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**FINANCIAL INTEGRATION AND
DEVELOPMENT
IN SUB-SAHARAN AFRICA:
INFORMAL FINANCE SECTOR
IN MALAWI**

C. Chipeta
and
M. L. C. Mkandawire

29 JAN 96

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Working Paper 85

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IN SUB-SAHARAN AFRICA:
INFORMAL FINANCE SECTOR
IN MALAWI**

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**Report of a study sponsored by the World Bank Research Committee
and Administered by the Overseas Development Institute**

January 1996

ISBN 0 85003 226 1

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Preface

As part of Structural Adjustment Programmes, many governments in sub-Saharan Africa initiated a large-scale restructuring of the financial system in the 1980s. Emphasis in these programmes was placed on the need i) to adopt financial liberalisation measures, and ii) to enhance regulatory and supervisory functions to ensure prudence of the financial institutions. Special Financial Sector Adjustment loans have been taken up to uphold reform measures and to restructure and strengthen distressed financial systems in several African countries. An improved regulatory environment with enhanced supervision is underscored in these operations, while the recent literature on the subject points to the need for careful design of the sequence, pace and timing of financial liberalisation and the importance of its coordination with changing macroeconomic conditions.

However, financial reform has at best had limited *developmental* effect in the region so far. It has been increasingly recognised that adoption of financial liberalisation policy alone has not been sufficient to generate a strong response in terms of increased savings mobilisation and intermediation through the financial system, wider access to financial services, and increased investment by the private sector. Fragmentation of financial markets persists, impeding efficient resource mobilisation and financial intermediation.

Given this background, a research project on 'Financial Integration and Development in Sub-Saharan Africa' has been undertaken at ODI, with financial support from the World Bank Research Committee, to examine the performance of financial systems for resource mobilisation and intermediation for economic development in sub-Saharan Africa. Field work has been conducted in Ghana, Malawi, Nigeria and Tanzania, based on common questionnaires addressed to formal, semi-formal and informal institutions and borrowers. The main objectives of the research were:

- i) to investigate the nature and degree of fragmentation and segmentation of financial markets in sub-Saharan Africa;
- ii) to examine the sources of segmentation against several theoretical paradigms and evaluate the conditions under which linkages between segments utilise the comparative advantages of each, and obstacles to such linkages;
- iii) to examine operational constraints facing formal financial institutions and informal associations/lenders;
- iv) to evaluate the effects of financial liberalisation on the whole financial system; in particular, to provide understanding of the impediments to financial deepening in Africa and the extent to which they can be relieved

through financial liberalisation and through active policies of positive interventions, technical assistance and infrastructure that support market development by facilitating information flows and lowering transaction costs and risks;

- v) to help the design of long-term policies towards financial sector development, and evaluate which policy and institutional measures can most effectively accelerate the financial system's ability to mobilise resources and intermediate between saving and investment. for broad-based development in Africa.

The present paper is one of a series that will provide initial presentation of results of the country case studies. It presents the *Malawian* case study, reporting the results of the field work on the behavioural characteristics of *informal* financial organisations/agents and the operational constraints in urban and rural areas.

Machiko Nissanke
Project Co-ordinator

May 1995

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1. Introduction

The broad consensus is that fragmentation of the financial sector in Africa has impeded the mobilisation of financial resources and restricted financial intermediation. This lack of integration can be attributed to historically repressive financial policies and, structural and institutional factors that have thwarted economic and financial development. In many African countries reforms have sought to remove these constraints by reducing direct government controls on the financial sector, but they have had only limited success. Even more problematic is the dearth of systematic research on this fragmentation in Africa, particularly on the structural and institutional bottlenecks that need to be removed in order to ensure greater interaction among the formal, semi-formal, and informal segments of the financial sector.

This study of informal finance in Malawi is part of a larger study on its financial sector. Similar studies on Ghana, Nigeria, and Tanzania are currently under way to facilitate cross-country comparisons. The overall project is investigating how obstacles to financial market integration and improved intermediation in sub-Saharan Africa can be overcome, and what policy, structural, and institutional reforms are necessary for this. The premise of the project is that efforts to liberalise the formal financial sectors of these countries will not be sufficient by themselves to create a well-integrated financial market and thus greater economic development. What must be dealt with first are the structural and institutional bottlenecks that prevent the effective mobilisation of resources and their more equitable allocation.

1.1 Conceptual origins

At the heart of this study are various explanations of the fragmentation of the financial sector, in other words financial dualism. Among them are the financial repression hypothesis (McKinnon, 1973; Shaw, 1973; Fry, 1988), which suggests that restrictive interest-rate policies and credit controls shift resources away from the market to the government and thus create parallel markets, and the imperfect information hypothesis (Hoff and Stiglitz 1990), whereby differences in the costs and characteristics of different types of transactions may lead to specialisation within financial markets. Other theories focus on institutional weaknesses within the financial system itself – in particular, how the inadequacy of the legal infrastructure affects the costs and risks associated with enforcement and thus the perceptions of risk among lenders.

Evidence of segmentation and fragmentation in the financial sector of Malawi is

seen in the wide variation in relative prices and the restricted flow of resources throughout the economy. This study investigates the existence of this segmentation and fragmentation, and the reasons why financial liberalisation has not by itself been effective in achieving integration and deeper financial intermediation.

1.2 Objective of the study

This study focuses on the structural and institutional constraints that exist both among the informal, semi-formal, and formal segments of the financial sector in Malawi and within the informal financial sector itself. The objective is to evaluate alternative policy interventions that will help to expand and accelerate the intermediation process by reducing fragmentation within the entire financial sector.

The study seeks to create a better understanding of the operational characteristics of the informal sector and how it differs from the formal sector. It is based on a comprehensive set of data on various types of informal lenders and borrowers, differentiated by urban and rural area. The data covers such aspects as the processes used to mobilise savings and lending, the costs of such practices and how they translate into the prices of financial services, the impact of these processes and costs on the quality and quantity of products, and how the processes, costs, and products of the informal sector differ from those of the formal sector.

2. Methodology

Field work on the informal financial sector in Malawi began in March 1993 and continued into May. The questionnaire was pre-tested in February of the same year.

2.1 Sampling procedures

The sample of informal financial institutions was chosen to yield a representative range of institutions: moneylenders (*katapila*), traders, estate owners (landlords), savings and credit associations (SCAs), co-operative savings associations (CSAs), and community funds (CFs). This range of institutions is comparable to those used in the other country studies. Neither the environment nor the names of individual operators were known in advance. The sample was broken down by urban and rural area. Urban institutions are those operating in Blantyre, Lilongwe, Mzuzu, and Zomba; according to the 1987 Census, their populations were 333,120, 223,318, 44,217, and 43,250, respectively. Rural informal institutions are those operating in areas outside these urban centres. Malawi does not have distinct economic regions; the survey did not therefore make any regional distinctions. Nor did it use ethnicity or religion as distinguishing features. Table 1 presents the distribution of the sample by type of institution and urban/rural area.

2.2 The data

The questionnaire for informal lenders provides three broad sets of data. One set gives information on the characteristics of the deposits of various informal financial institutions, including the number of depositors from 1990 to 1992, categorised by type of account. This data enabled us to assess how informal lenders generate their assets, and to match their assets with their liabilities. Another data set covers the characteristics of loans, including information on loan applications and their approvals, to provide rough clues about the situation with regard to supply and demand. This data also yields information on loan sizes for different categories of borrowers as well as maturities, interest rates, and other transaction fees. All the data covers a 3-year period, and yields some insight into the dynamics of loan transactions.

The third set of data covers the different information bases used by informal lenders in providing loans, as well as loan transaction and other costs. The questionnaire also broke this data down into different categories of borrowers.

Table 1 **Distribution of informal financial institutions**

	<i>Urban</i>	<i>Rural</i>	<i>Total</i>	
	<i>Number in subsample</i>	<i>Number in subsample</i>	<i>Number in subsample</i>	<i>% of total sample</i>
Moneylenders	14	9	23	32.9
Traders	7	4	11	15.7
Estate owners	0	18	18	25.7
Savings and credit associations	7	2	9	12.8
Co-operative savings associations	1	2	3	4.3
Community funds	3	3	6	8.6
Total	32	38	70	100.0

Note: The relatively small number of SCAs, CSAs and CFs in the sample is due to the difficulty in gaining access to their accounts.

Source: Calculated from survey data.

