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## Elasticities of demand for consumer credit

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CENTER DISCUSSION PAPER NO. 926

## **Elasticities of Demand for Consumer Credit**

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Notes: Center Discussion Papers are preliminary materials circulated to stimulate discussions and critical comments.

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# Elasticities of Demand for Consumer Credit

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## **Abstract**

The price elasticity of demand for credit has major implications for macroeconomics, finance, and development. We present estimates of this parameter derived from a randomized trial. The experiment was implemented by a consumer microfinance lender in South Africa and identifies demand curves that, while downward-sloping with respect to price, are flatter than recent estimates in both developing and developed countries throughout most of a wide price range. However, demand becomes highly price sensitive at higher-than-normal rates. We discuss several interpretations of this kink and present some related evidence. We also find that loan size is far more responsive to changes in loan maturity than to changes in interest rate. This pattern is more pronounced among lower income individuals, a comparative static that has been observed in the United States as well and is consistent with liquidity constraints that decrease with income.

Keywords: credit markets, microfinance, demand elasticity, development finance, maturity elasticity, consumer credit, liquidity constraints

JEL Codes: D1, D9, E2, G2, O1

## I. Introduction

The price elasticity of demand for credit has major implications for macroeconomics, finance, and development. It bears directly on the magnitude of inter-temporal substitution of consumption in response to changes in the real interest rate, thus impacting a host of macroeconomic issues, including the composition and level of aggregate demand, the deadweight loss of interest taxation, the burden of the national debt or unfunded social security, and the cyclical nature of consumption (Hall 1988). In finance, consumer price elasticities affect firm pricing decisions where market power exists, and inform analysis of high and sticky rates in consumer credit markets (Ausubel 1991). In development economics, demand elasticities shed light on the importance of interest-rate subsidies and ceilings designed to increase access to credit, and on microfinance institution pricing strategies for improving “sustainability” and “outreach” (Morduch 2000; Armendariz de Aghion and Morduch 2005).

Nonetheless, generations of studies have produced little consensus on the magnitude of consumer sensitivity to interest rates. Until recently, the bulk of empirical evidence suggested these elasticities are close to zero (Hall 1988). But new quasi-experimental methodologies employed by Gross and Souleles (2002), Allesie, Hochguertel, and Weber (2005), and Dehejia, Montgomery and Morduch (2005) find elasticities ranging from -0.73 to well below unity in the U.S., Italy, and Bangladesh, respectively.<sup>1</sup> These findings reinforce suspicions that earlier approaches were plagued by measurement and identification problems (Mishkin 1995; Browning and Lusardi 1996). Experimental methodologies solve several problems encountered by cross-sectional or panel data analysis of consumer credit patterns. On the demand side, observed interest rates may correlate with time or individual-specific investment opportunities or financing

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<sup>1</sup> Two other related papers estimate the response of consumption growth to the real interest rate (measured using asset returns) in micro-data. Vissing-Jorgensen (2002) finds elasticities of -0.3 to -0.4 for stockholders and -0.8 to -1.0 for bondholders in U.S., and Attanasio and Weber (1993) finds an elasticity of -0.8 in the U.K.

alternatives. On the supply side, the riskiness of the individual or project is (partially) observable to the Lender and hence correlates with the interest rates available to each individual.

Attanasio, Goldberg, and Kyriazidou (2004), (hereinafter “AGK”), shows that the elasticity of demand for credit with respect to loan maturity is an important parameter as well.<sup>2</sup> This elasticity is nonzero only in the presence of binding liquidity constraints; i.e., liquidity constrained consumers should exhibit sensitivity to the size of loan payments as well as to loan price. AGK finds widespread nonzero maturity elasticities in the market for car loans in the United States using survey data and a combination of structural and quasi-experimental exclusion restrictions.

We estimate elasticities of demand for consumer credit with respect to price and maturity using randomized trials implemented by a consumer lender. Our setup addresses identification problems by randomizing interest rates (directly) and maturity (via “suggestions”) across households. Specifically, we produced randomized loan offers that were distributed via direct mail to over 50,000 past customers of a major South African consumer microfinance lender (“The Lender”). Each offer contained a randomly different interest rate for a loan with a four-month fixed repayment schedule. A subset of borrowers was eligible for six- and twelve-month maturities as well. For this subset, each letter exhibited a randomly-chosen and non-binding maturity suggestion in the form of a four, six or twelve month “example” loan. The example maturity powerfully predicts the actual maturity chosen, and hence provides us with an instrumental variable for maturity that we use to identify maturity elasticities.<sup>3</sup> The observed demand responses to interest rates and loan maturity were orthogonal to unobserved characteristics by construction, and effectively enable us to observe the counterfactual of interest — what happens to a consumer’s borrowing behavior if we exogenously change her interest rate and/or loan maturity?

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<sup>2</sup> See also Juster and Shay (1964).

<sup>3</sup> We discuss *why* the maturity example effect was so powerful in Section VI. To preview, the strong influence of the “default” option (Madrian and Shea 2002), and the power of subtle priming and suggestion

We find demand curves with respect to price that are downward sloping, but flatter throughout most of the price range than the recent quasi-experimental estimates cited above. However, price sensitivity increases sharply at rates above the Lender's standard ones. We discuss several interpretations of this kink, including selection (our sample includes prior borrowers with particular discount rates), competition and contemporaneous substitution (raising rates drives borrowers to other lenders), intertemporal substitution (borrowers simply wait for the Lender's rates to drop), and behavioral explanations (fairness or loss aversion). We present some related evidence casting doubt on the first three explanations, although the results are far from conclusive.

We also find that loan size is an order of magnitude more responsive to changes in loan maturity than to changes in interest rate. Increasing maturity by a month (i.e., by 20%) raises demand by 15%. Interest rates would have to drop to essentially zero to have the same effect.

Interestingly, both elasticities vary with income in ways that are consistent with the (relatively) poor facing relatively severe liquidity constraints. Our price elasticities appear to increase with income and maturity elasticities decrease with income. This coincides with the evidence from the U.S. (Vissing-Jorgensen 2002; AGK).<sup>4</sup> As discussed in AGK, this pattern indicates the presence of binding liquidity constraints for the poor.

The paper proceeds as follows. Section II describes the market setting for the experiment. Section III details the experimental design. Section IV presents the empirical strategy and results. Section V considers macro implications of our results. Section VI estimates the price sensitivity of maturity choice. Section VII estimates the Lender's profit-maximizing short-run pricing strategy. Section VIII outlines the empirical strategy and results for the maturity elasticity of loan demand. Section IX concludes and discusses why elasticities may vary (or not) across different settings.

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in consumer goods and services (Morwitz, Johnson et al. 1993), generate the relationship between the example maturity and maturity choice.

<sup>4</sup> Dehejia, Montgomery, and Morduch (2005) find the opposite pattern based on a measure of wealth rather than income in Bangladesh—there price elasticities *decrease* in wealth.

## II. Market and Lender Overview

Our cooperating Lender competes in a “cash loan” industry segment that offers small, high-interest, short-term credit with fixed repayment schedules to a working poor population. Cash loan borrowers generally lack the credit history and/or collateralizable wealth needed to borrow from traditional institutional sources such as commercial banks. Cash lenders arose to substitute for traditional informal sector moneylenders following deregulation of the usury ceiling in 1992, and they are regulated by the Micro Finance Regulatory Council (MFRC). Aggregate outstanding loans equal 38% of non-mortgage consumer credit (Department of Trade and Industry South Africa 2003).<sup>5</sup>

Cash loan sizes tend to be small relative to the fixed costs of underwriting and monitoring them, but substantial relative to borrower income. For example, the Lender’s median loan size of R1000 (\$150) is 32% of its median borrower’s gross monthly income. Cash lenders focusing on the observably highest-risk market segment typically make one-month term loans at 30% interest *per month*. Lenders targeting observably lower risk segments charge as little as 3% per month.<sup>6</sup> Rejection is prevalent even at these high rates: the Lender denies 50% of new loan applicants.

The Lender has been in business over 20 years and is one of the largest micro-lenders in South Africa, with over 100 branches throughout the country. Our experiment took place in a mix of 86 urban and rural branches throughout the provinces of Kwazulu-Natal, Eastern Cape, Western Cape, and Gauteng. All loan underwriting and transactions are conducted face-to-face in the branch network, with the risk assessment technology combining centralized credit scoring with decentralized loan officer discretion. The Lender’s product offerings are somewhat differentiated

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<sup>5</sup> The prevalence of for-profit *consumer* lenders makes the credit market in South Africa distinct from most other developing countries (Porteous 2003).

from competitors. Unlike many cash lenders, it does not pursue collection or collateralization strategies such as direct debit from paychecks, or physically keeping bank books and ATM cards of clients. Its pricing is transparent and linear, with no surcharges, application fees, or insurance premiums added to the cost of the loan. The Lender also has a “medium-term” product niche. Most other cash lenders focus on 1-month or 12+-month loans.<sup>7</sup> The Lender’s standard 4-month rates, absent this experiment, ranged from 7.75% to 11.75% per month depending on the client’s creditworthiness, with 75% of clients in the high risk (11.75%) category.

Borrowers face several incentives to repay these high-interest loans. Carrots include decreasing prices and increasing future loan sizes following good repayment behavior. Sticks include reporting to credit bureaus, frequent phone calls from collection agents, court summons, and wage garnishments.

