Peer Influence, Strategic Discretion, and Loan Repayment in Community Lending: Evidence from Indian Demonetization

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Abstract

Prior research on community lending models in microfinance has emphasized the benefits of informal borrower-to-borrower relationships that enable peer monitoring and encourage loan repayment. However, we propose that following a crisis, the same relationships might hasten the spread of missed loan repayments within borrower communities, and thereby negatively affect the performance of lending organizations. We investigate this issue in the context of India's 2016 demonetization, a one-time suspension of the legal tender status of 87 percent of the country's currency that triggered a massive economywide shock. Analyzing proprietary data on approximately two million borrowers from a leading Indian microfinance organization, we find strong evidence that loan defaults did indeed spread through informal borrower-to-borrower relationships: the number of a borrower's peers who defaulted immediately following demonetization was positively correlated with that borrower's own likelihood of default in subsequent months. Further, we find that the involvement of specific borrowers in peer influence depended on the level of their strategic discretion to make timely loan repayment: borrowers with a greater ability to repay were more influenced by the defaults of their peers (incoming peer influence), and their defaults were also more influential upon their peers (outgoing peer influence). Our study thus uses community lending in microfinance as a context to generate new insights on peer influence following a crisis such as demonetization, and identifies the particular role of strategic discretion as a key moderator of such influence.

Keywords: peer influence; strategic discretion; microfinance; demonetization.