The loan transaction process consists of screening, monitoring, and contract enforcement; for each component, we established what information is used, whether it is adequate and how the information is obtained. To estimate the average administrative cost per kwacha loaned, we used figures on personnel, transport, and stationery costs, disaggregated by categories of borrowers. By comparing these figures across different informal institutions, appropriate correlations can be drawn between the various structures of lending institutions and the costs they incur in transacting loans.

2.3 Analysis

Frequency distributions, proportions and means of relevant variables, and other descriptive statistics were used to analyse the data. To test for the significance of differences in the proportions or means of comparable variables drawn from different samples, t-tests or Chi-square tests were used. All tests for significant differences were made at the 5% level. We also used cross-tabulations to establish the correlation between each type of informal financial unit and its urban/rural location and other relevant characteristics. Two-way analysis of variance based on F statistics was used to compare the means of categories of variables for types of lenders and by urban/rural location. The formula is as follows:

$F^* = \text{MSTR}/\text{MSE}$ where MSTR = Mean Square Treatment
MSE = Mean Square Error

$$= \frac{\{\sum\sum n_j(Y_{ij} - Y_{\dots})^2\}/k-1}{\{\sum\sum\sum(Y_{ijk} - Y_{ij})^2\}/N-k}$$

where Y_{ijk} is the k^{th} observation of the i^{th} level of the first factor (bank type) and the j^{th} level of the second factor (type of enterprise); $Y_{ijk} = \sum Y_{ijk}/n$ is the mean for the treatment corresponding to the i^{th} level of the first factor (bank type) and the j^{th} level of the second factor (type of enterprise); and $Y_{\dots} = \sum\sum\sum Y_{ijk}/N$ is the grand mean.

3. The literature on informal finance in Malawi

In recognition not only of the existence of an informal financial sector, but also of its potential in generating economic growth under a more liberalised financial environment, researchers as well as developmental planners have begun to focus on the size, characteristics, and economic role of the sector. While developmental planners are interested in how the informal and formal financial sectors can be integrated to improve financial services to small-scale and micro-enterprises (SMEs), researchers have concentrated on the types of informal lending institutions that exist, why they are segmented from the formal sector, and why fragmentation persists among them.

3.1 Types of informal institutions

A comprehensive study of the informal financial sector in Malawi recently found several different types of institutions involved in the sector (Chipeta and Mkandawire, 1991). They can be classified into individuals, associations, business firms, and governmental and non-governmental organisations (Chipeta, 1990). The common feature among these lenders is that they are not subject to registration or licensing procedures, or to monetary and financial policy control.

Legally, however, the literature seems to suggest that both customary and modern law recognise informal finance and provide adequate protection to both informal lenders and informal borrowers. One expert legal opinion is that, in relation to moneylenders, only the principal debt is enforceable in the traditional courts, but that under tribal law both the loans and the guarantor's obligations are enforceable (Chimango, 1977). In practice, however, courts are rarely used by moneylenders and other lenders to recover loans (Chipeta and Mkandawire, 1991). The present study may throw light on why this is the case.

In modern law, the literature states that the existence of informal lending activities is acknowledged through the 1934 Loans Recovery Act (Cap. 6.04) of the Laws of Malawi which is intended to limit hardship inflicted on borrowers by high rates of interest. The Act itself does not specify the type of informal lenders, who could be individuals, traders or SCAs. Another relevant piece of legislation is the Co-operative Societies Act (Cap. 47.02) of 1946. Although it is meant for registered societies, the Act could also apply to SCAs, CSAs and CFs whose objectives are similar to those of registered societies.

3.2 Segmentation in the financial market

The literature attributes the existence of financial dualism in Malawi to a history of repressive financial policies, to the structural and institutional advantages of informal lenders, and to independent, culturally related determinants. Financial repression has taken the form of government control over the volume and direction of bank credit as well as over interest rates, which, due to inflation, have been negative in real terms (Chipeta and Mkandawire, 1991). In response to the economic deterioration wrought by these policies, Malawi implemented Structural Adjustment Programmes which included several financial and monetary reforms. First, the deposit rates of non-banking financial institutions were freed from control in 1988. In 1990, the deposit and lending rates of banks and non-banks were liberalised; they were to be set according to changes in the bank rate. In 1991, ceilings on bank lending were eliminated; credit limits were to be set according to the variations in the liquidity of cash reserve ratios and open-market operations. Nevertheless, despite these reforms, the banking sector retains an oligopolistic structure. Moreover, growth in the mobilisation of domestic resources and the ratio of monetary aggregates to GDP has been limited, and access to bank credit by small and medium-scale enterprises has not increased appreciably (Malawi Government, 1993).

The literature suggests several structural determinants of the existence of informal finance: credit services that suit the needs of borrowers, including the simplicity and speed of loan procedures; personal collateral guarantees that are consistent with the capacity of borrowers; the absence of controls on how loans can be used; high nominal rates of interest on deposits and loans; and low administrative and transaction costs (Chipeta and Mkandawire, 1991). High nominal interest rates on loans are charged only by moneylenders, savings and credit associations, and community funds; high rates for deposits are offered only by SCAs. Other informal lenders charge lower rates of interest or none at all. The reason why moneylenders, SCAs and CFs charge higher nominal rates of interest than formal lenders has been the subject of several investigations. High rates of interest cannot be explained by the opportunity cost of lending, which is low, in Malawi (*ibid.*). Nor can they be due to the high administrative costs of lending, because the interest received is several times the cost of administering a loan and thus, bears little relationship to it (Bolnick, 1990). This suggests that merely reducing loan screening, monitoring and enforcement costs may not be enough to reduce high informal rates of interest. It also suggests that rigorous analysis is required to gain an adequate understanding of interest rate determination.

The literature on loan security indicates that, informal lenders have developed effective ways to secure loans other than by requesting collateral. Guarantees by borrowers or their relatives, co-signatures, and the withdrawal of credit facilities are normally used by moneylenders to secure loans, and these methods are believed to be quite effective. Although property is not normally a security pledge, lenders can

confiscate borrowers' property in the event of default (Chipeta and Mkandawire, 1991).

Associations ensure loan security by selecting their members prudently (often confining membership to workmates, friends, and neighbours). They can also rely on group pressure, as well as occasionally on the incomes and savings of individual members.

The absence of integration between the formal and informal financial sectors persists primarily because the formal sector has no incentive to expand its lending operations to small enterprises. As such, the flow of funds and transaction information between the sectors is severely restricted. Institutionally, formal (and semi-formal) financial institutions have little dealing with informal financial institutions or other small-scale and micro enterprises, because it is not their legal mandate to do so. In other words, their target group historically and intentionally excludes SMEs (Malawi/USAID, 1987).

The literature recognises the absence of links between the formal and informal sectors. In short, the direct credit links of the informal financial sector with the formal financial sector are insignificant, as are their direct deposit links. Among the few significant direct links is that between moneylenders and formal financial institutions (Chipeta and Mkandawire 1992). What persists in Malawi is in fact financial dualism, an extreme form of fragmentation into formal and informal sectors that have different relative prices and whose interchange of information and resources is restricted.

3.3 Fragmentation within the informal sector

Beyond the segmentation of the financial sector in Malawi, the market is fragmented overall, consisting of multiple financial institutions serving clients with different characteristics and needs. In the formal sector, for example, all financial institutions, apart from commercial banks and the Post Office Savings Bank, operate only in urban areas. Among semi-formal financial institutions, only the savings and credit co-operatives (SACCOs) serve both urban and rural areas; the rest operate specifically either in urban or rural areas.

This fragmentation also flows over into the informal sector. For example, associations accept contributions or deposits only from their membership, to whom they also largely confine their lending. Estate owners lend only to their tenants. Friends lend only to their friends; neighbours to neighbours; and kinspeople to their relatives. Thus, 'segmentation' – which may help achieve efficiency as units become specialists in different market niches (Von Pischke, 1991) – becomes fragmentation when integration among different units is absent. In the absence of

integration, prices and terms for comparable transactions and risks vary widely, and the extent to which clients may choose freely among institutions is restricted.

3.4 Integrating the sectors

What must be done to integrate the formal and informal financial sectors? Clearly, financial liberalisation alone will not be enough. The literature has suggested that each sector should become associated with the activities of the other, cross-adopting appropriate techniques. It has also been suggested that the informal sector should deposit surplus funds with the formal sector, and meet its requirements for extra resources by borrowing from the latter (Chipeta and Mkandawire, 1991).