### **III. Experimental Design and Implementation**

We identify demand curves for consumer credit by randomizing both the interest rate offered each individual client on a direct mail solicitation and the maturity of an example shown on the offer letter. This section outlines the experimental design and implementation, and validates the integrity of the random assignments using several statistical tests.

The experiment was implemented in three “waves” of mailer/start dates that grouped branches geographically, for logistical reasons. We pilot tested in three branches during July 2003 (wave 1), and then expanded the experiment to the remaining 83 branches in two additional waves that started with mailers sent in September 2003 (wave 2) and October 2003 (wave 3). We begin with a brief overview of the experiment, and then describe each step in detail below.

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<sup>6</sup> There is essentially no difference between these nominal rates and corresponding real rates. For instance, South African inflation was 10.2% *per year* from March 2002-2003, and 0.4% per year from March 2003-March 2004.



### A. *Design Overview*

First the Lender randomized the offer interest rate,  $r^o$ , attached to “pre-qualified,” limited-time offers that were mailed to 58,168 former clients with good repayment histories. 96% of the offers were at rates that were lower than the Lender’s standard ones, with an average discount of 3.2 percentage points (the average standard rate was 11.1%). Slightly more than one percent of the offers were at higher than normal rates (with a 1.9 percentage point increase on average), and the remaining three percent of offers were at the normal interest rate. Clients eligible for maturities longer than four months also received a randomized example of either a four, six or twelve month loan.

Clients wishing to borrow at the offer rate then went to a branch to apply, as per the Lender’s normal operations. Final credit approval (i.e., the Lender’s decision on whether to offer a loan after updating the client’s information) and maximum loan size supplied were orthogonal to the experimental interest rate by construction. Figure 1 shows the experimental operations, step-by-step.<sup>8</sup>

### B. *Sample Frame*

The sample frame consisted of all individuals from 86 branches who had borrowed from the Lender within the past 24 months, were in good standing, and did not have a loan outstanding

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<sup>7</sup> The Lender also has 1, 6, 12, and 18 month products, with the longer terms offered at lower rates and restricted to the most observably creditworthy customers.

<sup>8</sup> Actually *three* rates were assigned to each client, an “offer rate” ( $r^o$ ) included in the direct mail solicitation and noted above, a “contract rate” ( $r^c$ ) that was weakly less than the offer rate and revealed only after the borrower had accepted the solicitation and applied for a loan, and a dynamic repayment incentive (D) that was revealed only after all other loan terms had been finalized and extended preferential contract rates for up to one year, conditional on good repayment performance. This multi-tiered interest rate randomization was designed to identify specific information asymmetries (Karlan and Zinman 2005b). 40% of clients received  $r^c < r^o$ , and 47% obtained D=1. Since D and the contract rate were surprises to the client, and hence did not affect the decision to borrow, we exclude them from most analysis in this paper. In some specifications, such as those that examine loan size rather than take-up, we restrict the sample to those whose offer interest rate was equal to the contract interest rate in order to avoid any potential confounding issues.

in the thirty days prior to the mailer.<sup>9</sup> Table 1 presents summary statistics on the total sample frame (Column 1), those that applied (Column 2), those that borrowed (Column 3), and those that were eligible for the randomized maturity suggestion (Column 4). Most notably, clients eligible for the maturity suggestion differ in observable risk as assessed by the Lender. The Lender assigns prior borrowers into “low”, “medium”, and “high” risk categories, and this determines the borrower’s loan pricing and maturity options under normal operations. The Lender does not typically ask clients why they seek a loan, but the experimental protocol included a survey that indicates the following self-reported uses: education (19%), housing renovations (11%), payoff other debt (11%), household consumption and/or family event (13%), funeral and medical (4%) and miscellaneous/unreported (32%).

### C. *The Randomizations*

The offer rate randomization was conditional on the client’s observable risk category because risk determines the loan price under normal operations. The randomization program established a target distribution of interest rates for 4-month loans in each risk category<sup>10</sup> and then randomly assigned each individual to a rate based on the target distribution for her category.<sup>11</sup> Appendix Table 2 shows the resulting distribution of the offer rate,  $r^o$ , for the three observable risk categories. Rates varied from 3.25 percent per *month* to 14.75 percent per month.<sup>12</sup> At the time of the randomization, we verified that the assigned rates were uncorrelated with other known information, such as credit report score. Table 2, Column 1 shows that the randomizations were

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<sup>9</sup> See Appendix Table 1 for a reconciliation of the sample frame employed in this paper to two companion papers: Karlan and Zinman (2005b), and Bertrand, Karlan, Mullainathan, Shafir, and Zinman (2005).

<sup>10</sup> Rates on other maturities in these data were set with a fixed spread to the offer rate conditional on observable risk, so we focus exclusively on the 4-month rate unless noted otherwise.

<sup>11</sup> The 632 high-rate offers did not affect the randomization procedure in the sense that we still randomized within a predefined range and target distribution of rates, conditional on observable risk.

<sup>12</sup> These are “add-on” rates, where interest is charged upfront over the original principal balance, rather than over the declining balance. We adopt the cash loan market’s convention of presenting rates in add-on, monthly form.

successful, *ex-ante*, in this fashion; i.e., conditional on the observable risk category, the offer rate was uncorrelated with other observable characteristics.

A subset of borrowers in waves 2 and 3 received mailers containing a randomized maturity suggestion as well. The suggestion took the form of non-binding “example” loan showing one of the Lender’s most common maturities (four, six, or twelve months), where the length of the *maturity* was randomly assigned. All letters clearly stated that other loan sizes and maturities were available. The example loan *size* presented was simply the client’s last loan size. Only low- and medium-risk borrowers were eligible to receive the suggestion randomization, since high risk borrowers could not obtain maturities greater than 4 months under the Lender’s standard operations. 3,096 of these clients (of whom 493 borrowed) received a suggestion (51% 4-month, 25% 6-month, 24% 12-month).

Loan officers were instructed to ignore any example loan(s) presented on the letter. In both training and ongoing monitoring, the Lender’s management and the research team stressed to branch personnel that the mailers were for marketing purposes only, and should not have any impact on the loan officer’s underwriting of the loan application.

#### *D. The Offer and Loan Application Process*

Each mailer contained a deadline, ranging from two to six weeks, by which the client had to respond in order to be eligible for the offer rate. The Lender routinely mails teasers to former borrowers but had never promoted specific interest rate offers before this experiment. 1,423 mailers were returned to the Lender by the postal service and 3,000 contained atypical (i.e., non-decreasing) relationships between loan maturity and price, leaving us with a sample frame of 53,810 offers for analysis of demand (Appendix Table 1).

Clients accepted the offer by entering a branch office and filling out an application in person with a loan officer. Loan applications were taken and assessed as per the Lender’s normal

underwriting procedures. Specifically, loan officers (a) updated observable information and decided whether to offer *any* loan based on their updated risk assessment; (b) decided the maximum loan size to offer the accepted applicants; and (c) decided the longest loan maturity to offer the accepted applicants. Each decision was made “blind” to the experimental rates, with strict operational controls (including software developed in consultation with the research team) ensuring that loan officers instead used the Lender’s *standard* rates in any debt service calculations. This rule was designed to prevent loan supply from adjusting endogenously to a lower rate (due to allowable debt service ratios) and thereby complicating estimation of loan size demand elasticities. 4,540 clients (out of 53,810) in our sample frame applied for a loan at the offered interest rate (i.e., before the deadline on the letter), an 8.4% takeup rate. 3,887 of these were approved for a loan. Everyone who was approved for a loan accepted (the typical in-branch application process takes forty-five minutes, so once an applicant has decided to apply and is approved they rarely leave without cash).

Following the loan officer’s assessment, clients were informed the maximum they could borrow and then clients chose their loan size.

#### *E. Validation of Randomization Integrity*

As noted above, Table 2, Column 1 shows that the offer rate randomization was valid *ex-ante*. Columns 2 through 4 provide evidence that the experimental protocols were implemented properly *ex-post*. Column 2 shows that, as planned, client application decisions were predicted only by the offer rate, and not by the “surprise” rates (see footnote 8) that were to be revealed only after the client entered the branch. Column 3 shows that, as planned, loan officer rejection decisions are also uncorrelated with the surprise rates. Column 4 shows that the offer rate does not influence take-up *after* the deadline, which validates that individuals were indeed responding to the

offer interest rate since clients who borrowed after the deadline of the offer faced the Lender’s standard rate schedule.

#### **IV. Price Elasticities of Demand**

We estimate price elasticities over different margins, time horizons, and financing sources. Our primary results focus on initial (pre-deadline) borrowing from the Lender, but we consider aggregate borrowing over the six months following the initial offer as well. This longer-run analysis includes (imperfect) measures of borrowing from other lenders as well, using credit bureau data.

##### *A. Empirical Strategy*

Our identification relies on the random assignment of interest rates across potential borrowers, conditional on observable risk. Abstracting from functional form considerations for the moment, our basic model is:

$$(1) Y_i = f(r_i^o, X_i),$$

where  $i$  indexes potential borrowers in our sample frame;  $Y$  is a measure of extensive (take-up) or intensive (loan size) demand;  $r_i^o$  is the randomly assigned offer rate; and  $X_i$  is the Lender’s summary statistic for observable risk (low/medium/high).  $X_i$  also includes controls for the timing of mailers (the “waves” described above), and can be augmented with branch fixed effects and borrower demographics. The standard errors allow for clustering within branches.

