arrangements are available to the poor who do not borrow through bank loans or credit card debt. How do these alternative lending arrangements compare to more mainstream credit? How easy is it to obtain such loans? How large is the spread over typical bank loans or credit card debt? What is the risk of default?

The second major theme relates to how debt repayment is enforced. Here the main economic question is whether legal or nonlegal obstacles to debt collection lead to inefficiency in credit markets. Is the unavailability of credit for the poor driven by the lack of effective enforcement of debt collection? If so, should enforcement be strengthened, as the personal bankruptcy "reform" bill debated by the last five Congresses proposes? Or are existing limitations on debt collection justified as basic protections for those driven into debt by desperation?

The third issue deals with credit for investment and entrepreneurship. Here the central economic question is whether, as is often assumed, low levels of business creation and self-employment among poor households are explained by the inability to produce collateral for the first bank loan to launch a business. Part III of the

book makes it clear that the determinants of entrepreneurship among the poor are complex and that the dearth of business creation in that segment of society cannot be attributed solely to credit rationing. For example, social networks among the poor play an important role in the supply of financing. Also, when the poor borrow with collective responsibility, as in the Grameen Bank and its multiple offshoots, they may be able to self-enforce repayments via group monitoring and thus make lending more viable. Interestingly, as successful as these group-lending schemes have proved in some developing countries, their performance in more developed countries is at best mixed and raises the question whether the poor in developed countries are better off borrowing alone. Other questions are taken up in part III of this volume. One is how one can provide financing that allows the poor to default in exceptional circumstances, as a safety valve, without hurting their reputations for credit worthiness. Another is how important human capital is as a complement to financial capital.

### Credit and Banking Services at the Fringe

The chapters by John Caskey and by Lisa Servon, Robert Kaestner, and Antwuan Wallace both focus on households at the fringe of the formal banking sector. In chapter 2, Caskey builds on his earlier Russell Sage volume, *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor* (1994), and documents important changes that have occurred in the last decade in small-scale lending to poor households. He highlights a major shift away from lending by pawnshops to so-called "payday lending." The phrase refers to very short-term loans taken out by workers who run out of cash before payday. In a typical arrangement, the lender advances cash in exchange for a personal check made out by the borrower to the lender. The lender then holds on to the check for a limited time before depositing it. As Caskey documents, this form of short-term lending has now outgrown lending by pawnbrokers. Caskey's study raises a number of interesting positive and normative economic questions. An immediate first question is why has this form of lending gradually supplanted lending by pawnbrokers? Another question is why banks appear to be unwilling to cover this segment. Bank behavior is all the more puzzling given that payday lending requires that the bor-

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rower open a checking account at a bank. Caskey suggests that the rise in direct pay deposits by employers to employee checking accounts is the main reason for the relative growth in payday lending, and regulatory restrictions may explain why banks have not entered this lucrative market.

His study also reveals that many poor are repeat, even habitual, borrowers even though the costs are prohibitive. This raises the question of whether payday lenders are taking advantage of the lack of self-control or other behavioral biases of some poor borrowers. A related question is why the costs of borrowing for repeat borrowers are not brought down by competition.

In chapter 3, Servon, Kaestner, and Wallace are concerned with the general question of how poor households' exclusion from formal mainstream credit markets, whether as borrowers or savers, can be alleviated through policy. They point to the digital divide as an increasingly important factor in that bank policies of encouraging depositors to switch to online banking may have the unintended effect of excluding the poor, who do not have easy online access. They study an attempt of a major bank to tackle this issue by facilitating Internet access for poor depositors through grants of computers, Internet access, and training. As their study reveals and as one might have expected, the results of this laudable initiative are unfortunately somewhat disappointing. Although participants were conscious of the benefits of online access, insufficient resources toward training and toward subsidized online access were devoted by the bank to make this experiment work. It is hardly surprising that a profit-motivated bank would not set up an effective but loss-inducing program. Nonetheless, this study reveals that poor households would be responsive to such a program if it were adequately funded. It also points to an increasingly important divide, which is yet another factor excluding the poor from formal credit markets.