Some progress along this front has already been made. One commercial bank has agreed to on-lend to micro and small-scale enterprises (including informal financial institutions), with resources to be made available by the UNDP under a poverty reduction programme. Depending on the success of this experiment, the commercial bank may lend its own resources in the future to this target group.

Proposals have also been made for a rural financial services project, that contains a provision for extending formal financial sector credit to the informal sector. Group liability would be the primary security for guaranteeing this credit. As an incentive, formal institutions would be able to charge a higher rate of interest on loans than they normally charge their borrowers.

4. The structure of informal financial institutions

4.1 Some personal characteristics of informal lenders

Age. Sixty of the 70 informal lenders surveyed stated their age; their mean age was 37.9 years. Thus, the typical informal lender is nearing middle-age and is at the most active stage of his or her career. The mean age of moneylenders and traders, estate owners, and leaders of CSAs, SCAs and CFs does not vary significantly; the low was 34.8 years of age among traders and the high was 42.3 years of age among estate owners. The mean age of leaders of associations in rural areas was higher than that of their urban counterparts, while the mean age of moneylenders and traders in rural areas was lower than that of their urban counterparts. But the differences among mean ages in urban and rural areas were not significant.

Education. Sixty-seven of the informal lenders had been to school. The average level of education was the junior school certificate. The mean number of years spent in school was 11.5, implying that most of the sample had completed at least primary school, and that some had attended post-primary school. Thus, they would be expected to be able to keep simple records of financial transactions. Moneylenders spent fewer years in school on average, and leaders of associations spent more years in school, possibly reflecting the fact that associations are well-organised institutions that require proper management. The urban and rural means did not differ significantly from the sample mean. However, F-statistics indicated that the sample means differ significantly from each other, as do the urban and rural means. The type of lender accounted for more of the variation than did its urban or rural location.

Gender. The sample was dominated by males, constituting 82.6% of the sample. Because women do not normally own estates, all estate owners in the sample were male. The number of women who were leaders of other informal institutions was significant only among traders, SCAs and CSAs.

4.2 Deposit characteristics

Whether located in urban or rural areas, few of the moneylenders, traders, and estate owners in the sample accepted deposits, whereas in both urban and rural areas, SCAs, CSAs and CFs do receive contributions (from deposits).

Deposit amounts and number of depositors. The mean sum mobilised by the SCAs surveyed increased from K623 in 1989 to K902 in 1991; among the CSAs,

Table 2**Total and per capita deposits in Kwacha 1989-91**

<i>Type of Association</i>	<i>1989</i>			<i>1990</i>			<i>1991</i>		
	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>
Savings and credit associations									
Total	623	435	1,000	667	627	785	902	831	1,080
Per capita	48	29	100	39	31	98	47	38	108
Co-operative savings associations									
Total	N/A	N/A	N/A	1,280	2,200	360	1,515	2,640	390
Per capita	N/A	N/A	N/A	116	220	30	138	240	30
Community funds									
Total	738	650	870	936	923	955	1,060	1,010	1,135
Per capita	N/A	N/A	N/A	49	38	73	41	39	57

Source: Calculated from survey data.

it increased from K1,280 in 1990 to K1,515 in 1991; and among the CFs from K738 in 1989 to K1,060 in 1991 (Table 2). During this period, the rate of inflation was relatively low (11-12%), thus increasing these deposits in real terms. Per capita contributions in CFs declined, and in SCAs they remained constant. The increase in total contributions was thus due to an increase in membership: in CFs (from a mean of 19 to 24, or by 26%) and in SCAs (from a mean of 13 to 19, a growth rate of 46%). In contrast, mean membership in CSAs increased only slightly, from 11 in 1990 to 12 in 1991 (Table 3). Consequently, the increase in total contributions was primarily due to an increase in per capita contributions from K116 in 1990 to K126 in 1991. However, differences among mean contributions and among the mean number of depositors were not significant.

Table 3 Mean number of depositors per association

<i>Type of Association</i>	<i>1989</i>			<i>1990</i>			<i>1991</i>		
	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>
Savings and credit associations	13	15	10	17	20	8	19	22	10
Co-operative savings associations	14	16	12	11	10	12	11	11	13
Community funds	N/A	N/A	N/A	19	24	13	26	26	20

Source: Calculated from survey data.

Among SCAs and CFs, the number of depositors was lower in rural areas than in urban areas in 1991. But mean total contributions were higher in rural than in urban areas, implying that per capita contributions tend to be higher in rural areas where people have a marginally greater propensity to save.

The increase in membership in SCAs, CSAs, and CFs and the increase in aggregate contributions between 1989 and 1991 suggest that the informal financial sector is growing.

Seasonality of deposits. The flow of deposits into CSAs does not fluctuate annually, because contributions are fixed. In SCAs and CFs it does. Peak contributions in SCAs are bimodal, occurring in October for some SCAs, and in April for others. These are the months in which SCAs are reconstituted after previously accumulated funds have been distributed. Since the funds have been depleted, large deposits are made at the beginning of the next cycle to reconstitute

the lending base. Contributions are lowest in July and December among SCAs, and in June among CFs. Because accumulated funds are distributed in June and July, many SCAs have no need to accept deposits. Why this monthly pattern applies also to CFs is difficult to determine. In December, the demands of Christmas shopping limit the contributions made by members of both SCAs and CFs. The mean disparity between total deposits in the peak and trough months is 80% among SCAs, 95% among CSAs, and 99% among CFs. These mean disparity ratios do not differ significantly.

These findings provide evidence that savings in informal financial institutions are volatile. This volatility may be a determinant of the preference for short-term and flexible forms of savings. Mean per capita savings are also quite small. Mean per capita annual savings among SCAs were K48. Among CFs, they were also low, and fell from K53 in 1989 to K44 in 1991. Among CSAs, per capita savings increased from K116 in 1990 to K126 in 1991.

4.3 Characteristics of lending operations

One feature that distinguishes informal lenders from formal financial institutions is their low capital base and their inability to expand it because they lack access to formal finance. SCAs reported a mean capital sum of K902.14 in 1991, CSAs a mean of K1,515, and CFs a mean of K1,010. The mean capital base among rural SCAs and CFs was higher than that of their urban counterparts, due possibly to a greater marginal propensity to save among rural dwellers. The mean capital base among rural CSAs was smaller than that of their urban counterparts. However, variation among mean capital bases was not significant.

Start-up and ongoing capital. The main source of start-up capital for SCAs, CSAs and CFs was the contributions or deposits of members. The main sources of start-up capital for moneylenders, traders, and estate owners were personal savings or earnings from other activities. Only two informal lenders in our sample had access to bank loans for start-up capital; only one informal lender had access to informal sources. The current main source of capital for all informal institutions in the sample is thus profits. Other economic activities were also cited as sources, but minor ones. Only one informal lender had access to bank loans as a current source of capital; none had access to informal loans. Thus, there is evidence of fragmentation both between segments and among informal units themselves.

Most of the institutions reported that their capital base had grown, an indication of the growth of informal lending despite the fact that the formal financial sector has been liberalised. The mean rate of growth was 73%. Traders had the highest mean rate of capital growth at 99%, and estate owners and community funds the lowest, at 57%. Variations in the mean rates of capital growth are not significant.

Lending activity. Lending is a part-time activity among SCAs, CSAs, CFs and

moneylenders. Some traders and estate owners indicated that they engage in lending full-time. The mean time devoted to lending by all institutions was 25%. Variations in mean times devoted to lending are significant, and are caused by the type of lender. Competition existed among lenders in their local areas, with traders facing the greatest number of competitors. But variations in the mean number of competitors are not significant.

Almost 90% of informal lenders reported extensive fluctuations in loan applications. The peak demand was in January, due to demands for farming inputs, to household needs after Christmas spending, and to the demand for purchased food when foodstocks are low. The smallest number of loan applications is in July, when those demands are low. The mean disparity in loan applications between the peak and trough months was 64%. The highest disparity, 103%, was among estate owners; the lowest, 25%, among CFs. Variations in the mean disparity ratios are significant, and are caused by both type of lender and urban/rural location.

4.4. The characteristics of usual borrowers

One factor possibly influencing the transaction costs of borrowers is the cost of transport to and from lenders. It is noteworthy that more than 75% of usual borrowers lived in the same locality as the informal lenders from whom they received loans. Among non-resident borrowers, distances from estate owners and traders were greatest in rural areas. Otherwise, the mean distances to lenders in urban and rural areas were the same (9 km). For SCAs and CFs, which lend largely only to their members, the distances were shortest, but the variations in mean distances are not significant.