##### *B. Extensive Margin, Initial Borrowing from Lender*

We begin by estimating the extensive price elasticity of loan demand for pre-deadline borrowing. Here  $Y_i$  is defined as a binary measure of whether individual  $i$  accepted the Lender’s offer before her deadline for obtained  $r_i^o$  elapsed, and (1) is estimated using a probit. Our preferred

measure of take-up is the application decision (thereby including rejected clients), but our results are robust to using approved as well as applied. We start with the 99% of the sample frame that received offers at or below the Lender's standard rate. Table 3, Column 1 presents the marginal effects for this sample: a 100 basis point increase in the monthly interest rate reduces take-up by 3/10 of a percentage point.<sup>13</sup> This is a precisely estimated but rather small effect, given that average take-up is 8.5%. Thus a price decrease from the maximum (11.75%) to the minimum (3.25%) rates offered in this sample would only increase take-up by 2.6 percentage points, or 31% of the baseline take-up rate. Another way to scale the estimated magnitude is to calculate the take-up elasticity (i.e., multiplying the marginal effect by the ratio of the mean offer rate to mean takeup), which is -0.28.

### *C. Asymmetric Elasticities for Prices Increases versus Reductions*

Column 3 suggests that the demand curve steepens sharply at rates higher than the Lender's standard ones. The sample randomly assigned to receive higher-than-standard-rates exhibits a price sensitivity of take-up that is *6 times greater* than the low-rate sample.<sup>14</sup> Take-up falls 1.7 percentage points for each 100 basis point increase in the interest rate, on an average take-up rate of 6.6%. This kink in the demand curve, which we show graphically in Figure 2, is consistent with several underlying (and potentially complementary) explanations.<sup>15</sup>

There are at least four explanations for this asymmetry. One is selection based on discounting or rates of return. Since our sample consists only of prior borrowers, it could be that everyone in the experiment has a discount or return rate equal to the Lender's normal rates. Then lowering the interest rate would affect the intensive, but not extensive margin. On the other hand,

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<sup>13</sup> Results are robust to using OLS rather than probit, to controlling for the "surprise" experimental rates, and to controlling for branch fixed effects.

<sup>14</sup> Gross and Souleles (2002) finds the reverse asymmetry; in their data, the price elasticity is greater in absolute value for price *decreases*. See our Section IX for a discussion.

<sup>15</sup> The limited sample of clients whose rate was increased above the normal rate makes it impossible to test for an actual kink rather than a significant change in elasticities in that price range.

raising the interest rate would affect the extensive margin as well (unfortunately our small sample of rate increases does not permit estimating the intensive margin separately.) However, two pieces of circumstantial evidence cast doubt on this interpretation. First, the Lender has *several* standard rates that vary with risk level, and any individual borrower can obtain progressively lower rates through time with good repayment performance. Thus for selection to explain the kink, borrowers would need to have *time-varying* discount or return rates, or be willing and able to borrow at a loss for an extended period in order to obtain future credit at lower rates.

A second potential explanation for the kink is that consumers receiving high-rate offers borrowed elsewhere. However, competition in the Lender's niche is thin, with prior market research finding that nearly all competitors either offer much higher rates and/or require collateral. Thus there appears to be a dearth of close substitutes for credit from the Lender. Empirically, we test this by examining whether borrowing from *other* lenders is higher for those with higher offer rates. We do not find this to be the case (results discussed below, Table 7)

Third, high-rate consumers could wait for normal rates to return. This is testable by examining post-deadline borrowing: if high-rate consumers wait then they should be more likely to borrow after the high-rate offer expires. In fact we find the opposite-- high-rate offers produce *lower* post-deadline borrowing (Table 3, Column 5).

Lastly, specific behavioral models also predict relatively high sensitivity to high rates. Prospect theory generates this pattern because consumers evaluate prices relative to their prior experience and weight losses (price increases) more heavily than gains (Kahneman and Tversky 1979).<sup>16</sup> Models that allow for transaction utility also generate particular aversion to high-than-

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<sup>16</sup> See also Hardie, Johnson, and Fader (1993).

standard prices if consumer perceive the price increase as unfair (Thaler 1985; Thaler 1999).<sup>17</sup> Unfortunately, we have no way of directly testing these theories here.

#### *D. Unconditional Loan Size, Initial Borrowing from the Lender*

Table 4, Column 1 presents our core OLS estimate of the price sensitivity of the amount borrowed, unconditional on borrowing (this is the outcome featured in both Gross and Souleles (2002) and Dehejia, Montgomery and Morduch (2005)). The dependent variable here includes pre-deadline borrowing only. We limit the sample to prospective borrowers who were randomly assigned equal offer and contract rates (i.e., who did not get a surprise rate drop after being approved). The precisely estimated coefficient shows a R4.4 decrease for each 100 basis point increase the interest rate, with an implied elasticity of -0.32.

#### *E. Conditional Loan Size*

Columns 2 and 3 of Table 4 present our core estimates of price sensitivity, conditional on borrowing. Column 2 presents OLS results, with the precisely estimated coefficient showing a R26 decrease in loan size for each 100 basis point increase in the interest rate. The implied elasticity here is -0.13. The log-log specification (Column 3) yields an elasticity of -0.11. Again, these magnitudes are quite low relative to comparable recent estimates obtained in other settings.

#### *F. Plots and Nonlinearities*

Figures 2-4 present semi-parametric plots using locally weighted partial linear regression.<sup>18</sup> For each plot, the x-axis is the residual from a regression of the monthly offer interest on the randomization conditions (risk level and the month of the offer), and the y-axis is the residual from the regression of the demand outcome (take-up or loan size) on the same conditions. 95% confidence intervals were bootstrapped with 100 repetitions. Figure 2 examines the probability of

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<sup>17</sup> A “price point”, as discussed in Kashyap (1995), seems an unlikely explanation for our kink since the Lender’s standard prices do not match competitors or feature common price-endings.



borrowing (take-up), Figure 3 shows the loan size conditional on borrowing, and Figure 4 shows revenue produced per offer made by the Lender. Our interest in drawing demand curves is not purely aesthetic, as some models of intertemporal consumer choice predict specific nonlinear responses to the interest rate (Attanasio and Weber 1995). Here the plots reproduce the qualitative patterns found by the linear regressions (Tables 3, 4, and 9), although the plots' confidence bands are wide enough to contain nonlinearities.

### *G. Heterogeneity*

Next we estimate whether there is significant heterogeneity in price elasticities with respect to demographic characteristics. The motivation for this exercise is twofold: 1) the range and dispersion of price elasticities in an economy can have macro implications; 2) some characteristics (gender, income) are of particular interest to microfinance practitioners and policymakers.

We measure heterogeneity by adding demographics, and their interactions with the randomly assigned interest rate, to our base specification. Results by gender and income are of particular practical interest, since microfinance initiatives often target females and/or a certain income range. Table 5 presents the results for three outcomes: applied (Column 1), loan size unconditional on borrowing (Column 2), and loan size conditional on borrowing (Column 3). Focusing on Column 1 (applying) and Column 2 (loan size, unconditional), we find some evidence that the following types of individuals are more price sensitive: recent borrowers, female, unmarried, younger, and educated. In Column 3, we restrict the sample to those who took-up, and examine the determinants of the log of loan size. We find that loan size is more responsive to price for the higher income individuals. This finding differs from Dehejia et al which finds that low-wealth MFI borrowers in Bangladesh are about three times more elastic than their higher-wealth counterparts. In our case income is measured more precisely in Column 3 than in Columns 1 and 2

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<sup>18</sup> Plots were created using the `lowess` command in Stata 9.0

because it is updated when an individual applies for a loan; hence, we put more weight on the Column 3 results for income.

## **V. Towards Macro Implications: Attention and Crowd-Out**

The results thus far suggest that the Lender's prior borrowers have negatively sloping but relatively flat demand curves for consumer credit over most of the range of feasible prices. Elasticities estimated over the 99% of the sample offered standard rates or below range from -0.11 to -0.48. We now examine whether these estimates can inform us about the *aggregate* behavior of the South African economy. For example, say one was considering using our results to help forecast the response to an economy-wide real interest rate drop of the magnitude we engineered in our experiment. Thinking about extrapolating our results to this type of macro setting requires answers to at least three additional questions.

First we examine whether lack of attention to the offer letter produces estimates that are not useful for predicting shifts in aggregate demand as market interest rates change. The concern here is simply that many prospective applicants did not read the offer letter, and therefore did not actually have the information on the Lender's rate that they would have in the face of an economy-wide shift in interest rates. We address this by constructing proxies for clients who were most likely to read the offer letter, and then splitting the sample on these proxies, conditional on other demographics. The results are contained in Table 6. Lower risk clients may be more likely to read the letter if they are relatively attached to the Lender; e.g., if their investment in a lending "relationship" has paid off in lower rates that are not available from outside options. Indeed, the price elasticity for low and medium risk clients (Column 2) is relatively large in absolute value at -0.48 (Column 1 shows the comparable estimate including high risk clients: -0.33). On the other hand, clients that have borrowed more recently (Column 3) or more often (Column 4) from the

Lender exhibit elasticities that are similar to the full sample (Column 1). Thus while there is some evidence that our experimental implementation technology (direct mail) understates the true price elasticity of demand, any downward bias appears to be small in magnitude and economic significance.