### **Legal Institutions and Household Borrowing**

How do legal institutions affect the borrowing of households? How does the impact of the institution vary as a function of the borrower's income and wealth? These questions are addressed in part II in chapters by Raisa Bahchieva, Susan M. Wachter, and Elizabeth Warren, and Daniela Fabbri and Marco Padula. In chapter 4, Bah-

chieva, Wachter, and Warren study another potential form of exclusion—from home ownership via mortgage markets. They examine recent trends in home ownership and in mortgage debt for homeowners, painting a mixed picture of the spread of homeownership in the last decade or so. While undoubtedly homeownership has grown among poorer households and has facilitated the integration of those households into credit markets, it has also been accompanied by a rise in mortgage debt and greater financial fragility. The authors demonstrate that, among low-income households, the rising indebtedness was not so much a consequence of the changing tax status of low-income debt as it was of government policy that facilitated borrowing by low-income households. The chapter suggests that these policies may have led to too much indebtedness among lower income households.

Overindebtedness is reflected in the relatively higher growth in the number of personal bankruptcy filings in recent years versus the growth in home ownership. Thus, although poor households have benefited *ex ante* from a greater access to mortgage debt, the authors hint that *ex post* a large fraction of these households might have ended up worse off. They may be highly vulnerable to even small negative income shocks that would push them into bankruptcy and result in the loss of their homes. Furthermore, as the authors suggest, they might have ended up in this exposed financial state for lack of foresight and for imprudent borrowing encouraged by aggressive loan-marketing policies of lenders. About half of all bankruptcies are now homeowners or were homeowners shortly before bankruptcy. In their sample of households, average debt has risen faster than average assets. This finding, however, should be balanced against other evidence showing that median net worth has increased significantly over the past decade.

The authors find that loan-to-value ratios are lower in states where a large amount of home equity is protected in bankruptcy. Homeowners in those states are less likely to lose their homes. The authors therefore propose that higher homestead exemptions in bankruptcy may be called for as a way of protecting poor households against themselves, by discouraging them from borrowing too irresponsibly against their homes.

In chapter 5, and in contrast to Bahchieva, Wachter, and Warren's argument, Fabbri and Padula point to the benefits of better en-

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forcement of debt contracts in Italy. Indeed, their analysis reveals how Italian jurisdictions with stricter legal enforcement of creditor rights also have more developed credit markets and, in particular, more lending to poor households. Most of the loans in their sample are secured loans, but creditor costs in seizing the collateral against which they have lent vary across provinces.

That is, Fabbri and Padula argue that the variation in the backlog of pending cases in district courts across provinces is a proxy for the variation in debt collection costs across these same provinces. The higher the backlog, the longer the time to get court approval to seize collateral following default and therefore the higher the debt collection costs. Their study finds a positive statistical relation between this backlog variable and a variable indicating the fraction of poor households that have been denied a loan application. They also suggest that the variation in court backlogs is itself driven by variations in regional economic development, with poorer regions having more backlogs.

### **Small Business Loans**

Part III of this volume deals with the other major function of credit markets for the poor: allowing poor households to take advantage of investment opportunities and thus exit poverty. A common concern among social scientists is that poor households may be disadvantaged in accessing investment opportunities that may be open to them and that they may be “trapped in poverty” because they are not able to borrow to fund their initial investment outlays. In response to these concerns several policy initiatives have been set up to provide subsidies towards business creation by “disadvantaged” households. The chapter by Timothy Bates (chapter 6) studies government subsidized loans. Robert Townsend (chapter 7) explores how community networks affect credit markets. Loïc Sadoulet (chapter 8) explores how borrowers can be insured against short-term reverses. Malgosia Madajewicz (chapter 9) asks when group loans can succeed.

In chapter 6, Bates provides an illuminating assessment of some of these initiatives and a healthy warning, pointing to major flaws and deficiencies of existing subsidized business creation programs. He argues that there is little evidence to date that the facilitation of

small-business creation is an effective strategy towards poverty reduction. A basic problem with these programs, he observes, is that it is far from obvious that the typical disadvantaged household has the expertise to run a small business. In addition, these households might not have profitable investment opportunities available that would dominate other job opportunities. As a result, programs that subsidize small business creation often end up targeting the wrong households, those that might well have successfully set up a business even in the absence of a subsidy. Worse still, these programs may lure inexperienced households into entrepreneurship, thus setting them up for failure, and ultimately making them worse off. His chapter discusses the Economic Opportunity Lending (EOL) programs set up under the Johnson administration as a part of the War on Poverty and points out that the businesses created under these programs have been beset by high failure and default rates, so much so that the programs were eventually phased out in 1984.