Public servants constituted the single largest category of borrowers, at 40%; they used their loans primarily to purchase consumer goods. Farmers, traders, and artisans also featured prominently among borrowers; they used their loans primarily to finance both business and household expenditures.

The total number of loan applications and approvals rose steadily between 1990 and 1992 in both urban and rural areas and among both males and females. There is clear evidence of growth in informal financial activity. Almost all applicants and recipients of loans from estate owners were rural males. All applicants were granted loans. Among moneylenders, more applicants and recipients came from rural than from urban areas. Among the other informal financial units, more borrowers came from urban than from rural areas. Throughout the sample period, the total number of female borrowers exceeded the number of male borrowers only in 1992. Fewer rural than urban women applied for and received loans. The loan pattern among men was similar for SCAs and traders, but different for moneylenders, CFs, and CSAs.

Table 4 Mean annual number of loan applications to informal lenders 1990-92

	1990			1991			1992		
	Sample	Urban	Rural	Sample	Urban	Rural	Sample	Urban	Rural
Moneylenders	15	14	16	19	13	24	24	14	33
Traders	36	N/A	36	55	54	56	140	280	70
Estate owners	48	N/A	48	50	N/A	50	53	N/A	53
Savings and credit associations	22	26	11	20	24	12	23	25	16
Cooperation savings associations	N/A	N/A	N/A	12	10	13	12	11	13
Community funds	21	38	13	20	24	14	23	29	14

Source: Calculated from survey data.

Table 5 Mean annual number of loans approved by sample informal lenders, 1990-92

	1990			1991			1992		
	Sample	Urban	Rural	Sample	Urban	Rural	Sample	Urban	Rural
Moneylenders	44	69	18	60	89	25	70	85	39
Traders	60	78	42	60	86	42	104	134	53
Estate owners	41	N/A	41	46	N/A	46	50	N/A	50
Savings and credit associations	22	26	11	20	23	12	21	24	12
Cooperative savings associations	N/A	N/A	N/A	11	10	12	9	11	8
Community funds	21	38	13	19	23	14	22	29	13

1. For moneylenders and traders the number of loan recipients exceeds the number of loan applicants. The discrepancy is due to errors in recalling the number of loan applicants.

Source: Calculated from survey data.

As with the total numbers, **the mean number of loan applications and the mean number granted**, also depict a generally upward trend in the growth of informal lenders (Tables 4 and 5). But variation in the mean number of loan applicants is significant only in 1992, and is caused mainly by type of lender rather than by urban/rural location. Variations in the mean number of loan recipients are not significant, except among male loan recipients.

Lending to small-scale and micro enterprises (SMEs)

Lending by informal units to small-scale and micro enterprises, is generally insignificant, but the data reveals that the number of SME loan applicants and recipients has grown steadily (Table 6). Estate owners capture the predominant share of loans to SMEs; almost all their tenants grow burley tobacco on up to a hectare of land. Moneylenders, traders, SCAs, and CSAs are other important informal sources of credit for SMEs. Community funds do not lend to SMEs.

Traders and estate owners lend exclusively to rural SMEs; moneylenders and SCAs lend almost entirely to urban SMEs. Variations in the mean number of SME loan applicants and recipients are significant, and are caused by type of lender.

Slightly more than 89% of the SME borrowers used the resources to finance consumption. They included burley tobacco tenants who, in addition to receiving credit for seasonal inputs, also received credit for purchases of foodstuffs and other grocery items. A lower proportion of borrowers used the credit only for investment and working capital needs.

Table 6 Informal loan applications from and approvals to SMEs

<i>Lender</i>	<i>1990</i>		<i>1991</i>		<i>1992</i>	
	<i>Applications</i>	<i>Approvals</i>	<i>Applications</i>	<i>Approvals</i>	<i>Applications</i>	<i>Approvals</i>
Moneylenders	1	1	2	3	5	5
Traders	8	8	7	6	10	6
Estate owners	45	44	50	48	54	46
Savings and credit associations	0	0	4	6	4	5
Cooperative savings associations	0	0	5	5	7	7
Community funds	0	0	0	0	0	0

Less than one-fifth of informal lenders reported that lending to SMEs was profitable; about 30% indicated that it was not. More than half of all informal lenders indicated that the question was irrelevant to them, because they did not lend to SMEs.

5. The characteristics of loans from the informal sector

The loan characteristics of interest to this study are their interlinkages, size, maturity periods, and interest rates. A related characteristic is the lending capacity of informal institutions. These data enable us to test structural and institutional hypotheses for the persistence of segmentation between sectors, and to test structural hypotheses for the existence of fragmentation within the informal sector.

5.1 Interlinkage of loans

Informal credit contracts in Malawi can be linked or unlinked. Unlinked loans consist of a single market exchange between a lender and a borrower, regardless of whether the medium of credit is a commodity or money. Informal credit contracts entered into by SCAs, CSAs, and CFs fall into this category.

Linked loans consist of more than one market exchange between a lender and a borrower, regardless of the medium of credit used. Lenders have three reasons for interlinking credit. The first is to improve contract enforcement by increasing the amount of information on the borrower. The second is to reduce uncertainty by improving the lender's capacity to forecast the borrower's behaviour and thus, to enhance the lender's ability to select risk appropriately from several potential clients. The third is to expand the control variables and strategies available to the lender, thus enabling the lender to influence the actions of the borrower.

In Malawi, the interlinkage of credit is most common among estate owners, who link loans by requiring both that tenants purchase inputs and provisions from them, and that tenants sell the output to them. All the estate owners covered in this study linked their loans in this manner. Traders and moneylenders also link their loans, but none of those in our sample had made such a credit arrangement during the relevant time period.

5.2 Loan sizes and maturities

Moneylenders. The average total amount loaned by moneylenders in 1992 was K3,129, an increase from K1,922 in 1990 and K2,652 in 1991. In rural areas, the average total was K1,625 in 1992, an increase from K614 in 1990 and K1,028 in 1991, but significantly less than the average total amount of loans from urban moneylenders (Table 7). This difference is probably due to the lower level of

Table 7**Average total amount of loans by informal lender (kwacha)**

	1990			1991			1992		
	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>
Moneylenders	1,922	3,230	614	2,652	3,686	1,028	3,129	3,989	1,625
Traders	7,960	9,667	5,400	7,766	10,306	3,533	8,787	8,994	8,425
Estate owners	26,232	N/A	26,232	38,252	N/A	38,252	59,469	N/A	59,469
Savings and credit association	1,013	917	1,300	1,087	1,130	1,000	1,661	1,764	1,300
Cooperative savings associations	N/A	N/A	N/A	1,212	2,200	718	1,463	2,640	875
Community funds	763	200	1,045	1,155	760	1,550	1,506	1,477	1,550

Source: Calculated from survey data.

resources available to rural moneylenders. The largest single loan among urban moneylenders amounted to K535 in 1992; the largest in rural areas was K144. The smallest were K27 and K18, respectively. The average maturity of the loans was 1 month in both urban and rural areas. The longest was 3 months, and the shortest 1 month.

Traders. The average total amount loaned by traders in both urban and rural areas – K8,787 in 1992, an increase from K7,960 in 1990 and K7,766 in 1991– was higher than the average total amount loaned by moneylenders. The corresponding figures for rural areas only were K8,425 in 1992, an increase from K5,400 in 1990 and K3,533 in 1991, the average figures for 1990 and 1992 being significantly less than total average loans in urban areas. The largest and smallest loans in 1992 were also higher in urban areas: K1,276 compared with K433, and K39 compared with K33. The sums loaned fell far short of what was applied for, especially in urban areas. The average maturity of the loans was 1 month in both urban and rural areas. The longest maturity averaged 3 months, the longest maturity among rural traders being 4 months and the shortest 1 month.

Estate owners. The average total amount loaned by estate owners was higher than the average amount loaned by both moneylenders and traders. It increased from K26,232 in 1990 to K38,252 in 1991 and to K59,469 in 1992. Increases in the overall number of tenants probably account for this trend. The largest sum loaned in 1992 was K1,435 and the smallest K789. Tenants received slightly less than they asked for. The average maturity period was 8 months, the longest being 9 months and the shortest 7 months. No loans were granted for more than 1 year.