A second question to address in attempting to translate our results into macro implications is whether experimental borrowing from the Lender simply crowds-out other sources. Crowd-out could occur contemporaneously, with clients substituting Lender debt for other sources. Crowd-out might also occur intertemporally, with clients shifting their future borrowing with the Lender forward to the project time period. Table 7 addresses each of these margins.

Columns 1-2 of Table 7 show the price sensitivity of borrowing from the Lender from the experiment's start-date through six months *following* the end of experimental operations. If there is intertemporal crowd-out, then measures based on this "medium-run" definition of borrowing should respond *less* to price than our core, "short-run" measures of loan demand based on pre-deadline borrowing. Column 1 shows that, in fact, the medium-run effect is *larger*, with a R7.8 decrease in the amount borrowed per each 100 basis point increase in the interest rate, compared with the R4.4 decrease in short-run borrowing reported in Table 4, Column 1; but the implied elasticity is substantially smaller at -0.11 (versus -0.32), due to larger mean borrowing in the medium-run. Column 2 looks at the log of loan size, conditional on borrowing, and finds larger effects on medium-run borrowing (-0.17, vs. -0.11 in Table 4, Column 3). Column 3 examines the probability that individuals borrow multiple times within the medium-run window, and again shows that lower initial interest rates produce *more* future borrowing (with an implied elasticity of -0.40, versus -0.27 in the short-run).

These estimates suggest two key findings: (1) low initial rates produce crowd-*in* over the medium run; i.e., on every margin, borrowers facing lower short-run rates also borrow more over

the medium-run than their higher rate counterparts; (2) this crowd-in may indeed change the slope of the demand curve, but the effect appears to be small and our results are mixed as to its direction.. Estimating the intensive and extensive margins separately (Columns 2 and 3) delivers slightly *larger* (in absolute value) medium-run elasticities, while the estimate using unconditional level loan size produces a markedly smaller elasticity. In any case medium-run demand, like short-run demand, appears to be downward sloping but relatively flat with respect to price.

Borrowers might also substitute (or complement) across financing sources. We address this possibility by using credit bureau data obtained by the Lender six months after the end of the experiment. 25% of all letter recipients borrowed on average of R16,050 from outside sources during this period. Columns 4-6 of Table 7 show no significant effects of the experimental interest rate on outside borrowing, although the estimates are imprecise.<sup>19</sup>

On balance then we find no evidence that our core results are significantly biased estimates of the true price sensitivity in our sample. The basic qualitative result that the price elasticity of demand for consumer credit is downward sloping but relatively flat, over a wide range of rates below the Lender's standard ones, holds for our sample even when we allow for varying likelihoods of reading the letter and debt-shifting.

Thus our results will have macro applications if our parameter estimates have external validity; i.e., if they hold, or can be used to impute, price sensitivities for other populations. This is the third question to address in translating our finding into macro implications. As is customary in empirical work, it is difficult to draw firm conclusions about how sample-specific our parameter estimates are. The cash loan market as a whole is important in the aggregate (see Section II); thus, if our sample is representative of the cash loan market then our results likely have some macro implications. But our Lender's unique product niche (see Section II and Section IIIC) and

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<sup>19</sup> Gross and Souleles (2002) finds some significant "balance shifting" using credit bureau data. Dehejia et al (2005) and Alessie et al (2005) have no measures of outside borrowing.

variation in price sensitivity by demographics (see Section IVG) cast doubt on the notion that price elasticities are the same in (or can be extrapolated to) other segments of the South Africa population. Further research is needed on other credit markets and segments.

## **VI. Maturity Choice**

Loan pricing may also influence maturity choice, as credit constrained consumers must trade off the benefits of longer maturities (lower monthly payments) versus higher total financing costs (see also Section VIII). Only clients categorized as low or medium risk by the Lender have a maturity choice: they can take out four-, six-, or twelve-month loans. High risk clients are eligible only for four-month loans.<sup>20</sup> Thirty percent of eligible clients opt for longer (six or twelve month) maturities, and we examine the price sensitivity of this decision in Table 8. We find that maturity choice does vary inversely with interest rates.

Column 1 shows the results of an ordered probit specification with maturity (4, 6 or 12 months) on the first pre-deadline loan as the dependent variable. Column 2 shows the probit marginal effect of the interest rate on choosing a longer maturity (six- or twelve-month), unconditional on takeup (setting those without loans to a maturity of zero). Column 3 shows the marginal effect on longer maturity conditional on takeup. In each case higher rates induce a choice of shorter maturities; e.g., Column 3 shows that a one percentage point increase in the interest rate reduced the probability of choosing a longer term by 1.2 percentage points.

Loan pricing thus clearly impacts maturity choice, with higher prices producing reductions in maturity length. This has implications for the Lender's optimal pricing strategy, given the

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<sup>20</sup> All clients are also (technically) eligible for one-month loans, and some of the best clients may be eligible for eighteen-month loans. But these product offerings were not universally integrated into the Lender's operations, as evidenced by the fact that we see only 42 one-month loans and 44 eighteen-month loans in our sample frame of over 58,000 clients. Accordingly we drop one- and eighteen-month loans from the maturity choice analysis. Including them changes the point estimate from -.043 to -.041, and the p-value from .072 to .049.

presence of substantial fixed costs in administering, monitoring, acquiring, and retaining client relationships.

## **VII. Profits, and Implications for Optimal Pricing**

What do our findings thus far imply for the Lender's optimal pricing strategy? To answer this question we now translate our findings on demand curves into revenue terms, and combine this with new estimates on the impact of pricing on loan repayment.

We examine the revenue implications by estimating the price sensitivity of gross revenue obtained on initial, pre-deadline borrowing. Combining this with the repayment effects will yield a measure of short-run profitability. Measuring long-term profit implications would require a longer-term experiment or window of observation. Table 9, Column 1 and Figure 4 shows that Lender's gross revenue curve is slightly upward-sloping over the range of interest rates below its standard ones (3.25% to 11.75%). Each 100 basis point drop in the monthly rate reduces gross revenue by R2.6.

Table 9, Column 2 shows that loan defaults increase as interest rates increase. This will occur if there is adverse selection, moral hazard, and/or bad shocks that are difficult for borrowers to smooth (Karlan and Zinman 2005b). The average past due amount falls by R12.2 for every 100 basis point decrease in the interest rate.

Accordingly our results suggest strongly that an interest rate increase would be unprofitable for the Lender. It would produce a "double whammy" of decreased gross revenues due the kink in the demand curve (Figures 2 and 4; Table 3, Column 3) and increased loan losses (Table 9, Column 2). The question remains whether the Lender should cut rates. To estimate the Lender's optimal price we aggregate the revenue and repayment results over the entire sample frame that received rates at or below the Lender's standard ones. The gross revenue result (Table 9, Column 1) implies that a 100 basis point decrease produces R2.6 *less* revenue per existing client.

The default result (Table 9, Column 2) implies that the same interest rate decrease will generate higher repayment (conditional on take-up) of R12.2. With a 7.4% average take-up rate, this implies R0.90 *more* revenue (repayment) per client offered the loan, for a net revenue *decrease* of R1.7 per offered client. Thus unless our measure of default dramatically understates the true cost of default (conversations with the Lender's senior management suggest that this is not the case),<sup>21</sup> our results show that the Lender has no incentive to cut rates in partial equilibrium.

The prospect of strategic responses by competitors further discourages a price decrease. Our experiment likely identifies the upper bound on the price elasticity of demand for the Lender's credit, since the price cuts were unprecedented and short-term. Permanent cuts and/or repeated short-term cuts would be more likely to provoke a response from competitors. This would make the general equilibrium revenue curve relatively steep if in fact some of our short-term borrowers used the partial equilibrium rate cuts to pay off other debt, although recall that the results in Table 7 find no evidence of crowd-out on average.

### **VIII. Maturity Elasticities**

AGK shows that the loan demand of liquidity constrained agents will respond to loan maturity as well as loan price. The intuition for this finding is that longer maturities reduce monthly loan payments, effectively permitting more borrowing (relative to income or asset positions). Consider a client who is borrowing R1,000 to smooth consumption. With a 4-month maturity a low risk client will face an interest rate of 7.75% and a monthly payment of R328. At the same interest rate and monthly payment under a 12-month maturity, she could borrow R2,036. In practice, the Lender's interest rates decrease in maturities, which amplifies the extent to which

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<sup>21</sup> The measure of default used here is the average amount past due over the first 7-12 months of the loan. This will understate the true cost of higher rates on default to the extent that it fails to capture the marginal administrative cost of defaults and/or fails to anticipate future default. It will overstate costs to the extent that some defaults are eventually (partially) cured by the borrower, or (partially) recovered via collection efforts.

longer maturities relax liquidity constraints by decreasing monthly payments further. The tradeoff, however, is that the lifetime level of consumption will drop under longer maturities (assuming that loan amount and maturity do not impact income possibilities), due to larger total financing costs.