If lack of financial resources is only part of the explanation for the low rates of small-business creation among the poor, it is important to identify the other factors that are relevant for entrepreneurship. Are the high failure rates in the EOL programs due to a lack of training, or to low levels of education? Or are there other critical factors?

These questions are taken up in Townsend's study (chapter 7), which compares patterns of formal and informal lending to poor households in three ethnically diverse neighborhoods in Chicago and Minneapolis. Interestingly, his study points to extensive use of informal credit. Family and nonfamily connections are called on both to help face adverse income shocks due to illness or layoffs and to help start new business ventures. His study shows, however, that these informal lending relations cannot be a perfect substitute for more formal lending arrangements and cannot perfectly overcome credit rationing in the formal credit markets. Perhaps the most striking finding is that the extent to which households do rely on informal networks to smooth consumption or raise funds for investment varies considerably with the ethnic composition of the neighborhood. His study compares lending and small-business creation in three neighborhoods. The first is a predominantly Hispanic district in Chicago, with also some Korean businesses. The second is another Chicago neighborhood dominated by lower middle-class African American households. The third is a neighborhood in Minneapo-

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lis–St. Paul dominated by Hmong, an ethnic community from Laos. Townsend describes how in Hispanic communities informal lending networks are highly developed but involve relatively small transactions. Consistent with Bahchieva, Wachter, and Warren’s findings, he reports that the homeowners (or the households with higher incomes) tend to substitute away from these informal networks and rely more on formal credit markets. In the Hmong community these informal networks are, if anything, stronger and more persistent. Among Koreans, financial transactions rely less on family ties, are more formal, and involve larger amounts. In contrast, the African American communities appear more fragmented and seem to rely much less on lending through informal ethnic-based networks.

The importance of informal lending and ethnic- or community-based networks underlined in Townsend’s study has also been stressed in recent years in developing countries. Indeed, the most striking recent innovations in development finance are related to the microcredit movement around the Grameen Banks, which tries to exploit these community ties to initiate less default-prone credit to poor households. Some of these microcredit experiments have been so successful in raising very poor communities’ living standards that they have encouraged similar experiments in poor neighborhoods in developed countries.

In chapter 8, Sadoulet begins by pointing out the limited success of existing microcredit programs in developed countries. More often than not financial institutions specializing in this form of group lending to the poor have found that they could not generate a sufficiently high rate of return and have closed down. Sadoulet singles out several reasons—ranging from the higher costs of setting up a sufficiently dense branching network, poor contract design, inadequate processing of claims and lack of institutional credibility—why these programs could not be as successful as their counterparts in some developing countries. He argues that these programs would be more effective if they were run by regular banks rather than specialized institutions.

For banks to run successful group lending programs, however, Sadoulet argues that they need to set up a complementary repayment insurance program. He observes that group lending programs, while taking advantage of existing informal community networks and getting the network involved in monitoring the start-up busi-

ness by imposing joint liability on the group, also impose unwanted default risk on the credit group. He argues that this risk is more efficiently shared with the lending institution. He proposes that, to share this risk, the bank issue an experience-rated insurance policy along with the loan, giving the group borrower some protection against the joint liability risk. Should the individual borrower be unable to repay then he would be able to draw on his insurance policy. However, each draw on the policy would result in higher insurance premiums and/or lower future protection to preserve incentives.

As appealing as this proposal sounds, Sadoulet is aware of at least two potential obstacles to its implementation. First, he points out that the first bank who offers such an insurance policy may be seen as a "weak" debt enforcer and may thus encourage hit-and-run borrowing. Second, repayment insurance may be discouraged by bank regulators if it raises complex accounting and prudential regulation issues.

In chapter 9, Madajewicz points to another potential drawback of group lending, negative incentive effects of joint liability. She argues that group borrowers have reduced incentives to limit the risk of the individual projects they undertake to the extent that this risk is shared with other group members. Furthermore, she contends that this negative incentive effect is likely to be larger for relatively wealthier borrowers. She suggests that this incentive effect may be one reason for the observed better growth record of small businesses funded through individual loan than through group loan contracts. The reason is that the incentive problem under group lending induces lenders to lend smaller per-capita amounts as a way of mitigating risk-taking incentives. Thus, in her analysis, joint liability under group lending has both a positive and a negative effect. Madajewicz provides some supporting evidence for her analysis from Bangladesh and argues that the negative incentive effect she identifies may be one reason why microcredit has not been as successful in developed countries. Indeed, she points out that microcredit schemes in the United States have always taken the form of group lending. She suggests that perhaps individual loans might have been better in the more developed economies, where the poor have relatively more assets.