SCAs. The average total amount loaned by SCAs was K1,611 in 1992, an increase from K1,012 in 1990 and K1,087 in 1991. The total average amount loaned by rural SCAs was higher than for their urban counterparts in 1990, but lower in both 1991 and 1992. The largest amount loaned by urban SCAs in 1992 was K236; the largest among rural SCAs was K195. The smallest amounts were K56 and K40, respectively. The average amounts loaned fell short of what borrowers wanted. The average maturity was 4 months (1¼ months in rural areas); the longest was 4½ months (1½ months in rural areas), and the shortest was 4 month (1 month in rural areas). No loans were granted for more than 1 year.

CSA. The average total amount loaned by CSAs was K1,211 in 1991 and K1,463 in 1992. In rural areas, the average amounts were smaller, at K718 and K875, respectively. The largest sum loaned to co-operative members in 1992 was K92 in urban areas, and K28 in rural areas. This difference was only slightly less than the smallest amounts loaned out: K90 in urban areas, and K25 in rural areas. Higher incomes in urban areas account for these differences.

CFs. The average total amount loaned by community funds rose from K763 in 1990 to K1,155 in 1991, to K1,506 in 1992. The average amount loaned by rural

CFs was higher: K1,045, K1,550, and K1,550, respectively. The largest individual amount loaned in 1992 was also higher in rural areas, K133, compared with an average of K105 for the entire sample. The smallest was also higher in rural areas, K25, compared with K20 for the entire sample. What was loaned out fell short of what borrowers wanted. The average maturity was 3 months (2½ months in rural areas).

5.3 Interest rates in the formal and informal sectors

Approximately 60% of the informal lenders interviewed charged interest on a monthly basis. Just over 26% charged interest on an annual basis. Another 13% of the lenders did not disclose their interest rate basis.

Table 8 shows the structure of average nominal interest rates on loans by the informal sector; for comparison, Table 9 provides data on nominal interest rates in the formal financial sector. The data in these tables yield several observations, as follows.

Table 8 Average nominal interest rates on loans by informal lenders (%)

<i>Lending institutions</i>	<i>Annualised interest rates for loans of less than 1 Year^a</i>				<i>Interest rates for 1-year loans</i>			
	<i>1990</i>		<i>1992</i>		<i>1990</i>		<i>1992</i>	
	<i>Urban</i>	<i>Rural</i>	<i>Urban</i>	<i>Rural</i>	<i>Urban</i>	<i>Rural</i>	<i>Urban</i>	<i>Rural</i>
Moneylenders	568.8	600.0	487.2	600.0	50.0	50.0	47.5	50.0
Traders								
Estate owners	360.0	N/A	360.0	N/A	2.5	N/A	2.5	N/A
Savings and credit associations	N/A	278.4	N/A	254.4	N/A	37.3	N/A	37.5
Community funds	169.2	108.0	177.6	138.0	158.8	150.0	151.3	120.0
	50.4	60.0	50.4	60.0	20.0	N/A	20.0	N/A

Note: Deposit rates of interest were reported as 33.8% by SCAs and 4.6% by CFs on average.

^aMost of these loans were for 1 month.

Source: Calculated from survey data.

With the exception of interest rates charged by traders and community funds on

Table 9 Annual nominal interest rates in the formal sector 1987-94 (%)

<i>Year</i>	<i>Bank Rate</i>	<i>Savings deposit rate</i>	<i>Minimum lending rate</i>	<i>Maximum lending rate</i>	<i>Rate of inflation as measured by changes in CPI</i>
1987	14	13.75	Flexible		26.70
1988	11	10.75	Flexible		31.50
1989	11	10.75	18		15.70
1990	14	14	15	20	11.60
1991	13	13	14	20	11.90
1992	20	20	21	28	23.20
1993	24	24	26		22.80
1994	25	25	30		30.00

Source: Reserve Bank of Malawi, *Financial and Economic Review*, various issues.

one-year loans, all informal lending rates were positive in real terms in both 1990 and 1992. The interest rates charged by formal financial institutions were positive in 1990, but most of them were negative in real terms in 1992.

Nominal interest rates charged by different informal units vary widely. The differences are significant and are caused by the type of lender. SCAs and CFs charge relatively lower rates of interest, for the benefit of their members who are also largely their borrowers. Moneylenders, traders, and estate owners charge relatively higher interest rates on loans to clients with whom they may not be familiar. In determining these rates of interest, they take into consideration: whether the borrowers can afford the rates, the market value of the goods produced by the borrowers, what other lenders are charging, and the profit margins they can earn on the loans. The majority of lenders neither negotiate interest amounts with borrowers nor base interest rates on the rate of inflation.

Interest rates charged by all types of informal lenders on 1-year loans are lower than their annualised loan interest rates (primarily on 1-month loans). With the exception of SCAs, the differences in interest rates between 1-year loans and loans of less than 1 year are significant.

Rural moneylenders and community funds charge more on loans than do their urban counterparts, and rural SCAs charge less. But these variations are not significant.

Until the reforms of the late 1980s, the formal financial sector was repressed in Malawi. Since it was liberalised, the gap between interest rates in the formal and informal sectors has narrowed. However, the absolute gap remains large, contributing to the segmentation of the financial sector as a whole. Moreover, no evidence is available to suggest that financial deepening and expansion have occurred. Activities in the informal sector increased between 1989 and 1992, as clients are still restricted from operating freely between sectors.

The data lends support to the persistence of segmentation. Among moneylenders, interest rate differentials between the formal and informal sectors for loans of less than 1 year are higher in rural than in urban areas; this may well be because information can be less perfect in rural than in urban areas. The same is true of 1-year loans by estate owners as well as moneylenders. Interest rate differentials are lower among moneylenders in urban areas, probably because borrowers in urban areas have a greater propensity to operate in both formal and informal markets.

The data also lends support to the hypothesis of the persistence of fragmentation among informal units. Between 1990 and 1992, formal deposit and lending rates increased in Malawi. However, interest rates charged by traders and community funds remained static, as did those charged by moneylenders in rural areas; those charged by moneylenders in urban areas declined slightly. The rates charged by estate owners and SCAs fluctuated throughout the period.

5.4 Collateral

A significant portion of loans are secured, in one form or another. Moneylenders and traders reported accepting bank savings deposits and physical property as collateral security for loans. Informal lenders also reduce the risk of default by requiring personal guarantees or signatures, and by threatening to withdraw credit facilities. Estate owners use crops grown by tenants as well as signatures as security for the loans. SCAs, CSAs, and CFs select their members prudently in order to minimise the risk of default; they also apply group pressure, and rely on the incomes and savings of members.

The informal sector thus has effective substitutes for physical asset collateral, and can enforce contracts without resorting to legal channels. This institutional characteristic of the informal financial sector helps to explain the persistence of financial dualism.

5.5 Capacity to lend

Many of the informal lenders in the sample are not always able to satisfy the entire

requests for loans from qualified applicants, namely, 15 moneylenders, 9 SCAs, 4 estate owners and 1 trader. More than half the estate owners and about a third of the traders in the sample are always able to satisfy loan requirements, as compared with only one of the community funds. The remaining CFs are sometimes able to meet loan requirements, as are half the traders and a third of the moneylenders. Correspondingly, the number of loan applicants rejected was highest among moneylenders and smallest among traders.

These findings offer further evidence of the persistence of fragmentation among informal units.

6. Risk assessment and transaction costs

The information used by informal lenders to screen loan applications varies widely, as does the importance of such information to the screening process and the method by which it is obtained. It is noteworthy here, that about 99% of all informal lenders in our sample maintained some form of record of their loan transactions. The most popular type of record is a list of debtors; 57% of all those sampled use this record. CSAs use this record exclusively, and 91% of moneylenders use it. Approximately 29% of all informal lenders use individual ledgers, and about 11% use general ledgers.

6.1 Screening methods and information

Almost all loan seekers apply to informal lenders verbally – 91% of applicants to moneylenders, and 100% of applicants to all other informal lenders. Only 1.4% of moneylenders require a written application for a loan.

In the case of SCAs and community funds, observation of the habits of group members and the associations' obligations towards their members, constitute screening practices. Because members join SCAs in order to borrow from them, SCAs are obliged to fulfil this expectation. Their screening criteria does not lay stress on whether applicants are able to repay the loans, but rather on whether the members are committed to the principles of the association. In effect members, not loans, are screened; members are screened before they join the group.

About half of all moneylenders indicated that they have a business relationship with their applicants for loans. In both rural and urban areas, most moneylenders need to have a relationship with their borrowers for an average of about 3 months before they grant loans. Almost all moneylenders seek information on loan applicants from third parties. It is noteworthy that most of the referees are people who work or live in the same area as the moneylender, or are relatives or friends. Moneylenders rarely make visits to the business or project sites of borrowers.