In order to estimate maturity elasticities, we engineered exogenous variation in maturity choice in conjunction with the interest rate experiment. This was done via randomly-assigned maturity “suggestions” among clients eligible for longer maturities. The suggestion was delivered in the form of an example loan showing a maturity, loan size (the client’s last loan size), and monthly payment. Clients assigned to the “maturity suggestion” group received a single example loan on their mailer featuring a randomly chosen maturity of four, six, or twelve months. Those randomly chosen for the “no maturity suggestion” group received an analogous but larger table with several loans and maturities. The suggestion assignment was orthogonal to interest rates by construction. All example loans presented were non-binding, with the letter stating beneath the example loan(s): “Loans available in other sizes and terms” (‘term’ refers to ‘maturity’). Loan officers were instructed to ignore the offer letter in underwriting loan applications.

Prior evidence on the psychology of consumer choice in product and financial markets led us to believe that our suggestion would influence maturity choice. Subtle cues have been shown to influence product choice in a durable goods market (Morwitz, Johnson et al. 1993; Fitzsimons and Shiv 2001), and defaults are very powerful drivers of savings decisions (Madrian and Shea 2002).

The example maturity did powerfully predict the actual maturity chosen. Table 10 reports estimates of this first-stage. Both specifications are estimated using OLS and take the form:

$$(2) T_i = \alpha + \beta S_i + \chi R_i + \delta X_i + \varepsilon_{ib},$$

where  $T$  is the maturity chosen (parameterized linearly),  $S$  is the maturity suggestion,  $R$  is a vector of the randomly assigned interest rates ( $r^o$ ,  $r^c$ , and  $D$ ), and  $X$  includes not only risk and wave (per usual) but also the loan size presented in the offer letter’s example loan. We estimate (2) on a



sample that includes only the following clients: the low- and medium- risks (since high-risks are ineligible for longer maturities) who received a randomized maturity suggestion *and* took a loan.<sup>22</sup> This reduces the sample to 493. Table 10, Column 1 reports our highly significant estimate of the suggestion effect. It implies that for each additional month of maturity suggested, the actual maturity increases by 0.11 months. Column 2 reports results obtained from the categorical parameterization of the suggestion (with 4-month the omitted category). The suggestion categories are jointly significant at the 99% level, and it appears that the 12-month suggestion appears to drive the linear effect; in fact, the point estimate on this variable (0.89) implies the same per-month effect (0.11) as the linear case.

Next we use the maturity suggestions to instrument for actual maturity in two-stage least squares (2SLS) regressions that estimate the maturity elasticity of demand for consumer credit. Here loan size is the outcome of interest, and we estimate a second-stage version of equation (2), using S (suggested maturity) to identify exogenous variation in T (chosen maturity). The results are presented in Table 11. The four columns present specifications that vary only by the parameterizations of loan size (level or log) and the suggestion instrument(s) (linear or categorical). All four results are consistent with large maturity elasticities. Column 1 shows our only insignificant result (p-value 0.135), obtained using level loan size and the linear maturity suggestion. Column 3 uses log of loan size and finds that each month of additional maturity increases intensive loan demand by 12.7%. The magnitude and significance are almost identical when the instrumental variables are parameterized categorically (Column 4). Column 2 reports the result using level loan size and the categorical instruments; the marginally significant (p-value 0.07) increase of R231 for each month of maturity represents a 14.7% increase on the mean loan size of R1,570 for this sample.

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<sup>22</sup> As in the analysis of the price sensitivity of maturity choice, we drop those taking the relatively rare one- and eighteen-month maturities from the sample. This excludes only 13 additional observations.

Interpolating, these impacts on loan demand are about twice as large as in AGK, where a one-year lengthening of maturity increases loan demand by 88.5%. This is consistent with credit constraints binding more tightly in the uncollateralized, high risk South African cash loan market than in the collateralized, relatively low risk U.S. auto loan market, an intuitive proposition. As in AGK (which finds insignificant price sensitivity in the full sample), our maturity effect is very large relative to price sensitivity. A 1-month maturity increase has the same effect on level loan size as an 891 basis point decrease in the monthly interest rate (this is calculated by dividing 230.8, the coefficient on maturity in Table 11, Column 2, by 25.9, the coefficient on interest rate in Table 4, Column 2). Loan size decisions are far more sensitive to maturity than to interest rate both here and in AGK.

Table 12 explores heterogeneity in maturity sensitivity. We focus on subgroups that plausibly vary in the degree to which they are liquidity constrained, since maturity elasticities should increase with the severity of these constraints. We find that the maturity elasticity is significant for low-income but not high-income borrowers, as in AGK. There is weaker evidence that young borrowers exhibit more maturity sensitivity than older borrowers.

An alternative (or complementary) explanation to liquidity constraints is that income and age proxy for financial sophistication; i.e, perhaps the poor and inexperienced use a decision rule that lead them to focus on monthly payments rather than interest rates. In conversations with the Lender, they asserted this intuition as well. Note however that the Lender's underwriting rules provide maturity choice only to clients with multiple previous loans and successful repayment histories. Hence, the sample of individuals we study for the maturity elasticity analysis include only these more experienced and successful clients. Regardless, we cannot rule out this interpretation, and hence it seems plausible that both liquidity constraints and lack of sophistication contribute to large maturity elasticities.

## **IX. Conclusion**

This paper has used randomized trials implemented by a South African lender to estimate price and maturity elasticities of demand for consumer credit.

We find downward-sloping but relatively flat demand with respect to price (with no estimates of greater than 0.5 in absolute value) throughout a wide range of prices at and below the Lender's standard rates. Price sensitivity increases with income in our sample, a finding that we and prior literature note is consistent with the presence of liquidity constraints that decrease with income.

We find maturity elasticities that dwarf price elasticities in magnitude and economic significance, on average. But maturity sensitivity is significant only among relatively low-income borrowers; again, this is consistent with liquidity constraints that decrease with income.

Comparing our results to closely related papers yields some interesting similarities and differences. Our core results on price sensitivity find price elasticities that are relatively small in absolute value; however, the sharp kink in the demand curve at the Lender's standard rates illuminates the importance of distinguishing between rate decreases (which dominate our range and density) and increases. Moreover the fact that we find much greater sensitivity to rate *increases*, while Gross and Souleles (2002) finds greater sensitivity to rate *decreases*, suggests that it may be important to distinguish along the extensive margin of ex-ante indebtedness — many in the Gross and Souleles sample had debt outstanding at the time of rate changes, while no one in our sample did. We find some evidence that price sensitivity increases with income, as in Gross and Souleles (2002) and AGK; Dehejia et al (2005) finds the opposite pattern (using wealth rather than income). Our findings on maturity elasticity follow the same qualitative pattern as in AGK, despite seemingly vast differences in market, product, and borrower characteristics across the two samples.

We conclude by noting some implications for microfinance policy and practice. The worldwide microfinance “movement” has been driven largely by NGO innovation and delivery, with the backing of charitable and public subsidies. But as microfinance organizations mature and tout their comparative advantage in lending technologies, they are being pushed toward “sustainability” or “commercialization” [cite]. Many have argued that for-profit microfinance organizations (such as the Lender studied in this paper) provide superior efficiency without sacrificing “outreach” (access to financial services). As (Morduch 2000) [DMM?] notes, this argument rests on the assumption that targeted borrowers (or savers) are insensitive to price. Our paper adds to a small body of evidence that tests this assumption. Further work is needed, with particular focus on marginal borrowers and savers (including entrepreneurs), and on the relative importance of prices, frames, and other loan terms.

Our findings that liquidity constraints appear to bind differentially *within* a microcredit market also bear on the evolution of microfinance policy and practice. Coupled with related evidence on specific market frictions (Karlan and Zinman 2005a), these results suggest that lending to marginal borrowers could be welfare-improving even if it is privately sub-optimal for a lender to focus on outreach. This provides additional motivation for directly testing at the micro level the welfare effects of expanding access to credit.