Taken together, the four studies in part III identify a number of important conditions for small-business lending to be successful.

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Borrowing needs to be complemented by human capital. As Bates documents in chapter 6, subsidized loans to small businesses are much less likely to succeed if the borrower has no training and a low level of education. Borrowing needs to be complemented by social capital. At the same time, group effects cannot be artificially imposed from the outside. The experience of the Grameen Bank has led to many programs where a group of poor have joint liability for all the loans issued to the group. Townsend documents in chapter 7 the striking variety of informal lending across ethnically diverse neighborhoods, with family or community-based credit much more widely available to the Hmong living in Minneapolis, who have a tight interpersonal network, and to first-generation Mexicans in Chicago than to the more fragmented African American communities in Chicago. As Sadoulet and Madajewicz discuss in chapters 8 and 9, these programs are notoriously unsuccessful in the United States. Defaults, in particular, are rife. The low success rate of these programs in more developed countries may be due to higher administrative costs, as both Sadoulet and Madajewicz stress, but also to the fact that the constituency of poor group-borrowers is those households who have been denied other sources of credit, which in developed countries are relatively easier to get. Therefore, group borrowers in developed countries are likely to be on average less well suited to small-business creation through these programs.

### **Political Economy of Credit Markets**

Part IV completes the volume with chapter 10 by Howard Rosenthal, who explores how political forces shape policy intervention in credit markets. His chapter provides an overview of political economy analyses of credit markets. A valuable backdrop for the previous, mostly empirical, studies of credit markets for the poor, it lays out the policy questions related to the exclusion of the poor from credit markets and the protection of debtors in financial distress. Rosenthal focuses mainly on positive analyses of the link between inequalities in wealth, the operation of credit markets, and political intervention. He highlights how the interaction of credit markets and politics with inequality can be quite subtle. He points out, for example, that a high degree of initial inequality might prevent credit markets from operating altogether if the political process offers op-

portunities for the subsequent abrogation of debt obligations. At the other extreme, if the debtor constituency is not strong enough the political process will not deliver adequate relief to debtors in a financial crisis.

In several of the theoretical studies that Rosenthal summarizes, the model economies have the property that, when budding entrepreneurs borrow, the credit market will reduce poverty but lead to an increase in inequality. A few borrowers get lucky and reap huge returns. The models suggest that while the supply of credit to the poor may substitute for redistribution in terms of poverty reduction, the very success of a credit market may increase pressures to redistribute.

Other theoretical work discussed examines the effect of government regulation and political intervention. Usury laws, which limit the ability of the poor to borrow, can be seen as improving welfare. Lax enforcement, in the form of “fresh start” personal bankruptcy protections or of limitations on ability to collect debts and attach collateral, can be seen as largely beneficial to borrowers with high ability or endowments. The worst off, in terms of initial ability or endowments, will be unaffected, because they are always credit rationed. Intermediate types, however, may become credit rationed as laxity is increased. In many cases, the relevant political coalitions could thus involve the “rich” and “poor” intervening in debt markets against the interests of the middle.

### **Summary**

Credit markets for the poor operate largely apart from the mainstream credit markets. They are mostly invisible to the wealthier borrowers and lenders as well as to most financial researchers, who study the larger and more formal financial markets. Small improvements in these markets, however, can be of great importance for the poor, who are constrained to rely on them. As this volume highlights, these are not simple markets with simple financial transactions. Their efficiency and competitiveness could conceivably be improved along many different dimensions. However, to determine appropriate political interventions in these markets with greater confidence more research into these understudied markets is called for.

Credit markets transfer resources from the haves to have-nots.

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Unlike transfers, however, they may not reduce inequality. Some funded projects succeed and others fail. The successes escape poverty. The failures, at best, default and are no better off than they were before borrowing. Even worse, as with repeated payday borrowers, the poor may get into a vicious cycle of borrowing that drains their resources.

This book provides many new insights into how borrowing by the poor might be made more productive. Promising steps include fostering investment in both human and social capital that complements financial capital, and carefully designing laws and institutions that structure incentives and protect the poor from the temptation to borrow more than they can repay.

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