Most people borrowing from moneylenders are made aware of them by old clients of the moneylenders. Those lending to employed people could have an established business relationship with these clients, who could then pass on recommendations about the qualifications of individual applicants. The importance to moneylenders of a personal knowledge of applicants is evidenced by the fact that half of them know the loan applicants. But it is not necessarily a disadvantage to be unknown; most first-time applicants have also received loans from moneylenders. The experience of traders is more or less similar to that of moneylenders.

Among estate owners, all loan applicants are naturally their tenants. Aside from this landlord-tenant relationship, 94% of the landlords stated that they had other relationships with their borrowers, and that these relationships had to be established for an average of 2 months before they would grant loans. The majority of estate owners also seek information from third parties. Again most of the referees are people who live or work in the same area, or are relatives or friends. Tenants are made aware of estate owners primarily through old clients and relatives of the owners. Because estate owners work through supervisors and other personnel, the majority do not always know who their tenants are. But about half the estate owners visit businesses or project sites before extending credit to tenants.

Almost 66% of all informal lenders agreed that a business relationship must exist before they would consider a loan application. The majority of informal lenders also obtain the required screening information from friends and relatives of applicants, and also from people living and working in the same area. The individual character of the prospective borrower is what matters to most lenders. Only about 23% of all informal lenders visit the businesses or project sites of borrowers.

6.2 Creditworthiness criteria

The importance attached to the creditworthiness of borrowers, and the criteria used to assess it, differ sharply among informal lenders. Seventeen of the 18 estate owners in our sample indicated that they were always interested in the return on borrowers' investments; only one indicated that he was sometimes interested. The comparable numbers for moneylenders are 3 and 3, respectively, both of which are insignificant. Only 2 of the 11 traders indicated that they were sometimes interested. None of the associations indicated that they were interested in the creditworthiness of borrowers, given the group dynamics of membership.

As might be expected, all but 2 of the 18 estate owners indicated that they always evaluated projects; a few moneylenders, traders, and estate owners indicated that they sometimes evaluated projects. The majority agreed that they tried out applicants, usually by granting an initial loan. Moneylenders and estate owners also interviewed loan applicants. Moreover, along with traders, they believed that repayment rates among women in the sample were lower than among men.

6.3 Screening costs

Screening, monitoring, and contract enforcement costs include the average variable cost of a loan and the marginal cost of an additional loan. Essentially, these costs consist of variable personnel costs, measured according to the time devoted to loan application screening, travel time to project sites, salaries and wages, and transport

and stationery expenses. In calculating salaries and wages, we used the opportunity cost of the time of the personnel engaged in screening.

According to our investigation, screening is the most important component of the process of lending in the informal sector, and screening costs are the major component of transaction costs (Table 10). A two-way analysis of variance (ANOVA) for total screening costs in 1992 suggests that the variation among these costs is significant, and that the significant source of this variation is the type of lender.

Estate owners had the highest average total screening costs in 1992 – K1,496, or K29 per loan. Their personnel, transport, and stationery costs were also the highest. Moneylenders, with a mean total screening cost of K184, were a distant second, while traders, with a mean total screening cost of K164, came third. Their screening costs per loan were approximately K3 and K2, respectively. In both cases, screening costs were lower in rural than in urban areas. Both moneylenders and traders employ fewer staff for screening purposes than estate owners. In fact, moneylenders do their own screening.

Table 10 Mean total screening costs, 1992 (Kwacha)

<i>Type of Lender</i>	<i>Entire Sample</i>	<i>Urban Area</i>	<i>Rural Area</i>
Moneylenders	184	261	58
Traders	164	170	153
Estate owners	1,496	N/A	1,496
Savings and credit associations	26	28	21
Co-operative savings associations	33	N/A	33
Community funds	34	21	47

Source: Calculated from survey data.

Table 11, showing the mean cost of screening a one Kwacha loan, indicates that associations and traders have the lowest screening costs, moneylenders the highest, and estate owners the next highest. In urban areas, moneylenders again have the highest mean screening costs; in rural areas, moneylenders and CSAs have the highest mean screening costs.

Among associations, SCAs have the lowest screening costs, at K26. Those of the

Table 11 Mean total screening costs per one kwacha loan, 1992 (Kwacha)

Type of lender	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>
		<i>In Kwachas</i>	<i>In Kwachas</i>
Moneylenders	0.06	0.07	0.04
Traders	0.02	0.02	0.02
Estate owners	0.03	N/A	0.03
Savings and credit associations	0.02	0.02	0.02
Cooperative savings associations	0.04	N/A	0.04
Community funds	0.02	0.01	0.03

Source: Calculated from survey data.

CSAs are higher, at K33, which does not differ significantly from those of community funds at K34. Associations spend much less time on screening because the processors of loans do not visit project sites. Their transport costs are thus nil. Although they incur stationery costs, they are much less than those incurred by, say, traders and estate owners.

6.4 Loan monitoring and its costs

After granting loans, community funds never monitor them, and thus do not incur monitoring costs. Only one leader of an SCA said that he always monitored loans, but he did not indicate the costs. One moneylender and one trader sometimes monitored loans; for 1992, their total monitoring costs were estimated at K66.7 and K35, respectively. Seventeen of the 18 estate owners always monitored loans, and the mean sum of their personnel, transport, and other expenses was estimated at K3,366 in 1992. Thus, we consider here the monitoring costs for estate owners only, as the costs for all other informal lenders were essentially zero. Low default rates among estate owners may, in part, be due to their monitoring efforts. For the other categories of lenders, low default rates have nothing to do with monitoring.

6.5 Cost of funds

SCAs and CSAs lend 100% of their mobilised savings each month. Community funds lend 67%. Because lending in the informal financial market is lucrative, only

3 informal lenders in our sample reported that they sometimes refused to lend and instead invested in other markets.

Moneylenders and estate owners loaned more from their savings than from bank loans in 1992; so, it would appear, did traders. This is further evidence of the persistence of fragmentation.

The cost of funds in 1992 was estimated as the sum paid on bank loans, interest paid on lending capital from bank savings (if relevant), the difference in the expected rate of return from alternative markets and the lender's own interest rates, and the actual rate of return in an alternative market. As a percentage of each unit of the amount of the loan, the mean cost of funds was lowest among traders, at 0.18%. It was 8.4% among estate owners, 17.5% among moneylenders, and 22% among CSAs. Variations in the mean costs of funds are not significant.

7. Loan repayment trends and contract enforcement costs

The preferred repayment schedule among the majority of moneylenders and SCAs in both urban and rural areas consists of monthly payments of principal plus interest over the agreed period. Community funds were equally divided between those preferring monthly payments and those preferring other arrangements. The majority of traders also prefer other, possibly more flexible, arrangements. Estate owners use the method of bulk payment of principal and interest after the sale of the burley tobacco crop.

Among moneylenders, traders, and estate owners, delinquency in loan repayment was low in 1991 and 1992, but especially so in 1990. Among SCAs, CSAs, and CFs, delinquency was also low throughout the sample period. As of December 1992, fewer lenders had outstanding debts from 1990 than from 1992, implying that most of the outstanding debt is repaid eventually, in most cases after three months. Lenders use a variety of methods to enforce repayment. They do not rely on recourse to law, which is expensive; nor do they normally confiscate collateral, make personal threats, or restrict inputs. Rather, they rely on legal threats, the control of output (especially among moneylenders), and other techniques.

A third of all lenders attributed delinquency in loan repayments to other, 'more pressing' commitments on the part of borrowers; 20% cited poor returns on the investment, and 21% indicated other (unspecified) reasons. Moneylenders and traders were prominent among those citing other commitments on the part of borrowers, and estate owners were prominent among those citing poor returns. Poor returns were cited primarily in rural areas; other commitments were factors common to both urban and rural areas. In turn, poor returns were attributed to poor management. The majority of lenders do not levy new interest rates on outstanding debts; nor do they refinance new investments by defaulting borrowers.

The total mean cost of contract enforcement – K77.68 (Table 12) is only 4.7% of the total mean administrative cost of lending (Table 13). Variations among means are not significant. CSAs and community funds do not have delinquency problems, and only a few estate owners and SCAs experience them. Staff time and other costs are comparatively low, and only moneylenders and traders incur transport expenses to enforce loan contracts. Legal and security costs are rarely incurred.