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Figure 1: Operational Steps of Experiment

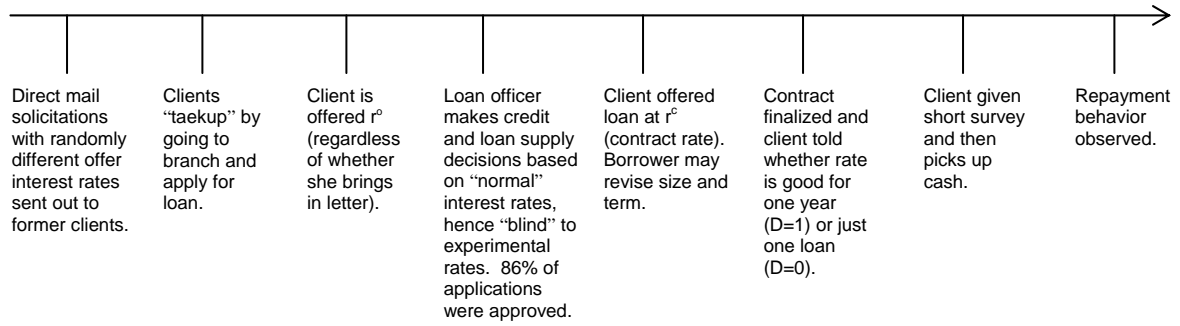


Table 1: Summary Statistics

	Sample:	All (1)	Applied (2)	Borrowed (3)	Eligible for Maturity Suggestion Randomization (4)
Panel A: Experimental variables					
Interest rate		8.029 (2.472)	7.410 (2.371)	7.345 (2.354)	6.440 (1.721)
Dynamic repayment incentive: Rate valid for one year		0.425 (0.494)	0.466 (0.499)	0.470 (0.499)	0.440 (0.496)
Example loan term = 4 months		0.506 (0.500)	0.520 (0.500)	0.522 (0.500)	0.506 (0.500)
Example loan term = 6 months		0.254 (0.435)	0.239 (0.427)	0.233 (0.423)	0.254 (0.435)
Example loan term = 12 months		0.241 (0.428)	0.241 (0.428)	0.245 (0.431)	0.241 (0.428)
Borrowed		0.072 (0.259)	0.856 (0.351)	1.000 -	0.163 (0.370)
Applied		0.084 (0.278)	1.000 -	1.000 -	0.176 (0.381)
Loan size		103.351 (506.430)	1224.956 (1290.813)	1430.744 (1285.177)	269.025 (880.112)
Panel B: Demographic Characteristics					
Female		0.476 (0.499)	0.487 (0.500)	0.487 (0.500)	0.809 (0.997)
Married		0.439 (0.496)	0.450 (0.498)	0.457 (0.498)	0.471 (0.500)
Age		41.174 (11.594)	40.819 (11.235)	40.843 (11.260)	42.206 (10.966)
More educated		0.388 (0.487)	0.409 (0.492)	0.416 (0.493)	0.401 (0.490)
Rural		0.158 (0.365)	0.152 (0.359)	0.149 (0.356)	0.194 (0.396)
Number of dependants		1.547 (1.732)	1.835 (1.742)	1.866 (1.739)	2.220 (1.748)
Gross monthly income		3.410 (20.496)	3.372 (2.115)	3.405 (2.164)	3.549 (4.709)
Number of loans with the lender		4.200 (3.850)	4.820 (4.233)	4.790 (4.231)	5.960 (4.184)
Number of months since last loan with Lender		10.640 (6.823)	6.720 (6.177)	6.305 (5.980)	2.911 (1.578)
Low risk		0.119 (0.324)	0.252 (0.434)	0.273 (0.445)	0.559 (0.497)
Medium risk		0.091 (0.288)	0.188 (0.391)	0.192 (0.394)	0.441 (0.497)
High risk		0.790 (0.408)	0.560 (0.497)	0.535 (0.500)	
Observation		53810	4540	3887	3096

Standard deviations reported in parentheses. More educated equals one if the number of years of education is in highest 40th percentile. Gross monthly income was reported by the client at time of last loan. Sample size varies slightly (between 52594 and 53180) for demographic variables based on availability.

Table 2: Experimental Validation Regressions

	Dependent Variable:	Interest Rate	Applied	Rejected	Borrowed After Deadline
	Specification:	OLS	OLS	OLS	OLS
	Sample:	All	All	Applied	All
		(1)	(2)	(3)	(4)
Interest rate			-0.296***	0.527	-0.013
			(0.100)	(0.515)	(0.063)
Adjusted interest rate lower than interest rate, indicator variable			0.00	0.02	
			(0.00)	(0.01)	
Spread between contract and offer monthly interest rate, basis points			0.00	-0.37	
			(0.11)	(0.54)	
Rate valid for one year, indicator variable			0.02	-0.00	
			(0.01)	(0.02)	
Number of months since last loan with lender		0.001			
		(0.003)			
Number of prior loans with lender, log		0.00			
		(0.01)			
Female		0.02			
		(0.02)			
Number of dependants		0.00			
		(0.01)			
Married		0.02			
		(0.02)			
Age, log		-0.00			
		(0.05)			
Rural		0.02			
		(0.03)			
More educated		-0.01			
		(0.02)			
External credit bureau score, log		0.01			
		(0.01)			
Record exists in external credit bureau		0.04			
		(0.10)			
Internal credit score, log		-0.06			
		(0.13)			
Constant		8.65***	0.09***	0.25***	0.18***
		(0.18)	(0.01)	(0.03)	(0.01)
Observations		53554	53810	4540	53810
R-squared		0.11	0.03	0.04	0.05

Robust standard errors reported in parentheses and are clustered within branch where the loan was processed. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. More educated equals one if the number of years of education is in highest 40th percentile. Controls included for risk category and wave of experiment. "Interest rate" is the randomly assigned interest rate offered in a letter to each individual, and "adjusted interest rate" is the contract interest rate each client received conditional on borrowing. The second rate was announced after the client applied for a loan in the branch of the Lender. In order to measure the presence of information asymmetries, the contract rate was lower than the offer rate for 40% of the individuals. See Karlan and Zinman (2005) for an analysis of these dual rates. We focus on the offer interest rate because this is the rate the client responded to when deciding to apply for a loan.



Table 3: Core Demand Results: Extensive Margin of Price Elasticity Below and Above Standard Rates

Dependent Variable:	Applied	Borrowed	Applied	Borrowed	Borrowed	Borrowed
	Probit	Probit	Probit	Probit	Probit	Probit
Specification:	Lower Rates Only	Lower Rates Only	Higher rates only	Higher rates only	Lower Rates Only	Higher rates only
Sample:	(1)	(2)	(3)	(4)	(5)	(6)
Interest rate	-0.289*** (0.047)	-0.262*** (0.041)	-1.723*** (0.160)	-1.167*** (0.109)	0.042 (0.064)	-1.239** (0.622)
Observations	53178	53178	632	632	53178	632
Mean dependent variable	0.08	0.07	0.07	0.05	0.15	0.18
Pseudo R-squared	0.04	0.05	0.06	0.05		

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. Marginal coefficients reported for probit specifications. Each column presents results from a single estimate of loan demand on the variables listed in the row headings. Interest rate coefficients in Columns 1 through 3 show the effect of a 100 basis point change in the monthly interest rate. The take-up and applied probits show the marginal effects in percentage point terms. Controls included for risk category and wave of experiment.

Table 4: Core Demand Results: Intensive Margin - Loan Size

Dependent Variable:	Loan size	Loan size	Log(Loan size)
Specification:	OLS	OLS	OLS
Sample:	Interest = Adjusted interest rate	Interest = Adjusted interest rate	Interest = Adjusted interest rate
	(1)	(2)	(3)
Interest rate (Log of interest rate in Col 6)	-4.368*** (1.093)	-25.876** (12.994)	-0.113** (0.049)
Constant	71.62*** (9.720)	1,143.21*** (115.440)	7.45*** (0.330)
Observations	31231	2325	2325
Conditional on borrowing:	No	Yes	Yes
R-squared	0.03	0.07	0.06

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. Controls included for risk category and wave of experiment. Units are South African currency (Rand), ~7Rand = US\$1. Column 3 uses log(loan size) and log(interest rate) for the dependent and independent variables, respectively, and hence this result is in elasticity units. Sample size falls for estimates of unconditional loan size, relative to takeup estimates, because we only include applicants that were not randomly assigned a surprise rate reduction upon applying for a loan (see text for details). "Interest rate" is the randomly assigned interest rate offered in a letter to each individual, and "adjusted interest rate" is the contract interest rate each client received conditional on borrowing. The second rate was announced after the client applied for a loan in the branch of the Lender. In order to measure the presence of information asymmetries, the contract rate was lower than the offer rate for 40% of the individuals. Sample restricted to the 60% of cases where the offer rate and adjusted rate were identical because the presence of differential, dual rates might confound interpretation of consumer responses to price in this case.

Table 5: Demand Heterogeneity

	Dependent Variable:	Applied	Loan size	Log(Loan size)
	Specification:	Probit	OLS	OLS
	Sample:	All	All	Borrowed
		(1)	(2)	(3)
Interest rate		-0.628*** (0.188)	-6.969 (4.257)	-0.091 (0.208)
Fraction of a year since last loan		-0.07*** (0.01)	-116.88*** (21.81)	-0.35 (0.48)
Fraction of a year since last loan X interest rate		0.06 (0.11)	6.57*** (2.34)	0.06 (0.07)
Number of previous loans from the lender		0.00 (0.00)	8.67* (4.78)	0.07 (0.08)
Number of previous loans from the lender X interest rate		-0.01 (0.01)	-0.85 (0.53)	-0.01 (0.01)
Female		0.01 (0.01)	39.54 (27.02)	0.41 (0.56)
Female X interest rate		-0.05 (0.09)	-4.23 (2.78)	-0.05 (0.08)
Number of dependants		0.00 (0.00)	-3.04 (8.65)	-0.04 (0.22)
Number of dependants X interest rate		-0.04 (0.02)	0.01 (0.91)	0.01 (0.03)
Married		-0.01 (0.01)	25.96 (26.65)	-0.81 (0.71)
Married X interest rate		0.17* (0.09)	-1.07 (2.86)	0.14 (0.11)
Age		-0.00** (0.00)	-1.92** (0.86)	-0.02 (0.03)
Age X interest rate		0.01* (0.00)	0.20** (0.09)	0.00 (0.00)
Rural		-0.00 (0.01)	-48.92 (36.26)	-0.80 (0.91)
Rural X interest rate		-0.10 (0.14)	3.81 (3.34)	0.10 (0.14)
More educated		0.01 (0.01)	79.21*** (25.47)	-1.31 (0.84)
More education X interest rate		-0.09 (0.10)	-5.08* (2.74)	0.22* (0.13)
Gross Income		-0.00 (0.00)	19.05*** (6.37)	0.57** (0.25)
Gross income X interest rate		0.00 (0.02)	-1.31* (0.67)	-0.07* (0.04)
Constant			137.99*** (39.45)	6.91*** (1.38)
Observations		52954	31082	2304
R-squared			0.04	0.25

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. Controls included for risk category and wave of experiment. More educated equals one if the number of years of education is in highest 40th percentile. Column 3 is a log-log regression (i.e. variables in this regression use log of each variable listed above.)