Data on the total cost of lending in 1992, as given in Table 13, and data on the total cost of lending as a percentage of total loans (Table 14), show that associations incur very low lending costs when compared with individual lenders. They have virtually no monitoring costs. Only SCAs have enforcement costs. Their

comparative advantage in lending is unquestionable. However, they do lend

Table 12 Total mean cost of contract enforcement, 1992 (Kwacha)

<i>Type of Lender</i>	<i>Total</i>	<i>Urban</i>	<i>Rural</i>
Moneylenders (n = 21)	49.28	69.72	16.06
Traders (n = 9)	129.94	58.16	219.66
Estate owners (n = 2)	91.28	N/A	91.28
Savings and credit associations (n = 2)	127.20	127.20	N/A
Co-operative savings associations (N/A)	N/A	N/A	N/A
Community funds (N/A)	N/A	N/A	N/A
Entire sample (n = 34)	77.68	N/A	N/A

Source: Calculated from survey data.

primarily to members. Moneylenders have a comparative advantage in rural areas, where enforcement costs are lower, but they are at a comparative disadvantage in urban areas, where enforcement costs are higher. The experience of traders is the opposite; they have higher enforcement costs in rural than in urban areas. Variation in mean total administrative costs is highly significant, and is caused by the type of lender.

Table 13 Total mean administrative costs of lending, 1992 (Kwacha)

<i>Type of Lender</i>	<i>Total</i>	<i>Urban</i>	<i>Rural</i>
Moneylenders (n = 23)	348.88	515.11	90.30
Traders (n = 11)	1,520.14	1,015.43	2,403.37
Estate owners (n = 17)	5,191.19	N/A	5,191.19
Savings and credit associations (n = 9)	57.85	64.78	33.54
Co-operative savings associations (n = 3)	45.45	67.50	34.42
Community funds (n = 6)	34.80	23.47	46.13
Entire sample (n = 69)	1,650.17		

Source: Calculated from survey data.

Table 14 Total mean administrative costs of lending as a percentage of total loans, 1992

<i>Type of lender</i>	<i>Entire sample</i>	<i>Urban areas</i>	<i>Rural areas</i>
Moneylenders (n = 23)	11	13 ^a	6
Traders (n = 11)	17	11	29 ^a
Estate owners (n = 16)	9	N/A	9
Savings and credit associations (n = 9)	3	4	3
Cooperative savings associations (n = 3)	3	3	4
Community funds (n = 6)	2	2	3
Entire sample (n = 68)	9		

^a Large enforcement costs account for these high costs as percentage of total loans.

Source: Calculated from survey data.

Although estate owners have the highest mean screening and monitoring costs, their mean enforcement costs are lower than those of traders. Because of their large volume of loans, estate owners spend less per one kwacha loan than do traders in rural areas.

Traders have the highest mean administrative cost per one Kwacha loan, followed by moneylenders (Table 15). Their mean cost is also the highest in rural areas, and

Table 15 Mean total administrative costs per one Kwacha loan, 1992

<i>Type of Lender</i>	<i>Entire sample In Kwachas</i>	<i>Urban areas In Kwachas</i>	<i>Rural areas In Kwachas</i>
Moneylenders	0.11	0.13	0.06
Traders	0.17	0.11	0.29
Estate owners	0.09	N/A	0.09
Savings and credit associations	0.03	0.04	0.03
Cooperative savings associations	0.03	0.03	0.04
Community funds	0.02	0.02	0.03

Source: Calculated from survey data.

the second highest in urban areas. Community funds have the lowest mean administrative cost per one Kwacha loan, followed by CSAs and SCAs. Estate owners have the third highest mean administrative costs.

8. Relationships with banks and other financial institutions

The findings in this section on direct links between informal lenders and formal financial institutions lend support to our earlier finding that direct deposit links between the two are significant, but direct credit links are not (Chipeta and Mkandawire, 1992).

Two-thirds of the informal lenders maintain deposits at banks. The proportion is highest among estate owners (16 of the 18 in the sample) and lowest among CSAs (only one of the three), most of whom pass on the money to beneficiaries as soon as it has been contributed. Most of the informal lenders had opened bank accounts primarily for security reasons, the savings deposit on which interest is earned being the most popular form of bank deposit. Half the estate owners have both savings and demand deposits. Moneylenders and traders have demand deposits. The majority of informal lenders do not deal with borrowers through banks.

Only 16 members of our sample (22.9% of the entire sample) had ever applied for and received bank loans. Of these, 10 were estate owners, 3 moneylenders and 3 traders. Variation in the mean number of applicants and recipients of bank loans is significant. The majority are not known as informal lenders by their bankers. Four of the bank loan recipients (1 trader and 3 estate owners) used the proceeds to boost their lending. The remainder used their bank loans to finance other economic activities. The banks approved the loans for the purpose for which they were used. Approximately 37% of the informal lenders in our sample knew what the bank lending rates were, but about 46% indicated that the bank rates did not influence the rates at which they lent money themselves. About 79% of the informal lenders indicated that they were interested in on-lending bank credit.

The National Bank of Malawi (NBM) and the Commercial Bank of Malawi (CBM) dominate the formal financial sector, providing all the usual commercial and retail banking services in savings, deposits, credit and lending, supply of foreign exchange, leasing and factoring, and transaction clearing. They are becoming increasingly competitive with each other, but still operate several anti-competitive agreements; for example, the routing of mobile agencies is divided between them, as is the location of sub-branches. Both banks are profitable and stable, with combined total assets as of 31 December 1991 of MK1,382 million (NBM, K920 million; CBM, MK462 million). Both are heavily involved in the mainstream Malawian business community. But they have very limited involvement with informal lenders and other SMEs; neither is able to provide statistics to show the extent of their activity in this area, but minimum loans are thought to be about

MK5,000. Their standard conditions for granting credits put them beyond the effective reach of most informal lenders: collateral must be provided, a track record established, business plans prepared, and modern banking practices understood and accepted. They therefore grant very few small loans.

The view of both banks is that informal lenders are entrepreneurs who are generally not trustworthy, and that their businesses suffer from very high failure rates. They are unable to provide adequate or even any collateral, and wish to borrow amounts which are not remunerative for the banks, given their relatively high transaction costs. The smaller informal lenders cannot even qualify to open a straightforward current account. Banks generally prefer their involvement in this sector to take the form of 'community affairs,' whereby they help another organisation targeted at this sector, such as the Small Enterprise Organisation of Malawi (SEDOM), by providing funding, management support, secondment, and so forth.

The direct deposit and credit links between informal lenders and semi-formal financial institutions are insignificant. For example, of 1,611 informal lenders interviewed in 1989, none had deposited money at a semi-formal financial institution, and only 6.5% had borrowed money from semi-formal financial institutions (see Chipeta and Mkandawire, 1991).

Malawi's semi-formal financial sector consists of the Malawi Union of Savings and Credit Co-operatives (MUSCCO), savings and credit co-operatives (SACCOs), the Smallholder Agricultural Credit Administration (SACA, which is being replaced by the Malawi Rural Finance Company) and a Grameen-type bank known as the Malawi Mudzi Fund. All these institutions share common characteristics which limit their accessibility to informal lenders. First of all, informal lenders are not included in their target groups. They are also dependent on donor funds, the delay of which can disrupt disbursements. Other features are: that the availability of resources for lending is limited; their screening, monitoring, and contract enforcement costs are high, which limits the amount of credit that can be extended to clients; and their coverage throughout the country is limited.

Most of the controls, inflexibility, and inefficiency from which MUSCCO and its member credit unions, suffered in the 1980s are now being addressed. MUSCCO has improved its capital structure by accepting deposits and share capital from member credit unions, in addition to donor funding. Both deposit and lending interest rates have been liberalised and raised to reflect prevailing market conditions. Professionals have been recruited and training provided to improve the staffing of MUSCCO itself and its member unions. Nevertheless, the default rate of 22% on loans is fairly high; moreover, the minimum size for loans from MUSCCO is above the requirements of most informal lenders.

Unlike SACA, the successor institution, the Malawi Finance Company, will accept deposits. But it may find it difficult to achieve a high rate of loan recovery because

the machinery for this within the rural economy upon which SACA relied has broken down. In the Malawi Mudzi Fund, a half-yearly repayment system has been introduced to improve the loan recovery rate. Like the Malawi Rural Finance Company, the MMF accepts deposits.

9. Summary and Conclusions

Three features characterise the financial sector in Malawi. First, it is segmented into three distinct sectors – a formal sector that serves primarily large-scale business enterprises, a semi-formal sector that serves small and medium-scale enterprises, and an informal sector that serves other clients. Second, segmentation exists among the financial units within each sector. For example, in the formal sector, commercial banks are responsible primarily for extending short-term credit to large-scale business enterprises, while the Post Office Savings Bank provides lending primarily to support central government policies. The sector also consists of specialised financial institutions that serve particular financial needs, such as leasing and construction. In the semi-formal financial sector, various funding institutions have different functions and serve different borrowers. For example, INDEFUND (Investment and Development Fund) and SEDOM do not mobilise deposits, and although MUSCCO and MMF do, they mobilise them from their members, who are also their borrowers. The target borrowers for INDEFUND are medium-scale enterprises, for SEDOM they are small-scale enterprises, and for MMF they are the rural poor. The same type of segmentation exists in the informal financial sector. SCAs, CFs, and (to a limited extent) moneylenders and traders mobilise deposits; the rest of the informal institutions do not. SCAs and CFs lend largely to their own members; traders lend primarily to their customers, estate owners to their tenants, and moneylenders to people whom they know.

Third, the financial sector in Malawi is fragmented; adequate intermediation among different units, both across and within segments, is lacking. The formal financial sector is the main depository of funds from the semi-formal and informal financial sectors, but is not a significant source of credit to the latter. Both direct deposit and credit links between the semi-formal and the informal sectors are insignificant. Within the formal financial sector, commercial banks serve as depositories of funds from other formal financial institutions, but not as sources of credit. Resources extended to other entities in the formal sector have taken the form of shares in the insurance and leasing finance industries. Neither direct deposit nor direct credit links exist among different units in the semi-formal financial sector. The informal sector also lacks these links.

These three features taken together create in Malawi what can be called financial ‘dualism’, or extreme fragmentation of financing into the formal and informal sectors, the relative prices of which differ and between which information and resource flows are constrained. Inadequate substitutability among the segments means that financial markets are unlikely to function effectively in intermediating between savers and investors, in allocating financial resources, and in transforming and distributing risks and maturities.

Why is the financial sector of Malawi both fragmented and segmented? Three factors are key: previously repressive financial policies, structural determinants, and institutional features (particularly the traditionally high interest rates).

Prior to the 1990s, financial transactions in Malawi were tightly controlled or restricted. Until 1988, ceilings were imposed on interest rates in the formal sector. Until 1990, all deposit and lending interest rates were controlled. And, until 1991, ceilings were imposed on the expansion of bank credit. The existence of direct credit allocation raised the demand for funds and depressed supplies below the equilibrium level. Unsatisfied demand forced financial intermediaries to ration credit according to measures other than interest rates. Among other things, it also led to an expansion of informal lending to borrowers who fall outside the rationing by formal financial units.

These financially repressive policies contributed to a dualism that saw the emergence of widely divergent interest rates and little overlap in the borrowing clientele. Although financial liberalisation subsequently narrowed the divergence between the interest rates of the two sectors slightly, it has not brought about financial expansion. Rather than hanging behind the activities of the semi-formal and formal sectors, activities in the informal sector have increased, since clients are still unable to operate across different segments. The problem is partly due to financial liberalisation itself, the process of which is incomplete. But it also pertains to the persistence of other conditions that give rise to financial dualism. They include autonomous factors (the nature and operation of the informal economy), adverse macroeconomic conditions, and the unique characteristics of the informal financial sector itself.

The structural origins of fragmentation have been ascribed to the different transaction costs of different informal units. Moneylenders, traders, and estate owners attach great importance to the screening process, which is the largest component of the transaction costs of loans. Estate owners also incur high monitoring costs. The transaction costs of associations are kept low because they screen 'borrowers' only when they become members of the association. As such, CFs have the lowest costs in administering a loan, followed by CSAs and SCAs.

Structural determinants of the persistence of fragmentation among units within the informal sector are also ascribed to financial constraints. For example, these units do not have much scope for staggering dates when deposits must be returned, or for covering shortfalls when repayments are due. Furthermore, informal lenders cannot expand their low capital base because they lack access to formal financial institutions. Finally, interest rates in the informal sector are not sensitive to changes in formal market interest rates.

Fragmentation in the informal financial sector also stems from the various reasons for becoming lenders. Some evolve, given the relative ease with which lending

operations can be started and terminated – for example, among the moneylenders and traders covered in this study. Estate owners who lend must do so because they are under an obligation to finance their tenants who lack capital. And associations create distinct clubs through which they can control member borrowers as one way of reducing moral hazard. Inevitably, the creation of distinct clubs may exclude the participation of non-member borrowers, who must then go to the moneylenders and traders.

Institutional factors and customs also explain segmentation in Malawi's financial market. Primary among these factors are patterns of interest rates among moneylenders. These rates of interest are high, thus helping to offset high risk. Over time, they have not yet come down.

High rates of interest in the informal sector need to be examined in the light of historical factors and custom. Informal lending and borrowing were originally carried out through the medium of commodities. A popular example of informal credit in the oral literature is that of a female debtor who borrowed a plateful of millet for the purpose of brewing beer for sale. By custom, she was expected to return a larger plateful of millet in order to ensure that the amount returned was substantially more than the original quantity borrowed. Alternatively, she could use the same type of dish as she used to borrow the millet, but with the contents overflowing. Or she could fill two dishes of the original size, according to the custom that the profits obtained from the sale of the beer were attributed largely to the original millet loan (Chimango, 1977).

A careful review of this type of folklore led to the hypothesis that high rates of interest reflected the custom of profit-sharing (Chipeta, 1981). The high rates of interest that applied originally to commodity credit were later extended to financial credit. The folklore also suggests that the reward was expected to be substantial; hence the hypothesis that high interest rates are a function of custom.

In relation to this hypothesis, two explanations can be added. The first explains high rates of interest in terms of the difficulty of measuring the exact weight or volume of grain payments in the absence of modern, graduated measures of weight or volume - that this difficulty led to 'twice as much as borrowed' and similar rules for determining interest. The second explains high interest rates in terms of the indivisibility of livestock. The borrower of a bull cannot pay a fraction of another bull as interest, because that would necessitate slaughtering the bull first, which would not be acceptable to the creditor. Thus, the debtor has no choice but to give another bull or a calf as payment (Chipeta, 1993).

Finally, financial expansion - an adequate flow of funds from the formal to the informal sector - has been inhibited by other factors. One is that the absence of information may be preventing banks from expanding their lending activities to either small borrowers or informal financial agents. Evidence for this comes from

the fact that, for some informal units, interest rate differentials between formal and informal segments are lower in urban areas, where savers and borrowers have a greater propensity to operate in both formal and informal markets. Our study also confirms that the informal sector uses substitutes for collateral to secure loans, and that it enforces contracts primarily through means other than formal legal channels. Furthermore, it confirms what is already known about informal financial sector units in Malawi: that because they operate in relatively small segments they are not able to serve business enterprises that require large sums of capital, and that the short-term nature of their liabilities and assets limits their scope for participating in term lending.

Increasing integration among the financial sectors in Malawi requires greater competition to be introduced in the banking system. In turn, greater competition requires more firms to be licensed to operate banking businesses. Increased competition should cause banks to compete for customers, leading to financial widening. One commercial bank has agreed to on-lend to SMEs, including informal financial institutions, with resources to be made available by the UNDP under a poverty reduction programme. Depending on the success of this experiment, the commercial bank may lend its own resources to this target group in future.

In the semi-formal financial sector, the number of institutions is larger. But several steps need to be taken. Some of their activities must be consolidated. Interest rates must be liberalised fully, while those institutions that do not take deposits from SMEs must be encouraged to do so. Informal financial institutions must be included among their target borrowers, and the minimum sum that can be lent must be reduced.

The interest rates and credit allocation of several institutions in the semi-formal financial sector are currently controlled, and only the Malawi Mudzi Fund and SACCOs/MUSCCO mobilise deposits. Liberalising interest rates in this sector may thus enable it to meet excess demand for financial services more effectively. Beyond seeking short-term funds, semi-formal financial institutions may need to mobilise term funds and apply the low transaction costs methods of the formal sector in order to expand lending.

The limited access of informal sector units to formal credit has constrained their ability to expand lending. The access of semi-formal sector institutions to formal credit is also limited. Giving both institutions greater access to formal credit may enable them to expand their lending operations.

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