Table 6: Price Sensitivity, by Proxies for Those Most Likely to Read the Letter

Dependent Variable:	Loan Size	Loan Size	Loan Size	Loan Size
Sample:	Base	Low/medium risk category	Borrowed within last 9 months	More than two loans from the lender
	(1)	(2)	(3)	(4)
Interest rate	-4.501*** (1.04)	-21.304*** (6.154)	-7.689*** (2.065)	-5.519*** (1.864)
Constant	115.440** (34.860)	-394.214 (102.175)	-216.897 (45.847)	157.913 (116.406)
Implied elasticity	-0.33	-0.48	-0.32	-0.32
Observations	31082	6725	14968	16769
R-squared	0.04	0.02	0.03	0.04

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. Column 1 is the same specification as Table 4, Column 1 (the core loan size specification) except we include demographic control variables in order to compare to Columns 2-4. Column 2 restricts the Column 1 sample to low and medium risks only. Column 3 restricts the Column 1 sample to applicants who have borrowed from the Lender recently (fewer than 10 months prior to the mailer). Column 4 restricts the Column 1 sample to frequent borrowers (more than 2 prior loans). Controls included for risk category and wave of experiment.

Table 7: Total Borrowing

Dependent Variable:	Total loan size	Log(Total loan size)	Multiple loans, same lender	Total loan size, outside lender	Log(Total loan size), outside lender	Loan, outside lender
Specification:	OLS	OLS	Probit	OLS	OLS	Probit
Sample:	All	Borrowed	All	All	Borrowed	All
	(1)	(2)	(3)	(4)	(5)	(6)
Interest rate (Log of interest rate in Col 2 and 5)	-7.739*** (2.364)	-0.167*** (0.051)	-0.252*** (0.036)	37.677 (68.025)	0.004 (0.169)	0.031 (0.085)
Rate valid for one year, indicator variable	150.91 (151.840)	-0.03 (0.050)	0.01 (0.010)	-264.83 (261.370)	-0.03 (0.100)	0.00 (0.010)
Constant	783.09*** 74.34	8.63*** 0.35		4031.25*** 729.82	8.91*** 1.12	
Implied elasticity	-0.11	-0.17	-0.4	0.07	0	0.01
Observations	31231	2325	53178	31231	754	53178
R-squared	0.08	0.04		0	0.01	

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. Each column presents results from estimating our base specification for the price sensitivity of loan demand, taking a measure of borrowing through June 15, 2004 (6 months after completion of the experiment) as the outcome of interest. The only modification to the base specification is the addition of a control for the dynamic incentive D. Outside borrowing is measured using credit bureau data (see text for details). Per usual interest rate coefficients in the level (Rand) and takeup (percentage point) specifications are scaled to reflect the effect of a 100 basis point change in the rate. Controls included for risk category and wave of experiment.

Table 8: Maturity Choice

Dependent Variable:	Loan maturity	Binary: Took 6 or 12 Month Loan	Binary: Took 6 or 12 Month Loan
Specification:	Ordered Probit	Probit	Probit
Sample:	Borrowed	All	Borrowed
	(1)	(2)	(3)
Interest rate	-3.493** (1.492)	-0.348*** (0.127)	-1.233** (0.627)
Observations	1780	11145	1790

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. All regressions are run for those who have medium/low risks. Controls included for risk category and wave of experiment. For Column 1, the dependent variables takes one of three values: 4 months, 6 months or 12 months. For Columns 2 and 3, the marginal effects reported for each coefficient.

Table 9: Revenues, Costs, and Loan Pricing

Dependent Variable:	Gross Interest	Average Past Due
Sample:	All	Borrowed
	(1)	(2)
Interest rate	2.553*** (0.438)	12.161*** (3.523)
Constant	-18.168*** (5.459)	53.227* (28.735)
Observations	31231	2325
R-squared	0.02	0.05

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. Columns 1 and 2 present the results obtained when estimating our base specification for price sensitivity using gross revenue and average past due amount as the outcomes of interest, respectively. Per usual the interest rate coefficient is scaled to reflect the effect (in Rand) of a 100 basis point increase in the rate. Controls included for risk category and wave of experiment.

Table 10: Maturity Elasticity 1st-Stage: The Power of Suggestion  
 Dependent Variable: Loan term (4, 6 or 12 months)

	(1)	(2)
Term shown (linear)	0.113*** (0.037)	
Term shown = 6 months, indicator variable		-0.029 (0.236)
Term shown = 12 months, indicator variable		0.886*** (0.290)
Interest rate	-0.122 (0.120)	-0.132 (0.120)
Adjusted interest rate dropped after completion of application	-0.015 (0.105)	-0.006 (0.106)
Rate valid for one year, indicator variable	-0.411* (0.229)	-0.424* (0.226)
Loan amount shown (in thousands)	0.414 ** (0.159)	0.426 *** (0.159)
Constant	5.564*** (0.696)	6.078*** (0.682)
Observations	493	493
R-squared	0.07	0.07

Robust standard errors reported in parentheses and are clustered within branch. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. This table shows the impact of our randomly assigned maturity suggestion on maturity choice. The sample frame includes those who received a suggestion (i.e., an example loan featuring a 4, 6, or 12 month maturity) and took up a loan. In both columns the maturity chosen is the dependent variable, and the suggestion variable(s) is (are) the regressor(s) of interest. In both cases we use OLS and a linear measure of maturity; column 1 uses a linear measure of the suggestion, column 2 a categorical measure (with 4-month the omitted category). The "loan amount shown" was in all cases the client's loan size on their most recent prior loan. Controls included for risk category and wave of experiment. "Interest rate" is the randomly assigned interest rate offered in a letter to each individual, and "adjusted interest rate" is the contract interest rate each client received conditional on borrowing. The second rate was announced after the client applied for a loan in the branch of the Lender. In order to measure the presence of information asymmetries, the contract rate was lower than the offer rate for 40% of the individuals. See Karlan and Zinman (2005) for an analysis of these dual rates. We focus on the offer interest rate because this is the rate the client responded to when deciding to apply for a loan.



Table 11: The Maturity Sensitivity of Loan Demand  
IV

Dependent Variable:	Loan size	Loan size	Log loan size	Log loan size
	(1)	(2)	(3)	(4)
Term	199.038 (131.314)	230.818* (123.533)	0.127** (0.058)	0.125** (0.057)
Interest rate (Log of interest rate in Col 2 and 4)	-50.982 (43.893)	-46.559 (43.720)	-0.274 (0.189)	-0.276 (0.190)
Loan amount (hundreds)	620.137*** (123.103)	606.361*** (116.062)	0.338*** (0.045)	0.339*** (0.044)
Constant	46.249 (789.315)	-154.277 (753.455)	7.033*** (0.841)	7.054*** (0.838)
Instrumental variable	Linear	Categorical	Linear	Categorical
Observations	493	493	493	493
R-squared	0.49	0.51	0.5	0.5

Robust standard errors in parentheses. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. Each column presents an estimate of the maturity elasticity of loan demand, using either level or log loan size as the dependent variable, and either the linear or categorical parameterization of the suggestion as the instrument for maturity. The sample frame and control variable specification are described in the note to Table 9. All regressions control for contracted interest rate and whether or not the rate offered was valid for one year. Controls included for risk category and wave of experiment.

Table 12: The Maturity Sensitivity of Loan Demand: Heterogeneity

	Sample:	Male	Female	Age < 41	Age > 40	Low income	High income
		(1)	(2)	(3)	(4)	(5)	(6)
Term		0.204 (0.157)	0.101 (0.074)	0.216*** (0.056)	0.121 (0.160)	0.224*** (0.076)	-0.107 (0.234)
Interest rate		-0.017 (0.034)	-0.038 (0.037)	0.003 (0.032)	-0.064 (0.064)	-0.037 (0.040)	0.020 (0.050)
Adjusted interest rate dropped after completion of application		0.033 (0.035)	-0.014 (0.034)	-0.018 (0.032)	0.042 (0.052)	0.032 (0.029)	-0.043 (0.051)
Rate valid for one year, indicator variable		-0.090 (0.097)	0.028 (0.071)	-0.179** (0.087)	0.049 (0.090)	0.054 (0.068)	-0.197 (0.120)
Last loan size		0.298*** (0.053)	0.209*** (0.074)	0.169** (0.079)	0.276*** (0.054)	0.276*** (0.099)	0.382*** (0.135)
Number of months since last loan with Lender		0.018 (0.057)	0.004 (0.033)	0.015 (0.033)	0.019 (0.039)	-0.017 (0.026)	-0.055 (0.081)
Number of previous loans with the lender		-0.015 (0.013)	-0.001 (0.008)	-0.001 (0.009)	-0.006 (0.007)	-0.002 (0.008)	-0.003 (0.014)
Constant		4.620*** (1.255)	5.671*** (0.551)	5.506*** (0.496)	5.777*** (1.168)	5.199*** (0.762)	5.488*** (1.514)
Observations		252	241	245	248	247	246
R-squared		0.55	0.56	0.49	0.60	0.55	

\* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. These results are obtained by taking our base specification for estimating the maturity sensitivity of log(loan size), adding the demographic controls used the analysis of price sensitivity heterogeneity, and then splitting the sample along a remaining characteristic of interest. The sample frame and units are identical to those used in Tables 10 and 11 (see Table 10 for description). "Interest rate" is the randomly assigned interest rate offered in a letter to each individual, and "adjusted interest rate" is the contract interest rate each client received conditional on borrowing. The second rate was announced after the client applied for a loan in the branch of the Lender. In order to measure the presence of information asymmetries, the contract rate was lower than the offer rate for 40% of the individuals. Regressions also control for individual characteristics: education, age, number of dependants, married, gross income, province, risk category and wave of experiment.

Appendix Table 1: Reconciliation of Sample Frames

	<u>Frequency</u>	<u>Total</u>
Sample frame reductions for this paper:		
Total letters mailed	58,168	58,168
Flat or upward sloping yield curve between 4, 6 and 12 month loan offers	3,000	55,168
Mail returned by postal service	1,358	53,810
Offer interest rate higher than normal rate	632	53,178
Number of observations available for analysis		53,178
Number of loan applicants		4,540
Number of loan applicants with offer interest rate higher than normal rate		42
Number of loan applicants with offer interest rate equal or lower than normal rate		4,498
Number of approved loan applicants		3,887
Number of approved loan applicants with offer interest rate higher than normal rate		32
Number of approved loan applicants with offer interest rate equal or lower than normal rate		3,855
Number of individuals eligible for multiple terms and shown one and only one term suggestion		3,096
Number of loans made to individuals eligible for multiple terms and shown one and only one term suggestion		493
Sample frame reductions for information asymmetry paper		
Total letters mailed	58,168	58,168
Offer interest rate higher than normal rate	635	57,533
Number of observations available for analysis		57,533
Sample frame reductions for psychology paper		
Total letters mailed	58,168	58,168
Pilot letters excluded (did not include psychology treatments)	4,974	53,194
Number of observations available for analysis		53,194

Sample reductions are demonstrated sequentially (e.g., 1423 had mail returned by the postal service, but 65 of those were already removed due to the flat or upward sloped yield curve. Individuals with flat or upward sloping yield curves were randomly chosen, and were removed from analysis since for those who did not borrow it is impossible to infer which rate they rejected. The information asymmetry paper is "Observing Unobservables: Identifying Information Asymmetries with a Consumer Credit Field Experiment" (Karlan and Zinman, 2005). The psychology paper is "What's Psychology Worth? A Field Experiment in Consumer Credit" (Bertrand, Karlan, Mullainathan, Shafir and Zinman, 2005).

Appendix Table 2. Frequency of Monthly Offer Interest Rates

Rate	Low Risk		Medium Risk		High Risk		Total	
	Freq.	Perc.	Freq.	Perc.	Freq.	Perc.	Freq.	Perc.
3.25	119	1.85%	76	1.55%	575	1.35%	770	1.43%
3.49	171	2.66%	64	1.31%	738	1.74%	973	1.81%
3.50	220	3.42%	90	1.84%	525	1.24%	835	1.55%
3.75	32	0.50%	18	0.37%	53	0.12%	103	0.19%
3.99	224	3.49%	66	1.35%	735	1.73%	1,025	1.90%
4.00	166	2.58%	73	1.49%	512	1.20%	751	1.40%
4.25	40	0.62%	21	0.43%	59	0.14%	120	0.22%
4.44	162	2.52%	57	1.16%	475	1.12%	694	1.29%
4.49	247	3.84%	84	1.72%	752	1.77%	1,083	2.01%
4.50	146	2.27%	82	1.67%	578	1.36%	806	1.50%
4.75	45	0.70%	22	0.45%	60	0.14%	127	0.24%
4.99	122	1.90%	73	1.49%	691	1.63%	886	1.65%
5.00	234	3.64%	96	1.96%	532	1.25%	862	1.60%
5.25	45	0.70%	19	0.39%	67	0.16%	131	0.24%
5.49	206	3.21%	90	1.84%	681	1.60%	977	1.82%
5.50	348	5.42%	77	1.57%	587	1.38%	1,012	1.88%
5.55	265	4.13%	71	1.45%	497	1.17%	833	1.55%
5.75	46	0.72%	20	0.41%	74	0.17%	140	0.26%
5.99	307	4.78%	134	2.74%	689	1.62%	1,130	2.10%
6.00	374	5.82%	108	2.21%	577	1.36%	1,059	1.97%
6.25	49	0.76%	23	0.47%	74	0.17%	146	0.27%
6.50	325	5.06%	103	2.10%	595	1.40%	1,023	1.90%
6.75	353	5.50%	122	2.49%	546	1.29%	1,021	1.90%
6.99	294	4.58%	141	2.88%	755	1.78%	1,190	2.21%
7.00	405	6.30%	186	3.80%	824	1.94%	1,415	2.63%
7.25	325	5.06%	161	3.29%	810	1.91%	1,296	2.41%
7.49	357	5.56%	167	3.41%	992	2.33%	1,516	2.82%
7.50	337	5.25%	181	3.70%	827	1.95%	1,345	2.50%
7.75	349	5.43%	169	3.45%	882	2.08%	1,400	2.60%
7.77	0	0.00%	184	3.76%	801	1.89%	985	1.83%
7.99	0	0.00%	143	2.92%	1,000	2.35%	1,143	2.12%
8.00	4	0.06%	157	3.21%	866	2.04%	1,027	1.91%
8.19	0	0.00%	152	3.10%	995	2.34%	1,147	2.13%
8.25	6	0.09%	25	0.51%	73	0.17%	104	0.19%
8.50	4	0.06%	177	3.62%	808	1.90%	989	1.84%
8.75	13	0.20%	35	0.71%	82	0.19%	130	0.24%
8.88	0	0.00%	196	4.00%	787	1.85%	983	1.83%
8.99	0	0.00%	169	3.45%	1,010	2.38%	1,179	2.19%
9.00	5	0.08%	199	4.06%	848	2.00%	1,052	1.96%
9.25	13	0.20%	202	4.13%	868	2.04%	1,083	2.01%
9.49	0	0.00%	193	3.94%	1,128	2.65%	1,321	2.45%
9.50	5	0.08%	37	0.76%	88	0.21%	130	0.24%
9.69	0	0.00%	155	3.17%	1,172	2.76%	1,327	2.47%
9.75	9	0.14%	214	4.37%	866	2.04%	1,089	2.02%
9.99	0	0.00%	0	0.00%	1,217	2.86%	1,217	2.26%
10.00	0	0.00%	1	0.02%	1,211	2.85%	1,212	2.25%
10.25	8	0.12%	3	0.06%	1,239	2.92%	1,250	2.32%
10.49	0	0.00%	0	0.00%	1,451	3.41%	1,451	2.70%
10.50	4	0.06%	6	0.12%	1,242	2.92%	1,252	2.33%
10.75	6	0.09%	4	0.08%	93	0.22%	103	0.19%
10.99	0	0.00%	0	0.00%	1,364	3.21%	1,364	2.53%
11.00	5	0.08%	2	0.04%	1,347	3.17%	1,354	2.52%
11.11	0	0.00%	0	0.00%	1,308	3.08%	1,308	2.43%
11.19	0	0.00%	0	0.00%	1,463	3.44%	1,463	2.72%
11.25	10	0.16%	2	0.04%	104	0.24%	116	0.22%
11.50	3	0.05%	0	0.00%	99	0.23%	102	0.19%
11.69	0	0.00%	0	0.00%	1,392	3.28%	1,392	2.59%
11.75	16	0.25%	5	0.10%	1,349	3.17%	1,370	2.55%
12.00	0	0.00%	2	0.04%	19	0.04%	21	0.04%
12.25	0	0.00%	4	0.08%	65	0.15%	69	0.13%
12.50	0	0.00%	2	0.04%	7	0.02%	9	0.02%
12.75	0	0.00%	2	0.04%	52	0.12%	54	0.10%
13.00	0	0.00%	5	0.10%	11	0.03%	16	0.03%
13.25	0	0.00%	8	0.16%	65	0.15%	73	0.14%
13.50	0	0.00%	3	0.06%	10	0.02%	13	0.02%
13.75	0	0.00%	15	0.31%	59	0.14%	74	0.14%
14.00	0	0.00%	0	0.00%	11	0.03%	11	0.02%
14.25	0	0.00%	0	0.00%	65	0.15%	65	0.12%
14.50	0	0.00%	0	0.00%	14	0.03%	14	0.03%
14.75	0	0.00%	0	0.00%	79	0.19%	79	0.15%
	6,424	100.00%	4,896	100.00%	42,490	100.00%	53,810	100.00%